

Chapter 6

The risk-based approach to audit: audit judgement

Questions

6.7

Take another look at both the County Hotel and Fine Faces and discuss the proposition that auditors are so willing to help management that they might forget that their primary duty is to form an opinion on the financial statements issued to and used by third parties.

6.8

What are the main practical differences between the audit risk approach and the business risk approach to auditing?

6.9

'It is very easy to apply the audit risk model. All you have to do is to multiply figures together to determine the amount of testing you have to do.' Discuss this statement.

6.10

Explain to your assistant what is meant by audit judgement and give examples of its application. How certain can you be that your judgement has produced the right answer?

6.11 Discuss the major factors that might influence managers in engaging in earnings management. Consider audit procedures that might be appropriate where earnings management is expected.

Solutions

6.7

We have discussed independence in Chapter 3 so you should have had little difficulty in addressing this question. The problem of course is that when you are advising management on certain aspects of their business you have to align yourself with management, to be on their side, thus creating a management threat to objectivity (identified by APB's ES1). However much the external auditor is advised not to get involved in making management decisions, it may be very difficult to avoid this. Clearly the auditors of the County Hotel and Fine Faces are very anxious to help management as a spin-off from the audit process.

One safeguard (the Ethics Partner might advise on this) would be for the auditor staff, once they have identified a problem or an area where advice to management could be given, to invite other personnel within the audit firm to take over from the personnel engaged in the audit. This might of course reduce the value of the business risk approach in influencing the way that the audit is carried out. Another

problem affecting independence is the additional fees earned from giving the advice. In circumstances like this it is vital that auditors maintain their integrity and that second opinions be sought from within the audit firm, whether from a formally appointed Ethics Partner or fellow partners. In the case of small firms, advice might even be sought outwith the firm.

6.8

There is a very different approach to audit risk and business risk as can be seen from their definitions:

- Audit risk: the risk that auditors may give an inappropriate audit opinion on financial statements.
- Business risk: the risk that the entity will fail to achieve its objectives.

Audit risk involves an approach from the auditors' point of view, while the business risk approach looks at risk from the company perspective. Both approaches have an important end an expression of opinion on the financial statements of the company. The protagonists of the business risk approach spend a lot of partner and manager time (the most expensive time) finding out about the company, often going into areas that only have an indirect relevance to the financial statements, but which may nevertheless have a bearing in the medium or long term and even in the short term.

We saw in the text that auditors using this approach will look at company objectives such as increasing market share, and we concluded that this objective might have an impact on the going concern status of the company. Similarly, a company's objective of increasing customer satisfaction might well have a bearing on the financial statements as customers will be more likely to pay and to purchase company products in the future. A concern for the environment may avoid costly court cases by persons alleging personal damage or avoid fines by government for infringement of laws protecting the environment. Thus, both approaches will include the important audit objective of giving an opinion on the financial statements. The business risk approach is however likely to give the audit firm the chance of earning additional income by the provision of advice and assurance services to management. The audit risk approach does involve the auditor in expensive fact finding too and often inherent risk and business risk cannot be easily differentiated. However the audit risk approach does tend to concentrate on the financial statements. We must remember that the financial statements only give one view of the company. There are many other views that the business risk approach might uncover.

6.9

If only this were true, but it is not. You will remember that the formula is expressed as follows:

$$\text{Audit risk (AR)} = \text{Inherent risk (IR)} \times \text{Control Risk (CR)} \times \text{Detection Risk (DR)}$$

The problem with formulas is that they tend to give a spurious sense of accuracy whereas it is clear that a considerable amount of judgement is involved in its application. Thus:

- Audit risk (AR). The auditors have to decide what level of risk they can live with, that is, what is tolerable to them. This clearly is a matter of judgement as to what is material in relation to the financial statements. We have not covered materiality yet but shall do so in Chapter 12.
- Inherent risk (IR). Again a considerable amount of judgement is involved. What leads auditors to decide that a particular risk will affect the financial statements? What makes them decide, for instance, that a particular group of customers in a particular industry are not likely to pay unless there are controls in force.
- Control Risk (CR). This kind of risk is about the ability of the company controls to reduce the impact of inherent risk. Auditors have to judge their effectiveness in the light of what they think about the competence and skill of management, the control environment management has put in and the functioning of individual controls. How does the auditor decide that the credit worthiness controls, for instance, are working properly all the time?

If auditors have got all these judgmental decisions right, they can apply the formula and calculate the desired level of detection risk – which they can then translate into a desired level of tests of detail.

We might mention that the business risk approach tends not to assess inherent risk and control risk separately, but nonetheless judgement is involved.

6.10

We talked quite a lot about judgment in 6.8 above, but you might like to explain what is meant by audit judgment to your assistant in more simple terms. The main point is that there is usually much uncertainty surrounding human activity so that we are all having to make judgments all the time in our daily lives. For instance, do I trust this person when he says he will pay back the £10 he wishes to borrow until next Friday? The same is true in business life and auditors are continually having to make judgements about the actions of management, controls in force and figures in the financial statements. Some things are easy and do not involve much judgement, if any. For instance, IAS 11 and FRS 102 allows profits on uncompleted Construction (long-term) contracts to be reflected in the profits of this year. There is no argument about this and therefore no exercise of judgement. Where judgement does have to be exercised is on the amount of profit that you can take up. This contract is only 10% complete - is this too soon to judge whether any profit can be taken up? This contract is running late. What is the likelihood that penalty clauses will be invoked, thereby reducing expected profit and affecting the amount of profit that can be taken up. We discuss construction contracts in Chapter 15 and show you all the judgements that have to be made in respect of the accounting for them. There are

many other examples: This inventory is unsold at the year-end. Will it be sold above cost? This debtor outstanding at the balance sheet date has not paid at the time of the audit. What is the likelihood that he will pay? The company says this item of plant has a twenty- year life. I have to judge that management's assertion is valid.

You should also say to your assistant, however, that judgment is not exercised in a vacuum. The auditors may have a lot of information to help them make judgments. For instance, in the case of the debtor, a review of the account shows that this debtor, though slow-paying has always paid the balance outstanding in the past. Regarding the inventory, the auditor might look at how well the inventory has moved in the past in order to form a view about the movements in the future,

Finally, you can say to your assistant that the exercise of judgement becomes easier as experience is gained. In the meantime you will help him or her to make the necessary judgements and explain why they have been made.

6.11

EM is quite a broad term and may encompass:

- a) Deliberate misstatement of financial reporting figures, such as omitting purchases and accounts payable or overstating inventories – and so on.
- b) Making accounting choices within GAAP that may influence the behaviour of stakeholders, such as taking an over-positive or over-negative view of the lives of non-current assets, value of inventories, collectability of debtors – and so on.
- c) Making real economic choices that will have an impact on stated earnings, for instance:
 - (i) basing part of employees' remuneration on earnings, thereby increasing expenditure in good years and reducing expenditure in poor years
 - (ii) cutting research and development expenditure or repairs and maintenance expenditure in years where earnings are low and increasing such expenditure in years where earnings are high.

We can regard a) above as plainly wrong, b) as sharp practice, using the opportunities within GAAP for showing a desired outcome, c) (i) is clearly an acceptable practice but c) (ii) are short-term measures that may have an unfortunate long-term effect.

Managements might wish to manage earnings for a number of different reasons, including:

- a) The success of management is often judged by the share price of the company. Managing earnings upward would tend to increase share price, making management look more successful than it is.

- b) There might also be pressure to increase share price in like fashion, if shares are being issued as consideration for the purchase of a company.
- c) In the circumstances of a reorganization of a company or a proposed management takeover, excessive provisions before the event (known as 'big bath' provisions) would make the company 'look better' in future years.
- d) Managements might indulge in income-smoothing, a form of earnings management, if profits have been adversely or favourably affected by conditions unlikely to be repeated. In other words, the smoothed income might be a better guide to future earnings.
- e) Remuneration of key people within the entity is often tied to reported earnings. Income smoothing would avoid swings in remuneration.
- f) Earnings management might be used to influence perceptions of financial strength by a range of third parties, including present and potential competitors, customers, suppliers, employees, politicians and regulators. Earnings management might be used to mislead providers of finance, where debt covenants are in danger of being infringed.

This chapter has been about the audit approach to risk. Clearly the risk of misstatement will be higher where managements could benefit from earnings management. This would clearly be the case, for instance, where the remuneration of executives is based on the earnings figure or where there is doubt about the going concern status of the entity. Earnings management might be more likely under circumstances such as these.