Improving Compliance with International Standards on Auditing

ISA 315 Identifying And Assessing the Risks of Material Misstatement Through Understanding the Entity and Its Environment

Introduction and Overview

- Aim of this session
  - Risk assessment
  - ISA considerations
  - ISA requirements
  - General discussion
- Presenter
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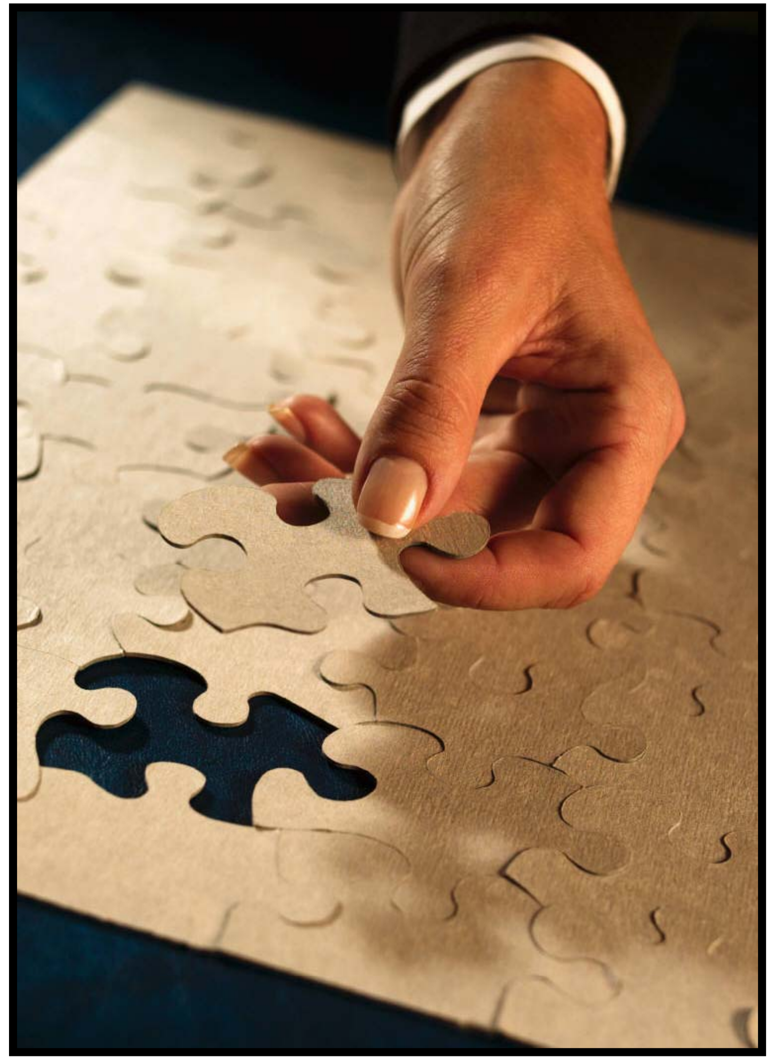

Risk Assessment

Where are we now?

- Agreed the terms of our engagement
- Considered quality control
  - Ethical considerations
  - Acceptance/continuance procedures
  - Assigned a competent team
- Considered potential for fraud
- Considered applicable laws/regulations
- Started our communications with our client
- Documented our audit procedures

Recent observations

- Lack of documentation of audit risks relevant to entity
- No demonstration of how risk and materiality are integrated into the audit process.

What is audit risk?

- The risk that the auditor expresses an **inappropriate audit opinion** when the financial statements are materially misstated. (ISA 200.13)

- Audit risk is a function of
  - the **risks of material misstatement** and
  - **detection risk**.

What is risk of material misstatement?

- The risk that the financial statements are **materially misstated** prior to audit. This consists of **two components**, at the assertion level (ISA 200.13) :
  - Inherent risk
  - Control risk

What is inherent risk?

- The **susceptibility of an assertion** about a class of transactions, account balance or disclosure **to a misstatement that could be material**, either individually or when aggregated with other misstatements, **before consideration of any related controls**. (ISA 200.13)

- Factors which can impact inherent risks are:
  - errors (unintentional) and;
  - fraud (intentional).

What is control risk?

- The risk that a misstatement that could occur in an assertion about a class of transaction, account balance or disclosure and that could be material, either individually or when aggregated with other misstatements, will not be **prevented**, or **detected and corrected**, on a timely basis by the entity's internal control. (ISA 200.13)

Risk assessment

- Risk assessment is the process by which we **attribute meaning** to the information we have been gathering during the planning phase of the audit.

- We use the risk assessment process to **determine the nature, timing and extent** of further audit procedures to be performed.

Risk assessment

- When planning the audit, we start our considerations at the **financial statement level**, for which **we identify and assess inherent risks** and **develop an audit response**.

- We develop an audit plan that will appropriately respond to assessed risks of misstatement **in order to lower the audit risk to an acceptably low level.**

More relevant standards

- ISA 240 The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements
- ISA 315 Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and Its Environment

ISA 315 Considerations

Scope

- ISA 315 deals with the auditor's responsibility to **identify** and **assess** the **risks of material misstatement** in the financial statements, through understanding the entity and its environment, including the entity's internal control.

Objective

Auditor's objective is to

- **identify** and **assess** the risks of material misstatement, whether due to fraud or error,
- at the **financial statement** and **assertion** levels,
- through **understanding the entity** and its environment, including the entity's internal control,
- thereby providing a basis for **designing and implementing responses** to the assessed risks of material misstatement.

What is that?

- **Assertions**

  Representations by management, explicit or otherwise, that are embodied in the financial statements, as used by the auditor to consider the different types of potential misstatements that may occur.

- **Business risk**

  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.

What is that?

- Internal control

  The process designed, implemented and maintained by those charged with governance, management and other personnel to provide reasonable assurance about the achievement of an entity's objectives with regard to reliability of financial reporting, effectiveness and efficiency of operations, and compliance with applicable laws and regulations. The term "controls" refers to any aspects of one or more of the components of internal control.

What is that?

- **Risk assessment procedures**

  The audit procedures performed to obtain an understanding of the entity and its environment, including the entity's internal control, to identify and assess the risks of material misstatement, whether due to fraud or error, at the financial statement and assertion levels.

- **Significant risk**

  An identified and assessed risk of material misstatement that, in the auditor's judgment, requires special audit consideration.

ISA 315 Requirements

Risk Assessment Procedures and Related Activities

Risk assessment procedures

- Perform risk assessment procedures to identify and assess risks of material misstatement at the financial statement and assertion levels.
- Risk assessment procedures by themselves do not provide sufficient appropriate audit evidence.

Understanding the entity

- Understanding the entity and its environment, including internal control, is a **continuous**, **dynamic** process of **gathering**, **updating** and **analyzing** information.

- Information obtained may be used as audit evidence to support assessments of the risks of material misstatement.

- Use **professional judgment** to determine the extent of the understanding required.

Risk assessment procedures

- Risks to be assessed include both those due to error and those due to fraud – ISA 315

- Fraud assessment is significant – ISA 240 includes further requirements and guidance

Risk assessment procedures

- Risk assessment procedures shall include:
  - Inquiries of management, of internal audit, and of others who may have information likely to assist in identifying risks of material misstatement due to fraud or error.
  - Analytical procedures
  - Observation and inspection.

Inquiries of management

- Much of the needed information obtained from management and those responsible for financial reporting, internal audit, and others who may have information.
- We may also obtain information, or a different perspective through inquiries of others in the entity.
  - TCWG
  - Legal counsel / Risk Manager
  - Operational and Sales personnel
  - IT personnel
- Continuous process of enquiry

Analytical procedures

- Performed as risk assessment procedures
  - May identify aspects of the entity of which the auditor was unaware and
  - May assist in assessing risks of material misstatement in order to provide a basis for designing and implementing responses to the assessed risks.
- May include both financial and non-financial information.
- Unusual or unexpected relationships identified may help identify risks of material misstatement, especially due to fraud

Analytical procedures

- When APs performed using data aggregated at a high level, results only provide a broad initial indication about whether a material misstatement may exist.
- Consider such results along with other information gathered.

Observation and inspection

- May support inquiries of management and others
- May provide information about the entity and its environment.
- May include observation or inspection of:
  - Entity's operations.
  - Documents (such as business plans and strategies), records, and internal control manuals.
  - Reports prepared by management (such as quarterly management reports and interim financial statements) and those charged with governance (such as minutes of board of directors' meetings).
  - The entity's premises and plant facilities.

Other considerations

Consider information from

- Acceptance or continuance process
- Other engagements performed for the entity
- Previous experience with the entity and from audit procedures performed in previous audits
  - Determine whether changes have occurred since the previous audit

Team discussions

- Engagement partner and other key engagement team members shall discuss
  - Susceptibility of the entity's financial statements to material misstatement, and
  - Application of the applicable financial reporting framework to the entity's facts and circumstances.
- Engagement partner shall determine which matters are to be communicated to engagement team members not involved in the discussion.

ISA 315 Requirements

The Required Understanding of the Entity and Its Environment, Including the Entity's Internal Control

Required understanding

- Entity and Its Environment
- Entity's Internal Control
  - Control environment
  - The entity's risk assessment process
  - The information system, including the related business processes, relevant to financial reporting, and communication
  - Control activities relevant to the audit
  - Monitoring of controls

Entity and its environment

- Relevant industry, regulatory, and other external factors including the applicable financial reporting framework.

- Nature of the entity, including:
  - operations;
  - ownership and governance structures;
  - types of investments, including special-purpose entities; and
  - Way entity is structured , financed, to enable understanding of classes of transactions, account balances, disclosures

Entity and its environment

- Selection and application of accounting policies, including the reasons for changes thereto. Evaluate whether appropriate business and consistent with the applicable financial reporting framework and accounting policies used in the relevant industry.

- Objectives and strategies, and those related business risks that may result in risks of material misstatement.

- Measurement and review of the entity's financial performance.

Entity's internal control

- Obtain an understanding of internal control relevant to the audit.

- Most controls relevant to the audit are likely to relate to financial reporting, but not all controls that relate to financial reporting are relevant to the audit.

- It is a matter of the auditor's professional judgment whether a control, individually or in combination with others, is relevant to the audit.

Entity's internal control

- When obtaining understanding of controls relevant to the audit,
  - evaluate the design of those controls and
  - determine whether they have been implemented, by performing procedures in addition to inquiry of the entity's personnel.

Control environment

- Obtain an understanding of the control environment.

- Evaluate whether:
  - Management, with the oversight of TCWG, has created and maintained a culture of **honesty** and **ethical behaviour**; and
  - The strengths in the control environment elements collectively provide an **appropriate foundation** for the other components of internal control, and whether those other components are not undermined by deficiencies in the control environment.

Risk assessment process

- Obtain understanding of whether the entity has a process for:
  - Identifying business risks relevant to financial reporting objectives;
  - Estimating the significance of the risks;
  - Assessing the likelihood of their occurrence; and
  - Deciding about actions to address those risks.

The information system

- Obtain understanding of the IS, including related business processes, relevant to financial reporting, including:
  - Classes of transactions significant to the FS;
  - Procedures, both IT and manual, by which those transactions are initiated, recorded, processed, corrected as necessary, transferred to the general ledger and reported in the financial statements

The information system

- Obtain understanding of the IS, including related business processes, relevant to financial reporting, including:
  - Related accounting records (manual or electronic), supporting information, specific accounts in FS used to initiate, record, process, report transactions, including corrections, and how information transferred to GL. The records may be in either form;
  - How the IS captures events and conditions, other than transactions, that are significant to FS;

The information system

- Obtain understanding of the IS, including related business processes, relevant to financial reporting, including:
  - Financial reporting process used to prepare FS, including significant accounting estimates and disclosures; and
  - Controls surrounding journal entries, including non-standard journal entries used to record non-recurring, unusual transactions or adjustments.

The information system

- Obtain understanding of how entity communicates financial reporting roles and responsibilities and significant matters relating to financial reporting, including:
  - Communications between management and TCWG; and
  - External communications, such as those with regulatory authorities.

Control activities

- Obtain understanding of control activities relevant to the audit, being those necessary to
  - Understand in order to assess the risks of material misstatement at the assertion level and
  - Design further audit procedures responsive to assessed risks.
- Does not require an understanding of all the control activities or for every assertion.
- Include understanding of how the entity responded to risks arising from IT.

Monitoring of controls

- Obtain understanding of major activities used to monitor internal control over financial reporting, including those related to those control activities relevant to the audit, and how entity initiates remedial actions to deficiencies.

- If there is IA function, obtain understanding of the nature of responsibilities, organizational status, and the activities

Monitoring of controls

- Obtain understanding of sources of information used in monitoring activities, and basis upon which management considers the information to be sufficiently reliable for the purpose.

ISA 315 Requirements

Identifying and Assessing the Risks of Material Misstatement

Identify and assess risks

- The auditor shall identify and assess the risks of material misstatement at:
  - the **financial statement level**; and
  - the **assertion level** for classes of transactions, account balances, and disclosures, to provide a basis for designing and performing further audit procedures.

Identify and assess risks

- Identify risks throughout process of obtaining an understanding of the entity and its environment;
- Assess identified risks, and evaluate whether they relate more pervasively to FS as a whole and potentially affect many assertions;
- Relate identified risks to what can go wrong at the assertion level, taking account of relevant controls you intend to test; and
- Consider likelihood of misstatement, possibility of multiple misstatements, and whether potential misstatement is of a magnitude that could result in a material misstatement.

Risks requiring special consideration

- As part of the risk assessment, determine whether any of risks identified are, in the auditor's judgment, a significant risk.
  - Assess inherent risk for each risk based on the nature of the risk and the likelihood and magnitude of potential misstatement(s).

- In exercising this judgment, exclude effects of identified controls related to the risk.

Why assess risk as significant?

- Consider
  - Whether risk is a risk of fraud;
  - Whether risk is related to recent significant economic, accounting or other developments and, therefore, requires specific attention;
  - Complexity of transactions;
  - Whether risk involves significant transactions with RPs;
  - Degree of subjectivity in the measurement of financial information related to the risk, and wide range of measurement uncertainty; and
  - Whether risk involves significant transactions outside normal course of business, or otherwise appear to be unusual.

Significant risks

- For each significant risk, obtain understanding of controls, including control activities, relevant to that risk.
- Management override of controls is a significant risk on every audit engagement (**ISA 240.31**)).
- There is a rebuttable presumption that fraud risk in revenue recognition is a significant risk on every audit engagement unless, in rare circumstances, audit team is able to overcome the presumption (**ISA 240.26**) and document the rationale (**ISA 240.47**).

Revision of risk assessment

- Assessment of risks of material misstatement at the assertion level may change during the course of the audit as additional audit evidence is obtained.

- Where we obtain audit evidence, or new information, which is inconsistent with original assessment, revise assessment and modify further planned audit procedures accordingly.

ISA 315 Requirements

Documentation

Documentation

- Discussion among the engagement team, and the significant decisions reached

- Key elements of understanding obtained regarding each required aspect of the entity and its environment, and each required internal control component; sources of information from which understanding obtained; and risk assessment procedures performed

Documentation

- The identified and assessed risks of material misstatement at the financial statement level and at the assertion level
- The risks identified, and related controls about which the auditor has obtained an understanding

Conclusion

Summary

- The auditor's risk assessment is based on evidence obtained from (**ISA 315.6, 315.7**):
  - Acceptance & continuance
  - Understanding of the entity and its environment including an understanding of related parties and the legal and regulatory framework
  - Risk Assessment Analytics
  - Fraud Risk Assessment, and
  - Additional Risk Assessment Procedures including, accounting estimates and going concern

Summary

- Risk assessment procedures are performed to identify and assess risks at both (**ISA 315.25):**
  - The financial statement level; and
  - The assertion level for classes of transactions, account balances and disclosures.
- Management override of controls is a significant risk on every audit engagement (**ISA 240.31**)).

Summary

- Risk assessment procedures are performed to identify and assess risks at both (**ISA 315.25):**
  - The financial statement level; and
  - The assertion level for classes of transactions, account balances and disclosures.
- Management override of controls is a significant risk on every audit engagement (**ISA 240.31**)).
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Summary

- Significant related party transactions outside the entity's normal course of business are likely significant risks.
- In determining the level of the inherent risk, do not consider the effect of identified controls related to the risks (**ISA 315.27**).
- The auditor needs to demonstrate critical thinking skills in order to understand business issues relevant to risk identification and assessment and understand the audit implications.

Summary

- The involvement of the engagement partner is **critical** in the process of proper risk identification and assessment.

General discussion

Questions???

Thank you!