



## **Article: Audit Risk and Business Risk**

**By: Ger Long MBA, FCA, AITI, ACIM, Examiner Professional 2 Audit Practice and Assurance Services**

### **Audit Risk and Business Valuation**

Students have long been familiar with the idea of Audit Risk, which is nothing more than the risk that the auditor will get his or her opinion wrong. The idea that audit risk breaks down into three components namely Inherent Risk, Control Risk and Detection Risk is also well understood. Recently though the professional literature, textbooks, and crucially auditing examinations have moved on to discuss a concept that is not unrelated but is subtly different. This is the concept of business risk and the business risk (BR) approach to auditing.

Business risks “result from significant conditions, events, circumstances or actions that could adversely affect the entity's ability to achieve its objectives and execute its strategies, or through the setting of inappropriate objectives and strategies”. Put more simply anything that pushes a business away from profit maximisation and in the direction of failure can be called a business risk. There are several ways of subdividing business risk. Sometimes risks are classified between operating risks, financial risks, and compliance risks. On other occasions a division is made between internal and external risks. However it is defined or divided the Business Risk model does not sit particularly neatly with the Audit Risk model. The best that can be said in terms of connecting the two is as follows:

1. Any attempt to quantify or assess inherent risk within the audit risk model would necessarily involve an assessment of business risk.
2. The audit risk model is more concerned about risk to the auditor - business risk directly assesses the risks to the business from both internal and external factors and any resulting risk to the auditor would only be assessed as a by-product of the business risk.
3. Whereas using the audit risk approach is merely a modification or a sort of quantification of the systems (or even substantive) approach to auditing, taken to its logical conclusion the Business Risk approach to auditing could result in a fundamentally different way of thinking about the audit process.
4. Perhaps as a result of this (which will be examined further below) it may well be that the Business Risk approach will be more fully applied by internal auditors who perhaps do not feel as constrained in their approach as external auditors are.

### **How is the Business Risk approach different?**

A traditional audit - as any textbook will tell you - consists of the auditor gaining knowledge of the business, understanding the systems, confirming the understanding, documenting the systems, performing tests of controls, relying (or not as the case may be) on the results, and then performing limited (or extended) substantive tests; reviewing the overall results and so forth. This in turn gives rise to a typical current audit file with detailed flowcharts, records of all the tests mentioned above and a balance sheet/substantive testing section going from property plant and equipment, to share capital and reserves.

Under a Business Risk approach the starting point of an audit is quite different (although the need for the auditor to obtain knowledge of the business is probably even greater under this approach). The auditor does not begin by trying to verify the correctness of the property plant and equipment or the receivables or even to understand the wages system, but rather begins by asking the question - what risks does this business face? Having identified the risks faced by the entity being audited (it need not necessarily be a commercial or profit-making enterprise) the next question the auditor asks is: "How is the entity coping or dealing with these risks?" Typically, some risks for, say, a traditional bookshop could be illustrated and categorised as in the following matrix.

	High likelihood	Low likelihood
High impact	<ul style="list-style-type: none"> <li>Loss of business due to increasing competition from internet-based book-sellers.</li> <li>Loss of business due to recession.</li> </ul>	<ul style="list-style-type: none"> <li>Loss of computer systems due to software failure.</li> <li>Loss of assets and business due to fire, flood etc.</li> </ul>
Low impact	<ul style="list-style-type: none"> <li>Increased level of costs due to commodity price increases.</li> </ul>	<ul style="list-style-type: none"> <li>Decrease in popularity of particular book types e.g. children's books.</li> </ul>

The financial statements are then assessed based on the results of this exercise. In the case of the more material risks, we need to decide what impact each risk is likely to have on the financial statement assertions. In other words, we need to assess the extent to which *business risks* give rise to *financial statement risks*. Sometimes this exercise will have a similar consequence to the traditional approach to auditing. Let us take two examples:

1. An assessment that the risk of shipping goods to a customers who are bad credit risks is high would lead to a particular investigation of the adequacy of the bad debts provision, or
2. An assessment that there was a significant risk that a particular line of credit to an organisation was in danger of being discontinued could lead to a reassessment of its ability to continue as a going concern.

However, it could also have quite different consequences. If, for example, it was found that the organisation's market share in a foreign market was at risk of declining this information may be of more immediate use to management than to an external auditor. In other words, this is an example of a business risk which does not directly give rise to a financial statement risk but could, and should, still be communicated to the client.

## Dealing with risks

If a risk is deemed both highly likely to happen and very significant then from the management point of view some action needs to be taken to reduce, mitigate, or transfer the risk. In the example given above namely the risk arising from internet-based book-sellers, management might consider the possibility of becoming involved in this market. In the case of the anticipated commodity price increase entering into forward contracts for the purchase of the commodity could help mitigate the risk if the impact of the risk was considered sufficiently serious. Risks that are in the high impact/low likelihood quadrant are typically dealt with by transferring the risk, usually through insurance. Risks in the low impact/low likelihood quadrant are likely to be accepted but should still be monitored.

The auditor, on the other hand, needs to access the consequences for audit purposes of the existence of the risk, and of any measures taken by management to deal with the risk and those consequences could and should include consideration of going concern issues. To take another example, if the above company had taken a decision in principle to enter the internet-based market, the auditor would wish to establish if this had lead to any capital expenditure or capital commitments on the part of the company, and if so, were these issues properly recorded and disclosed in the financial statements.

One final consequence of the using the audit risk approach could be that the audit file would (at least at first glance) seem very different. Instead of, or more likely in addition to, the traditional headings usually associated with systems, property, plant and equipment and the like we could have headings devoted to understanding the business and identifying risks including the following subsections:

1. Evaluation of the client's risk management process
2. Analysis of the business environment
3. Preliminary analytical review.
4. Consideration of business risks
5. Consideration of information flows.

In order to be effective, this work needs to be carried out by senior and experienced personnel in a the audit firm and a consequence of this is that higher grade staff need to be involved at an earlier stage of the audit process.

In summary the advantages and disadvantages of the BR approach to auditing can be set out as follows:

**Advantages:**

1. It will tend to provide information that is more useful to the client.
2. It forces the auditor to have a more complete understanding of the business and it will therefore be more unlikely that any fundamental issues will be overlooked.
3. It puts more emphasis on the strategic focus of the business and on the quality of management.
4. It is less easy for the client to anticipate and thus circumvent tests to be carried out by the auditor.

**Disadvantages:**

1. It is much more difficult to structure and plan an audit under this approach.
2. Delegation of work to, and reliance on of the work of relatively junior staff is more problematic under this approach.
3. It would be more difficult for firms to ensure quality control under this method since, for example, working papers would not as standardised.
4. It is very difficult to ensure that all risks are addressed in any particular audit.

\* From the auditor's point of view the term *financial statement risk* simply means the risk that the financial statement are materially in error. It is thus a product of *inherent risk* and *control risk*.