Concept of Risk Based Audit
Session-04

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How to define Risk

“ Risk is a condition in which there is a possibility of an adverse deviation from a desired outcome that is expected or hoped for”

Source: Risk Management by Emmett J. Vaughan

Definition Contd..

- The threat that an action or event will adversely affect an organization's ability to achieve its objectives and execute its strategies successfully.
  - A risk is invariably a threat (something that might happen)
  - The risk relates to an event (something that has to occur for the risk to crystallize)
  - The event, if it occurs will have impact on achievement of business objectives

Contd..

“The potential that a given threat will exploit vulnerabilities of an asset or group of assets and thereby cause harm to the organization“

International Organization of Standardization (ISO)

Risk: Characteristics

- Uncertainty
  - The risk may or may not happen
- Loss-
  - The risk becomes a reality and unwanted consequences or losses occur

Classifications of risk

- Financial and Non- financial risks
  - The term risk includes all situations in which an exposure to adversity exists.
  - This adversity sometimes involves financial loss.

- Financial risk involves the relationship between an individual or an organization and an asset or expectation of income that may be lost or damaged

Classifications of risk

- Static and Dynamic risks
  - Dynamic risks are those resulting from changes in the economy
    - Economy
    - Industry
    - Competitors
    - Consumers
  - Changes in these factors are uncontrollable, but all have potential to produce financial loss to the firm

- If we could hold consumer tastes, output and income and the level of technology constant, some individual would still suffer financial loss.
- Dynamic risks are less predictable than static risks, in as much as they do not occur with any degree of regularity

Contd..

- Static risks involve those loses that would result even if no changes in the economy occurred.
  - Static losses involve either the destruction of the asset or a change in its possession as a result of dishonesty or human failure
  - Static losses tend to occur with a degree of regularity over time and are generally predictable

Contd..

- Pure and Speculative risks
  - Speculative risk describes a situation that holds a possibility of either loss or gain. e.g., Gambling
  - The term pure risk is used to designate those situations that involve only chance of loss or no loss.

- Fundamental and Particular risks
  - Fundamental risks involve losses that are impersonal in origin and consequences. They are group risks, caused for the most part by economic, social and political phenomena
    - Unemployment
    - War
    - Inflation
    - Earthquake
    - floods

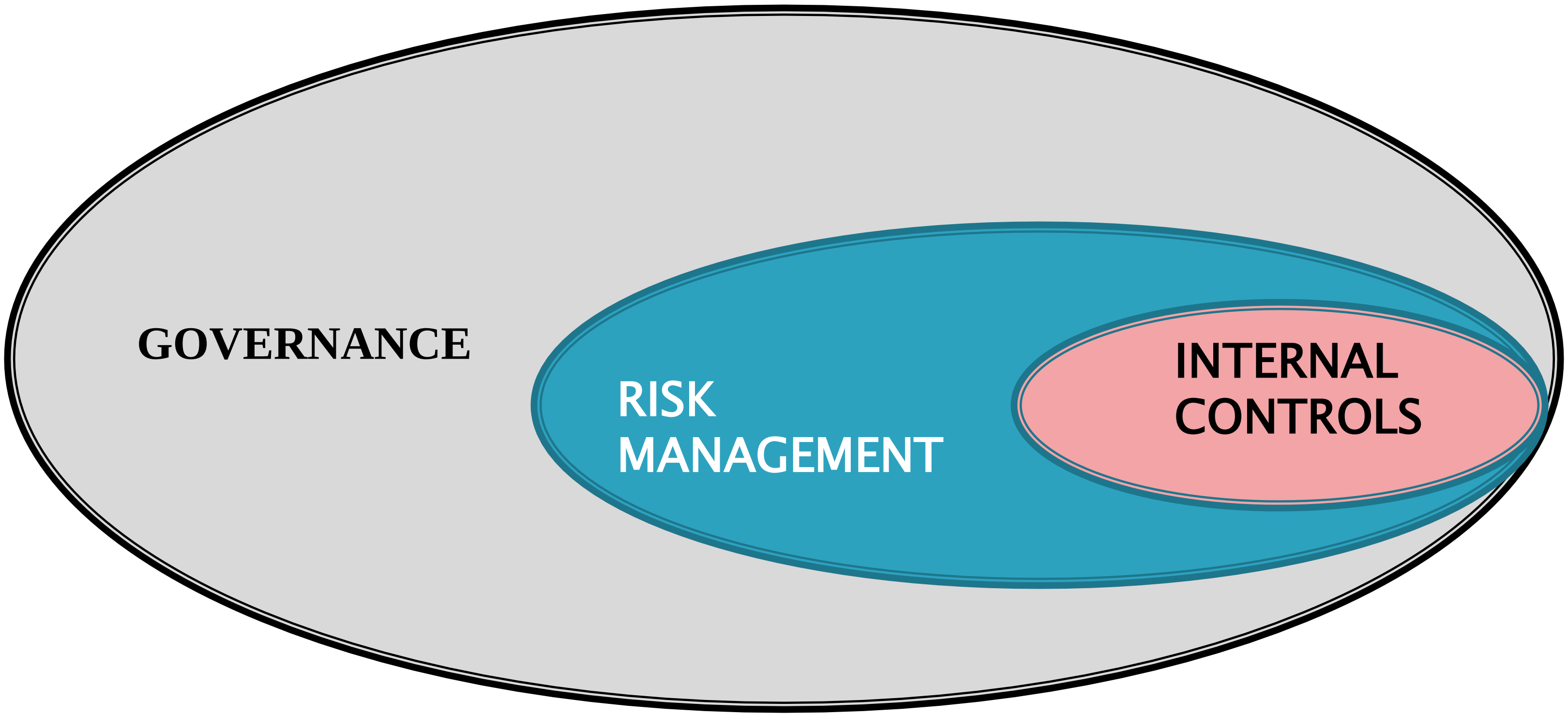
- Particular risks involve losses that arise out of individual events and are felt by the individuals rather than the entire group. These can be static or dynamic
  - Burning of a house
  - Robbery at a bank

What is Risk Based Auditing?

- Risk based auditing (RBA) as a methodology that links auditing to an organization’s overall risk management framework.

- RBA allows audit to provide assurance to the entity that risk management processes are managing risks effectively, in relation to the risk appetite

Relationship of Governance RM &IC



Risk Based Audit Approach

- The approach adopted by an audit organization to a specified audit assignment is a key factor in determining the outcome of the audit.

- Inability to adopt the correct audit approach increases the likelihood of defective audit results

Audit Approaches

- Four different audit approaches
  - System- based approach
  - Balance sheet approach
  - Substantive procedure approach
  - Risk- based audit approach

Audit Approaches

- System- based approach
  - This approach requires the auditors to assess the effectiveness of the internal controls of an entity & then to direct the substantive procedures primarily to those areas where it is considered that systems objectives will not be met.

  - Reduced testing is carried out in those areas where it is considered systems objectives will be met.

Audit Approaches

- Balance sheet approach
  - In this approach substantive procedures are focused on balance sheet accounts, with only very limited procedures being carried out on income statements/ profit and loss account items.

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Audit Approaches

- Balance sheet approach
  - The stated benefit of this approach is that if the management assertions for all balance sheet accounts are tested and verified, then the profit/ loss figures reported fro the accounting period will not be materially misstated.

Audit Approaches

- Substantive procedure approach
  - This is also referred to as vouching or direct verification approach
  - Audit resources are targeted on testing large volumes of transactions & account balances without any focus on specified areas of the financial statements.

Audit Approaches

- Risk- Based Audit Approach
  - In this approach the audit resources are directed towards those areas of the financial statements that may contain misstatements as consequence of the risks faced by the entity.

Audit Approaches

- Risk- Based Audit Approach
  - The independent audit assessment of both the risks and controls that were originally evaluated by management
  - Providing clear guidance or the activities to take to deal with resultant exposures

Risk based Audit Approach

- Every audit assignment presents a different challenge for the audit office be it the sector, size governance issues or the complexity of the operations
- Risk based audit approach minimizes the possibility of the audit objectives not being met.

Historical Perspective

- In 1999 the Turnbull report on Corporate Governance set out to change the way the organizations in UK used to manage and report their activities on behalf of their stakeholders
- The need for active management of risks was stressed
- The challenge was alike for the private limited companies as well as the public sector senior management

Source: Risk Based Auditing ,Phil Griffiths, 2005

Historical Perspective

- The Australian/New Zealand risk standards developed in 1995 are recognized world wide
- These standards were developed using the OSO guidelines and have been adopted as standard for corporate Governance
  - COSO Guidelines are meant to improve the quality of financial reporting through a focus on Corporate Governance, ethical practices & internal controls

THANK YOU