

Risk Assessment as it pertains to Audit Planning

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Objective

- Risk assessment is a key requirement of the planning phase of an audit.
- We perform risk assessment procedures to obtain an understanding of the entity and its environment, including the entity's controls, to identify and assess the risks of material misstatement, whether due to error or fraud, at the financial statement and relevant assertion levels, which aids us in designing further audit procedures.
- The objective of this presentation is to provide an overview of the risk assessment process as it relates to the planning of the audit.

What is Risk Assessment?

- Risk assessment is the identification and evaluation of several aspects of an entity whereby risks are identified and evaluated for use in guiding the audit procedures that will be necessary in order to substantiate the amounts reported in the financial statements.

What is Risk Assessment?

- Risk assessment is the determination of the QUANTITATIVE and QUALITATIVE estimate of risk.
- Quantitative is a property that can exist as a multitude or magnitude. Quantitative quantities can be compared in terms of "more", "less", or "equal", or by assigning a numerical value in terms of a unit of measurement.
- Qualitative properties are properties that are observed and can generally not be measured with a numerical result. The way an entity deals with its citizens is probably the most obvious qualitative aspect of a government unit. Although measuring something in qualitative terms is difficult, most people can (and will) make a judgment about a behavior on the basis of how they feel treated.

Why is Risk Assessment so Important to an Audit?

- Risk assessment can be an auditor's best friend, particularly if we desire efficiency and effectiveness for the audit.
- Risk assessment, when properly performed, tells us:
 1. which audit procedures are necessary to do,
 2. and which audit procedures can be omitted.
- **In other words, risk assessment is the doorway to maximum impact with minimal effort.**

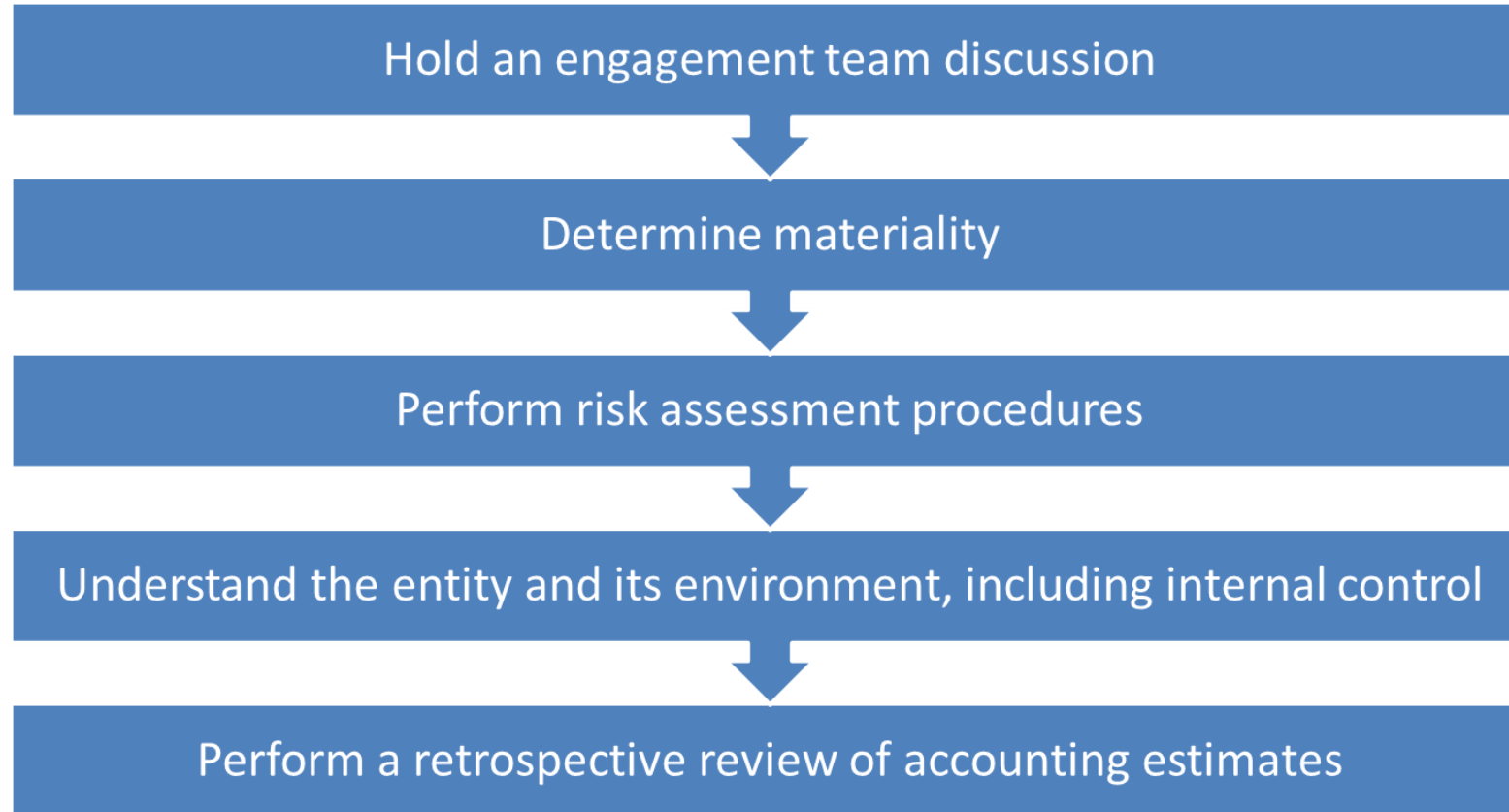
So, why do some auditors avoid audit risk assessment?

- We don't understand it.
- We'd rather continue doing what we've always done.
- Too often auditors keep doing audit procedures the same as last year (commonly referred to as SALY), no matter what. It's more comfortable than using risk assessment because it is familiar.
- But **what if SALY is faulty or inefficient?** Or what if the “tried and true” has blind spots? Maybe it's better to assess risk annually and to plan our work based on present conditions and identified risks.

The Risk Assessment Process

- There are several aspects of the risk assessment process including:
 - Understanding and evaluating the entity and its environment
 - Understanding and evaluating the risks of fraud at the entity
 - Understanding and evaluating the internal control processes and procedures at the entity
 - Performing an overall evaluation of all information gathered and risks assessed
 - Design audit procedures to respond to the overall risk of material misstatement and any other significant risks

Planning and Risk Assessment Procedures



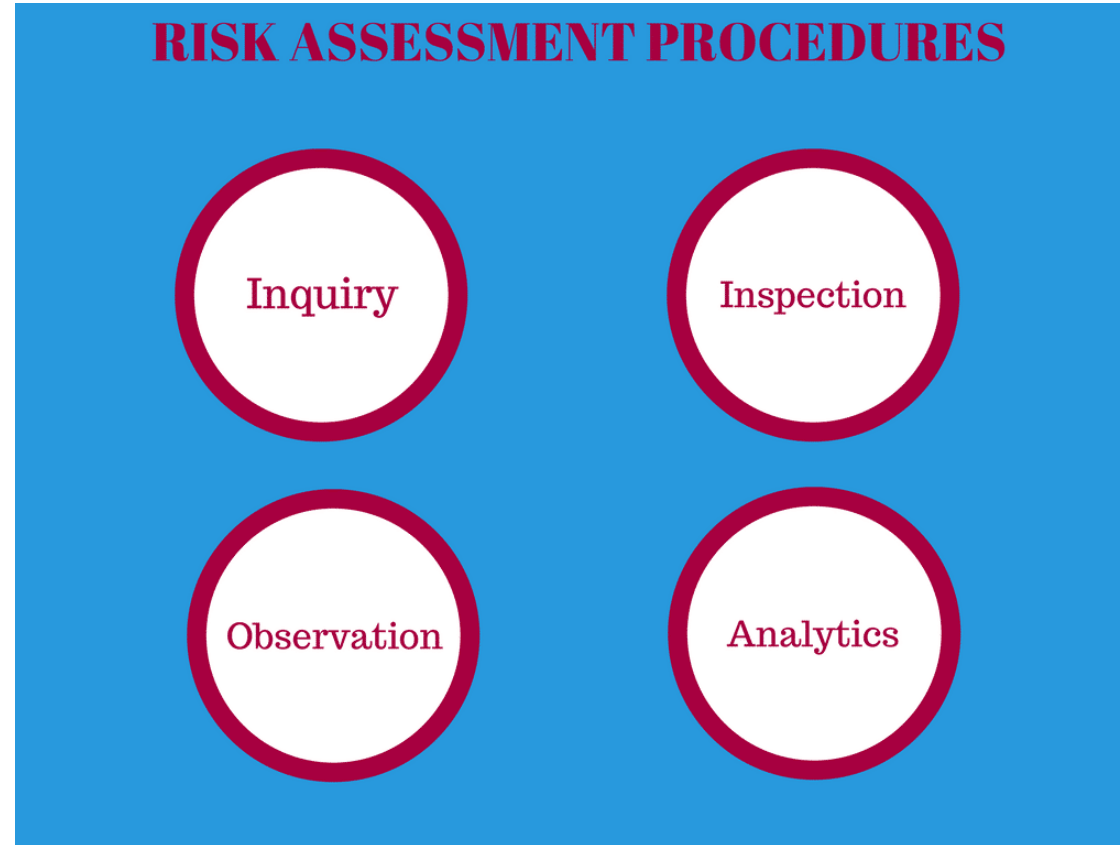
Engagement Team Discussion

- An exchange of ideas or "brainstorming" among the audit team members, including the auditor with final responsibility for the audit, about how and where they believe the entity's financial statements might be susceptible to material misstatement due to fraud, how management could perpetrate and conceal fraudulent financial reporting, and how assets of the entity could be misappropriated. Including:
 1. A consideration of the known external and internal factors affecting the entity that might (a) create incentives/pressures for management and others to commit fraud, (b) provide the opportunity for fraud to be perpetrated, and (c) indicate a culture or environment that enables management to rationalize committing fraud. The discussion should occur with an attitude that includes a questioning mind.
 2. And, for this purpose, setting aside any prior beliefs the audit team members may have that management is honest and has integrity. In this regard, the discussion should include a consideration of the risk of management override of controls. Finally, the discussion should include how the auditor might respond to the susceptibility of the entity's financial statements to material misstatement due to fraud.
- An emphasis should be placed on the importance of maintaining the proper state of mind throughout the audit regarding the potential for material misstatement due to fraud.

Determine Materiality

- Determine the amounts that will be considered material in relation to the financial statements.
- Use industry standards to perform this calculation.

Risk Assessment Procedures



Risk Assessment Procedures

- Types of risk assessment procedures include:
 - Inquiries of management and others within the entity and those charged with governance.
 - Observation
 - Inspection
 - Analytical procedures
- Risk assessment procedures are performed to validate information obtained during the risk assessment process.

Analytical Procedures

- Preliminary analytical procedures:
 - analytical procedures must be performed while planning the audit with an objective of identifying the existence of unusual transactions or events, and amounts, ratios, and trends that might indicate matters that have financial statement and audit planning implications.
- Analytical procedures related to revenue:
 - the auditor also should perform analytical procedures relating to revenue with the objective of identifying unusual or unexpected relationships involving revenue accounts that may indicate a material misstatement due to fraudulent financial reporting.

Identifying the Risk of Material Misstatement Due to Fraud

- Make inquiries of management and others within the entity to obtain their views about the risks of fraud and how they are addressed.
- Consider any unusual or unexpected relationships that have been identified in performing analytical procedures in planning the audit.
- Consider whether one or more fraud risk factors exist.
- Consider other information that may be helpful in the identification of risks of material misstatement due to fraud.

The auditor should inquire of management about:

- Whether management has knowledge of any fraud or suspected fraud affecting the entity
- Whether management is aware of allegations of fraud or suspected fraud affecting the entity, for example, received in communications from employees, former employees, analysts, regulators, short sellers, or others
- Management's understanding about the risks of fraud in the entity, including any specific fraud risks the entity has identified or account balances or classes of transactions for which a risk of fraud may be likely to exist
- Programs and controls the entity has established to mitigate specific fraud risks the entity has identified, or that otherwise help to prevent, deter, and detect fraud, and how management monitors those programs and controls
- For an entity with multiple locations, (a) the nature and extent of monitoring of operating locations or business segments, and (b) whether there are particular operating locations or business segments for which a risk of fraud may be more likely to exist
- Whether and how management communicates to employees its views on business practices and ethical behavior

Considering Fraud Risk Factors

- Because fraud is usually concealed, material misstatements due to fraud are difficult to detect.
- The auditor may identify events or conditions that:
 1. indicate incentives/pressures to perpetrate fraud
 2. opportunities to carry out the fraud, or:
 3. attitudes/rationalizations to justify a fraudulent action.

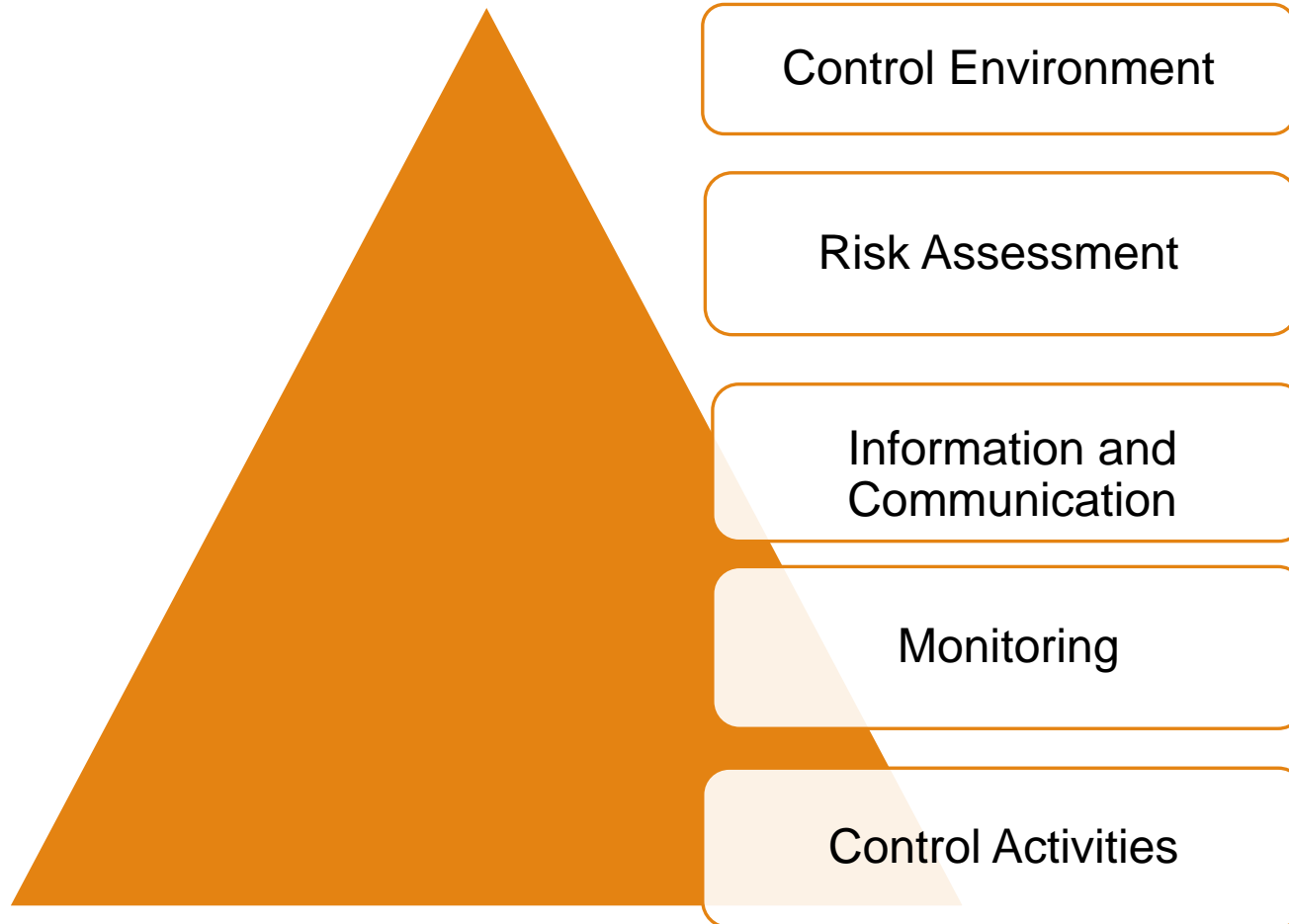
Understand the Entity and Its Environment

- I like to start by asking management the question, “What keeps you awake at night and what would you change if you could remove one problem?” The answer tells us a great deal about the entity’s risk.

To understand the entity and its related threats, ask questions such as:

- How is the industry faring?
- Are there any new competitive pressures or opportunities?
- Have key vendor relationships changed?
- Can the entity obtain necessary knowledge or products?
- How strong is the entity's cash flow?
- Has the entity met its debt obligations?
- Who are your key personnel and why are they important?
- What is the entity's strategy?
- Do you have any related party transactions?

Understanding Internal Control



Understanding Internal Control

- Gain an understand of the entity's policies and procedures to determine in a control system is in place and controls are properly designed and implemented.
- Perform inquiry, observation, and inspection to determine if controls have been properly implemented.
- Note: Inquiry alone is not sufficient to understand the design and implementation of controls

Understanding Internal Control

- Evaluate the design and implementation of controls
 - Related to significant risks
 - Related to risks that cannot be tested effectively using substantive procedures alone
- Gain an Understanding of the entity policy and procedures
 - How the incorrect processing of transactions is resolved
 - How detail is reconciled to the general ledger for material accounts

Performing Walkthroughs

- Walkthroughs can be a very effective way of determining whether controls have been properly designed and implemented. Procedures of a walkthrough include:
 - Select one or a few transactions
 - Trace from initial creation of the source document to final posting in the general ledger
 - Inspect documents and records used in processing, make inquiries, and observe procedures being performed

Understanding Internal Control

- Document the following:
 - Understanding of internal control components
 - Sources of information
 - Procedures performed
 - Controls evaluated related to significant risks and risks for which substantive procedures alone are not effective
 - Processing of transactions for each significant transaction class
 - The financial close and reporting process

Retrospective Review of Accounting Estimates

- Performed to evaluate:
 - Effectiveness of management's estimation process
 - Information relevant to current year estimates
 - The need for disclosure
 - The existence of possible management bias

Identifying Significant Audit Areas

- Audit areas that present a reasonable possibility of material misstatement of the financial statements or disclosures based on:
 - Volume of activity
 - Size and composition of accounts
 - Types of transactions
 - Presence of fraud risks or other significant risks
 - Changes from the prior period

Tests of Controls

- The auditor should perform tests of controls if:
 - We are relying on the controls to reduce the level of substantive procedures conducted.
 - Substantive tests alone are not adequate
- Reminder: Inquiry alone is not sufficient for testing controls

Tests of Controls

- Rotational tests of controls are permitted in certain circumstances:
 - Obtain evidence about whether the controls have changed using inquiry, observation, and inspection
 - If controls have changed, rotation is not appropriate
 - Test a control at least once every three years
 - If several controls are rotationally tested, test some controls each year
 - If relying on controls for significant risks, controls must be tested in the current year

Assessing Risks and Developing Responses

Assess risks at the financial statement level



Develop the overall audit strategy



Assess risks at the relevant assertion level



Develop the detailed audit plan

Assess Risks at the Financial Statement Level

- Identify risks that are pervasive to the financial statements and potentially affect many assertions
- Assess the risk of material misstatement at the financial statement level
- Develop overall responses
- Document the risk assessment and the responses

Develop the Overall Audit Strategy

- The overall audit strategy should include identification and evaluation of the following:
 - Characteristics of the engagement that define its scope
 - Reporting objectives of the engagement
 - Important factors that determine audit focus
 - Resources needed to perform the audit

Factors That Determine Audit Focus

- Materiality levels
- Overall risks and responses
- Preliminary identification of high risk audit areas
- Preliminary identification of material locations and accounts
- Whether you plan to test and rely on controls
- Composition and deployment of the audit team

What is the Assertion Level?

- The “assertion level” is the level at which statements are presented as completely true.
 - For example, management tells the auditor the financial statements show a true valuation of inventory – management are formally “asserting” this statement as being correct, so we call this at the “assertion level”.

Assess Risks at the Relevant Assertion Level

- Identify risks of material misstatement (due to error or fraud) for specific—
 - Account balances
 - Transaction classes
 - Disclosures
- Consider what can go wrong at the relevant assertion level

Assess Risks at the Relevant Assertion Level

- Assessing risks at the assertion level
 - Are the risks of a magnitude that could result in material misstatement?
 - What is the likelihood that the risks could result in material misstatement?
- Likelihood is a function of:
 - Inherent risk
 - Control risk
- Need a basis for the assessment

Assess Risks at the Relevant Assertion Level

- Identify significant risks that require special audit consideration:
 - Fraud risks
 - Other significant risks
- Significant risks often relate to:
 - Significant economic, accounting, or other developments
 - Complex, non-routine, or judgmental matters
 - Transactions with related parties

Assess Risks at the Relevant Assertion Level

- Identify risks for which substantive procedures alone are not adequate
- Revise the risk assessment and reconsider planned audit procedures if audit evidence contradicts the original risk assessment

Assess Risks at the Relevant Assertion Level

- Document the following:
 - Risk assessment at the relevant assertion level
 - Basis for the assessment
 - Significant risks
 - Risks for which substantive procedures alone are not adequate

The Detailed Audit Plan

- The nature, timing, and extent of further audit procedures to respond to the risk assessment (i.e., the audit program)
- Provides linkage between the risk assessment and the responses at the assertion level

Tailoring the Audit Programs

Low RMM

- Primarily substantive analytics
- Some tests of details (required by SASs)

Low to Moderate RMM

- Substantive analytics
- Tests of details needed to respond to risk

Moderate to High RMM

- Tests of details and extended analytics
- For audit areas or assertions with higher risk

Assess the Risk of Material Misstatement

- Risk of Material Misstatement = Inherent Risk X Control Risk
- Using the RMM formula, we are assessing risk at the assertion level.
- Audit procedures are selected and performed in response to the calculated RMM.

Common Errors in the Risk Assessment Process

- Risks identified in planning are not considered in the risk assessment.
- Fraud risks identified are not reflected in risk assessment and no audit response is prepared.
- Areas identified as significant in other planning steps are not identified as significant in the risk assessment planning.
- Audit responses developed to address identified risks are not reflected in the audit program.
- Audit procedures to be performed which are documented in the risk assessment are not added in the audit program.
- Low risk areas identified during risk assessment as areas being addressed using a limited approach are actually tested substantively with excessive audit procedures.

The Input and Output

- The inputs in audit planning include all of the above audit risk assessment procedures.
- The outputs (sometimes called linkage) of the audit risk assessment process are:
 - Audit strategy
 - Audit plan (audit programs)
- We tailor the strategy and plan according to the risk assessment.

The Risk Assessment Process

- In a nutshell, we identify risks and then respond to them.

Questions???????