Risk assessment

AAS 6 defines three types of risk-

- Inherent risk- It is the susceptibility of an account balance or transaction to misstatements, e.g. generally cash bears more inherent risk than transactions through bank.
- Control risk- It is the risk that the internal control will fail to detect a material misstatement. It is the risk that internal control would fail to function properly.
- Detection risk.- It is the risk that the substantive procedures applied by the auditor could not detect an existent misstatement.

It would not be wrong to say that these three types of risks will directly put an effect upon the audit risk, which precisely is the risk of an inappropriate audit opinion, by the auditor. The relation of direct bearing could be proved as below: -

Relation between different types of risks

Let,
Rm- risk of misstatements i.e. inherent risk.
De- chances of detection of misstatements by the entity.
Da- chances of detection of misstatements by the auditor.

So it can be concluded that-
1-P(De)- probability of error not being detected by the entity,
i.e. in other words, the internal controls are ineffective.
i.e. control risk.

1-P(Da)- probability that error will not be detected by the auditor,
i.e. detection risk.

Now, the chances of misstatements remaining after conclusion of audit, i.e. the audit risk would be,

(Risk of misstatements)(Chances of non-detection by entity)(Chances of non-detection by auditor)

Or, in other words,

AR= IR x CR x DR

Where,
AR - audit risk
IR - inherent risk
CR- control risk
DR- detection risk.

Illustration

Let,

Risk of misstatements	30%
Chances of detection by internal control	70%
Chances of detection by auditor	80%

Then,

Audit risk= 0.30(1-0.70)(1-0.80)

= 0.30 X 0.30 X 0.20

= 0.018

Or, 1.8%

This is how; the audit risk could be measured by quantification technique.
To reduce the audit risk, either control risk, or detection risk should be decreased, because, inherent risk could not be practically reduced with certainty.

However, practically, it may not be appropriate to say that each and every auditor could assess the risk range in such a chronic manner. So it is a general practice to usually assess it in comparative terms (like high, medium, low etc.). The procedure of risk assessment by comparative terms involves the preparation of a special instrument, which could be termed as the risk register, or the risk sheet.

The risk register/risk sheet

The risk register is an effective equipment that could help the auditor to ascertain risk in a better way. This register should generally be prepared by "higher audit staff" bearing a good knowledge about the entity by virtue of his experience or otherwise. The results achieved by the risk sheet should form an integral part of the audit programme, which will guide the lower audit staff about the kind and extent of audit procedure. This risk register should form a part of the permanent audit file, and should be updated on yearly basis in order to achieve the best out of them.

The risk register should respect materiality, and would be compared with expected frequency of its occurrence. The combined analysis will provide a line of safety, below which, minimal concern on the part of the auditor is needed. Above this point there are various care level to be kept in mind, while framing the nature timing and extent of substantive procedures.

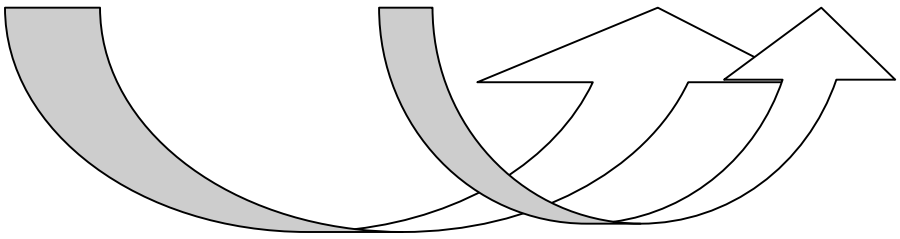
The risk register illustrated next, is just meant for illustrative purpose. The type and content of actual risk register may include or exclude such other details as the auditor deems fit.

STEP 1 - The auditor should first quantify the likelihood and consequences of risk in order to facilitate proper mapping. A sample scale of quantification is contained in table 1. Here in this scale, the auditor should quantify both the consequences of risk, and it's likelihood of occurring. The quantified assessments will then be used to derive the scale of acceptability as follows-

Scale multiplier (S)= consequence of risk x likelihood of risk.

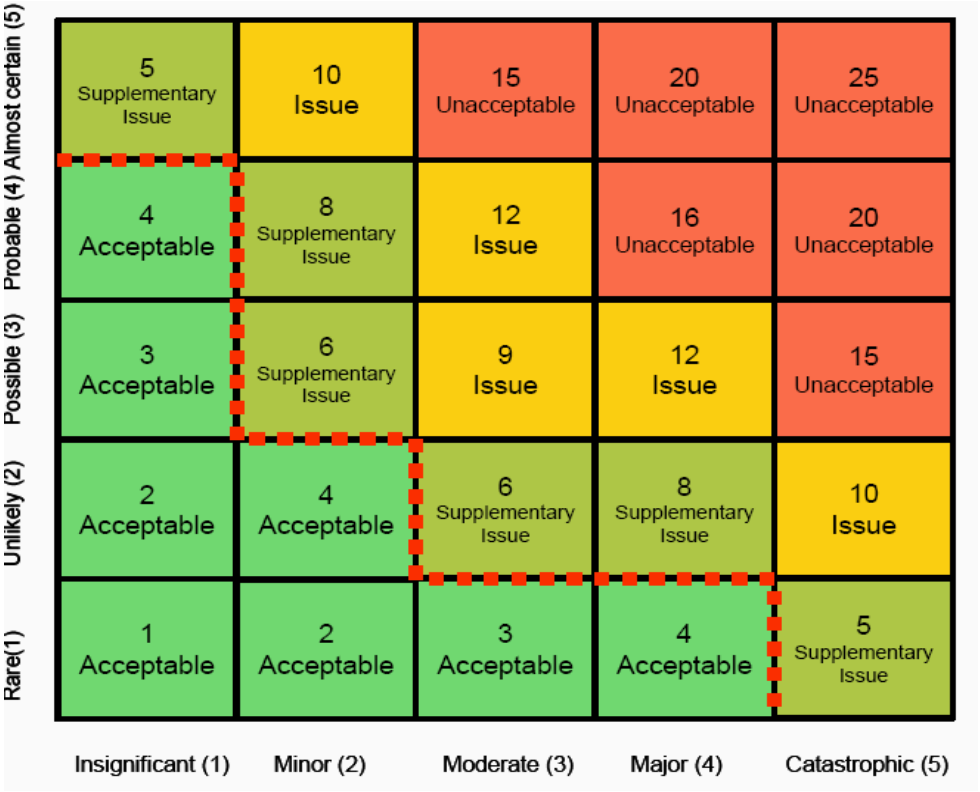
Table 1: The risk scale

Consequences of risk	OR the likelihood of risk occurring	Defined measure
To close down the organisation, or a significant part, for a very long Period	Almost certain	Very high (1)
To prevent the organisation achieving a major part of its Objectives for a long time	Probable	High (2)
To stop the organisation achieving its some of its objectives for a limited period	Possible	Medium (3)
To cause inconvenience but not affecting the achievement of significant objectives	Unlikely	Low (4)
To cause very minor inconvenience, not affecting the achievement of objectives	Rare	Very low (5)



STEP 2 - After the scale multiplier is determined, it would be searched in a predetermined risk map (see table 2). The risk map will depict the degree of substantive procedures, which is required to be carried out. The final verdict upon the substantive would be would be formulated, with the help of a risk-degree scale (see table 3). On a case-to-case basis, the HAS will determine all the relevant risk-degree scales, on the basis of their previous audit experience and professional skeptism.

Table 2: risk mapping



Likelihood of risk Vs Consequences of risk.

This is a sample risk mapping, with various possible scale multipliers (S). The extent of substantive procedures will depend accordingly. The acceptability of risk can be enumerated as under-

Table 3: Risk-degree scale

Scale multiplier (S)	**Degree of risk**	**Substantive procedures**
1-4	Acceptable	Low
5-8	Supplementary issue	High
9-12	Issue	Higher
13-25	Unacceptable	Highest

Line Of Safety

This line of safety is the point below which there is no concern is required on the part of the auditor.

STEP 3- the audit assistants will be provided with the final verdict upon the risk situation, which will be provided through an additional fact in the audit programme.

STEP 4- during the course of audit procedure if the assessment changes, it should be the duty of the auditor to revise the assessments as per Table-1.

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