

Auditing in a Changing Environment:



Risk Assessment & Response

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Risk Assessment

As required by **ISA 315**, the auditor should obtain an understanding of the entity and its environment, including its internal control, sufficient to identify and assess the risks of material misstatement of the financial statements whether due to fraud or error.

The auditor's understanding of the entity and its environment consists of an understanding of the following aspects:

- ▶ Industry, regulatory, and other external factors, including the applicable financial reporting framework.
- ▶ Nature of the entity, including the entity's selection and application of accounting policies.
- ▶ Objectives and strategies and the related business risks that may result in a material misstatement of the financial statements.
- ▶ Measurement and review of the entity's financial performance.
- ▶ Internal control.

Risk Assessment

The term “**error**” refers to an unintentional misstatement in financial statements, including the omission of an amount or a disclosure, such as the following:

- ▶ A mistake in gathering or processing data from which financial statements are prepared.
- ▶ An incorrect accounting estimate arising from oversight or misinterpretation of facts.
- ▶ A mistake in the application of accounting principles relating to measurement, recognition, classification, presentation or disclosure.

The term “**fraud**” refers to an intentional act by one or more individuals among management, those charged with governance, employees, or third parties, involving the use of deception to obtain an unjust or illegal advantage. Although fraud is a broad legal concept, for the purposes of this ISA, the auditor is concerned with fraud that causes a material misstatement in the financial statements.

Risk Assessment – Fraud Risk

In accordance with **ISA 240**, in planning and performing the audit to reduce audit risk to an acceptably low level, the auditor should consider the risks of material misstatements in the financial statements due to fraud.

As part of this work the auditor performs the following procedures to obtain information that is used to identify the risks of material misstatement due to fraud:

- ▶ Makes inquiries of management, of those charged with governance, and of others within the entity as appropriate and obtains an understanding of how those charged with governance exercise oversight of management's processes for identifying and responding to the risks of fraud and the internal control that management has established to mitigate these risks.
- ▶ Considers whether one or more fraud risk factors are present
- ▶ Considers any unusual or unexpected relationships that have been identified in performing analytical procedures.
- ▶ Considers other information that may be helpful in identifying the risks of material misstatement due to fraud.

Risk Assessment – Fraud Risk

Consideration of Fraud Risk Factors

When obtaining an understanding of the entity and its environment, including its internal control, the auditor should consider whether the information obtained indicates that one or more fraud risk factors are present. For example:

- ▶ The need to meet expectations of third parties to obtain additional equity financing may create pressure to commit fraud;
- ▶ The granting of significant bonuses if unrealistic profit targets are met may create an incentive to commit fraud; and
- ▶ An ineffective control environment may create an opportunity to commit fraud.

Risk Assessment – Fraud Risk

Consideration of Fraud Risk Factors



Although a fraud risk may be greatest when all three fraud conditions are observed or evident, we cannot assume that the inability to observe one or two of these conditions means there is no fraud risk.

Risk Assessment – Fraud Risk

Risk Factors Relating to Misstatements Arising from Fraudulent Financial Reporting

The following are examples of the three conditions generally present when fraud occurs:

- ▶ **Incentive or pressure** - financial stability or profitability is threatened by economic, industry, or entity operating conditions as indicated by significant declines in customer demand and increasing business failures in either the industry or overall economy.
- ▶ **Opportunity** - the nature of the industry or the entity's operations provide opportunities to engage in fraudulent financial reporting due to assets, liabilities, revenues, or expenses based on significant estimates that involve subjective judgments or uncertainties that are difficult to corroborate.
- ▶ **Attitude or Rationalization** - there is a practice by management of committing to analysts, creditors, and other third parties to achieve overly aggressive or unrealistic forecasts.

Risk Assessment – Fraud Risk

Risk Factors Relating to Misstatements Arising from Misappropriation of Assets:

- ▶ **Incentive or pressure** - personal financial obligations may create pressure on management or employees with access to cash or other assets susceptible to theft to misappropriate those assets.
- ▶ **Opportunity** - certain characteristics or circumstances may increase the susceptibility of assets to misappropriation. For example, large amount of cash, assets that are easily convertible or small items of fixed assets.
- ▶ **Attitude or Rationalization** - disregard for the need for monitoring or reducing risks related to misappropriations of assets. Or behavior indicating displeasure or dissatisfaction with the entity or its treatment of employees.

Risk Assessment – Fraud Risk

Examples of Circumstances that Indicate the Possibility of Fraud:

- ▶ Discrepancies in accounting records – (incorrectly recorded transactions, unsupported or unauthorized balances/transactions, last minute adjustments).
- ▶ Conflicting or missing evidence – (missing documents, significant unexplained items on reconciliations, unusual discrepancies between entities records and confirmation replies).
- ▶ Problematic or unusual relationships between the auditor and management – (denial of access to records, undue time pressure to resolve complex issues, intimidation of engagement team members etc.).
- ▶ Accounting policies that appear to be at variance with industry norms.

Risk Assessment – Fraud Risk

Identification and Assessment of the Risks of Material Misstatement Due to Fraud

To assess the risks of material misstatement due to fraud the auditor uses professional judgment and:

- ▶ Identifies risks of fraud by considering the information obtained through performing risk assessment procedures and by considering the classes of transactions, account balances and disclosures in the financial statements;
- ▶ Relates the identified risks of fraud to what can go wrong at the assertion level;
- ▶ Considers the likely magnitude of the potential misstatement including the possibility that the risk might give rise to multiple misstatements and the likelihood of the risk occurring.

Response to the Risk of Material Misstatement Due to Fraud

The auditor should determine overall responses to address the assessed risks of material misstatement due to fraud at the financial statement level and should design and perform further audit procedures whose nature, timing and extent are responsive to the assessed risks at the assertion level.

ISA 330 requires the auditor to perform substantive procedures that are specifically responsive to risks that are assessed as significant risks.

The auditor responds to the risks of material misstatement due to fraud in the following ways:

- ▶ A response that has an overall effect on how the audit is conducted, that is, increased professional skepticism and a response involving more general considerations apart from the specific procedures otherwise planned.
- ▶ A response to identified risks at the assertion level involving the nature, timing and extent of audit procedures to be performed.

Response to the Risk of Material Misstatement Due to Fraud

The auditor responds to the risks of material misstatement due to fraud in the following ways, continued:

- ▶ A response to identified risks involving the performance of certain audit procedures to address the risks of material misstatement due to fraud involving management override of controls, given the unpredictable ways in which such override could occur. For example:
 - Test the appropriateness of journal entries recorded in the general ledger and other adjustments made in the preparation of financial statements;
 - Review accounting estimates for biases that could result in material misstatement due to fraud; and
 - Obtain an understanding of the business rationale of significant transactions that the auditor becomes aware of that are outside of the normal course of business for the entity, or that otherwise appear to be unusual given the auditor's understanding of the entity and its environment.

Response to the Risk of Material Misstatement Due to Fraud

Overall Responses:

In determining overall responses to address the risks of material misstatement due to fraud at the financial statement level the auditor should:

- ▶ Consider the assignment and supervision of personnel;
- ▶ Consider the accounting policies used by the entity; and
- ▶ Incorporate an element of unpredictability in the selection of the nature, timing and extent of audit procedures.

▶ Evaluation of Audit Evidence:

As required by **ISA 330**, the auditor, based on the audit procedures performed and the audit evidence obtained, evaluates whether the assessments of the risks of material misstatement at the assertion level remain appropriate.

Response to the Risk of Material Misstatement Due to Fraud

► Management Representations:

The auditor should obtain written representations from management that:

- It acknowledges its responsibility for the design and implementation of internal control to prevent and detect fraud;
- It has disclosed to the auditor the results of its assessment of the risk that the financial statements may be materially misstated as a result of fraud;
- It has disclosed to the auditor its knowledge of fraud or suspected fraud affecting the entity.
- It has disclosed to the auditor its knowledge of any allegations of fraud, or suspected fraud, affecting the entity's financial statements communicated by employees, former employees, analysts, regulators or others.

Relying on the Work of Others

ISA 600 - Using the Work of Another Auditor

When the principal auditor uses the work of another auditor, the principal auditor should determine how the work of the other auditor will affect the audit.

The following procedures should be carried out by the principal auditor:

- ▶ The principal auditor should consider the professional competence of the other auditor in the context of the specific assignment.
- ▶ The principal auditor should perform procedures to obtain sufficient appropriate audit evidence, that the work of the other auditor is adequate for the principal auditor's purposes, in the context of the specific assignment.
- ▶ The principal auditor should consider the significant findings of the other auditor.

Reporting Considerations:

When the principal auditor concludes that the work of the other auditor cannot be used and the principal auditor has not been able to perform sufficient additional procedures regarding the financial information of the component audited by the other auditor, the principal auditor should express a qualified opinion or disclaimer of opinion because there is a limitation in the scope of the audit.

Relying on the Work of Others

ISA 610 - Considering the Work of Internal Audit

The external auditor should consider the activities of internal auditing and their effect, if any, on external audit procedures.

The following procedures should be carried out by the external auditor:

- ▶ The external auditor should obtain a sufficient understanding of internal audit activities to identify and assess the risks of material misstatement of the financial statements and to design and perform further audit procedures.
- ▶ The external auditor should perform an assessment of the internal audit function when internal auditing is relevant to the external auditor's risk assessment.
- ▶ When the external auditor intends to use specific work of internal auditing, the external auditor should evaluate and perform audit procedures on that work to confirm its adequacy for the external auditor's purposes.

Relying on the Work of Others

ISA 620 - Using the Work of an Expert

When using the work performed by an expert, the auditor should obtain sufficient appropriate audit evidence that such work is adequate for the purposes of the audit.

When planning to use the work of an expert, the auditor should perform the following procedures:

- ▶ Evaluate the professional competence of the expert. This will involve considering the expert's:
 - Professional certification or licensing by, or membership in, an appropriate professional body; and
 - Experience and reputation in the field in which the auditor is seeking audit evidence.

- ▶ Evaluate the objectivity of the expert.

Relying on the Work of Others

ISA 620 - Using the Work of an Expert , Continued

If the results of the expert's work do not provide sufficient appropriate audit evidence or if the results are not consistent with other audit evidence, the auditor should resolve the matter. This may involve discussions with the entity and the expert, applying additional audit procedures, including possibly engaging another expert, or modifying the auditor's report.

Reference to an Expert in the Auditor's Report :

When issuing an unmodified auditor's report, the auditor should not refer to the work of an expert. Such a reference might be misunderstood to be a qualification of the auditor's opinion or a division of responsibility, neither of which is intended.

Questions

THANK YOU