Belarusian
State University

The Theory of Auditing

Industrial Management
"Controlling and Audit"

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Main Issues

1. The Essence of Audit
2. Audit and Agency Theory
3. Financial Statements Audit
4. The Role and Risks of Audit. TQM

1. The Essence of Audit

AUDIT: DEFINITION

An audit is a "systematic, independent and documented <u>process for obtaining audit evidence</u> [records, statements of fact or other information which are relevant and verifiable] and <u>evaluating it objectively to determine the extent to which the audit criteria</u> [set of policies, procedures or requirements] <u>are fulfilled</u>" *(ISO 19011:2011—Guidelines for auditing management systems)*.

Types of audits

- Product (which includes services)
- Process
- System
- Personnel

Product audit

An examination of a particular product or service (hardware, processed material, software) to evaluate whether it conforms to requirements (that is, specifications, performance standards, and customer requirements).

PROCESS AUDIT

- A verification that processes are working within established limits. It evaluates an operation or method against predetermined instructions or standards to measure conformance to these standards and the effectiveness of the instructions. Such an audit may:
  - Check conformance to defined requirements such as time, accuracy, temperature, pressure, composition, responsiveness, amperage, and component mixture.
  - Examine the resources (equipment, materials, people) applied to transform the inputs into outputs, the environment, the methods (procedures, instructions) followed, and the measures collected to determine process performance.
  - Check the adequacy and effectiveness of the process controls established by procedures, work instructions, flowcharts, and training and process specifications.

SYSTEM AUDIT

- An audit conducted on a management system. It can be described as a documented activity performed to verify, by examination and evaluation of objective evidence, that applicable elements of the system are appropriate and effective and have been developed, documented, and implemented in accordance and in conjunction with specified requirements.
  - A ***quality management system audit*** evaluates an existing quality program to determine its conformance to company policies, contract commitments, and regulatory requirements.
  - Similarly, an ***environmental system audit*** examines an environmental management system, a ***food safety system audit*** examines a food safety management system, and ***safety system audits*** examine the safety management system.

Personnel audit

the analysis and evaluation of personnel policies, procedures and practices to determine the effectiveness of personnel/human resource management in an organisation; a periodic review to measure the effectiveness of personnel management and to determine the steps required for more effective utilization of human resources.

A major objective of personnel management is to "improve productivity" of individual employees and thus increase "organisational effectiveness" by better utilization of a firm's human resources.

Other types of audits

- Some audits are named according to their purpose or scope.
- The scope of a *department or function audit* is a particular department or function.
- The purpose of a *management audit* relates to management interests such as assessment of area performance or efficiency.

Purposes of Audits → Types of Audits

An auditor may specialize in types of audits based on the audit purpose, such as to verify compliance, conformance, or performance.

Some audits have special administrative purposes such as auditing documents, risk, or performance or following up on completed corrective actions.

Performance vs compliance/conformance audits

The audit purpose relates to organization performance. Audits that determine compliance and conformance are not focused on good or poor performance.

A key difference between compliance/conformance audits and audits designed to promote improvement is the collection of audit evidence related to organization performance versus evidence to verify conformance or compliance to a standard or procedure.

Follow-up audit

A product, process, or system audit may have findings that require correction and corrective action.

Since most corrective actions cannot be performed at the time of the audit, the audit program manager may require a follow-up audit to verify that corrections were made and corrective actions were taken.

Due to the high cost of a single-purpose follow-up audit, it is normally combined with the next scheduled audit of the area.

Phases of an audit: Audit preparation

- Audit preparation consists of <u>everything that is done in advance by interested parties</u>, such as the <u>auditor, the lead auditor, the client, and the audit program manager</u>, to ensure that the **audit complies with the client's objective**.
  - The preparation stage of an audit begins with the decision to conduct the audit.
  - Preparation ends when the audit itself begins.

Phases of an audit: Audit performance

- The performance phase of an audit is often called the *fieldwork*. It is the data-gathering portion of the audit and covers the time period from arrival at the audit location up to the exit meeting.
- It consists of activities including on-site audit management, meeting with the auditee (one subjected to an audit), understanding the process and system controls and verifying that these controls work, communicating among team members, and communicating with the auditee.


Auditor
Helpful
Tips
Auditees

Phases of an audit: Audit reporting

- The purpose of the audit report is to communicate the results of the investigation.
- The report should provide correct and clear data that will be effective as a management aid in addressing important organizational issues.
- The audit process may end when the report is issued by the lead auditor or after follow-up actions are completed.

Phases of an audit: Audit follow-up and closure

- According to ISO 19011, clause 6.6, "The audit is completed when all the planned audit activities have been carried out, or otherwise agreed with the audit client".
- Clause 6.7 of ISO 19011: verification of follow-up actions may be part of a subsequent audit.

Public vs. Private Sector

- The public sector involves organisations pertaining to public interest, such as Education, Transport, or Health. The public sector is usually operated by the government and not designed for the financial profit of its owners. Structures and hierarchies within the public sector vary between industries and regions and the objective of these organisations is the benefit of society.
- Private companies, ranging from family businesses to global, publicly-trading corporations, are not part of the government.
- Their profits are designated at the operators' prerogative, often for good old capitalist gain, and companies' objectives can differ vastly.

Similarities between Public and Private Auditing

- An auditor in a private company and an auditor in the public sector will have the same qualifications, they will apply the same basic principles to their work and are expected to comply with the same independent auditing standards.
- Both types of auditors are expected to be unbiased with no vested interest in the organisation that they audit.
- Furthermore, auditors in both private and public sectors must commit to the accuracy of their reporting.

DIFFERENCES BETWEEN PUBLIC AND PRIVATE AUDITING

- Most auditors in the public sector focus on cyber safety, information systems performance, and security. They are only provided with limited information on financial statements and they focus more on providing services rather than monitoring income, taxes, and profits.
- They typically report to a minister or departmental head.
- Auditors working for private sectors focus more on auditing the financial statements of the companies.
- Their main task is to ensure the proper presentation of financial reports to help shareholders and to portray the company's financial standing.
- They are hired to ensure that companies are operating in the best interest of their investors.

MAIN DIRECTIONS OF AUDITING

- The main goal of the audit is to <u>assure stockholders that the assertions and financial statements provided by the company are accurate and complete</u>.
- Aside from checking financial statements, auditors are also expected <u>to review the segregation of duties within the company.</u> This is to create a system of checks and balances inside the organisation. *For instance, the person who submits an invoice should not be the same person who approves it and makes payment.*

FIRST-, SECOND-, AND THIRD-PARTY AUDITS

A **first-party audit** is performed <u>within an organization to measure its strengths and weaknesses against its own procedures or methods and/or against external standards</u> adopted by (voluntary) or imposed on (mandatory) the organization.

<u>A first-party audit is an internal audit conducted by **auditors who are employed by the organization being audited but who have no vested interest in the audit results of the area being audited.**</u>

FIRST-, SECOND-, AND THIRD-PARTY AUDITS

A **second-party audit** is an external audit performed on a supplier by a customer or by a contracted organization on behalf of a customer. A contract is in place, and the goods or services are being, or will be, delivered.

Second-party audits are subject to the rules of contract law, as they are providing contractual direction from the customer to the supplier. Second-party audits tend to be more formal than first-party audits because audit results could influence the customer's purchasing decisions.

FIRST-, SECOND-, AND THIRD-PARTY AUDITS

A **third-party audit** is performed by <u>an audit organization independent of the customer-supplier relationship and is free of any conflict of interest.</u> Independence of the audit organization is a key component of a third-party audit.

Third-party audits <u>may result in certification, registration, recognition, an award, license approval, a citation, a fine, or a penalty</u> issued by the third-party organization or an interested party.

INTERNAL OR EXTERNAL AUDIT

- An audit may also be classified as internal or external, depending on the interrelationships among participants.
- **Internal audits** are performed by employees of your organization.
- **External audits** are performed by an outside agent.
- **Internal audits** are often referred to as ***first-party audits,*** while **external audits** can be either ***second-party, or third-party***.

Internal audit

- is a function that, although operating independently from other departments and reports directly to the audit committee, resides within an organisation (i.e. they are company employees).
- It is responsible for performing audits (both financial and non-financial) within a wide range of areas within a business, as directed by the annual audit plan.
- Internal audit look at key risks facing the business and what is being done to manage those risks effectively, to help the organisation achieve its objectives.

External audit

- is an independent body which resides outside of the organisation which it is auditing.
- They are **focused on the financial accounts or risks associated with finance and are appointed by the company shareholders.**
- The main responsibility of external audit is to perform the annual statutory audit of the financial accounts, providing an opinion on whether they are a true and fair reflection of the company's financial position. As part of this, external auditors often examine and evaluate internal controls put in place to manage the risks which could affect the financial accounts, to determine if they are working as intended.

Internal	External
considers whether **business practices** meet **strategic objectives**	considers whether the **annual accounts** give a 'true and fair view' and are prepared in accordance with legal requirements
auditors can be **employed** by the business **or outsourced**	***auditors*** are an **outside firm of accountants**
agenda is set internally **in the light of** the **business's risks and objectives**	the ***external audit*** firm will set its own programme of work based on its assessment of the **risks of the accounts being materially misstated**

Internal	External
Relevant managers u**sually receive copies of reports**; internal auditors **report to the audit committee**	report **primarily to the shareholders** or the trustees
a tailored report about how the **risks and objectives** (**are being managed**: a **focus on helping the business move forward**	report is in a format required by standards and **focuses on whether the accounts give a true and fair view** and comply with legal requirements
Discretionary reports **are not published publicly** **consultative help afterwards**	Legal requirements main **report will be publicly available** **no follow up**

What is
the difference between
audit and controlling?

Internal audit and controlling

Audit (internal)

- Internal audit is organized by the company in the interests of its owners; it is a control system for the observance of the established order of accounting and reliability of the entity's internal control.
- Specialists in the field of internal audit work with total data (at the end of the period), checking and monitoring all the economic evidence of any activities of the organization.

Controlling

- The main objective of controlling is the orientation of the management process to achieve all the goals of the enterprise;
- "manage the process of management".

2. Audit and Agency Theory

A FUNDAMENTAL PURPOSE OF AUDITS – AGENCY THEORY

Audits serve a fundamental purpose in promoting confidence and reinforcing trust in financial information.

The principal-agent conflict depicted in agency theory, where principals lack reasons to trust their agents because of information asymmetries and differing motives, is critical to understanding the **development of the audit over the centuries as well as its usefulness and purpose.**

AGENCY RELATIONSHIPS

- An agency relationship arises when one or more **principals (e.g. an owner)** engage another person as their **agent (or steward)** to perform a service on their behalf. Performance of this service results in the delegation of some decision-making authority to the agent.
- This delegation of responsibility by the principal and the resulting division of labour are helpful in promoting an efficient and productive economy. However, such delegation also means that **the principal needs to place trust in an agent to act in the principal's best interests.**

AGENCY COSTS

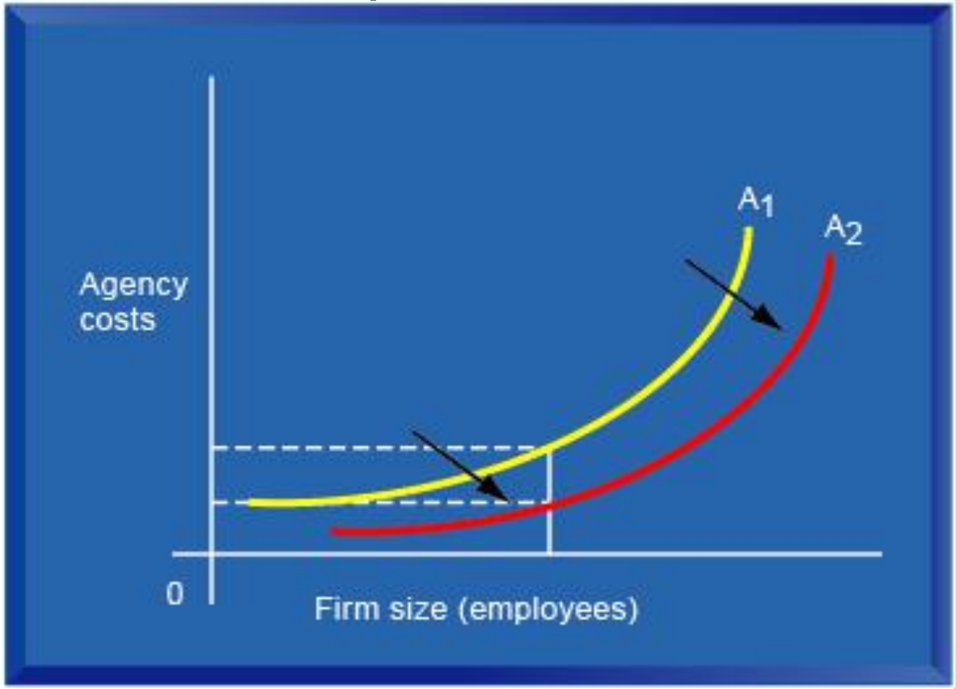
- the failure of employees (as ‘agents’), hired by the owners (the ‘principals’) of a business, to fully
comply with the terms and responsibilities stipulated in their contract of employment.
- Agency costs are best reduced by providing appropriate in centive to align the interests of both agents and principals.

Agency costs

- Agency costs are internal costs incurred from asymmetric information or conflicts of interest between principals and agents in an organization.
- In a corporation, the principals would be the shareholders and the agents would be the managers. The shareholders want the managers to run the company in a way that maximizes shareholder value. The managers, on the other hand, may want to run the company in a way that maximizes the managers' own personal power or wealth, even if it lowers the market value of the company. **These divergent interests can result in agency costs. There are three common types of agency costs: monitoring, bonding, and residual loss**.

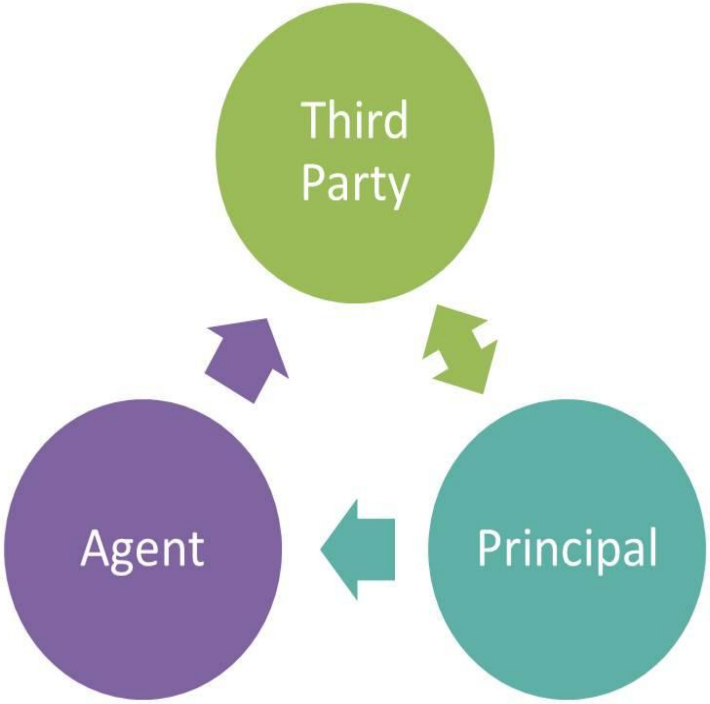
Agency costs

- **Monitoring costs** are incurred when the principals attempt to monitor or restrict the actions of agents.
- **Bonding costs** are incurred by the agent. An agent may commit to contractual obligations that limit or restrict the agent’s activity.
- **Residual losses** are the costs incurred from divergent principal and agent interests despite the use of monitoring and bonding.



AGENCY THEORY

- A simple agency model suggests that, as a result of information asymmetries and self-interest, principals lack reasons to trust their agents and will seek to resolve these concerns by putting in place mechanisms to align the interests of agents with principals and to reduce the scope for information asymmetries and opportunistic behaviour.



Conflict of interests: agents vs principals

- Agents are likely to have different motives to principals.
- They may be influenced by factors such as financial rewards, labour market opportunities, and relationships with other parties that are not directly relevant to principals. This can, for example, result in a tendency for agents to be more optimistic about the economic performance of an entity or their performance under a contract than the reality would suggest.
- Agents may also be more risk averse than principals. As a result of these differing interests, agents may have an incentive to bias information flows.
- Principals may also express concerns about information asymmetries where agents are in possession of information to which principals do not have access.

Trust in agents

- Differing motivations and information asymmetries lead to concern about <u>the reliability of information, which impacts on the level of trust that principals will have in their agents</u>.
- There are various <u>mechanisms that may be used to try to align the interests of agents with principals and to allow principals to measure and control the behaviour of their agents and reinforce trust in agents</u>.

Mechanisms

- In such scenarios the basic salary is likely to be set at a relatively low level, but it would go hand in hand with a package of other benefits which might include bonuses and share options.
- Such mechanisms, however, create potential new agency problems related to the measurement of performance. Duties can be written into contracts and made the subject of enforcement and penalties or an alternative is to embody the duties of agents in statute (and introduce sanctions for those who do not comply), such as duties placed on directors under company law.

AUDIT: THE SOLUTION OF THE PROBLEM

- The less trust there is in an agent the more likely it is that principals will opt for certain performance-related pay measures and incentives that will align interests.
- An audit provides an independent check on the work of agents and of the information provided by an agent, which helps to maintain confidence and trust.

The simplest agency model

- assumes that **no agents are trustworthy and if an agent can make himself better off at the expense of a principal then he will.**
- This ignores the likelihood that <u>some agents will in fact be trustworthy and will work in their principals' interests whether or not their performance is monitored and output measured.</u>
- <u>The degree of untrustworthiness is therefore a key factor in determining the extent to which incentives and monitoring mechanisms need to be put in place.</u>

EXPLANATION

- A company has a board of directors (the agents) and a body of shareholders (the principals). The directors have been delegated responsibility for managing the affairs of the company. Control of a company may be divorced from its ownership.
- In effect, directors act as trustees for shareholders. They are bound by certain duties that are established in common law and under statute. Currently directors' fiduciary duties, such as acting in good faith and in the best interests of the company, are found in common law.

THE FINANCIAL STATEMENTS

- The **financial statements** are the primary mechanism for shareholders to monitor the performance of directors.
- However, as a result of the separation of ownership and control, problems with information asymmetries and differing motives, there may be **tension in the shareholder-director relationship.**

AUDIT IN MAINTAINING CONFIDENCE AND REINFORCING TRUST

- Shareholders have limited access to information about the operations of a company and may believe, therefore, that they are not getting the right information they need to make informed decisions or that the information being provided by way of the financial statements is biased.
- As such, shareholders may lack trust in the directors and in such a situation the benefits of an **audit in maintaining confidence and reinforcing trust are likely to be perceived as outweighing the costs.**

AUDIT: OBJECTIVE

- Auditors are appointed by and report to the shareholders of the company.
- The auditors provide an independent report to the shareholders on the truth and fairness of the financial statements that are prepared by the board of directors.

AUDIT: OBJECTIVE

- audit therefore plays a fundamental stewardship role;
- auditors are directly accountable and hence owe a duty of care to the company's existing shareholders as a body.
- Auditors are engaged as agents under contract but they are expected to be independent of the agents who manage the operations of the business. The primary purpose of audited accounts in this context is one of accountability and audits help to reinforce trust and promote stability.

Simple agency theory limitations

- If as simple agency theory implies, principals do not trust agents to provide them with reliable and relevant information, then they will hire in external experts, who are independent of these agents.
- This, however, introduces the concept of auditors as agents of principals, which leads to new concerns about trust, threats to objectivity and independence.
- Auditors act as agents to principals when performing an audit and this relationship therefore brings with it similar concerns with regard to trust and confidence as the director-shareholder relationship, prompting questions about who is auditing the auditor.

Trust in a simple agency model

- Agents (whether they are directors or auditors) may be trustworthy without a need for further incentives to align interests or monitoring mechanisms such as audit or increased regulation.
- However, the simple agency model would suggest that agents are untrustworthy. Like directors, auditors will have their own interests and motives to consider.

The dual character of audit

- Auditor independence from the board of directors is of great importance to shareholders and is seen as a key factor in helping to deliver audit quality. However, an audit necessitates a close working relationship with the board of directors of a company.
- The fostering of this close relationship has led (and continues to lead) shareholders to question the perceived and actual independence of auditors and to demand tougher controls and standards.
- Auditors have an important incentive to maintain independence to protect their reputation.

Financial reporting

Financial reporting was intended to act as a substitute for the lack of shareholder rights in state law.

Audits are performed to provide protection against the provision of false information to the market influencing share price. However, problems arise as markets are inherently unstable and fluctuate and they do not, therefore, act like principals.

Dependent and independent auditors

- Companies are required to place certain financial information on the public record. This generates public interest in the information provided and its audit, beyond that of the shareholders.
- Whilst auditors carrying out a statutory audit of financial statements are accountable and report to the shareholders of a company only, there may be other stakeholders who believe that an independent audit provides some means of ensuring that the company's responsibilities to them are being met; in effect that it serves their interests too.
- There is also an expectation among these other stakeholders that auditors should be independent of shareholders. These other stakeholders may or may not have a contractual relationship with the company.

Statutory and non-statutory purposes

- Stakeholders such as creditors, lenders, credit agencies, customers and employees may claim an interest in the audit.
- <u>Some contracting parties may be forced to enter into separate contracts because the statutory audit is not deemed suitable for their purpose.</u>
- Other contracting parties may want <u>the ability to commission an audit for a particular non-statutory purpose.</u>

CONFIDENCE AND TRUST

- It is clear that audits serve a fundamental purpose in promoting <u>confidence and trust in certain financial information in financial statements.</u>
- <u>Concern about trust and the reliability of financial information helps to explain why the audit is seen as an important mechanism for shareholders</u> to help ensure that the directors are running the company in the shareholders’ best interests.

Unaudited information

- Some financial information provided to shareholders remains unaudited.
- Shareholders must clearly have some trust in directors to accept this information or must believe that the benefits resulting from an audit in these areas would not outweigh the costs.

The expansion of the model

- Shareholders have a critical interest in the audit as a check on their agents.
- However, further analysis reveals a more complex picture. Other stakeholders including regulators, boards of directors and other third parties, who may or may not be in a contractual relationship with the company, and the auditors have an interest in the audit.
- **The simple agency model needs to be expanded to address the interests and expectations of these other parties.**

ASSUMPTIONS

- We know that an audit is of value to a variety of stakeholders to engender trust and confidence, but for many different purposes, which do not fit into the simple agency model.
- The corporate world is complex.
- Companies' financial information is publicly available and other stakeholders such as regulators, creditors and lenders will therefore claim an interest in it and the audit.

ASSUMPTIONS

- The expectations of stakeholders and their understanding of the purpose of an audit may be significantly at odds with those of shareholders or auditors, or indeed regulators and stakeholders in other countries.
- This in turn impacts on the varying demands for improvements in audit quality.
- Auditors are agents too and will have their own motives and interests which, if the simple agency model was applied, would result in a lack of trust in auditors and an ongoing need to find further mechanisms for aligning the interests of shareholders, directors and auditors. **This cycle can only ever be broken if trust in agents is established.**

DIFFERENT INTERESTS IN AUDITS

- Different interests have implications for the use of global and principle-based standards on auditing.
- If there is no consistent and agreed purpose of an audit then difficulties arise when trying to develop, maintain and apply a global set of universally accepted auditing standards. This also impacts on audit reporting.

3. Financial Statements Audit

Financial statement audit

- An independent financial statement audit is conducted by a registered public accounting firm.
- It includes examining, on a test basis, evidence supporting the amounts and disclosures in the company's financial statements, an assessment of the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation to form an opinion on whether the **financial statements taken as a whole are free of material misstatement**.

INTERNAL CONTROL OVER FINANCIAL REPORTING (ICFR)

- An important **element of the framework that company management maintains to enable it to produce reliable financial statements** is **internal control over financial reporting (ICFR).**
- Management is also required <u>to provide an annual assessment of the effectiveness of its internal control structure and procedures for financial reporting to investors in its annual report.</u>
- **The audit of ICFR is integrated with the audit of the financial statements of the company.**

An Integrated Audit

- ICFR is integrated with an audit of the financial statements (an integrated audit)
- The **objectives of these two types of audits are complementary but not identical.** They are performed by the same audit firm at the same time and are usually "integrated" in the sense that
- procedures supporting the opinion on financial statements are executed concurrently with procedures that involve testing of the related controls.

THE FINANCIAL STATEMENT AUDIT REPORT

- is the culmination of the audit, but it is based on the responsibilities of <u>three distinct but interrelated groups that make up the financial reporting supply chain.</u>

Company Management

Bears the primary responsibility for the company's financial statements. Management also is responsible for implementing and maintaining internal control over financial reporting and for periodically assessing its operating effectiveness.

Audit Committee

Oversees the financial reporting process, including internal control over financial reporting. The audit committee also is responsible for the appointment, compensation, and oversight of the independent auditor. Often, the audit committee oversees the company's internal audit group as well.

Independent Auditor

Provides <u>a public audit report on the company's annual financial statements</u>. That report provides an opinion about whether the financial statements taken as a whole are fairly presented, in all material respects, in accordance with the standards.

<u>Independent auditors are external to the company and must be independent of the organizations</u> they audit in accordance with specific regulations governing their independence. They <u>report directly to the audit committee, which engages them and oversees their work.</u>

All audits are guided by two important factors:

- **reasonable assurance** and
- **materiality**.

These two factors impact the way in which the independent auditor examines, on a test basis, transactions that occurred and controls which functioned during the year.

Assurance

- Because it is not practical for independent auditors to examine every transaction, control and event, there is no guarantee that all material misstatements, whether caused by error or fraud, will be detected. Instead, the audit is designed to provide a level of assurance that is reasonable but not absolute.
- Absolute assurance from the audit is, practically speaking, impossible. Independent auditors cannot test 100 percent, or, in most cases, even a majority of transactions recorded by a company; it would preclude timely financial reporting and be prohibitively expensive and resource intensive.

Materiality

- The concept of materiality <u>is applied in planning and performing the audit, in evaluating the effect of any identified misstatements, and in forming the opinion included in the independent auditor's report</u>.
- Determining materiality <u>involves both quantitative and qualitative considerations.</u>
- The determination of materiality <u>is a matter of professional judgment and is affected by the independent auditor's assessment.</u> Inherent in reaching judgments about materiality is the concept of what a reasonable investor would deem important.
- Materiality: <u>missing or incorrect information in financial statements is considered to have an impact on the decision-making of users.</u>

Types of Audit Procedures

Inspection	The examination of records or documents, whether internal or external, in paper form, electronic or other media, or physically examining an asset. For example, inspecting a sample of invoices.
Observation	Observing a process or procedure being performed by company personnel or others. For example, observing a company's physical inventory count, and re-performing counts on a test basis.
Inquiry	Seeking information from knowledgeable persons in financial or non-financial roles within the company or outside the company.
Confirmation	Obtaining information or representation of an existing condition directly from a knowledgeable third party.
Recalculation	Checking the mathematical accuracy of documents or records.
Analytical procedures	Comparison of recorded amounts, or ratios developed from recorded amounts, to expectations developed by the independent auditor.
Reperformance	The auditor's independent execution of procedures or controls that originally were performed as part of the company's internal control over financial reporting.

FINANCIAL STATEMENT ASSERTIONS CAN BE CLASSIFIED INTO THE FOLLOWING CATEGORIES:

- **Existence or Occurrence:** Assets or liabilities of the company exist at a given date, and recorded transactions have occurred during a given period.
- **Completeness:** All transactions and accounts that should be presented in the financial statements are included.
- **Valuation or Allocation:** Asset, liability, equity, revenue, and expense components have been included in the financial statements at appropriate amounts.
- **Rights and Obligations:** The company holds or controls rights to the assets, and liabilities are obligations of the company at a given date.
- **Presentation and Disclosure:** The components of the financial statements are properly classified, described, and disclosed.

THE AUDIT REPORT: THREE MAIN ELEMENTS

An introduction that identifies the financial statements that were audited and the division of responsibility between the auditor and management.

A discussion of the scope of the engagement, which describes the nature of the audit.

The auditor's opinion on the financial statements.

4. The Role and Risks of Audit. TQM

AUDITING RISKS

- The **auditing risks** one faces in any organisation. It is split into three areas:
  - business risks, including
  - operational risks and
- other (pension management environmental/sustainability) risks.

BUSINESS RISKS

- Strategic risks
- Compliance risks
- Financial risks
- Operational risks

OPERATIONAL RISKS

- People risk
- Third party risk
- Infrastructure risk
- Information technology risk
- Security risk
- Change risk
- Financial prudence risk
- Financial crime risk

SPECIFIC RISKS IN AUDITING

- **Audit risk** can be defined as the risk that the auditor **will not discern errors or intentional miscalculations during the process of reviewing the financial statements of a company or an individual.** The audit risk generally features two categories – <u>risk regarding evaluation of financial materials</u> and <u>risk regarding the affirmations created by evaluation of financial documents.</u>

Inherent Risk

- **Inherent Risk** is <u>the risk of a material misstatement in the financial statements arising due to error or omission as a result of factors other than the failure of controls</u> (factors that may cause a misstatement due to absence or lapse of controls are considered separately in the assessment of control risk).
- *For example, amounts that are based on highly subjective accounting estimates or the application of complex accounting standards have a higher risk of being materially misstated than amounts that are more objective in nature and based on relatively uncomplicated, well-established accounting standards.*

Control Risk

- **Control Risk** is the risk of a material misstatement in the financial statements arising due to absence or failure in the operation of relevant controls of the entity.
- Organizations must have adequate internal controls in place to prevent and detect instances of fraud and error. Control risk is considered to be high where the audit entity does not have adequate internal controls to prevent and detect instances of fraud and error in the financial statements.
- *Assessment of control risk may be higher for example in case of a small sized entity in which segregation of duties is not well defined and the financial statements are prepared by individuals who do not have the necessary technical knowledge of accounting and finance.*

Detection Risk

- **Detection Risk** is the risk that the auditors fail to detect a material misstatement in the financial statements.
- An auditor must apply audit procedures to detect material misstatements in the financial statements whether due to fraud or error.
- Misapplication or omission of critical audit procedures may result in a material misstatement remaining undetected by the auditor.
- *Some detection risk is always present due to the inherent limitations of the audit such as the use of sampling for the selection of transactions. Detection risk can be reduced by auditors by increasing the number of sampled transactions for detailed testing.*

AUDIT RISK

- is the risk that the auditor expresses an <u>inappropriate audit opinion when the company's financial statements are materially misstated.</u>
- The independent auditor seeks to <u>reduce the level of detection risk through the nature, timing, and extent of the audit tests performed.</u>
- <u>**Inherent and control risk are functions of the company and its environment while detection risk is not.**</u>

Model

- **Audit Risk = Inherent Risk x Control Risk x Detection Risk**

- **Audit risk model** is used by the auditors to manage the overall risk of an audit engagement.
- Auditors proceed by examining the inherent and control risks pertaining to an audit engagement while gaining an understanding of the entity and its environment.

Explanation

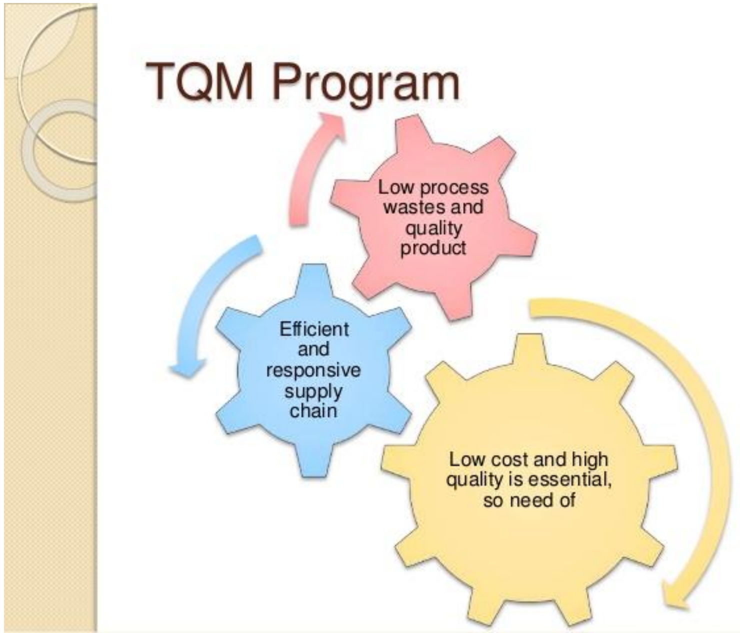
- Detection risk forms the residual risk after taking into consideration the inherent and control risks pertaining to the audit engagement and the overall audit risk that the auditor is willing to accept.
- Where the auditor's assessment of inherent and control risk is high, the detection risk is set at a lower level to keep the audit risk at an acceptable level. Lower detection risk may be achieved by increasing the sample size for audit testing.
- Conversely, where the auditor believes the inherent and control risks of an engagement to be low, detection risk is allowed to be set at a relatively higher level.

TOTAL QUALITY MANAGEMENT (TQM)

- Total Quality Management is a management approach that originated in the 1950s and has steadily become more popular since the early 1980s.
- Total Quality is a description of the culture, attitude and organization of a company that strives to provide customers with products and services that satisfy their needs.

TOTAL QUALITY MANAGEMENT (TQM)

- is a set of ideas and methods, which include all aspects of work within the enterprise employed to achieve the development and continuous improvement in quality levels for all products and processes.
- The goal is to gain the achievement of customer satisfaction and increase production; thus, strengthen the competitive performance of the business. This is possible by focusing on the system of TQM.



Total Quality management aids

- to improve performance and facilitate communication, collaboration and participation within organizations of elements;
- ultimately, leading to achievement of quality requirements by creating an environment supported by quality and continued focus on improvement of all sectors of organization.

ISO

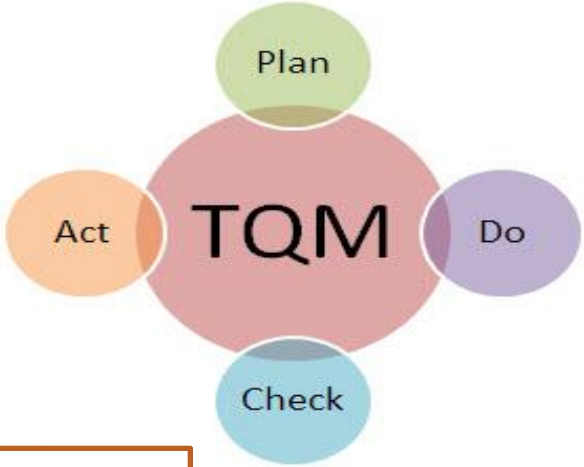
International Organization for Standardization

TQM AND AUDIT

- TQM system is largest and widest utilized of various process of quality control; namely because it allows
- internal audit department to focus on overall objective,
- to use results to improve performance and to help maintain TQM.

TQM AND AUDIT

- *Internal audit department must gain access to an efficient and effective performance of professional services*.
- This means that *TQM creates substantial benefits of sections of the internal audit, internal auditors, and their organizations;* the <u>largest being the continuous improvement of their services.</u>



Thanks for Your Attention!