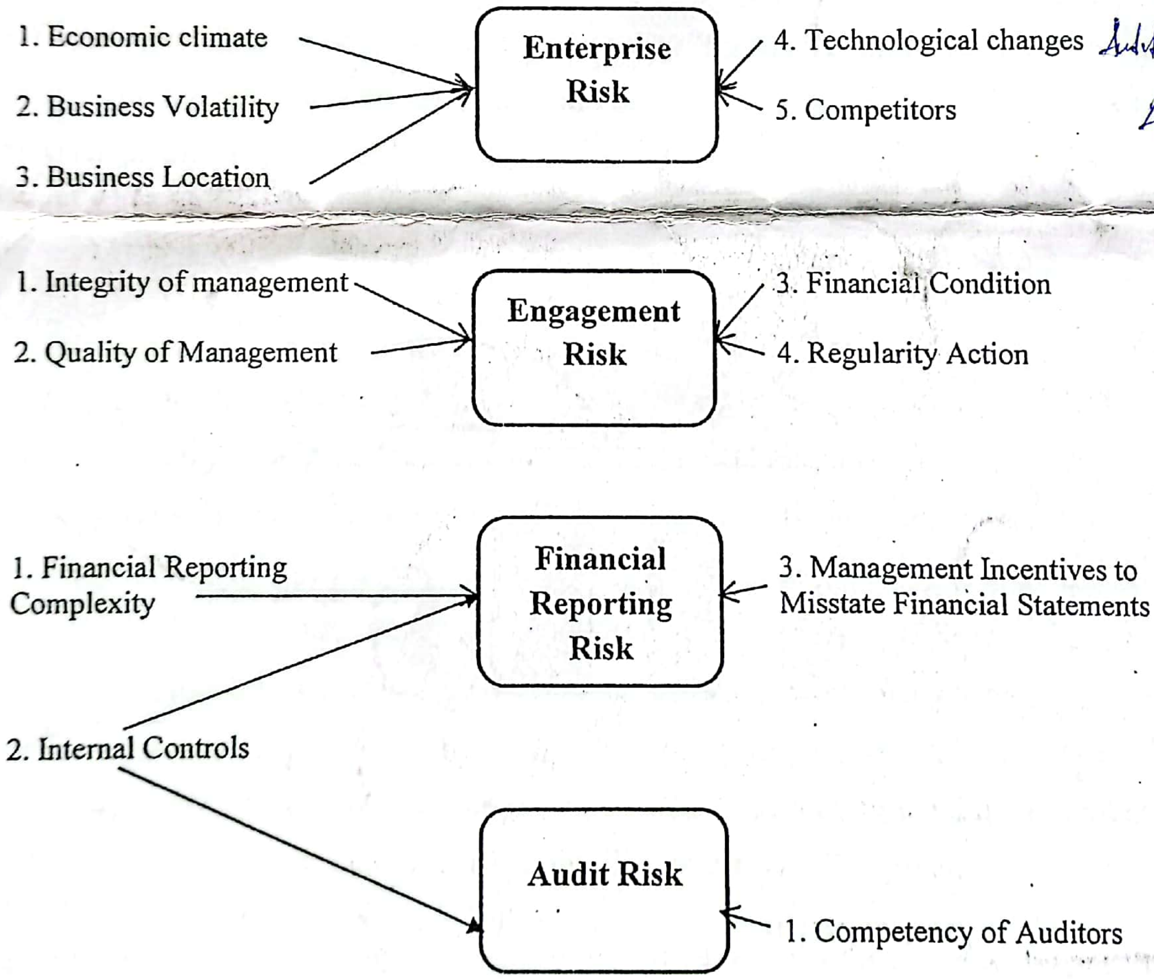
Business Risk, Auditors Engagements and Audit Risk

The four critical components of risk that will affect the audit approach are illustrated in **Figure 1.** They are the enterprise risk; engagement risk; financial reporting risk and the audit risk. ***Enterprise risks*** are those risks that affect the operations of the business while ***engagement risks*** are the auditors encounter by being associated with a particular client. Engagement risks is the risk that the auditor is exposed to financial loss, or damage to his or her professional reputation from litigation, adverse publicity, or other events arising in connection with financial statements audited and reported on. ***Financial reporting risks*** are those risks that relate directly to the recording of transactions and the presentation of financial data in an entity's financial statements.

Partner
Manager 1 Manager 2
Auditor Auditor Auditor
Auditor Auditor Auditor

Figure 1, Overview of Risk Elements affecting an Audit



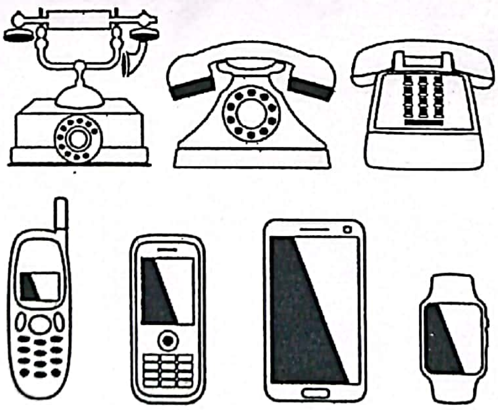
Without following auditing standards the auditor issue wrong · Audit failure
Audit Risk

Audit risk is the risk that the auditor may provide an unmodified (clean) opinion on the financial statements that are materially misstated.

Each of the risk components is interrelated to other components and more importantly each component of risk can be managed. The effectiveness of risk management process will determine whether a company continues to survive. Some of the basic risk relationships that an auditor must understand in planning and conducting the audit are illustrated in **Figure 1.** The first box in Figure 1 demonstrates that an entity is faced by a number of business risks such as the economic climate, business volatility, business location, technological changes as well as its competitors.

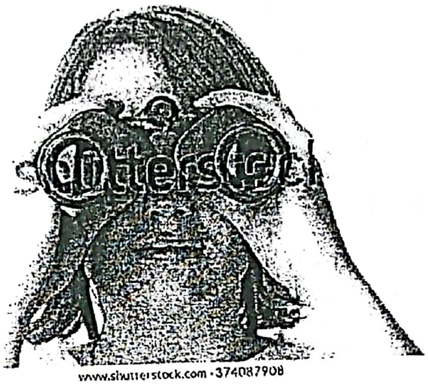
Enterprise (Business) Risk

Auditing standards define business risk as a risk resulting from significant conditions, events, circumstances, actions or inactions that could adversely affect an entity's ability to achieve its objectives and execute its strategies, or from the setting of inappropriate objectives and strategies (ISA 315). For instance, ***technological changes*** represent a high risk for a company where technology develops at an amazingly fast speed such as a telephone trading company. This is because the devices produced yesterday become out-of-date very fast and loose market. History indicates that devices that have only one use like calculators, alarm clocks and cameras were good yesterday but today they are being replaced by smartphones. Phone chargers and with cords



are also fading out in favor of wireless models. There is a chance that remote charging may soon become a reality. Chargers that will soon become unnecessary People will be able to charge their phone from anywhere without any physical contact at all.

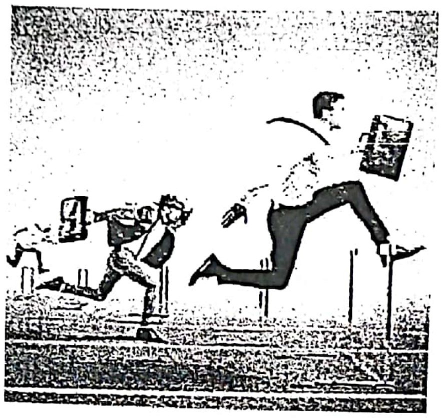
While we are not sure what idly innovative ideas the future will bring, but there is a pretty good sense of which devices will fall into to disuse. Here are few things that will probably be obsolete by 2022: Fax machines, CDs and DVDs. Gold rings and gold chains will also be obsolete because the yellow metal is slowly disappearing from earth's surface, and miners are pulling themselves out of this business By 2030 there won't be any privacy because wherever you are, wherever you go, with the advancement of the Internet of Things (IoT) technology you will always be under watch. It will not make any difference if you have logged out or go offline.



By 2040 Fast-Food workers will also be looking for a job change because. Taking orders, preparing meals, and serving guests are jobs that will be handled by robots while touch screens will be installed for selecting items from the menu, your meal will be assembled by the bots themselves.

In a global market, businesses face a number of ***competitions.*** Business Competition is the contest among businesses selling similar products and targeting the same buyers to gain more market share compared to others. Competitors will try to win market share by cutting costs, improving efficiency, lowering price and innovating by either creating new products and services or improving upon old ones. Business competition can be fierce, especially in markets with aggressive competitors and when customer spending is slowing down. Increased competition can create lower market share and fewer profits for any company. It makes a business overspend on marketing and other promotional strategies to persuade the customers, and business partners..

Businesses that plan for growth or invest in new technology (innovative) are more successful than businesses that stand still. Companies that experience innovation success grab onto it and believe that it is their secret to everlasting success. Unfortunately, this is not the case. On the other hand an unwillingness to innovate puts any company at risk of failure, but refusing to evolve with the market can be even more devastating. "*Without a robust and resilient innovation strategy, no company can survive*. Former industry heavyweights such as Blackberry and Nokia have all been laid low after being faced with aggressive competitors.



Coca-Cola and Pepsi-Cola are other biggest rivals in the history of businesses.

Economic turmoil may put an enterprise at risk because a country may find itself without proper finances and most may be poor. ***Commodity volatility*** can put an enterprise at high risks as the prices of commodities may rise or fall sharply within a short term period. Geographical location is also a potential risk for enterprises for a number of reasons such as crimes threats, availability of reliable security, local politics, and high competitions and availably of reliable customers.

Enterprise risk, in turn, affects the auditors' assessment of engagement risk, that is, whether is is too risky for an auditor to be associated with a client because such association will likely have an adverse effect on the auditor. It is the responsibility of the management to properly manage enterprise risk. It is believed that good management can manage risk the risk better. Conversely weak management can worsen the risk (make it more likely to happen).

Engagement Risk

Engagement risk has been defined as the risk that the auditor might incur by being associated with a particular client. As shown in **figure: 1** engagement risk is influenced by:

- The integrity and quality of management. Specifically, management with questionable integrity increases the engagement risk.
- Financial condition of the company. For example, if a company is on the brink of declaring bankruptcy, it is more likely that the auditor's opinion will be questioned+-

If the auditor questions management integrity, then the auditor cannot trust management responses to audit questions and there is a likelihood that management will try to cover up financial misstatements. Auditors have discovered that being associated with companies with poor` integrity creates risks that can destroy the auditor or significantly increase costs.

Auditors Responses to Engagement Risks

The auditor reacts to high engagement risks by:

- Not associating with high risk audit clients. That is referred to as the "client acceptance or retention decision, or
- Setting audit risk low, that is, to manage the risk of materially misstated financial statements by increasing amount of audit work to render an audit opinion.

There are several factors that affect the auditor's decisions to accept or retain an audit client, but most factors revolve around management integrity, management competence, the company's risk management process, corporate governance and the financial condition of a company.

Financial Reporting Risk

Financial reporting is the process of reporting the profit or loss and the financial position of a reporting entity. Financial data is the name given to the record of actual transactions carried out by a business e.g. sales of goods, purchases of goods, payment of expenses

The key factors that affect financial reporting risk include:

Detecting
Collective
Preventive

- The quality of the company's internal control
- The complexity of the company's transactions and financial reporting
- Management's motivation to misstate the financial statements
- The company's financial health

Accepting New Clients: Reducing Risks

Current auditing standards on "Audit Firm Changes" require a successor auditor to discuss with the predecessor auditor to gain an understanding of the reasons for the change. Because of the confidentiality rule, the successor auditor must obtain the clients permission to talk to the predecessor auditor. The auditor is particularly interested in determining whether there was any disagreement with the client on auditing or accounting procedures that would have led to the auditor's dismissal or resignation. Auditing standards requires the focus on the following: integrity of Management; disagreement with management on accounting or auditing procedures

(Engagement risk)

1: Engagement risk is the risk that auditors encounter by being associated with a particular client: which of the following would not be considered an engagement risk?

A: loss of reputation

B: inability of the client to pay the auditor

C: financial loss because management is not honest and inhibits the audit process

D: Technological changes

2: Engagement risk means that it may be too risky for an auditor to be associated with a client because such association will likely have an adverse effect on the auditor. Engagement risk is influenced by several factors. Which of the following do not influence engagement risk?

A: the integrity and quality of management
B: The current financial position of the client
C: if the company is on the verge of declaring bankruptcy
D: Geographic location of the client

3: Engagement risk has been defined as a risk (resulting in a potential loss) that an auditor might incur by being associated with a particular client. Engagement risk is most likely not increased when an audit firm is associated with the following:

A: management with questionable integrity
B: a failed company, e.g., a company files for bankruptcy
C: a materially misstated financial statement
D: a company with strongly effective corporate governance

4: Audit firms understand that being associated with companies with poor integrity creates risk that can destroy the firms. Thus each year they take several measures to address the risky clients. Which of the following measures is not related to the avoidance of risky clients?

A: establish a client acceptance procedure and decide whether to accept a client
B: establish a client retention procedure and decide whether to retain a client
C: avoids all companies that have questionable management integrity
D: Choice "C" is the only right answer

5: The auditor responds to high engagement risks in one of the two ways. Which of the following responses is (are) true?

(i) to effectively manage engagement risk by not associating with "high risk" audit client ("client acceptance or retention decision")

(ii) by setting audit risk low, i.e., to manage the risk of materially misstated financial statements by increasing an amount of audit work

A: (i) only
B: (ii) only
C: (i) and (ii) and simultaneously
D: (i) or (ii) but separately

6: Which of the following factors do not influence the auditors' decision to accept or retain the audit client?

A: management integrity
B: management competence
C: the company's risk management process
D: the industry in which the client is operating

7: There are a number of factors that affect the auditor's decision to accept or retain an audit client. The main factors include:

A: the effectiveness of corporate governance
B: the industry (type of business) in which the client is operating
C: the location of the client
D: All the above

8: The quality of corporate governance is often considered as a major factor in determining whether to accept or retain an audit client. The key factors that a CPA will analyse regarding corporate governance include all of the following except the following:

A Management integrity
B: the geographical location of the business
C: quality of management's risk management
D: independence and competence of the board of directors

Communications Before Successor Auditor Accepts Engagement

The term predecessor auditor refers to an auditor who (a) has reported on the most recent audited was engaged to perform an audit of the financial statements and has resigned, declined to stand for reappointment, or been notified that his or her services have been, or may be, terminated.

The term successor auditor refers to an auditor who is considering accepting an engagement to audit financial statements but has not communicated with the predecessor auditor as provided as required by auditing standard.

An auditor should not accept an engagement until he or she has communicated with the predecessor auditor.

Auditing standards require the auditor to advise the prospective client that acceptance cannot be final until the communications have been evaluated.

Inquiry of the predecessor auditor is a necessary procedure because the predecessor auditor may be able to provide information that will assist the successor auditor in determining whether to accept the engagement.

The successor auditor should make specific and reasonable inquiries of the predecessor auditor regarding matters that will assist the successor auditor in determining whether to accept the engagement.

The initiative for communicating rests with the successor auditor.

The communication may be written or oral. Both the predecessor and successor auditors should hold in confidence information obtained from each other.

Matters subject to inquiry should include:-
—Information about the integrity of management.
—Disagreements with management as to accounting principles, auditing procedures, etc.
—Communications to those charged with governance regarding fraud and illegal acts by clients.
—The predecessor auditor's understanding as to the reasons for the change of auditors.

The successor auditor should request permission from the prospective client to make an inquiry of the predecessor auditor prior to final acceptance of the engagement. In addition, the successor auditor should ask the prospective client to authorize the predecessor auditor to respond fully to the successor auditor's inquiries.

If a prospective client refuses to permit the predecessor auditor to respond or limits the response, the successor auditor should inquire as to the reasons and consider the implications of that refusal in deciding whether to accept the engagement. The predecessor auditor should respond promptly and fully, on the basis of known facts, to the successor auditor's reasonable inquiries.

However, should the predecessor auditor decide, due to unusual circumstances such as impending, threatened, or potential litigation; disciplinary proceedings; or other unusual circumstances, not to respond fully to the inquiries, the predecessor auditor should clearly state that the response is limited.

If the successor auditor receives a limited response, its implications should be considered in deciding

TEST QUESTION

Past exam question BTX3 and BAC3

Ngarawa audit firm had been an auditor for Amazing Adventures, Inc. for a long time. However, in 2016, Ngarawa did not accept a re-election as an auditor for Amazing Adventures, Inc. As a result Sigala audit firm was appointed an auditor in 2017

Read the above Paragraphs and Answer the 4 Questions Related to the *Change of Auditors*

03 As a successor auditor, Sigala audit firm is required to initiate a communication with Ngarawa audit firm to find out reasons that made the firm to decline re-election with Amazing Adventures, Inc. For such communication to be binding and effective, all of the following actions should be fulfilled **except;**

A Sigala audit firm should request permission from the Amazing Adventures, Inc. to make an inquiry of Ngarawa audit firm prior to acceptance of the engagement

B Sigala audit firm should ask the Amazing Adventures, Inc, to authorize the Ngarawa audit firm to respond fully to the Sigala audit firm's inquiries

C The Amazing Adventures, Inc. should initiate the Sigala-Ngarawa audit firms communication. This is because the Sigala and Ngarawa do not know each other

D Both Sigala and Ngarawa audit firms should hold in confidence information obtained from each other

04 In the Sigala and Ngarawa audit firms, the Sigala audit firm should make specific inquiries of the Ngarawa audit firm regarding matters that will assist the Sigala audit firm in determining whether to accept the engagement. The Sigala audit firm is particularly interested in all of the following **except;**

A Information about the integrity of the management of the Amazing Adventures, Inc., for example, involvement in creative accounting.

B Disagreements with management as to accounting principles, auditing procedures, or other similarly significant matters

C The Ngarawa audit firm's understanding as to the reasons for the change of auditors (i.e. not seek re-election)

D Whether the Amazing Adventures Inc. is involved in politics or not

05. There are several reasons why an audit firm may not seek re-appointment. All of the following pairs of statements, except one, represent reasons why an audit firm may not seek re-appointment. Identify one pair which has one/two incorrect expectations

A (i) The relationship between the auditor and client might have been long-standing. This familiarity threat may impair auditor independence. (ii) If an auditor takes on a new audit client which is a competitor of an existing audit client **(conflict of interest)**

B (i) The audit firm could have outstanding fees which may not be fully recovered due to a client's poor cash flow position. (ii) If the auditor feels that management is acting with extraordinary integrity and highest competence.

C (i) The audit firm may find that it lacks the resources to continue to provide the audit service to a rapidly growing client. (ii) If an audit client buys an overseas company and the auditor does not have a sub office in the overseas location,

D (i) Conflict of interest: If an auditor takes on a new audit client which is a competitor of an existing audit client. (ii) The audit firm could have outstanding fees which may not be fully recovered due to a client's poor cash flow position

06 A predecessor auditor is required to respond fully to the successor auditor's inquiries. But, due to unusual circumstances, the predecessor auditor may decide not to respond fully to the inquiries. Such circumstances include all of the following **except;**

A Impending litigation (court case)

B threatened litigation (legal action)

C potential disciplinary proceedings;

D If the prospective client is involved in dubious business decision

AR = IR X CR X DR

IR ⇒ AE
AR = AE Inverse

07 Which of the following statements is correct with regard to the predecessor- successor communications?

A The successor auditor has no responsibility to contact the predecessor auditor

B The successor auditor should obtain permission from the entity before contacting the predecessor auditor

C The successor auditor should contact the predecessor regardless of whether the prospective client authorizes contact

D The successor auditor need not contact the predecessor if the successor is aware of all available relevant facts.

Answers Pick a pair

(1) A) i) Yes
ii) No) No correct

B) i) Yes . \ ...

(2) A i) Yes
ii) No

B i)

(3) D