A New Approach to Risk Assessment by Auditors

by Garret Wynne

Audit firms of all sizes will need to revisit their firm's approach to risk assessment for all audits of financial statements under newly revised auditing standards for periods commencing 15 December 2021.

The International Standard on Auditing (Ireland) (ISA (Ireland)) 315 Identifying and Assessing the Risks of Material Misstatement has been updated by The Irish Auditing and Accounting Supervisory Authority (IAASA) for audits of financial statements for periods beginning on or after 15 December 2021. While early adoption is permitted, in most cases financial years ending 31 December 2022 will be the first audits completed under the revised standard.

The standard has been revised to respond to challenges and issues with the current standard, ISA (Ireland) 315 Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and its Environment. The revised standard introduces major changes in the approach to risk identification and assessment by focusing on what needs to be done and how procedures are undertaken.

At first look, the first thing many auditors will notice is the actual size of the revised standard over the previous version of this standard. The additional volume allows for more extensive application material and the inclusion of six specific appendices with detailed additional guidance to help on implementation.

The enhancements will affect all audits and the readers of this article should understand the concept of scalability as highlighted in the revised standard. In accordance with ISA (Ireland) 200 Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing scalability emphasises the application of the requirements to all entities regardless of size or complexity. The explanatory material supporting the standard expands on this point for both less and more complex entities. The expectation of the revised standard is that this is applied to all entities regardless of size or complexity.

Through the revision of the standard, it is hoped that the changes will:

- Make the standard more scalable and applicable to all entities;
- Reduce complexity and make the standard more usable by auditors;
- Promote more consistent risk assessments with more focused responses to identified risks; and
- Help auditors by incorporating detailed guidance material.

While the changes to the standard are extensive, the objective of the auditor as set out in the revised standard is consistent with the current standard – to identify and assess the risks of material misstatement, whether due to fraud or error, at the financial statement and assertion levels thereby providing a basis for designing and implementing responses to the assessed risk of material misstatement.

The key changes put forward in the revised standard are:

1. Enhanced requirements relating to the exercise of professional scepticism

Professional scepticism is necessary for the critical assessment of audit evidence and the revised standard is focused on the need not to bias work towards obtaining evidence that is corroborative or excluding evidence that is contradictory to the existence of risks. The revised standard encourages a robust engagement team discussion at planning that will lead to a better assessment of the risks of material misstatement.

2. Applicable financial reporting framework

The revised standard emphasises a separate focus on understanding the applicable financial reporting framework and the application of accounting policies that are appropriate and consistent.

3. Obtaining and understanding of the entity and its environment

Understanding the entity and its environment assists the auditor in identifying events or conditions, the characteristics of which may affect the susceptibility of assertions about classes of transactions, account balances or disclosures to misstatement. The revised standard requires 'sufficient appropriate' evidence to be obtained from the risk assessment procedure to provide the basis for the risk assessment. The revised standard requires inherent risk and control risk to be considered assessed separately.

4. Entity's system of internal control

The revisions to the standard have expanded on the need of the auditor to understand the entity's system of internal control for both direct and indirect controls relevant to the audit. The auditor is expected to obtain an understanding of the following control activities:

i. Controls that address a significant risk

ii. Controls over journal entries

iii. Controls for which the auditor plans to test the operating effectiveness

iv. Other controls that the auditor considers are appropriate

If the auditor does not plan to test the operating effectiveness of controls, the assessment of the risk of material misstatement shall be the same as the assessment of inherent risk.

5. Inherent risk factors

The revised standard introduces five new inherent risk factors (complexity, subjectivity, change, uncertainty and susceptibility to misstatement due to management bias or other fraud risk factors insofar as they affect inherent risk) to assist the auditor in undertaking the risk assessment process.

6. Spectrum of inherent risk

The concept of a 'spectrum of inherent risk' has been introduced in the revised standard. The spectrum is based on the likelihood and magnitude of a possible misstatement on a range from higher to lower. Significant risks, defined as the relative importance of a matter, lie at the upper end of this spectrum and are judged by the auditor in the context of which the matter is being considered.

7. Increased focus on information technology

An entity's system of internal control contains manual and automated elements, the complexity of the entity varies with the mix of manual and automated elements and the entity's use of IT. The revised standard has been updated to reflect increasing use of automated tools and techniques by some auditors and focuses on the need for an auditor to understand an entity's use of IT in its business.

8. Significant classes of transactions, account balances and disclosures

The revised standard has introduced a new concept of significant classes of transactions, account balances and disclosures and relevant assertions to assist with the identification and assessment of the risks of material misstatement.

9. Stand back requirement

A new stand back requirement has been introduced for the auditor to evaluate the completeness of the significant classes of transactions, account balances and disclosures at the end of the risk assessment process.

Audit firms should use the time available in 2022 to prepare for the practical challenges on implementation to ensure a smooth transition to the revised ISA.

As noted previously the revisions to this standard take effect for period commencing 15 December 2021. Understanding the extent of changes required will be a significant task for all audit firms and staff. Audit firms should use the time available in 2021 to prepare for the practical challenges on implementation to ensure a smooth transition to the revised ISA. Audit firms should focus on the following areas:

i. Revisions and updates to standard audit working programmes, providers of standard audit methodologies will need time to incorporate the significant updates outlined above

ii. Educating audit staff on revised changes, new concepts and the application of the inherent risk spectrum

iii. Assess the impact on current audit clients and consider the impact of scalability on the firm's approach to future audits

iv. Prepare for next years audits by rolling forward audit files to incorporate all changes

Risk assessments are critical to the performance of all financial statement audits and firms have struggled with the application of ISA (Ireland) 315 for a number of years. The incorrect application of ISA (Ireland) 315 is a common weakness identified in the majority of file reviews performed. It is hoped that the improved revised standard will assist auditors to improve their documented risk assessments and specific audit approach to identified risks by forcing the auditor to stand back and review all information available in determining its risk assessment. The assessment of risk should be specific to the audit entity and not the application of standard generic risks on all audit files.

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