When It’s Double Or Nothing In Assessing Audit Risk

Janet L. Colbert

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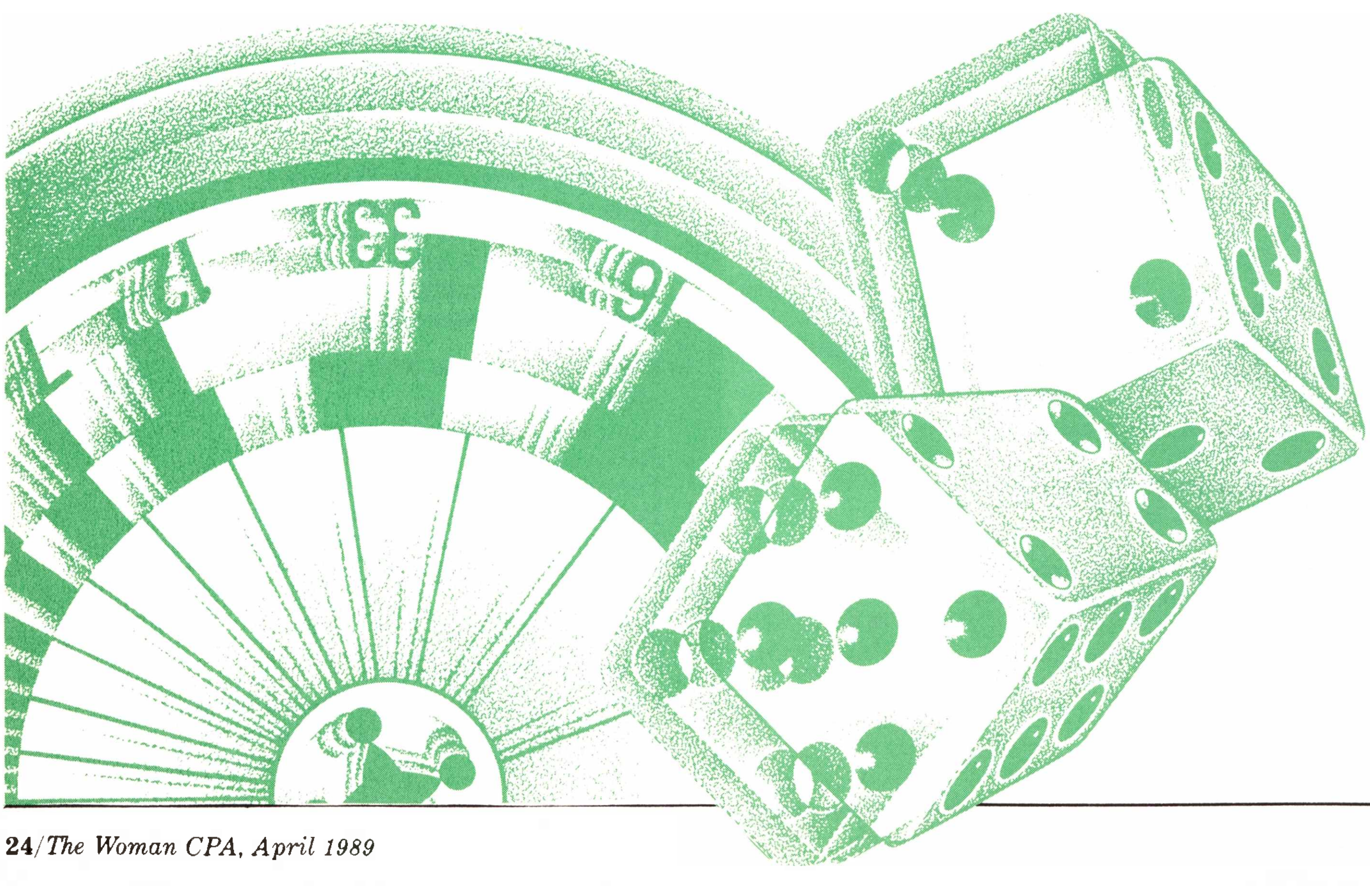
Introduction

In April 1988, the Auditing Standards Board issued Statement on Auditing Standards (SAS) 60 entitled "Communication of Internal Control Structure Related Matters Noted in an Audit" [AICPA, 1988]. The Statement requires the auditor to communicate significant deficiencies in the control structure, or "reportable conditions," to the client's audit committee.

Many matters that the auditor deems to be reportable conditions may also be factors that bear on the auditor's assessment of inherent risk. SAS 47, "Audit Risk and Materiality in Conducting an Audit" [AICPA, 1983], requires the auditor to consider inherent risk when planning the work for an individual account balance or class of transactions. Numerous factors may bear on the auditor's assessment of inherent risk. The purpose of this article is to explore the relationship between reportable conditions and inherent risk factors and to investigate how the conditions/factors that are common to both affect the work of the auditor.

Reportable Conditions

SAS 60 defines reportable conditions as matters that the auditor believes



> . . . represent significant deficiencies in the design or operation of the internal control structure, which could adversely affect the organization's ability to record, process, summarize, and report financial data . . . [para. 2].

Reportable conditions include matters which affect the three elements of the control structure: the control environment, the accounting system, or the specific control procedures.

Under SAS 60, the auditor is required to communicate reportable conditions that are found during the engagement to the audit committee or to individuals who have the authority and responsibility equivalent to that held by an audit committee. While communicating reportable conditions is beneficial to the client, it is not the primary objective of the audit, and users of the financial statements should be aware that auditors are obligated to report only those conditions found in the normal course of the audit engagement. The auditor is not required to perform special procedures to search for reportable conditions.

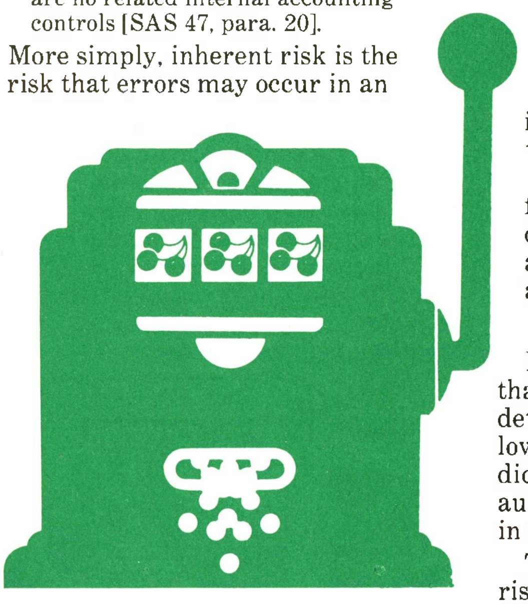
Reportable conditions can be grouped into three categories. The first, deficiencies in control structure design, includes such items as the application of accounting principles, the segregation of duties, and the system's output. The second category covers failures in the operation of the control structure such as evidence of failure to safeguard assets or evidence of intentional misapplication of accounting principles. The final category includes other items the auditor may believe indicate control-related deficiencies. Examples are the client's lack of objectivity in making accounting decisions and the absence of a sufficient level of control consciousness within the client's firm.

Inherent Risk Factors

Inherent risk is the

> . . . susceptibility of an account balance or class of transactions to error that could be material, when aggregated with error in other balances or classes, assuming there are no related internal accounting controls [SAS 47, para. 20].

More simply, inherent risk is the risk that errors may occur in an



audit area without giving consideration to the effect internal controls may have on preventing or detecting the errors.

Inherent risk is one component of audit risk at the individual account balance or class of transactions level. The other risks comprising individual audit risk are control risk and detection risk. Control risk is the risk that once errors have occurred, they are not prevented or detected by the system of internal control. Detection risk is the risk that, given errors have occurred and were not detected by the system of internal control, these errors are not detected by the auditor.

Audit risk at the individual account balance or class of transactions level and its three components can be modeled as follows:

$$AR = IR \times CR \times DR$$

where
AR is audit risk,
IR is inherent risk,
CR is control risk,
DR is detection risk.

This model is derived from the multiplicative model of audit risk found in SAS 39, "Audit Sampling," and updated for the provisions of SAS 47.[1] It is intended to help the auditor plan the work in an audit area.

The model is manipulated as follows to aid the auditor in determining the nature, timing, and extent of testing in an audit area:

$$DR = AR/(IR \times CR)$$

In this format, the model shows that when inherent risk is high, detection risk must be limited to a low level (confidence must be high), dictating that more substantive audit procedures must be applied in the audit area.

The auditor assesses inherent risk by considering factors that bear on that risk. Inherent risk factors may be divided into those that affect many, or all, audit areas (pervasive factors) and those that affect a particular area (account-specific factors).

The factors can be classified into five groups: 1) the environment of the operating entity, 2) the structure of the entity, 3) the characteristics of management and the board of directors of the entity, 4) the financial position and accounting practices of the entity, and 5) auditor concerns and relations.

An example of a pervasive inherent risk factor in the first group is the state of the general economy [Colbert, p. 46]. A depressed economy may concern

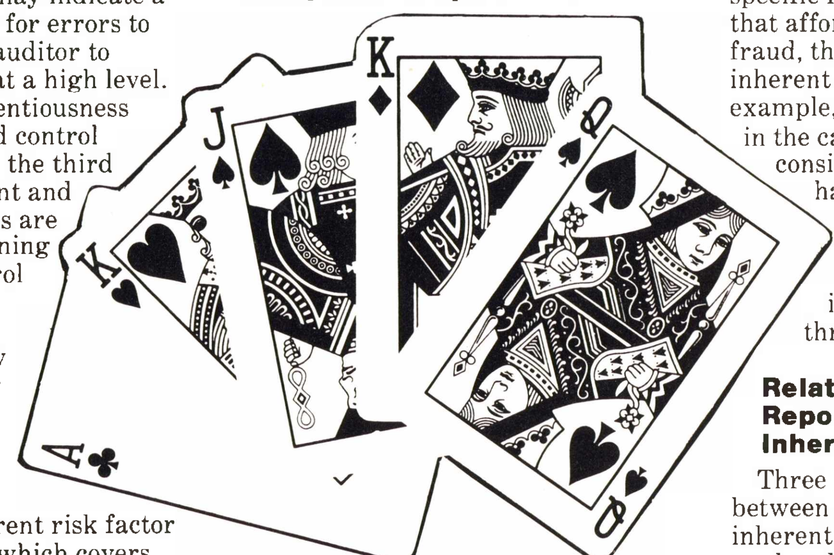
Under SAS 60, the auditor is required to communicate reportable conditions . . . to the audit committee . . .

the auditor and may indicate high inherent risk while a healthy, growing economy may allow the auditor to assess inherent risk at a low level. The second group is the structure of the entity, and one factor in the group is the complexity of the organization. A complex organization (many diverse product lines, various means of distribution, widely scattered locations) may indicate a higher susceptibility for errors to occur and cause the auditor to assess inherent risk at a high level.

The level of conscientiousness about accounting and control matters is a factor in the third group. If management and the board of directors are conscientious concerning accounting and control matters, the auditor will be able to assess inherent risk at a low level. Procedures for identifying mistakes in recording transactions and applying accounting principles is an inherent risk factor in the fourth group, which covers the entity's financial situation and accounting practices. If the client has established procedures for reviewing entry data and the procedures show that few mistakes are made, the auditor has evidence to indicate that a low inherent risk assessment may be appropriate. The fifth and final group of pervasive factors is auditor concerns and relations. One factor here is the implementation of recommendations of internal and external auditors. If recommendations are generally ignored, the auditor may feel management is not conscientious about accounting matters and assess inherent risk at a high level.

Account specific inherent risk factors fall into four categories: 1) management and personnel, 2) accounting matters, 3) accounting systems, and 4) miscellaneous matters. When assessing these factors, the auditor should consider them as they apply only to the particular account being examined.

The experience and training of management and personnel in the specific area under examination is a factor in the first category. If management and personnel,



particularly accounting personnel, are well-trained and experienced, the auditor may be able to assess inherent risk for the area at a low level. The second category covers items such as the history of errors in the area. If the audit area has experienced many errors in the past, the auditor may believe this indicates high inherent risk.

Only when a factor adversely affects inherent risk can it possibly be a reportable condition.

The third category, the accounting system for the area, includes segregation of duties. If an area has proper segregation of duties, the auditor may be able to judge inherent risk to be low. Miscellaneous factors, for instance, the opportunity for fraud, make up the final category of account specific factors. In an audit area that affords a high opportunity for fraud, the auditor may assess inherent risk to be high. For example, in judging inherent risk in the cash area, the auditor might consider a credit union, which has a large volume of cash transactions, to have higher inherent risk in the cash area than a firm in which cash is collected through a lockbox system.

Relationship Between Reportable Conditions And Inherent Risk Factors

Three aspects of the relationship between reportable conditions and inherent risk factors need to be explored:

- the categorization of some items as both reportable conditions and inherent risk factors
- the effect of the conditions/factors on the audit risk model
- the communication of

conditions/factors to the audit committee

Reportable Conditions/ Inherent Risk Factors

Several of the possible reportable conditions are also inherent risk factors. Consider, for example, that the "absence of a sufficient level of control consciousness within the organization" is a possible reportable condition. Earlier, it was stated that the "level of conscientiousness about accounting and control matters" by management and the board of directors is a pervasive inherent risk factor. Thus, "level of conscientiousness about control" is both a reportable condition and an inherent risk factor.

Another reportable condition that also bears on inherent risk is "evidence of manipulation, falsification, or alteration of accounting records or supporting documents." Inherent risk factors that parallel this condition are: "procedures to identify intentional wrongdoing" by management or the board of directors, "procedures to identify intentional or unintentional mistakes in recording transactions," and "motivation to misstate" (by management and personnel).

Other reportable conditions and related inherent risk factors are listed on page 29.

Note that inherent risk factors are stated in neutral terms while reportable conditions have a negative connotation. Only when a factor adversely affects inherent risk can it possibly be a reportable condition. For example, the inherent risk factor "objectivity in accounting decisions" is stated in neutral terms and the related reportable condition "evidence of undue bias or lack of objectivity by those responsible for accounting decisions" has a negative connotation. If management is objective in making accounting decisions, this has a positive effect; the auditor will tend to decrease the assessed level of inherent risk. If, however, management is not objective, the auditor will likely judge inherent risk to be higher; additionally, the item will be communicated as a reportable condition. Thus, factors must be at levels that cause inherent risk to be assessed as high to have the negative connotation of reportable conditions and consequently be communicated to the audit committee.

The Audit Risk Model

The relationship between reportable conditions and inherent risk factors is particularly significant when considering the audit risk model. Items that are both reportable conditions and inherent risk factors affect the model in a unique manner: the item bears on the auditor's assessment of both control risk and inherent risk.[2] Because reportable conditions represent significant deficiencies in the control structure, they are necessarily considered in the auditor's judgment of control risks. Reportable conditions cause control risk to be assessed at a high level. A reportable condition which is also an inherent risk factor will most likely lead to a high assessment of inherent risk. The reportable condition and the inherent risk factor are really the same item, but the condition/factor bears on two different components of the audit risk model for different reasons. Examples will clarify this.

Consider this reportable condition: "evidence that employees or management lack qualifications and training to fulfill their assigned functions." The auditor may believe that there is a risk that such personnel may not adhere to the established control structure. Perhaps control procedures could be bypassed or performed incorrectly. In this situation, because the control system cannot be relied upon, the auditor will likely believe control risk is high.

Inherent risk factors that parallel this reportable condition are: "commpetency" and "experience and training" of management and personnel. If the auditor finds management and personnel are not as competent as they should be and if they lack experience and training, then the auditor may believe that there is a high risk that errors could enter that accounting area. Inherent risk is then assessed at a high level. Thus, one item may affect more than one component of the audit risk model, but for different reasons. The condition/factor bears on inherent risk because it may indicate that the accounting area is susceptible to errors. The condition/factor may affect the auditor's assessment of control risk because it may cause the auditor to suspect that the control structure may not be operating effectively.

Another example of a reportable condition that may also bear on inherent risk is the absence of a sufficient level of control consciousness within the organization. The corresponding inherent risk factor is the level of conscientiousness about accounting and control matters. If the client is

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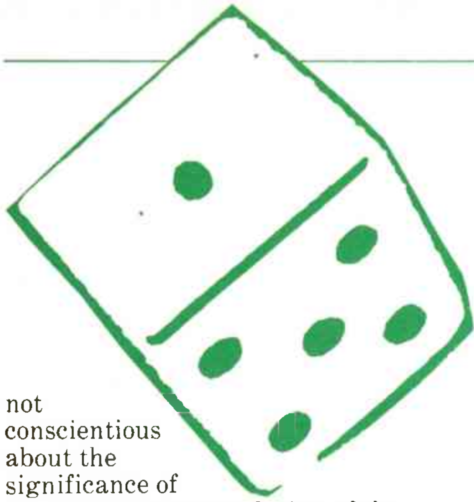

not conscientious about the significance of the functioning and design of the control structure, the auditor may decide to assess control risk at a high level. Similarly, if management is not conscientious concerning accounting and control matters, errors may have a greater chance of entering the system and the auditor would judge inherent risk to be high. One aspect of the condition/factor bears on the item entering the system and the other affects the risk of the system not preventing or detecting the error. These are two distinct phases in the accounting system; assessing a condition/factor in both phases is appropriate and is not double-counting.

Communication of Conditions/Factors

As mentioned earlier, the auditor is required to communicate reportable conditions to the audit committee. In entities that do not have an audit committee, the communication is made to individuals with a level of authority and responsibility equivalent to that delegated to an audit committee. Either written or oral communication is allowed. SAS 60 provides examples of wording that the auditor might use in a written communication.

Professional standards do not require the auditor to communicate inherent risk factors to the audit committee (or its equivalent). Nevertheless, because some inherent risk factors are also reportable conditions, they will necessarily be communicated to the client. Only reportable conditions are communicated to the client; no mention need be made that the item included as a reportable condition is also an inherent risk factor.

Conclusion

Reportable conditions and inherent risk factors are related in the following ways: 1) some reportable conditions are also inherent risk factors, 2) both reportable conditions and inherent risk factors affect the audit risk model, and 3) inherent risk factors that are also reportable conditions are communicated to the audit committee.

Several reportable conditions parallel factors that bear on the auditor's judgment of inherent risk. By their nature, reportable conditions necessarily affect the auditor's assessment of control risk. If a reportable condition is also an inherent risk factor, then two components of the audit risk model are affected. That is, one condition/factor bears on both inherent risk and control risk but for different reasons. When inherent risk and control risk are assessed at high levels, the audit risk model shows that the planned level of detection risk must be lower. Audit procedurees are then designed to provide the auditor confidence in order to limit detection risk to its planned low level.

SAS 60, "Communication of Internal Control Structure Related Matters Noted in an Audit," requires the auditor to communicate reportable conditions to the client's audit committee. Because some inherent risk factors are also reportable conditions, they will be communicated to the client (only as reportable conditions; the items need not be identified as inherent risk factors).

When the auditor locates a reportable condition, the audit is affected in three ways: 1) the condition must be reported to the audit committee, 2) the condition affects the judgment of control risk, and 3) the condition bears on the assessment of inherent risk if the condition is also an inherent risk factor. In order to comply with the new SAS and to plan an effective engagement, the auditor must consider all three effects when planning the audit.

FOOTNOTES

[1]SAS 39 presents a multiplicative model of audit risk; SAS 47 indicates that audit risk has three components but does not present them in a mathematical formula. The model given here is not meant to be used in a strict mathematical sense. Rather, it should aid in understanding the relationships of the components of audit risk.

[2]This is also true for items which are reportable conditions and business risk factors or factors which bear on planned audit risk.

REFERENCES

American Institute of Certified Public Accountants, *Statement on Auditing Standards No. 60*, "Communication of Internal Control Structure Related Matters Noted in an Audit" (AICPA, 1988).

________, *Statement on Auditing Standards No. 47*, "Audit Risk and Materiality in Conducting an Audit" (AICPA, 1983).

Colbert, Janet, "Use the Concept of Inherent Risk — It Helps!" *The Internal Auditor*, (April 1987), pp. 45-58.

Related Reportable Conditions and Inherent Risk Factors

Reportable Condition	Inherent Risk Factor
Absence of a sufficient level of control consciousness within the organization	Level of conscientiousness about accounting and control matters
Evidence of undue bias or lack of objectivity by those responsible for accounting decisions	Objectivity in accounting decisions
Evidence that employees or management lack qualifications and training to fulfill their assigned functions	Competency of management and personnel Experience and training of management and personnel
Evidence of willful wrongdoing by employees and management	Procedures to identify intentional wrongdoing Procedures to identify intentional mistakes in recording transactions
Evidence of manipulation, falsification, or alteration of accounting records or supporting documents	Procedures to identify intentional wrongdoing by management or the board of directors Procedures to identify intentional or unintentional mistakes in recording transactions Motivation of management and personnel to misstate
Evidence of intentional misapplication of accounting principles	Procedures for identifying intentional mistakes in applying accounting principles Motivation of management and personnel to misstate