External audit

Risk assessment and audit strategy

The auditor's assessment of risk is fundamental to the whole audit.

The audit strategy should be determined by the assessment of risk. This strategy should address the scope, timing and direction of the audit. If risks are high, this is likely to mean that more detailed audit testing is required. If the control environment is found to be good and risks are low, then this will probably mean that less detailed audit testing is required.

In this module, we will examine the concept of audit risk and how a risk assessment should be carried out. This risk assessment will include a consideration on the extent to which the external auditor can rely on the work of internal audit.

We will then consider how the assessment of risk should inform the audit strategy.

Audit risk

Audit risk can be defined as:

- the risk that the auditor expresses an inappropriate audit opinion.

This could lead to an audit opinion that the financial statements are true and fair, when they are in fact not, or that they are not true and fair, when they actually are. Auditors are required by law to consider this risk when planning and carrying out their work.

There are three elements to audit risk.

- Inherent risk: the risk of misstatements or errors due to the nature of an organisation and the business environment in which it operates.
- Control risk: the risk of misstatements due to the weaknesses or failures in an organisation's internal control system.
- Detection risk: the risk that audit procedures do not detect material misstatements.

Detection risk is the only element of audit risk that can be influenced by the auditor directly.

Worked example 1

Take a look at this worked example.

James owns and operates a small beach café.

90% of revenue is generated during the summer season, and all revenue is cash. James buys fresh supplies on a daily basis. These factors are all typical of the beach café industry.

James employs a small team of casual employees. These employees are not interviewed: James places advertisements in the local newspaper. The first five respondents are given work immediately. These casual employees are paid in cash.

Cash takings are sometimes left in the café’s cash register overnight, as James does not always have time to bank takings on a daily basis.

Identify the risks and classify them as either inherent or control risks.

Click to display/hide the solution and explanation.

Practice example

The worked examples show how to address a question on audit risk. You can now have a go at putting together an answer yourself, in your own time, for the example below.

You are the auditor of Gothmog Ltd, a company that sells plastic models for use in table-top strategy games. Gothmog Ltd operates a performance incentive scheme for its board. Directors are entitled to a bonus on the achievement of a certain level of profit. This is typical of companies in the table-top strategy game industry.

The bonus will be paid in the month following the publication of the audited financial statements. Directors are keen for the audit to be completed as quickly as possible.

Identify the risks and classify them as either inherent or control risks.

Click to display/hide the solution and explanation.

Reliance on the work of internal audit

This risk assessment will include a consideration on the extent to which the external auditor can rely on the work of internal audit.

Internal audit forms part of the client's system of internal control. A good quality internal audit function may, therefore, reduce control risk.

The external auditor must assess the work of internal audit with regard to:

- organisational status
- the technical competence of staff in the internal audit function
- whether or not internal audit is carried out with due professional care
- the effect of any constraints that are placed on internal audit by company management.

Worked example 2

Take a look at this worked example.

You are the external auditor for Gothmog Ltd. Gothmog Ltd is owned and managed by Daniel Green. Daniel is chief executive and chairman of the company board.

Gothmog Ltd has an internal audit department. The internal audit department is line managed by the company finance director, Jack Twain. All staff in the internal audit department are AAT qualified. All internal audit work is compliant with statutory and regulatory requirements. Internal audit cover all aspects of the company's internal control system, other than the executive bonus scheme. Daniel Green does not allow internal audit to review this system.

Assess the quality of Gothmog Ltd's internal audit department and the extent to which you, the external auditor, may place reliance on its work.

Click to display/hide the solution and explanation.

Practice example

The worked examples show how to address a question on the reliance on the work of internal audit.

You are the external auditor of Fangorn Ltd, a company that sells plastic trees and flowers.

Fangorn Ltd has an internal audit department. The internal audit department is prepared to assist you with the audit of the financial statements. Specifically, it is prepared to provide you with systems documentation of the inventory management system that is used at Fangorn Ltd. The documentation shows how inventory transactions are processed, the risks in the system and the operation of the controls that have been put in place to manage those risks.

The internal audit department is independent and reports to the company's board. It is not involved in the operation of the inventory management system. All staff are AAT qualified. The chief internal auditor is a former head of inventory management at another company and holds a professional qualification in inventory management. No constraints are placed on internal audit by company management.

Use of the systems documentation will speed up the external audit and free up external audit resources to examine other areas of Fangorn Ltd's accounting systems.

Outline the factors that would determine the extent of reliance that could be placed on the systems documentation.

Click to display/hide the solution and explanation.

Audit strategy

The audit strategy should be determined by the assessment of risk. This strategy should address the scope, timing and direction of the audit.

The scope of the audit should reflect the financial reporting framework (for example, international accounting standards) that has been used to prepare the financial statements. Any industry specific requirements should also be reflected in the scope of the audit.

The timing of the audit should ensure that all deadlines are met.

The direction of the audit relates to the overall audit approach and concerns issues such as materiality and risk. Information is material if its omission or misstatement could influence the economic decisions of the users of the financial statements.

Worked example 3

Take a look at this worked example.

Gothmog Ltd has included the results of Tirith Ltd, a subsidiary, in its consolidated financial statements. A fire at Tirith Ltd destroyed the physical inventory count sheets that were the only record of the year end inventory at Tirith Ltd. Tirith Ltd has included an estimated inventory of £500,000 on its balance sheet.

The consolidated pre-tax profits of Gothmog Ltd were £50.5 million. Pre-tax profits for Tirith Ltd were £1.3 million.

Assess the level of materiality that will need to be determined as part of the audit strategy.

Click to display/hide the solution and explanation.

Practice example

The worked examples show how to address a question on the materiality element of audit strategy. You can now have a go at putting together an answer yourself, in your own time, for the example below. This example considers the issue of risk and the way in which it should inform audit strategy.

Auditors should plan and perform audit procedures to recognise that fraud and error may materially affect the financial statements.

Give three examples of indicators in a business that the risk of fraud and error may be high.

From:

- previous experience of management quality at the client
- profit based bonus schemes
- weaknesses in the internal control system
- high volumes of cash transactions
- unusual transactions
- problems in obtaining audit evidence
- high staff turnover
- poor industrial relations.