J. of Acc. Ed. 32 (2014) 276–287

Contents lists available at ScienceDirect

J. of Acc. Ed.

journal homepage: www.elsevier.com/locate/jaccedu

Teaching and educational notes

An approach to learning risk-based auditing

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ARTICLE INFO

Article history:
Available online 3 July 2014

Keywords:
Auditing
Risk-based auditing
Business risk analysis
Analytical procedures

ABSTRACT

This paper presents a discussion of a risk-based auditing project that can be used in an undergraduate or graduate auditing course. The project gives students an opportunity to apply the concepts learned in their auditing class about risk-based auditing to a real world company. A number of companies are selected from a particular industry. Each student team is assigned a company and performs business risk analysis related to the entity and its environment using a structured questionnaire (template). The students are required to perform analytical procedures (ratio analysis) on the company and compare it to industry data or a competitor. Student evaluations of the project indicate that it helped them apply their audit knowledge, and was relevant to the auditing class.

1. Introduction

Risk-based auditing (RBA) is the central framework that guides the financial statement audit process. Auditing students need to develop skills to help them understand the concepts that underlie RBA and how to apply those concepts when they enter the auditing profession. In this paper, a class project is described that provides students with an opportunity to perform RBA on a real-world company. While I have only used this project in the undergraduate course, it can be adapted for use in a graduate auditing class.

In the next section, an overview of the RBA project is provided. The following section discusses the development, use, and grading of the RBA project. The next section discusses the evaluation of the RBA project. The last section provides some concluding comments.

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http://dx.doi.org/10.1016/j.jaccedu.2014.06.003
0748-5751/

2. Overview of risk-based auditing

Since the late 1990s, public accounting firms have been implementing audit approaches generically referred to as *risk-based auditing* (Bell, Peecher, & Solomon, 2005, Chapter 2; Knechel, 2007; Lemon, Tatum, & Turley, 2000). All of the major standard setters have issued risk assessment standards. The Auditing Standards Board (ASB) and the International Auditing and Assurance Standards Board (IAASB) issued their standards in 2005–2006 (American Institute of Certified Public Accountants (AICPA), 2013; International Auditing, 2013), while the Public Company Accounting Oversight Board (PCAOB) issued risk assessment standards in 2010 (Public Company Accounting Oversight Board (PCAOB), 2013).[1] Standard setters believe that the introduction of a risk-based auditing process will improve the quality of audits. For example, the ASB stated that its risk assessment standards would enhance audit quality by requiring (1) a more in-depth understanding of the entity and its environment to identify the risks of material misstatement in the financial statements and what the entity is doing to mitigate them, (2) a more rigorous assessment of the risks of material misstatement of the financial statements based on that understanding, and (3) an improved linkage between the assessed risks and the nature, timing, and extent of audit procedures performed in response to those risks (AICPA., 2006a, iii).

The auditor's risk assessment process starts by performing risk assessment procedures (i.e., inquiries of management and others within the entity, analytical procedures, and observation and inspection) for the purpose of obtaining an understanding of the entity and its environment (Public Company Accounting Oversight Board (PCAOB), 2013, AS 12; American Institute of Certified Public Accountants (AICPA), 2013, AU-C 315), to identify business risks, and assess the risk of material misstatement.[2] The auditor uses the information obtained from the understanding of the entity and its environment to make acceptance and continuation decisions about clients and to design and perform audit procedures that address the risks of material misstatement. In other words, the auditor links the risks of material misstatement to what can go wrong in the related financial statement accounts affected by the various business processes. Lastly, the auditor evaluates the evidence obtained from the risk assessment procedures, tests of controls, and substantive tests, and then issues the appropriate opinion on the financial statements.

3. The RBA project

3.1. RBA project content and development

The project is intended to provide the students with an opportunity to perform business risk analysis on a real company. Auditing standards indicate that the auditor must develop an understanding of the entity and its environment in order to assess the business risks faced by the entity. The first part of the project includes a questionnaire (WORD template) that contains the following six categories of information that are used to evaluate the entity and its environment:

- The nature of the entity.
- Industry, regulatory, and external factors.
- Objectives, strategies, and business risks.

[1] The effective dates for the ASB, IAASB, and PCAOB standards are December 15, 2012, December 15, 2009, December 15, 2010, respectively. The clarified SASs issued by the ASB use "AU-C" instead of "AU" section numbers. "AU-C" is a temporary identifier to avoid confusion with references to existing "AU" sections, which remain effective through 2013, in AICPA *Professional Standards*. The "AU-C" identifier will revert to "AU" in 2014, by which time these SASs become fully effective for all engagements. Throughout the paper, we will generally only refer to the PCAOB and recent ASB (clarified) standards. The ASB standards are virtually identical to the IAASB standards as a result of the convergence project (see AICPA, 2008 and Morris & Thomas, 2011 for a discussion of the clarity and convergence project).

[2] Most auditing textbooks provide a description of risk-based auditing (e.g., Arens, Elder, & Beasley, 2014 Chapter 8 and 9; Louwers, Ramsay, Sinason, Strawser, & Thibodeau, 2013, Chapters 3 and 4; and Messier, Glover, & Prawitt, 2014, Chapter 4).