Audit objectives and the audit risk model

MODULE 2 | 2.1.1 | STUDENT COMPANION

An audit exists to **increase the confidence** that intended users can place in the financial statements, through an opinion based on **reasonable assurance**. **Management** prepares the statements and runs the controls; **the auditor** gives the opinion. **Audit risk** combines the client's risks of material misstatement (inherent risk and control risk) with the auditor's own detection risk, and only detection risk is in the auditor's hands.

Why an audit exists

Users such as shareholders and lenders can't check the statements for themselves, so an independent opinion raises the confidence they can place in them. For an Australian company, the opinion covers whether the statements are **true and fair** and comply with the accounting standards. The auditor aims to obtain **reasonable assurance** that the statements as a whole contain no material misstatement, from either fraud or error, and then reports and communicates as the standards require. Reasonable assurance is high, but never a guarantee.

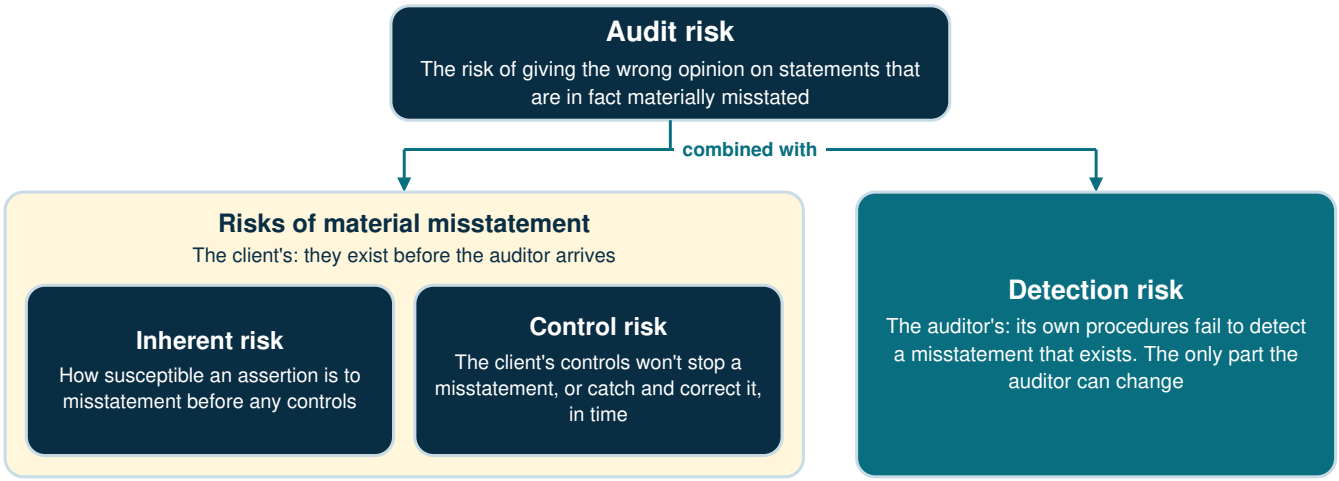
Who is responsible for what

Management, overseen by the directors	The auditor
Prepares the statements in line with the applicable framework	Plans and performs the audit to obtain reasonable assurance
Runs the internal control needed to prepare statements free from material misstatement	Forms and expresses the opinion; reports and communicates as the standards require
Gives the auditor access to all relevant information and people	Stays independent: fixing the client's accounts would mean checking its own work

Meet Voltana Energy Ltd (imagined)

Fact	Why it matters to the audit
ASX-listed; 30 June year end; home batteries assembled in Brisbane	Investors watch its results closely
Imports cells and inverters, paying its suppliers in US dollars	Exchange rates flow into inventory cost
Own commissioned sales team and partner electricians sell and install	Revenue depends on installation, not signing
Ten-year performance warranty on every battery	A large provision built on judgement
Revenue about $240m (last year $180m); profit before tax about $12m	Fast growth strains systems and people
New accounting and operations system from February; bonuses tied to 30% revenue growth	Untried controls; an incentive to bring sales forward
The founder and chief executive owns a large stake and the company that leases Voltana its factory	A related party lease to disclose
$60m bank facility with strict conditions; audited for five years by Linden Ridge Partners (imagined)	Pressure to meet the bank's terms; familiarity to manage

How audit risk is built



The risks of material misstatement are assessed at two levels

Financial statement level	Assertion level
Pervasive: affects the statements as a whole and many assertions at once. At Voltana: a new system that feeds almost every account	A particular account balance, class of transactions or disclosure. At Voltana: the valuation of the warranty provision

Two levels. A **financial statement level** risk is pervasive: it touches many assertions at once and can't be pinned to one account, such as pressure on management to hit a target. An **assertion level** risk sits in a particular account balance, class of transactions or disclosure, and for each one the auditor assesses inherent risk and control risk separately.

The five inherent risk factors at Voltana

Complexity	Subjectivity	Change	Uncertainty	Bias or fraud
Converting US dollar purchases and costing batteries built from imported parts: calculations that are easy to get wrong	The warranty provision rests on management's judgements about future failure rates	The new system went live mid-year, and changes to data and processes often create errors	Nobody knows how the newer battery design will perform over ten years	Bonuses tied to 30% revenue growth create an incentive to record sales too early

The fifth factor in full: susceptibility to misstatement through management bias or fraud

Each risk sits on a spectrum: how likely a misstatement is, and how large it could be



Lower end — **Upper end: significant risks**

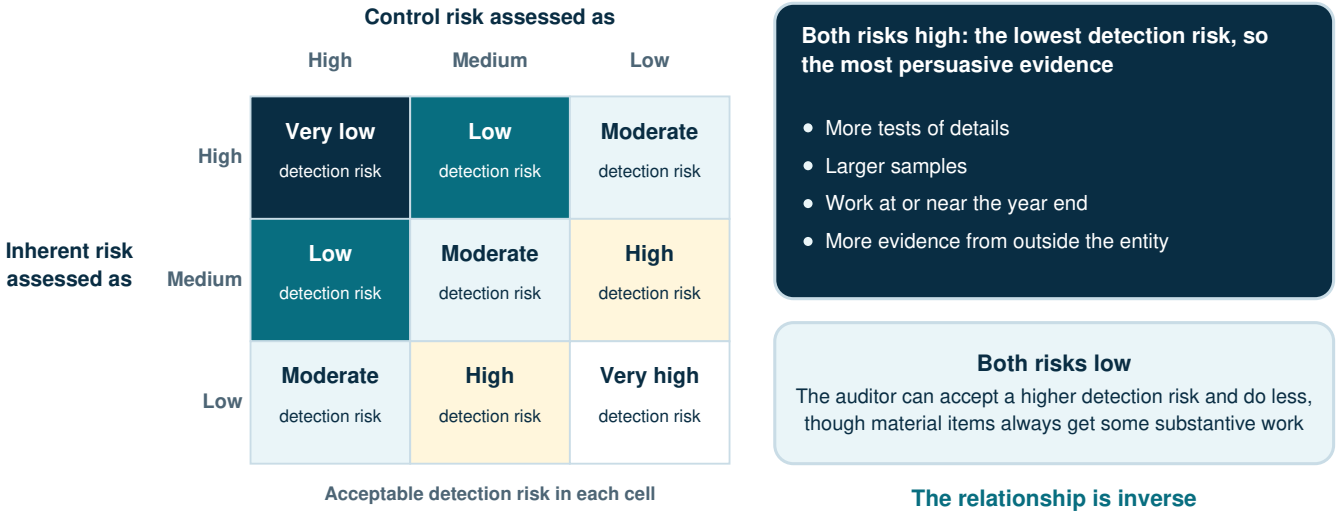
Significant risks need special audit attention

The spectrum of inherent risk. Each risk is judged by the **likelihood** of a misstatement and its possible **magnitude**, with the five factors explaining why an assertion is exposed. A risk at the upper end of the spectrum is a **significant risk**, which receives special audit attention later in this module.

Control risk

Control risk is the chance that the client's controls won't prevent a material misstatement, or won't detect and correct it in time. At Voltana the new system raises it: its controls are untried, and any errors in the data moved from the old system could flow straight into the accounts. **The assessment rests on testing.** If the auditor doesn't plan to test whether a control operates effectively, it can't assume the control works, so the assessed risk of material misstatement is simply the assessment of inherent risk. Both risks belong to the entity, and managing them is management's job.

The detection risk grid



Both risks high: the lowest detection risk, so the most persuasive evidence

- More tests of details
- Larger samples
- Work at or near the year end
- More evidence from outside the entity

Both risks low

The auditor can accept a higher detection risk and do less, though material items always get some substantive work

The relationship is inverse

Detection risk is the chance that the auditor's procedures miss a misstatement that exists. The auditor can't change the client's risks, so it changes the **nature, timing and extent** of its procedures: the higher the assessed risks, the lower the detection risk it can accept, and the more persuasive the evidence must be.

Putting a number on it (illustration only)

The standards set no percentage for acceptable audit risk, and auditors normally use words such as low, medium and high. The arithmetic only shows why weak controls and risky accounts make an audit bigger.

Situation	Risk of material misstatement	Acceptable detection risk	Audit risk
Voltana's revenue as assessed	About 50%	About 10%	50% x 10% = 5%
If better controls halved the risk	About 25%	About 20%	25% x 20% = 5%

Practice questions

MODULE 2 | 2.1.1 | TRY THESE BEFORE THE WORKED ANSWERS

Question 1 - Name the factor and the level

Ardlow Cheese Ltd (imagined) is a listed cheese maker with a 30 June year end. For each fact, name the inherent risk factor it represents, and say whether it creates a risk at the financial statement level or for a particular assertion (name the assertion).

Fact	Inherent risk factor	Financial statement level, or which assertion?
(a) Cheese matures for 6 to 24 months, and the cost of each batch includes milk, labour and a share of factory overheads spread across the maturing period.		
(b) The final price paid to dairy farmers for this year's milk won't be set until September, so at 30 June management must estimate the extra amount it will owe them.		
(c) Management judges how much of the cheese now maturing will reach premium grade, which decides the price it will sell for.		
(d) A new accounting and inventory system went live in January, and all inventory and payroll data were moved across from the old system.		
(e) The chief executive and the finance director earn bonuses of up to 80% of salary if earnings before interest and tax grow by 15% or more.		
(f) About 40% of sales are exports invoiced in US dollars, and the company uses forward exchange contracts to protect its margins.		

Question 2 - Rank the accounts

Using the facts in Question 1, rank these four Ardlow accounts from highest (1) to lowest (4) risk of material misstatement, and explain your ranking.

Account	Rank (1 = highest)	Why
Inventory of maturing cheese		
Amount owed to farmers for the final milk price		
Trade receivables from export customers		
Cash at bank		

Question 3 - Use the risk grid

Use the detection risk grid to decide the acceptable detection risk for each Ardlow account, and describe the evidence each would need.

Account and assessments	Acceptable detection risk	Evidence needed
(a) Inventory. Inherent risk high. Control risk high: the new system's controls haven't been tested.		
(b) Amount owed for the final milk price. Inherent risk high. Control risk medium: the board reviews the estimate, but only against management's own assumptions.		
(c) Cash at bank. Inherent risk low. Control risk low: daily bank feeds and monthly reconciliations, with the controls tested and found effective.		

Worked answers

MODULE 2 | 2.1.1 | WORKED ANSWERS - ATTEMPT THE QUESTIONS FIRST

Question 1 - Ardlow Cheese

	Factor	Level and assertion
(a)	Complexity	Assertion: accuracy, valuation and allocation of inventory (and cost of sales)
(b)	Uncertainty, with some subjectivity	Assertion: completeness and valuation of the amount owed to farmers, and the cost of sales it feeds
(c)	Subjectivity	Assertion: valuation of inventory, as cheese that misses premium grade may sell for less than it cost
(d)	Change	Financial statement level: the system feeds many accounts, so errors in the moved data could affect many assertions at once
(e)	Susceptibility to management bias or fraud	Financial statement level: the incentive could push any judgemental figure, especially revenue and the estimates in (b) and (c)
(f)	Complexity	Assertion: accuracy of export sales and receivables converted from US dollars, and valuation of the forward contracts

Some facts fit more than one factor: what matters is explaining why the item is exposed.

Question 2 - Ranking (suggested)

Rank	Account	Why
1	Inventory of maturing cheese	Large, and exposed to three factors at once: complex costing, subjective grading and data moved into a new system. Overstating it also lifts profit and bonuses.
2	Final milk price owed	Uncertain and subjective, and an under-estimate lifts earnings, so the bonus adds a bias risk. A single figure that can be checked against the September price.
3	Export receivables	Some complexity from US dollars, but balances can be confirmed with customers and checked against cash received after year end.
4	Cash at bank	Little judgement, and easily confirmed with the bank.

Ranks 1 and 2 could be swapped: the reasoning is what counts.

Question 3 - Using the grid

	Detection risk	Evidence needed
(a) Inventory	Very low	Most persuasive evidence: attend the 30 June count and test counts both ways; recalculate costing and overheads; check grading against prices after year end; agree balances moved into the new system; larger samples.
(b) Final milk price	Low	Compare the estimate with the price announced in September; recalculate litres times the expected price; read the supply contracts; check last year's estimate against the outcome for bias.
(c) Cash at bank	Very high	Less work: a bank confirmation sent directly to the auditor and a check of the year-end reconciliation. A material balance always gets some substantive work.