Audit Risk Model & Substantive Evidence Master Cheat Sheet

AR = IR x CR x DR Formula, Risk of Material Misstatement (RMM) & Management Assertion Testing | CPA AUD

1. THE AUDIT RISK MODEL ARCHITECTURE

Risk Component	Auditor's Definition & Assessment	Auditor Control & Inverse Response
Audit Risk (AR)	Risk that auditor expresses an inappropriate clean (unmodified) opinion when statements are materially misstated.	Set low (typically 5% or less) by engagement policy. Held constant.
Inherent Risk (IR)	Susceptibility of an assertion to material misstatement before considering any internal controls (e.g., complex derivatives, cash).	**Client entity characteristic**. Auditor assesses but cannot control.
Control Risk (CR)	Risk that client internal controls fail to prevent or detect and correct a material misstatement on a timely basis.	**Client system characteristic**. Auditor tests controls to assess CR. **IR × CR = RMM**.
Detection Risk (DR)	Risk that auditor's substantive procedures fail to detect a material misstatement that exists. **DR = AR / (IR × CR)**	**SOLELY CONTROLLED BY AUDITOR**. Inverse to RMM: If RMM is High → set DR Low → perform more substantive testing!

2. MANAGEMENT ASSERTIONS & SUBSTANTIVE AUDIT PROCEDURES

Management Assertion	Audit Objective & Testing Direction	Key Substantive Audit Procedure
Existence / Occurrence (Overstatement Risk)	Vouching from accounting journals/ledgers backward to physical source documents (invoices, shipping).	Send bank confirmations, count inventory, vouch recorded revenue to bills of lading.
Completeness (Understatement Risk)	Tracing from physical source documents forward into recorded journals and ledgers.	Search for unrecorded liabilities by examining vendor invoices paid after year-end.
Valuation & Allocation	Assets and liabilities included at appropriate amounts (GAAP net realizable value or fair value).	Recalculate depreciation schedules; test allowance for doubtful accounts aging model.
Rights & Obligations	Entity holds or controls the rights to assets and liabilities are obligations of the entity.	Review loan agreements, inspect title deeds, confirm collateralized factored receivables.