Chapter 7
Risk Assessment

Full chapter infographic: LO 1 to LO 6

1 Introduction to risk assessment

Understand the entity and
- Industry, regulatory and other external factors
- Structure, ownership, governance, business model, use of IT
- Performance measures used by management and stakeholders

Understand the AFRF
- Entity's accounting policies and reasons for any changes
- Do the policies comply with the AFRF?

Inherent risk factors (affect each
- Financial statement level: affects F/S as a whole, e.g. management override
- Assertion level: specific objectives, e.g. Completeness, Existence

Understand internal control
- Are controls properly designed and effectively implemented?

Document the understanding
- Team discussions and decisions reached
- Key elements of understanding: sources and procedures performed
- Evaluation of control design and implementation
- Risks identified and assessed at both F/S and assertion levels

2 Concept of assertions

What are assertions?
- Representations by management embodied in the F/S
- Used to identify types of potential misstatement and to design procedures
- A bridge between F/S items and audit procedures

2 areas of F/S
- Account balances: balance sheet items
- Classes of transactions and events: income statement items

Linking to procedures
- Revenue: occurrence, accuracy, cut-off
- Inventory: existence, completeness, valuation
- Risk linked to assertion, then procedures on it, reduces audit risk

Account balances (period-end)
- 1 Existence: recorded assets, liabilities, equity exist
- 2 Rights and obligations: entity holds rights to assets; liabilities are its obligations
- 3 Accuracy, valuation and allocation: included at appropriate amounts
- 4 Completeness: nothing unrecorded
- 5 Classification: in proper accounts
- 6 Presentation: aggregated, described, disclosed per AFRF

Classes of transactions (during the period)
- 1 Occurrence: recorded transactions actually occurred (prevents overstatement)
- 2 Accuracy: amounts recorded properly
- 3 Cut-off: recorded in the correct period
- 4 Completeness: all recorded (prevents understatement)
- 5 Classification: proper accounts
- 6 Presentation: aggregated, described, disclosed per AFRF

3 Types of risks and audit risk model

Business risk
- Events, conditions or actions that harm the entity's ability to achieve objectives (poor decisions, competitors, regulation changes, loss of key customers)
- Most business risks affect F/S, then they become audit risks

Audit risk (AR)
- Risk the auditor gives an inappropriate opinion when F/S are materially misstated
- AR = IR x CR x DR
- RMM (risk of material misstatement) = IR x CR

Inherent risk (IR)
- Susceptibility of a balance, transaction or disclosure to material misstatement before considering controls
- e.g. theft of portable inventory; depreciation and provisions
- Significant risk: assessed near the upper end of inherent risk
- Never zero

Control risk (CR)
- Risk controls will not prevent, detect or correct a material misstatement timely
- Assumed high at the start; tests of controls decide reliance
- Strong controls lower CR and reduce substantive testing
- Never zero (human error, override, collusion)

Detection risk (DR)
- Risk audit procedures fail to detect an existing material misstatement
- The only component the auditor directly manages
- More substantive testing = lower DR
- Example: IR 50%, CR 80%, target AR 10%, so DR = 25%

Financial statement level risk
- Examples: fraud by management, management override, incompetent or dishonest management, going concern issues
- Responses: more professional skepticism; tighter materiality; more experienced staff or experts; more supervision and review; unpredictability in procedures; more work at year-end instead of interim; more reliable evidence; careful look at policies and estimates

Assertion level risk
- Examples: portable assets may not exist; liabilities may be unrecorded; complex or unusual transactions misrecorded; large year-end transactions misstated
- Responses: tests of controls to check reliability of systems; substantive procedures (detailed testing, analytical procedures)

4 Risk assessment from given information

1 Receivables and payables
- Receivable days up or disputes: doubtful debts, provision needed
- Creditors or turnover falling: liabilities may be unrecorded (completeness)

2 Provisions and obligations
- Warranty: claims rising, provision understated
- Restructuring or staff termination not recorded: liabilities understated
- Litigation and contingent liabilities not fully disclosed

3 Assets
- Non-current assets held for sale: lower of carrying value and fair value
- Development costs: research wrongly capitalised
- Patents: possible impairment
- Revaluation: subjective, deferred tax errors
- Machinery impairment when sales fall

4 Inventory
- Existence: multiple locations, third parties, no count at balance sheet date
- Valuation: lower of cost and NRV; falling sales, returns, damage mean overstatement

5 Sales and income
- Overstated sales to meet targets or bonuses; fake or next-year sales
- Income or expenses recognised on cash movement instead of when earned or incurred

6 Compliance and
- New rules or laws: failure to comply means misstatement and penalties
- Reduces credibility of reporting

7 Audit evidence
- Predecessor resigned or modified opinion: higher audit risk
- Restricted audit time: insufficient evidence, incorrect report risk

8 Internal controls and staffing
- Weak segregation of duties, inexperienced staff, absent controllers: errors
- New IT systems without supervision

9 Going concern
- Current ratio falls, creditors' turnover rises, major customer bankrupt: liquidity and doubt about continuing

Additional risks
- Long-term contracts: revenue by stage of completion
- Related parties: not at arm's length
- Cash transactions: unrecorded sales, theft
- Loans: current vs non-current classification, unaccrued interest
- Bank reconciliations not done
- Taxation: understated liabilities, deferred tax
- Leases: finance vs operating
- Intangibles: impairment
- Insurance claims
- Government grants: income vs deferred income

Ratio formulae for risk assessment
- Sales % = current sales / last year x 100
- Cost of sales % = cost of sales / sales x 100
- GP ratio = gross profit / sales x 100
- Selling and operating expenses / sales
- Admin expenses % = current / last year x 100
- Finance charges % = interest / loans x 100
- Debtors days = debtors / sales x 360
- Creditors days = creditors / purchases x 360
- Inventory days = inventory / cost of sales x 360
- Liquidity: falling current ratio, net profit ratio, interest cover (profit before interest / interest)

Exam tip
- One piece of information affects multiple areas. E.g. falling sales can indicate machinery impairment, inventory valuation problems and going concern problems at the same time.

5 Business risks and related audit risks

Business risk	Related audit risks
1 Decline in market demand and technology change	Inventory overstated (slow or obsolete not written down); PPE overstated if underutilised and impaired
2 Credit defaults and lenient credit policy	Receivables overstated if doubtful debts not provided; revenue overstated if sales later reversed
3 Non-compliance with laws and regulations	Provisions incomplete if fines not recorded; contingent liabilities omitted if litigation not disclosed
4 Product malfunctions and returns	Defective inventory kept at cost; warranty provisions understated; recall obligations not disclosed
5 Cybersecurity breaches	Financial records compromised or corrupted; regulatory fine provisions incomplete
6 Economic downturn	Receivables overstated; inventory overvalued (unsold goods pile up); PPE impaired
7 Factory or business unit closures	Restructuring provisions understated; PPE from closed unit not written down
8 Foreign currency exposure	Foreign balances incorrectly translated; exchange gains or losses misstated
9 Poor financial condition and debt covenant breaches	Going concern doubt needing disclosure; long-term debt wrongly non-current; penalties unrecorded
10 Fraud and management override	Deliberate misstatements; related party transactions hidden; journal entries manipulated
11 Related party transactions	Not disclosed; assets or liabilities misstated due to non-market pricing
12 Cash handling and misappropriation	Cash balances overstated if theft occurs; bank reconciliations manipulated

6 Audit approach in not-for-profit organizations (NFPO)

What is an NFPO?
- Does not work to make profit; provides services to society or a group
- Examples: charities, clubs, societies, government-owned organisations

Planning the audit
- Environment the NFPO operates in (health, education)
- Objectives and scope
- Local regulations
- Form and content of F/S
- Key areas: cash collection, restricted funds

Assess audit risk: 3 headings
- Inherent risk, control risk, detection risk

Inherent risk factor (income)	Explanation	Effect on audit approach
Income wholly from donations	Unpredictable; income may fall in a downturn, creating going concern issues	May add "Material Uncertainty Related to Going Concern" paragraph
Cash collected by volunteers from different places	Completeness hard to verify; volunteers may lack training; cash may be stolen with no invoices issued	Possible scope limitation; opinion may be modified

Inherent risk factor (expenses)	Explanation	Effect on audit approach
Constitution (Trust Deed) specifies how income should be spent	Expenditure for purposes outside the constitution	Review expenditure so funds are not misused (not "ultra vires")
Donations with specific instructions	Misclassification (liability vs income) or misuse	Check donation recorded as liability and spent per donor's instructions
Constitution limits admin expenses to a fixed % of income	Exceeding the limit or misclassifying other expenses as non-admin	Check compliance with the limit; investigate unusual expense increase

Evaluating internal controls
- Controls over receipts (cash, cheques, fundraising events)
- Controls over payments (authorisation, funds for specified purposes)
- Controls over income and expenditure recording (fees, grants, donations)
- Often weak: small staff (poor segregation), untrained volunteers, no internal audit, weak trustee authorisation

Obtaining evidence
- Rely more on substantive testing than systems testing
- Completeness of income, expenses, assets, liabilities
- Detect misuse or diversion of funds
- Analytical procedures for reasonableness
- Review final F/S and accounting policies

Reporting phase
- Audit required by law: follow legal requirements
- Voluntary audit: report reflects agreed objectives; usually follow ISA 700 structure with suitable modifications

Special considerations
- Cash often significant but controls weak
- Donation income hard to predict and verify
- Restricted funds need careful monitoring
- Unstable income and expenses reduce usefulness of analytical review
- Stakeholders watch % spent on admin, so misclassification risk is important