

# IDENTIFYING AND UNDERSTANDING SOURCES OF AUDIT AND BUSINESS RISKS AND THE EMERGING RISKS DUE TO COVID-19

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# OBJECTIVES



At the end of this session, delegates will be able to:

- ▶ Understand audit risk model and sources of audit risk
- ▶ Understand business risk and its sources
- ▶ Appreciate the impact of COVID -19 on entities and on the auditor

# OVERALL OBJECTIVES OF THE AUDITOR

In conducting an audit of financial statements, the overall objectives of an auditor are:

- To obtain assurance that the financial statements as a whole are **free from material misstatement**, whether **due to fraud or error**, thereby enabling the auditor to **express an opinion** as to whether the financial statements are prepared, in all material respects **in accordance with an applicable financial reporting framework**.
- To report on the financial statements, and communicate as required by the **ISAs**, in accordance with the auditor's findings.

# OVERALL OBJECTIVES OF THE AUDITOR



## *Financial Reporting Frameworks*

Without an acceptable financial reporting framework, management does not have an appropriate basis for the preparation of the financial statements and **the auditor does not have suitable criteria for auditing the financial statements.**

Frameworks generally fall into one of two categories, being **general purpose financial statements and special purpose financial statements.**

# OVERALL OBJECTIVES OF THE AUDITOR



Examples of such financial reporting frameworks include, but are not limited to:

- ❑ International Financial Reporting Standards (IFRSs) issued by the International Accounting Standards Board (IASB);
- ❑ International Public Sector Accounting Standards (IPSASs) issued by the International Public Sector Accounting Standards Board; and
- ❑ accounting principles issued by an authorized or recognized standard-setting organization in a particular jurisdiction provided the organization follows an established and transparent process involving deliberation and consideration of the views of a wide range of stakeholders.

# OVERALL OBJECTIVES OF THE AUDITOR



Factors to consider in determining whether the financial reporting framework is acceptable include:

- ✓ the nature of the entity (for example, listed entity, public sector entity or not for profit entity);
- ✓ the purpose of the financial statements (whether they are prepared to meet the common financial statement needs of a wide range of users or just the financial information needs of specific users);
- ✓ the nature of the financial statements (whether they are a complete set or a single financial statement); and
- ✓ whether law or regulation prescribes the applicable financial reporting framework.

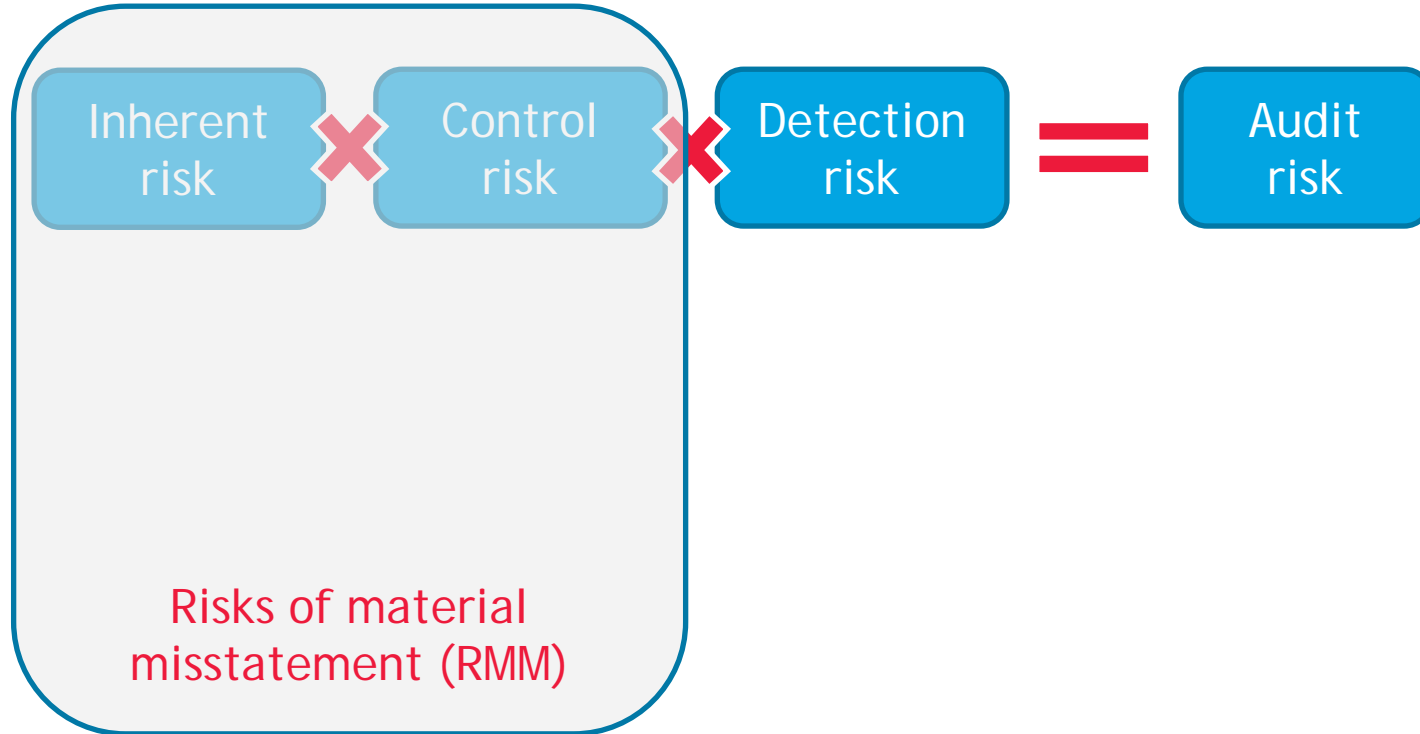
# AUDIT RISK AND BUSINESS RISK EXPLAINED

**Audit risk** : the risk that the auditor expresses an inappropriate audit opinion when the financial statements are materially misstated.

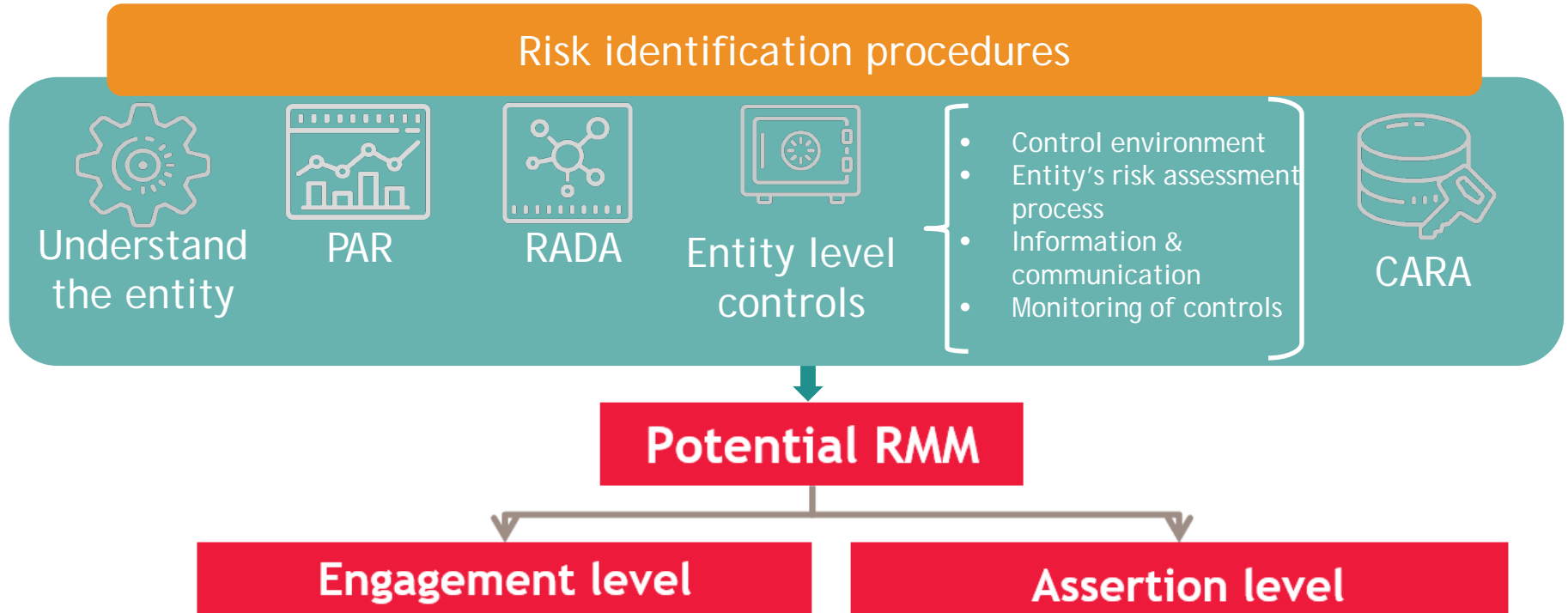
**Business risk**: a threat to the company's ability to achieve its goals.



# THE AUDIT RISK MODEL



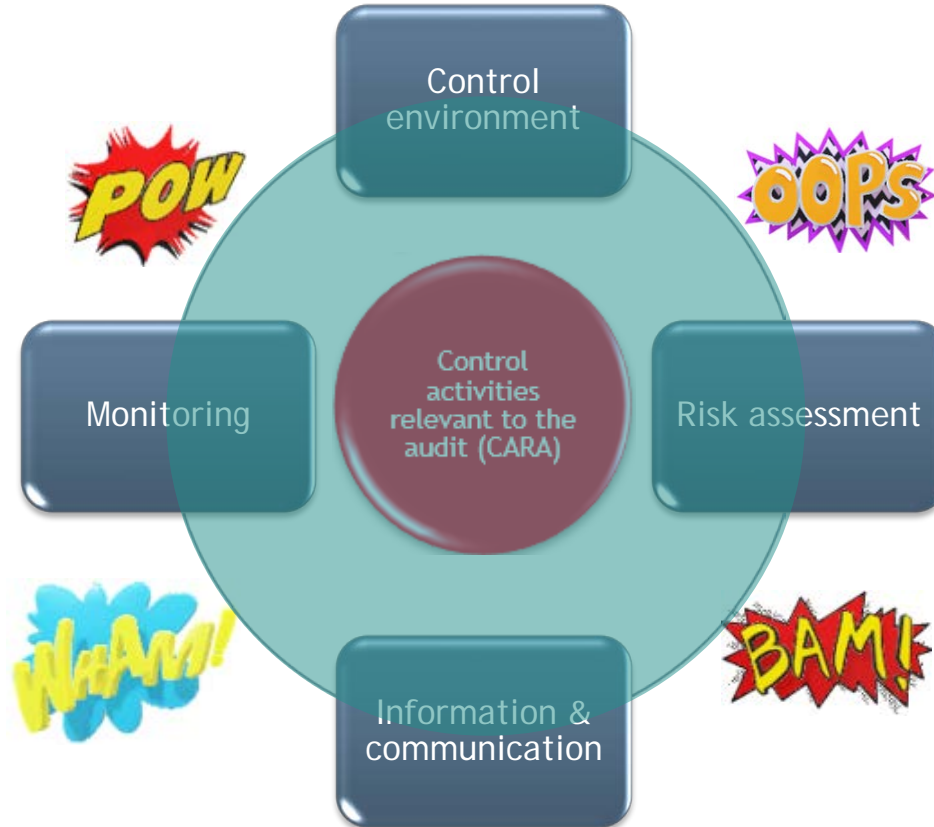
# SOURCES OF POTENTIAL RMM



# COMPONENTS OF INTERNAL CONTROL



# COMPONENTS OF ENTITY LEVEL CONTROLS



# DO WE HAVE A RISK?



Small entity, no  
internal audit  
function?



What about  
management  
override?



Does it give rise  
to an RMM?

# OBTAINING AN UNDERSTANDING...



Visits to client premises



Review of minutes



Discussions with management & staff



Interviews with management's experts

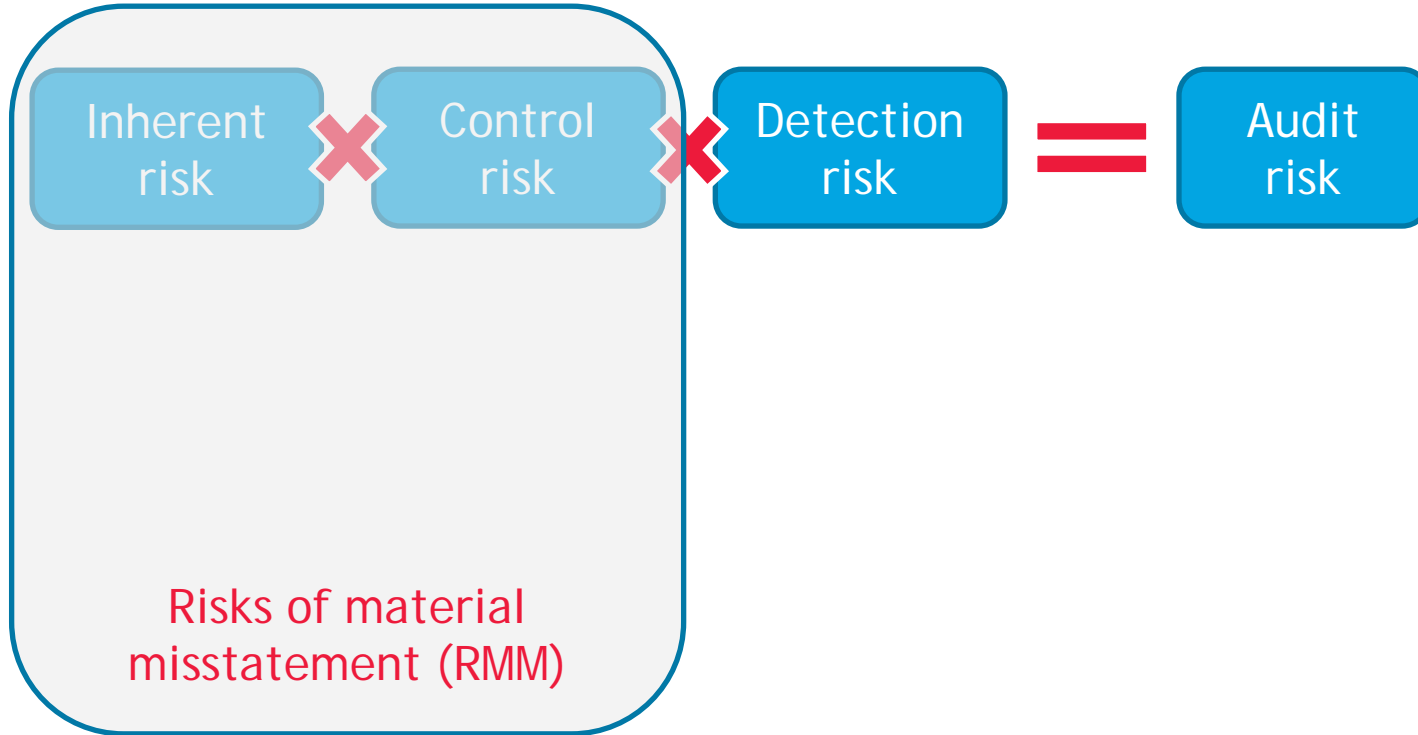


Observation



Review of internal audit reports

# THE AUDIT RISK MODEL



## ENGAGEMENT LEVEL RISKS

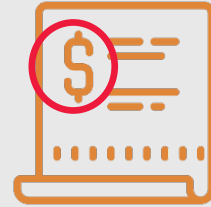


- Pervasive
- Not specific to certain parts

- Impacts overall behaviors & testing

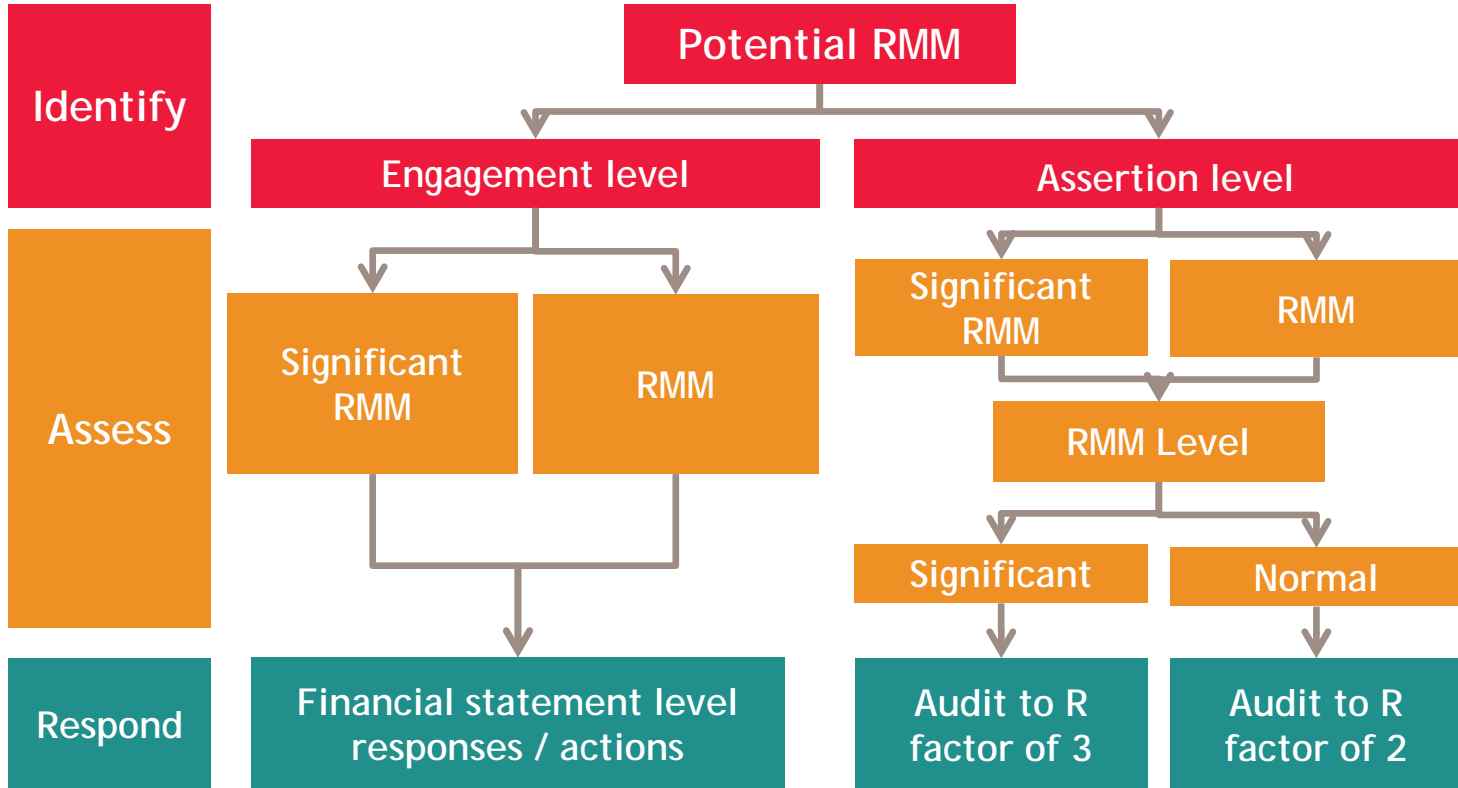


## ASSERTION LEVEL RISKS

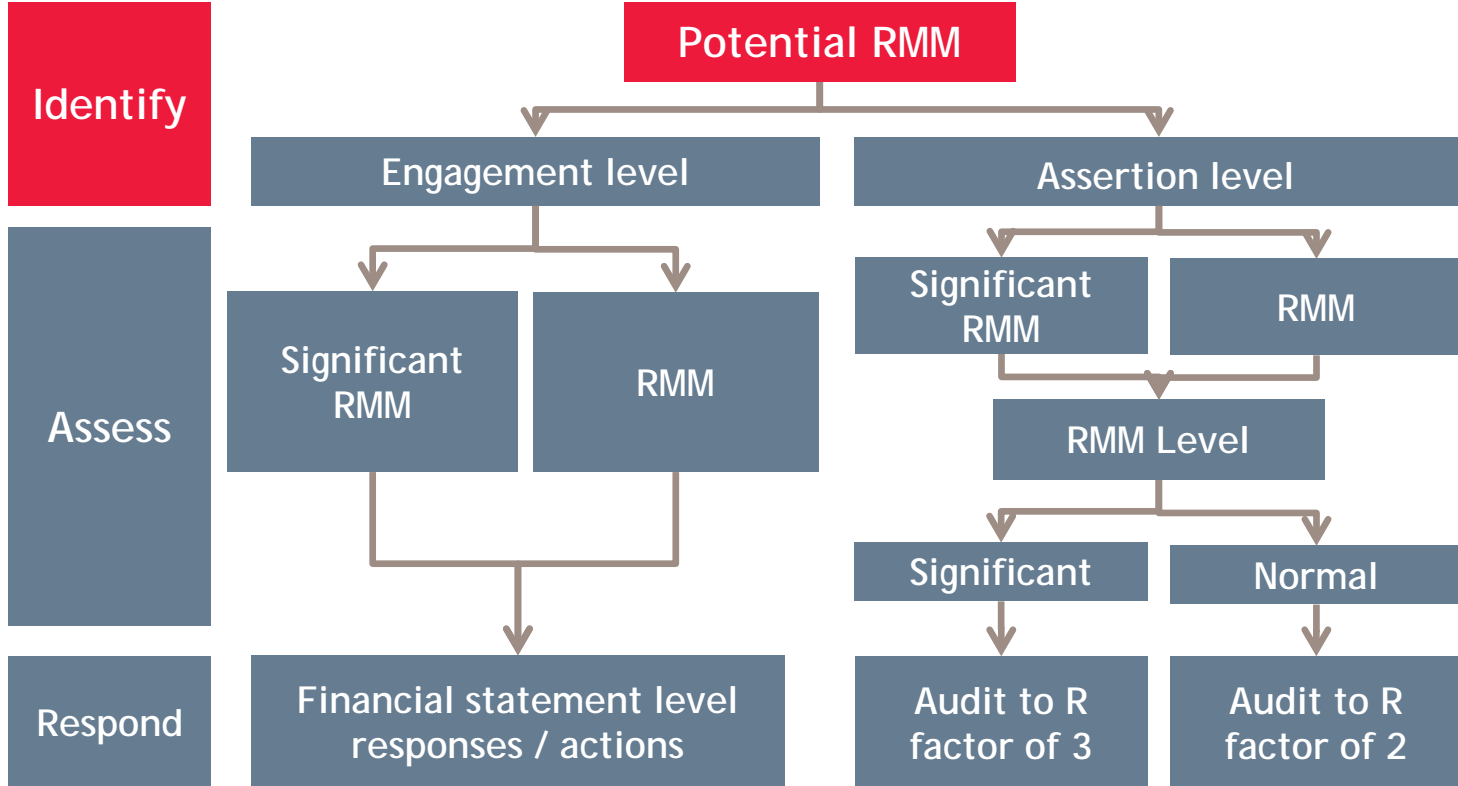


Classes of transactions, account balances or disclosures

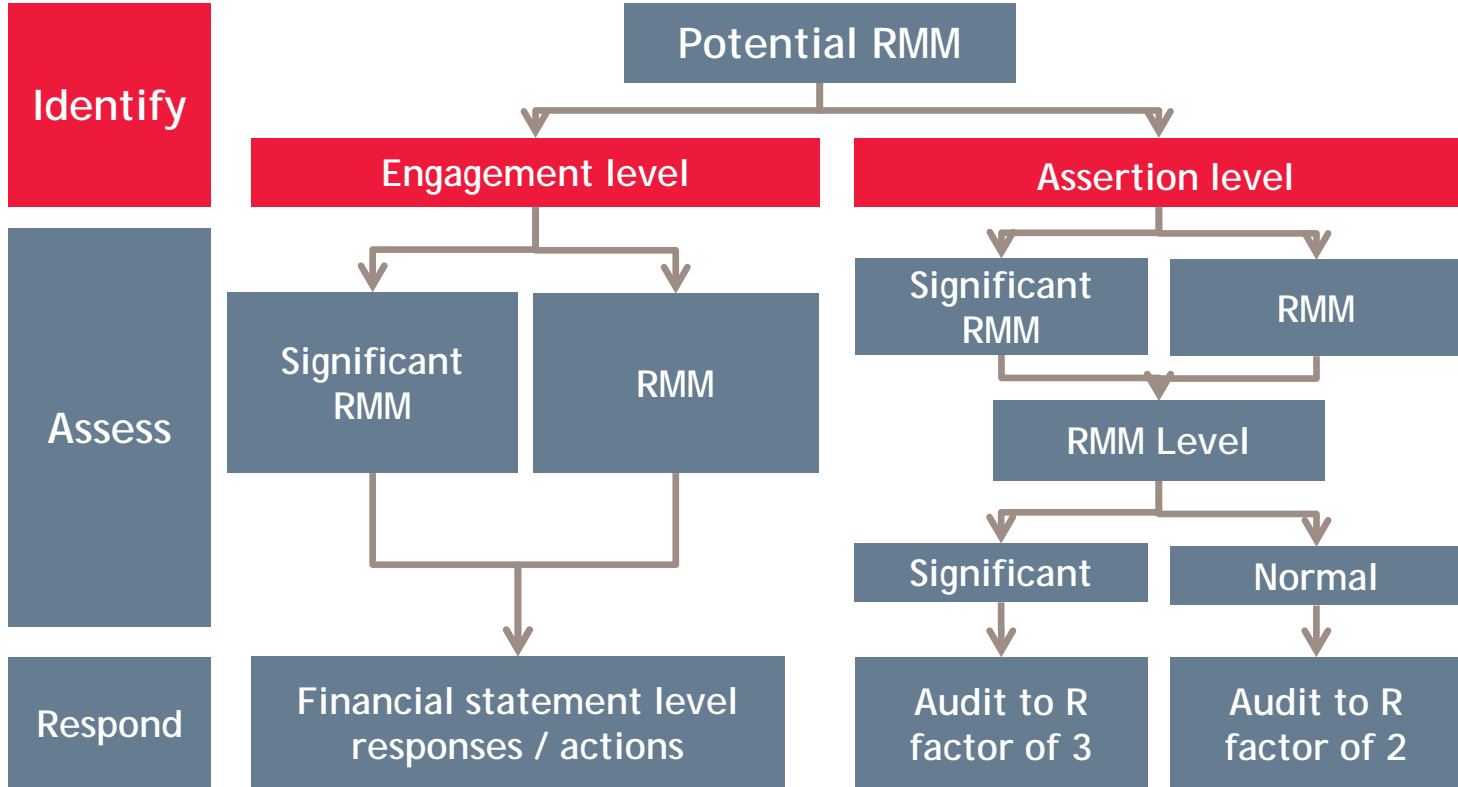
# RISKS OF MATERIAL MISSTATEMENT



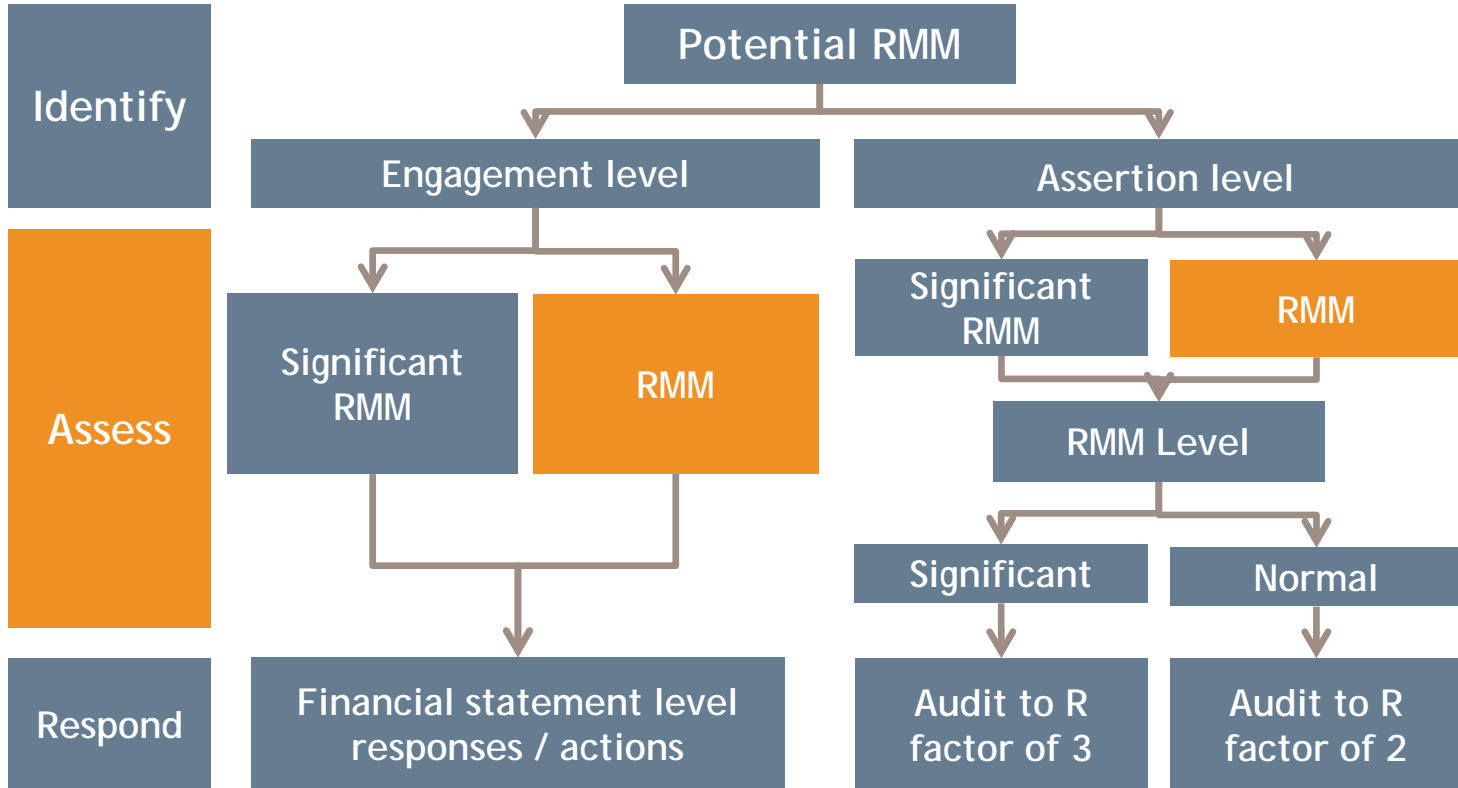
# RISKS OF MATERIAL MISSTATEMENT



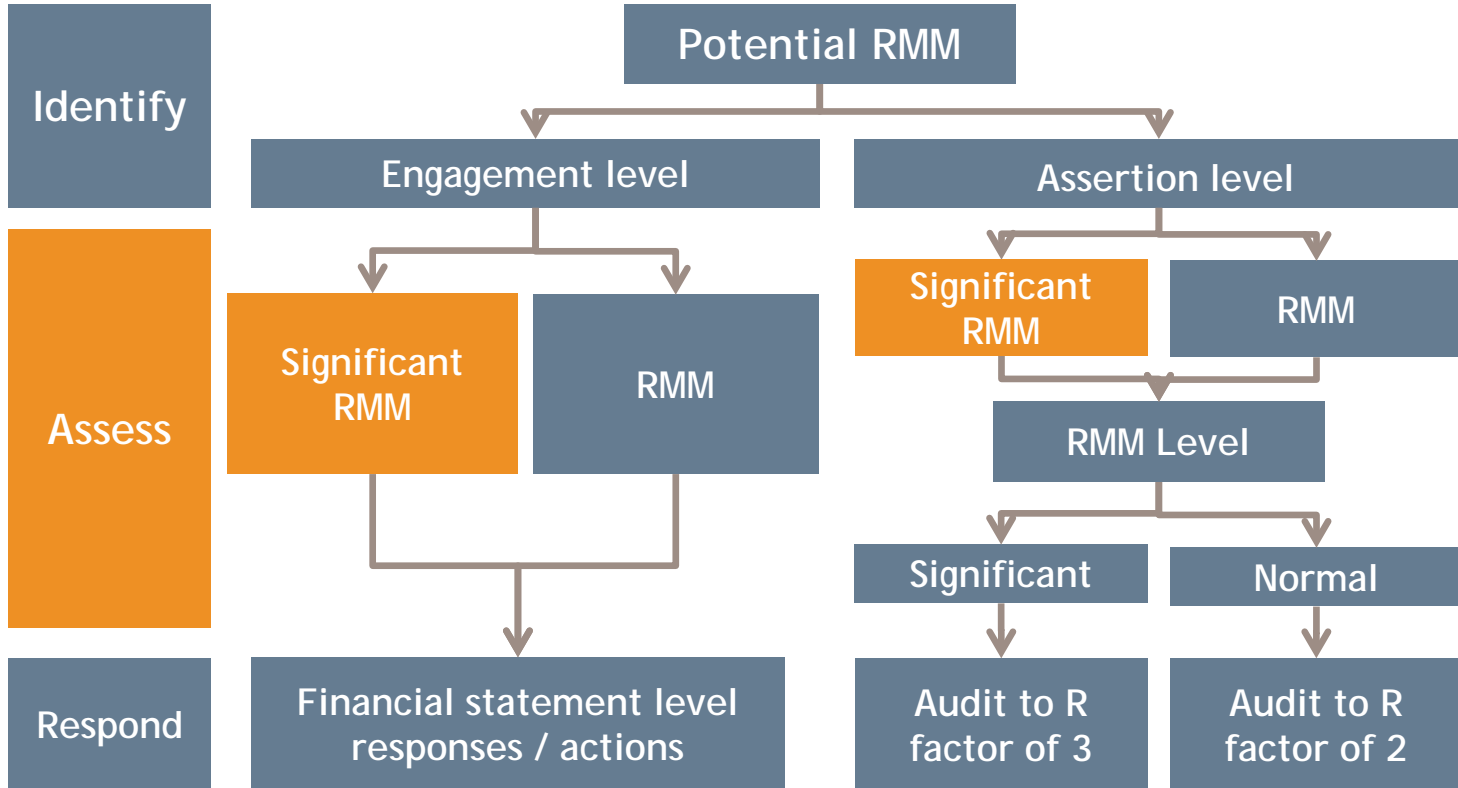
# RISKS OF MATERIAL MISSTATEMENT



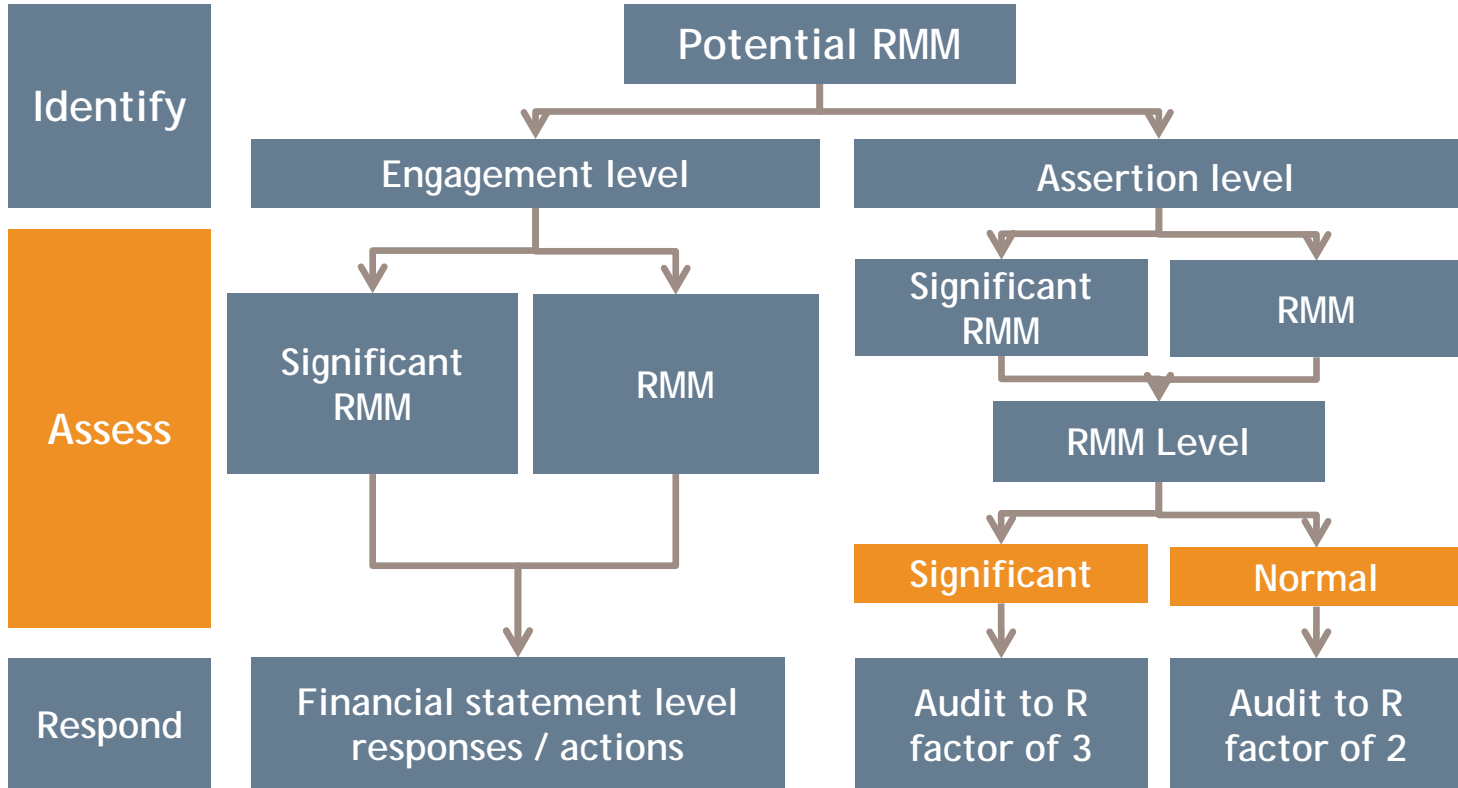
# RISKS OF MATERIAL MISSTATEMENT



# RISKS OF MATERIAL MISSTATEMENT



# RISKS OF MATERIAL MISSTATEMENT



# RISKS OF MATERIAL MISSTATEMENT

## Conditions or Events Indicating Potential RMMs

- Operations in regions that are economically unstable, for example, countries with significant currency devaluation or highly inflationary economies.
- Operations exposed to volatile markets, for example, futures trading.
- High degree of complex regulation.
- Going concern and liquidity issues including loss of significant customers.
- Constraints on the availability of capital and credit.
- Changes in the industry in which the entity operates.
- Changes in the supply chain.
- Developing or offering new products or services, or moving into new lines of business.
- Expanding into new locations.
- Indications that there may have been a cyber incident

# RISKS OF MATERIAL MISSTATEMENT

## Conditions or Events Indicating Potential RMMs

- Changes in the entity such as large acquisitions or reorganizations or other unusual events.
- Entities or business segments likely to be sold.
- Complex alliances and joint ventures.
- Lack of personnel with appropriate accounting and financial reporting skills.
- Changes in key personnel including departure of key executives.
- Deficiencies in internal control, especially those not addressed by management.
- Incentives for management and employees to engage in fraudulent financial reporting.
- Inconsistencies between the entity's IT strategy and its business strategies.
- Changes in the IT environment.
- Installation of significant new IT systems related to financial reporting.

# RISKS OF MATERIAL MISSTATEMENT

## Conditions or Events Indicating Potential RMMs

- Inquiries into the entity's operations or financial results by regulatory or government bodies.
- Past misstatements, history of errors or a significant amount of adjustments at period end.
- Significant amount of non-routine or non-systematic transactions including inter-company transactions and large revenue transactions at period end.
- Transactions that are recorded based on management's intent, for example, debt refinancing, assets to be sold and classification of marketable securities.
- Application of new accounting pronouncements (for example, IFRS 9, IFRS 15, IFRS 16 and IFRS 17).
- Accounting measurements that involve complex processes.

# RISKS OF MATERIAL MISSTATEMENT

## Conditions or Events Indicating Potential RMMs

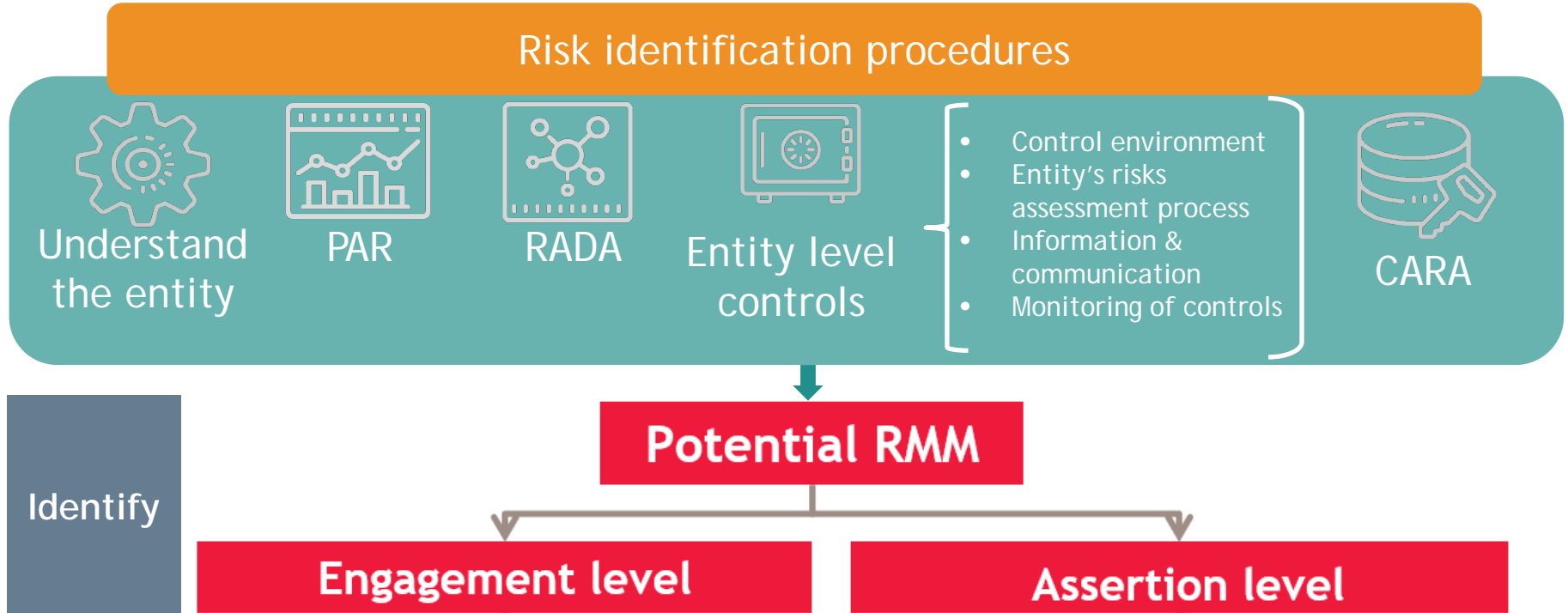
- Events or transactions that involve significant measurement uncertainty, including accounting estimates, and related disclosures.
- Omission, or obscuring, of significant information in disclosure.
- Pending litigation and contingent liabilities, for example, sales warranties, financial guarantees and environmental remediation.
- The entity has issued or invested in crypto assets.

# RISKS OF MATERIAL MISSTATEMENT

To determine whether an RMM is significant we shall consider:

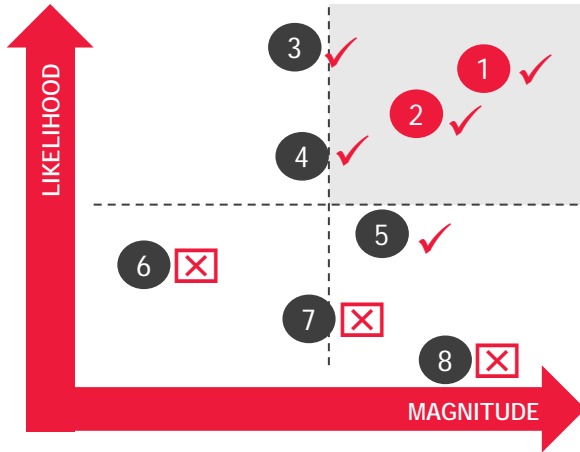
- whether it is a risk of fraud.
- whether it is related to recent significant economic, accounting or other developments and, therefore, requires specific attention;
- the complexity of transactions;
- whether it involves significant transactions with related parties;
- the degree of subjectivity in the measurement of financial information related to the risk, especially those measurements involving a wide range of measurement uncertainty; and
- whether it involves significant transactions that are outside the normal course of business for the entity, or that otherwise appear to be unusual. (ISA 315.28)

# SOURCES OF POTENTIAL RMM



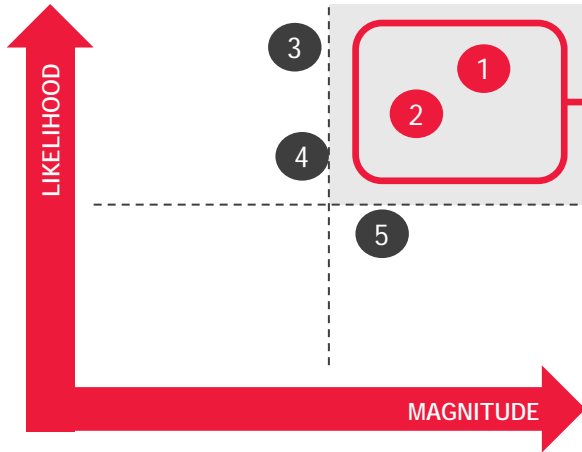
# RMM (NO LONGER JUST 'POTENTIAL')

*"Matters identified by the team which, based on the team's knowledge at that point in time, they believe could result in an assessed risk of material misstatement ('RMM'), either due to fraud or error."*



# SIGNIFICANT RMM

*“Significant RMMs are those RMMs which, in our judgement, require special audit consideration. In making this judgement, we exclude the effects of identified controls related to that risk.”*



Special audit  
consideration

# UNDERSTANDING THE ENTITY AND ITS ENVIRONMENT

The auditor shall perform risk assessment procedures to obtain an understanding of:

(a) The following aspects of the entity and its environment:

- ✓ The entity's organizational structure, ownership and governance, and its business model, including the extent to which the business model integrates the use of IT;
- ✓ Industry, regulatory and other external factors; and
- ✓ The measures used, internally and externally, to assess the entity's financial performance;

(b) The applicable financial reporting framework, and the entity's accounting policies and the reasons for any changes thereto; and

(c) How inherent risk factors affect susceptibility of assertions to misstatement and the degree to which they do so, in the preparation of the financial statements in accordance with the applicable financial reporting framework.

# UNDERSTANDING THE ENTITY AND ITS ENVIRONMENT

Performing risk assessment procedures in (a) and (b) above assists the engagement team in understanding the events and conditions that are relevant to the entity (i.e., understand the current period **business risks**), and in identifying potential RMMs.

An auditor's knowledge and understanding of the applicable financial reporting framework may assist in developing initial expectations about whether one or more IRMMs may exist within the entity's business process and the related FSAs and assertions.

The auditor's risk assessment procedures to obtain the required understanding may be less extensive in audits of less complex entities and more extensive for entities that are more complex.

# UNDERSTANDING THE ENTITY AND ITS ENVIRONMENT

## THE ENTITY'S BUSINESS MODEL

Understanding the entity's objectives, strategy and business model helps the auditor to understand the entity at a strategic level, and to understand the business risks the entity takes and faces.

An understanding of the business risks that have an effect on the financial statements assists the auditor in identifying risks of material misstatement, since most business risks will eventually have financial consequences and, therefore, an effect on the financial statements. (ISA 315.A61R).

# UNDERSTANDING THE ENTITY AND ITS ENVIRONMENT

## THE ENTITY'S BUSINESS MODEL

Business risks increasing the susceptibility to risks of material misstatement may arise from:

- ❖ Inappropriate objectives or strategies, ineffective execution of strategies, or change or complexity.
- ❖ A failure to recognize the need for change may also give rise to business risk, for example, from:
  - ✓ The development of new products or services that may fail;
  - ✓ Market which, even if successfully developed, is inadequate to support a product or service; or
  - ✓ Flaws in a product or service that may result in legal liability and reputational risk.
- ❖ Incentives and pressures on management, which may result in intentional or unintentional management bias, and therefore affect the reasonableness of significant assumptions and the expectations of management or those charged with governance. (ISA 315.A63R)

# UNDERSTANDING THE ENTITY AND ITS ENVIRONMENT

## THE ENTITY'S BUSINESS MODEL

Examples of matters that the auditor may consider when obtaining an understanding of the entity's business model, objectives, strategies and related business risks that may result in a risk of material misstatement of the financial statements include:

- Industry developments, such as the lack of personnel or expertise to deal with the changes in the industry;
- New products and services that may lead to increased product liability;
- Expansion of the entity's business, and demand has not been accurately estimated;
- New accounting requirements where there has been incomplete or improper implementation;
- Regulatory requirements resulting in increased legal exposure;
- Current and prospective financing requirements, such as loss of financing due to the entity's inability to meet requirements;
- Use of IT, such as the implementation of a new IT system that will affect both operations and financial reporting; or
- The effects of implementing a strategy, particularly any effects that will lead to new accounting requirements. (ISA 315.A64R)

# UNDERSTANDING THE ENTITY AND ITS ENVIRONMENT

## THE ENTITY'S BUSINESS MODEL

Examples of matters that the auditor may consider when obtaining an understanding of the activities of the entity (included in the entity's business model) include:

### (a) Business operations such as:

- ✓ Nature of revenue sources, products or services, and markets, including involvement in electronic commerce such as Internet sales and marketing activities.
- ✓ Conduct of operations (for example, stages and methods of production, or activities exposed to environmental risks).
- ✓ Alliances, joint ventures, and outsourcing activities.
- ✓ Geographic dispersion and industry segmentation.
- ✓ Location of production facilities, warehouses, and offices, and location and quantities of inventories.
- ✓ Key customers and important suppliers of goods and services, employment arrangements (including the existence of union contracts, pension and other post-employment benefits, stock option or incentive bonus arrangements, and government regulation related to employment matters).
- ✓ Research and development activities and expenditures.
- ✓ Transactions with related parties.

# UNDERSTANDING THE ENTITY AND ITS ENVIRONMENT

## THE ENTITY'S BUSINESS MODEL

Examples of matters that the auditor may consider when obtaining an understanding of the activities of the entity (included in the entity's business model) include:

### (b) Investments and investment activities such as:

- ✓ Planned or recently executed acquisitions or divestitures.
- ✓ Investments and dispositions of securities and loans.
- ✓ Capital investment activities.
- ✓ Investments in non-consolidated entities, including non-controlled partnerships, joint ventures and non-controlled special-purpose entities.

# UNDERSTANDING THE ENTITY AND ITS ENVIRONMENT

## THE ENTITY'S BUSINESS MODEL

Examples of matters that the auditor may consider when obtaining an understanding of the activities of the entity (included in the entity's business model) include:

### (c) Financing and financing activities such as:

- ✓ Ownership structure of major subsidiaries and associated entities, including consolidated and non-consolidated structures.
- ✓ Debt structure and related terms, including off-balance-sheet financing arrangements and leasing arrangements.
- ✓ Beneficial owners (for example, local, foreign, business reputation and experience) and related parties.
- ✓ Use of derivative financial instruments. (ISA 315R)

# IMPLICATIONS OF COVID-19 ON THE AUDIT OF FINANCIAL STATEMENTS

## I. Timing of audits

- ✓ Accounting transactions for some or most of the 2020 financial year are more likely to have been prepared when the entity was operating under COVID-19 conditions (entity staff working from home, a lack of access to premises/data, increasing levels of staff illness/absence, etc.).

### ■ Entity impact

This may mean that:

- Entity staff are working under increased pressure, additional workload or following changed procedures which may have led to internal controls being overridden or applied differently or incorrectly.
- Entity management decisions, estimates and other judgments may have been made using more limited information or information that changed or became quickly out of date.
- These circumstances, combined with reduced entity staff capacity, poor segregation of duties, untrained or new staff working on unfamiliar tasks, other entity staff working unsupervised or without preventive or detective controls operating effectively, could have increased opportunities for fraud and error.

## I. Timing of audits cont'd

### ■ Entity impact

- With management and TCWG focused on the immediate issues of entity financial and commercial survival during 2020, they may have paid less attention to fraud risks.
- The above disruptions are compounded in group audits with multiple components, some of which may be operating in different jurisdictions (which may have been affected by COVID-19 at completely different times and to varying extents).
- Reductions in personnel within financial institutions/suppliers/ customers may have an impact on the ability of those entities to conduct operations effectively, which may affect their ability to respond in a timely manner to confirmations.

# IMPLICATIONS OF COVID-19 ON THE AUDIT OF FINANCIAL STATEMENTS

## I. Timing of audits cont'd

### ■ Assurance impact

- ✓ We may identify increased risks of errors or fraud, both in routine transactions and in year-end adjustments or accounting estimates.
- ✓ Our ability to access Information Produced by the Entity (IPE) on a timely basis for single entity and group audits may be more affected by COVID-19 than in 2020, requiring us to be more engaged in communications with entity personnel and component auditors.
- ✓ Where third parties have faced accounting records disruption or there is lack of personnel, this may impact our ability to perform procedures such as confirmations which may lead us to apply alternative approaches to obtain sufficient appropriate evidence (online account reviews, reconciliations of supplier statements, etc.). These may be more time consuming and less reliable than confirmations.

## II. Financial health of entities subject to audit or review

### ■ Entity impact

- ✓ Uncertainty about the immediate outlook for many entities in 2021, and the sectors within which they operate, remains high.
- ✓ As government assistance programs start to wind-down and governments try to reduce public spending, entities may be operating in worsening economic conditions (reduced support payments, reduced market demand from continuing lockdowns, supplier disruption, etc.).

# IMPLICATIONS OF COVID-19 ON THE AUDIT OF FINANCIAL STATEMENTS

## II. Financial health of entities subject to audit or review

### ■ Entity impact

- ✓ Other financial impacts from 2020 activities that may affect what we see during 2021 engagements, may include:
  - Increased pressure to meet targets (especially given the declining financial situation in 2020).
  - More opportunity for entities to accelerate 'write offs' to reduce taxes and generate a bigger perceived recovery in future years, leading to increased risks of fraud or other irregularities.
  - Increased liquidity issues with entities unable to meet liabilities (especially if government assistance programs impact liquidity or lenders start to limit access to credit facilities).
  - Lower availability of staff, closure of premises and poorer cash flows (leading to reduced budgets for security personnel/ procedures) may have led to weakened security over physical assets during 2020.
  - Penalties, fines or repayments may be imposed this year on entities that may have made improper claims (tax rebates, government assistance) or did not fulfil required obligations for the assistance.

# IMPLICATIONS OF COVID-19 ON THE AUDIT OF FINANCIAL STATEMENTS

## II. Financial health of entities subject to audit or review

### ■ Entity impact

Therefore, management should be addressing the impact on entity financial health in the preparation of financial statements that will be subject to audit or review in 2021. In particular, they need to make appropriate judgments related to:

**Going concern** - given the current uncertainty in the economy, management needs to consider whether material uncertainties exist related to going concern. Going concern assessments will be more difficult for management to make (assumptions harder to make, outcomes more uncertain). Important considerations will be whether entities have access to liquid assets and can remain solvent into 2022.

**Estimates** - COVID-19, combined with changes in an entity's facts and circumstances, may result in increased estimation uncertainty and complexity - making it harder for management to make informed and appropriate estimates.

**Error** - the full impact of having personnel operating remotely, potentially with less supervision and training, in an unprecedented set of circumstances and with limited access to onsite resources or accounting records, is likely to have increased the risk of errors being made during 2020.

# IMPLICATIONS OF COVID-19 ON THE AUDIT OF FINANCIAL STATEMENTS

## II. Financial health of entities subject to audit or review

### ■ Entity impact

**Fraud** - the impact of a poorer control environment, key staff/management who may have been absent, reduced segregation of duties and potential use of 'workarounds', can all lead to increased opportunities for individuals to commit fraud. Declining financial health of entities, reduced pay, poor working conditions, and potential redundancies may also have increased motivation and rationalization incentives to commit fraud.

○ **Non-compliance with laws and regulations/accruals/ provisions** - a proliferation of new laws and regulations were imposed in 2020 across many jurisdictions at a time when many entities were struggling to survive. As a result, a number of laws and regulations may not have been complied with appropriately - (potentially exposing entities to future tax or other liabilities) or accounted for correctly.

**Accounting for government assistance** - management will have had to make decisions about how to account for government assistance (as loans repayable at some future point in time, non-repayable, etc.). Initial decisions made by management may have been incorrect (including eligibility criteria) or further guidance issued by government may indicate subsequently that the accounting treatment of the assistance needs to change.

# IMPLICATIONS OF COVID-19 ON THE AUDIT OF FINANCIAL STATEMENTS

## II. Financial health of entities subject to audit or review

### ■ Assurance impact

□ Declining financial health of entities may lead auditors to:

- ✓ Identify additional risks (including error and fraud risks) which require us to plan additional audit procedures responsive to those risks or seek out alternative evidence that is more persuasive.
- ✓ Design audit procedures to focus on those areas that were most susceptible to error and fraud (for example, establishing which parts of the accounting function were most impacted, the timeframe or where controls were overridden).
- ✓ Consider whether procedures using data for comparison and analysis purposes (such as Substantive Analytical Procedures or Data Analytics Tests) may provide lower levels of assurance.
- Remain alert and apply heightened professional skepticism (e.g., in relation to IPE, management explanations/ rationale and items within the financial statements that are based on judgments).
- Seek to understand what management and TCWG have done to prevent or detect errors and fraud being made by entity staff and management in 2020.

# IMPLICATIONS OF COVID-19 ON THE AUDIT OF FINANCIAL STATEMENTS

## II. Financial health of entities subject to audit or review

### ■ Assurance impact

- Declining financial health of entities may lead auditors to:
  - Have jurisdictional and/or ethical requirements to identify (and potentially report) non-compliance with laws or regulations.
  - ✓ This may increase this year if, for example, entities have been operating in breach of COVID-19 laws or regulations or asking personnel to work when they should not be doing so.
  - Consider unusual or non-recurring amounts or disclosures being made in the financial statements, which can affect how materiality is set .
  - Apply specific materiality to additional or different classes of transactions, account balances or disclosures as a result of changes or additional disclosures.
  - Change those components identified as being significant and redesign group audit strategy to ensure the nature, timing and extent of audit procedures provide the auditor with the evidence needed for group purposes.

