# PERFORMING RISK ASSESSMENT PROCEDURES


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# OBJECTIVES

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

- Understand the audit risk model and sources of audit risk;
- Identify Risks of Material Misstatement(RMMs) ;
- Report on going concern issues

# 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.

# THE AUDIT RISK MODEL

Inherent risk × Control risk × Detection risk = Audit risk

Risks of material misstatement (RMM)

# SOURCES OF POTENTIAL RISKS OF MATERIAL MISSTATEMENT

**Risk identification procedures**

- Understand the entity
- PAR
- RADA
- Entity level controls
  - Control environment
  - Entity's risk assessment process
  - Information & communication
  - Monitoring of controls
- CARA

**Potential RMM**

- Engagement level
- Assertion level

# COMPONENTS OF INTERNAL CONTROL

# SOURCES OF POTENTIAL RISKS OF MATERIAL MISSTATEMENT

## The Risk Assessment Process

### 1.Identify risks (Overall purpose)

We perform risk assessment procedures to provide a basis for the identification and assessment of potential RMMs at the financial statement level and assertion levels.

### 2.Identify risks through understanding the entity and its environment and applicable financial reporting framework

This understanding is used to identify potential RMMs through documentation of an Understanding the Entity questionnaire (UTE) and carrying out a preliminary analytical review (PAR). We may also use risk assessment data analytics (RADA) during this phase.

### 3.Identify risks through understanding internal control

For those key cycles identified, we gain an understanding of the processes and controls within the cycle from transaction initiation through to reporting and identify all CARA.

# SOURCES OF POTENTIAL RISKS OF MATERIAL MISSTATEMENT

## The Risk Assessment Process

### 4.Assess risks

This is where the potential RMMs we have identified are considered individually, and in aggregate, in order to decide if they are an actual RMM and whether any of those are significant RMMs.

We then assess the RMM level for each scoped in FSA assertion at either Normal or Significant taking into account the RMMs and Significant RMMs allocated to the assertion.

In addition, we also consider the engagement level risks identified.

The engagement team discussion (ETD) is a key mechanism for this.

# SOURCES OF POTENTIAL RISKS OF MATERIAL MISSTATEMENT

The Risk Assessment Process

## Example: SOLA LIGHTING COMPANY

### Planning meeting with the Company

You attended a planning meeting with the Company and learned the following:

During the year under audit, the Company appointed a new finance director who joined from one of the Company's competitors.
She has over 20+ years' experience in the industry, is a CPA(K), and began her career in public accounting.

Other than Ms Veronica, the new financial director, there are no other changes to the leadership team of Mr Hassan (CEO), Mrs Cherotich (COO) and Mr Ochieng (Financial controller).

# SOURCES OF POTENTIAL RISKS OF MATERIAL MISSTATEMENT

## The Risk Assessment Process

## Example: SOLA LIGHTING COMPANY

### Planning meeting with the Company

The Company has recently seen an increase in average trade debtor days with the average account now taking 90 days to pay its balance.

This has caused the Company to struggle with cash flow and it has had to increase drawings on its' revolving line of credit.

During the meeting, the Controller accidentally reveals that Sola has currently borrowed all of the funds available under the line of credit, but, he doesn't foresee any problems repaying it on a timely basis or meeting the interest payments and covenants.

The Controller also mentioned that there was a lawsuit filed against them during the year by Current Technologies Ltd. The case is still in the very early phases and Sola is still investigating the claim. We also received an email confirmation from their internal counsel(Mr. Law) that indicated that he is not aware of any other pending lawsuit against the Company.

# SOURCES OF POTENTIAL RISKS OF MATERIAL MISSTATEMENT

## The Risk Assessment Process

## Example: SOLA LIGHTING COMPANY

### Planning meeting with the Company

Overall, the Company is happy with its ownership structure and operations, though the Controller does acknowledge that the new financial director has "tightened the belt", instituting a small workforce reduction and trimming overhead costs.

These small changes make the Controller optimistic that they will meet the budget for the year. He also mentions that the Company is currently on track, which he's happy about as his (and the rest of the management team's) annual bonus is tied to how well they perform against the budget.

No other large scale changes are planned for the Company prior to year-end, or for the foreseeable future.

# SOURCES OF POTENTIAL RISKS OF MATERIAL MISSTATEMENT

## The Risk Assessment Process

## Example: SOLA LIGHTING COMPANY

### Other research

To make sure you're familiar with the company and it's industry you perform an internet search.

You come across the industry journal *Lumen Revolution*. Your research indicates that that overall, the industry has held constant over the last several years in terms of units of production, sales, and growth rate, however with consumers becoming more ecologically conscious and many governments trying to cut greenhouse gas emissions, the industry is investing in research for a less energy technology with those able to innovate first able to cash in.

# SOURCES OF POTENTIAL RISKS OF MATERIAL MISSTATEMENT

## The Risk Assessment Process

## Example: SOLA LIGHTING COMPANY

Your review of the prior year financial statements and working papers reveals that the geographical dispersion of Sola's customer base is as follows :

- approximately 25% of year-to-date revenues is from customers outside Kenya, with 15% in Uganda and the remaining 10% split between Tanzania, Rwanda and South Africa.

All inventory is held in a single warehouse near School lane. An annual blind count is performed at the warehouse and your firm will be present for the observation. In the prior year, your firm was also present at the inventory count and concluded that the Company had adequate controls in place to monitor inventory.

The Company records a reserve for future expected warranty issues based on historical trends and data. In the past, the reserve has been insignificant, and this is expected to remain the same for the current year.

# SOURCES OF POTENTIAL RISKS OF MATERIAL MISSTATEMENT

## The Risk Assessment Process

## Example: SOLA LIGHTING COMPANY

## Potential RMMs Identified

## Risk #1 - Revenue Recognition

| Description | There is a risk that revenue is not being appropriately recognised (per auditing standards). |
| --- | --- |
| Engagement level risk? | No |
| Fraud Risk Factor? | Yes |
| Assertion allocation | Revenue; C,E |

## The Risk Assessment Process

## Example: SOLA LIGHTING COMPANY

## Risk #2 - Management Override of controls

| Description | There is a risk that management are intentionally overriding the company's internal control to manipulate the financial statrements (per auditing standards |
|---|---|
| Engagement level risk? | No |
| Fraud Risk Factor? | Yes |
| Assertion allocation | Management Override of Controls; P |

# SOURCES OF POTENTIAL RISKS OF MATERIAL MISSTATEMENT

The Risk Assessment Process

## Example: SOLA LIGHTING COMPANY

## Potential RMMs Identified

## Risk #3 - Impairment of Intangible Assets

| | |
|---|---|
| Description | The company has a trademark for a brand of product which was hiostorically sold to a single customer, however during the current year, the company lost that customer business. There is a risk that the related intangible may be impaired. |
| Engagement level risk? | No |
| Fraud Risk Factor? | No |
| Assertion allocation | Intangibles;V |

# SOURCES OF POTENTIAL RISKS OF MATERIAL MISSTATEMENT

## The Risk Assessment Process

## Example: SOLA LIGHTING COMPANY

## Potential RMMs Identified

## Risk #5 - Inventory Reserve Valuation

| Description | The inventory reserve is calcualted using management's assumptions and forecasts. There is a risk that the inventory reserve is not properly valued due to its highly judgemental nature. |
|---|---|
| Engagement level risk? | No |
| Fraud Risk Factor? | No |
| Assertion allocation | Inventory(V),other expenses(C,A) |

# SOURCES OF POTENTIAL RISKS OF MATERIAL MISSTATEMENT

## The Risk Assessment Process

## Example: SOLA LIGHTING COMPANY

### Potential RMMs Identified

### Risk #6 - Patent lawsuit pending

| Description | SOLA Lighting Ltd had a lawsuit filed against them for patent infringement. There is a risk that the pending lawsuit is not properly accrued or disclosed in the financial statements |
|---|---|
| Engagement level risk? | No |
| Fraud Risk Factor? | No |
| Assertion allocation | Commitments and Contingencies (P) |

# 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

Inherent risk × Control risk × Detection risk = Audit risk

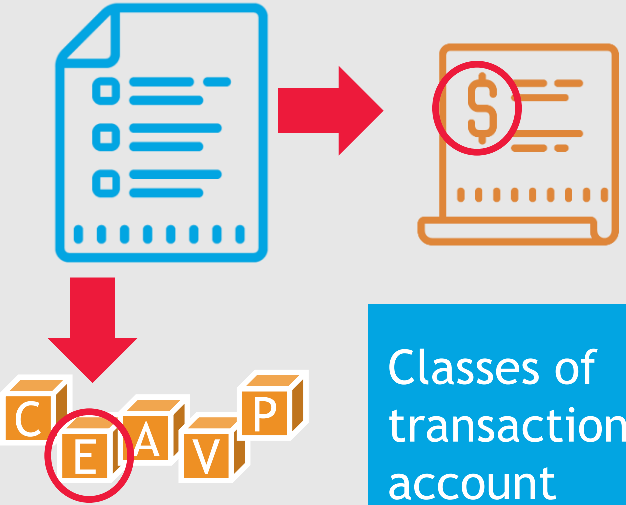
Risks of material misstatement (RMM)

# ENGAGEMENT LEVEL RISKS

- Pervasive
- Not specific to certain parts

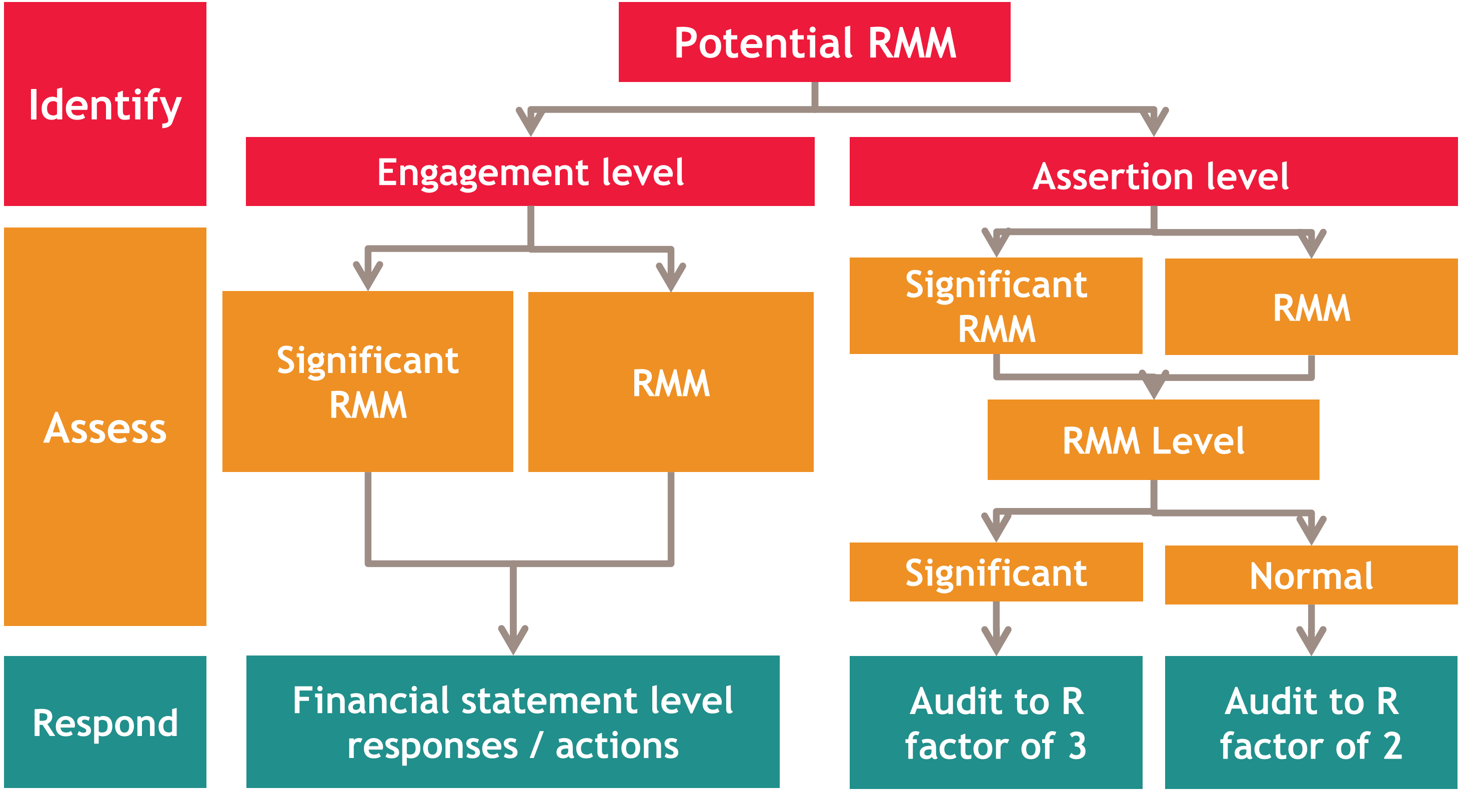
- Impacts overall behaviors & testing

# ASSERTION LEVEL RISKS




Classes of transactions, account balances or disclosures

# RISKS OF MATERIAL MISSTATEMENT



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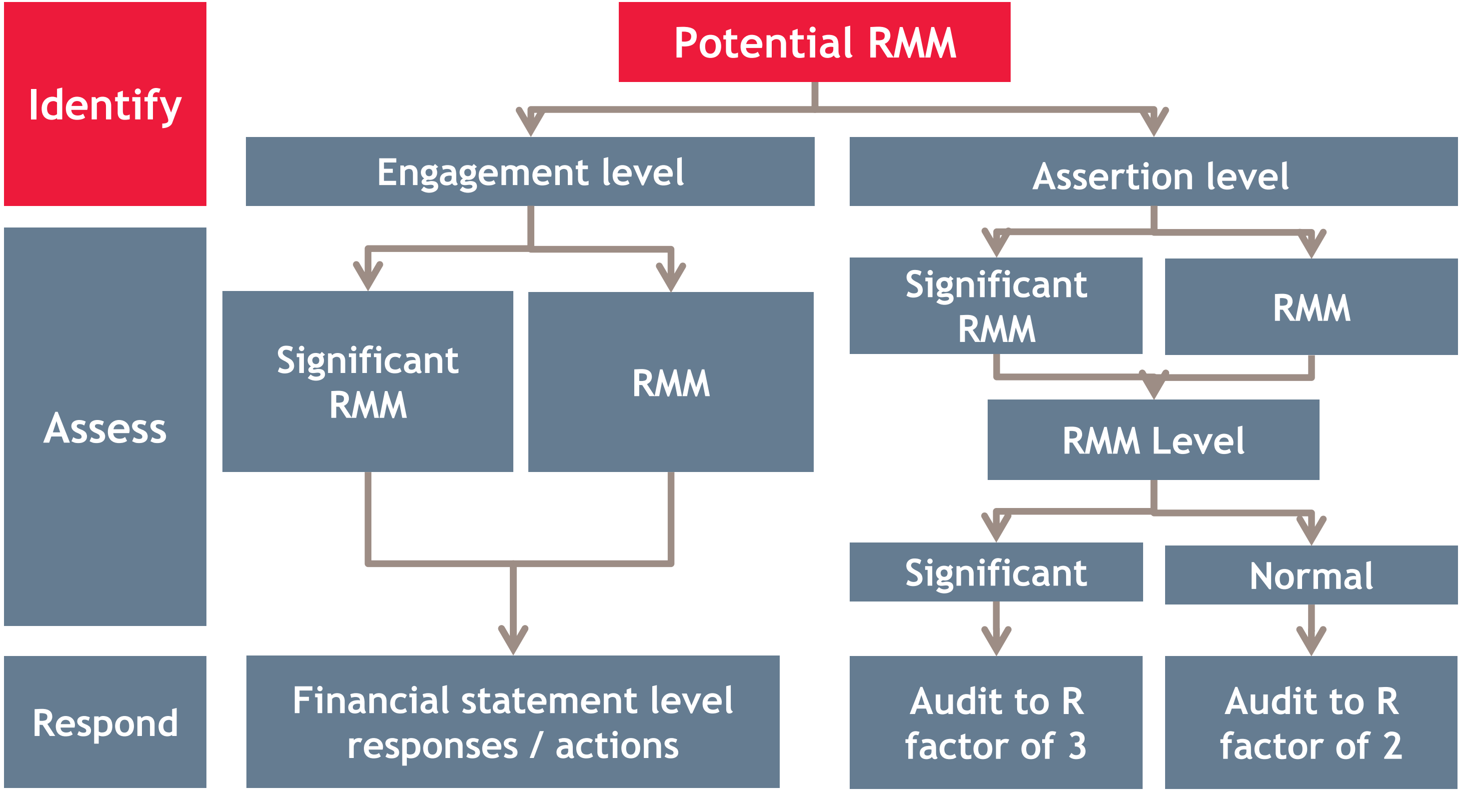

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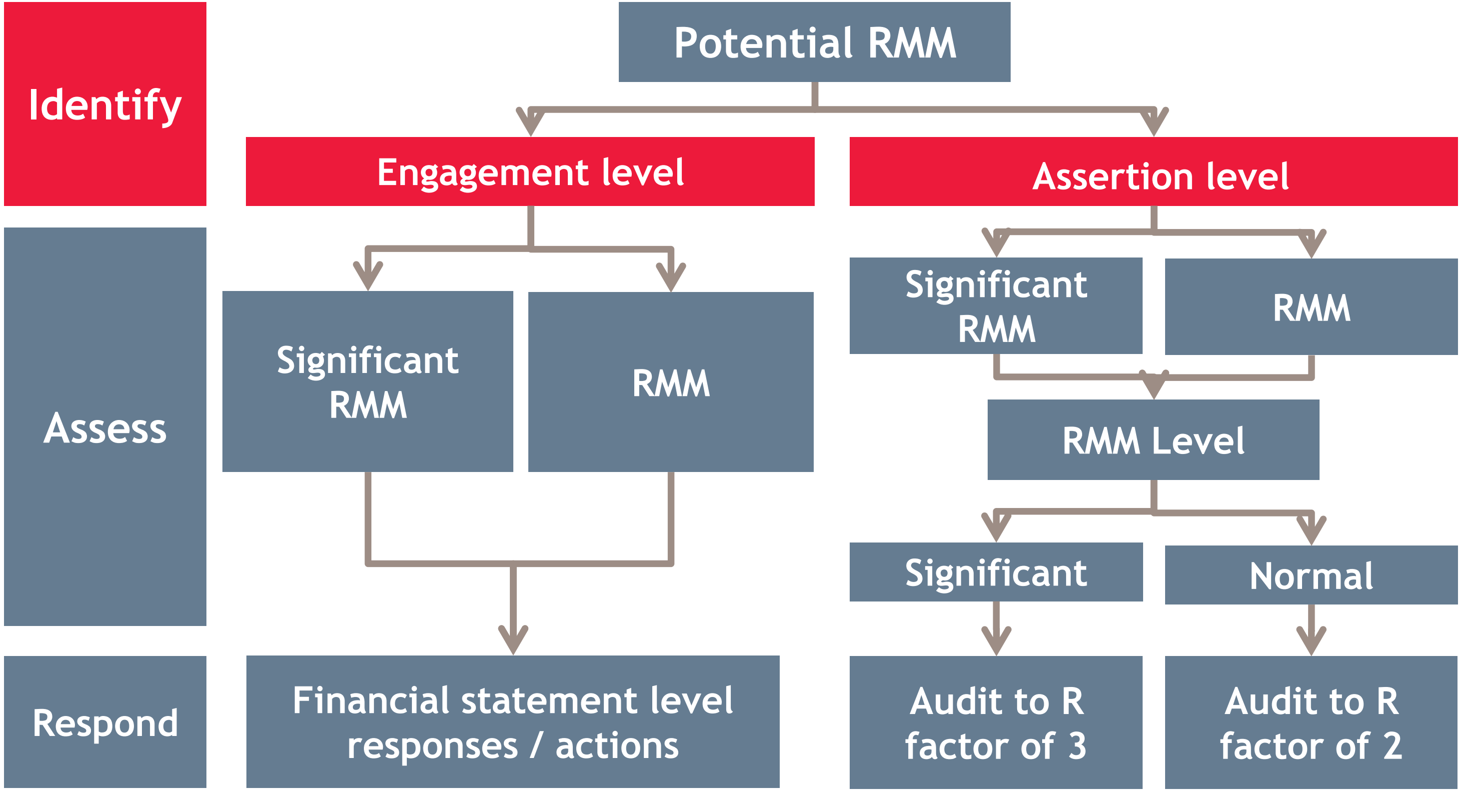

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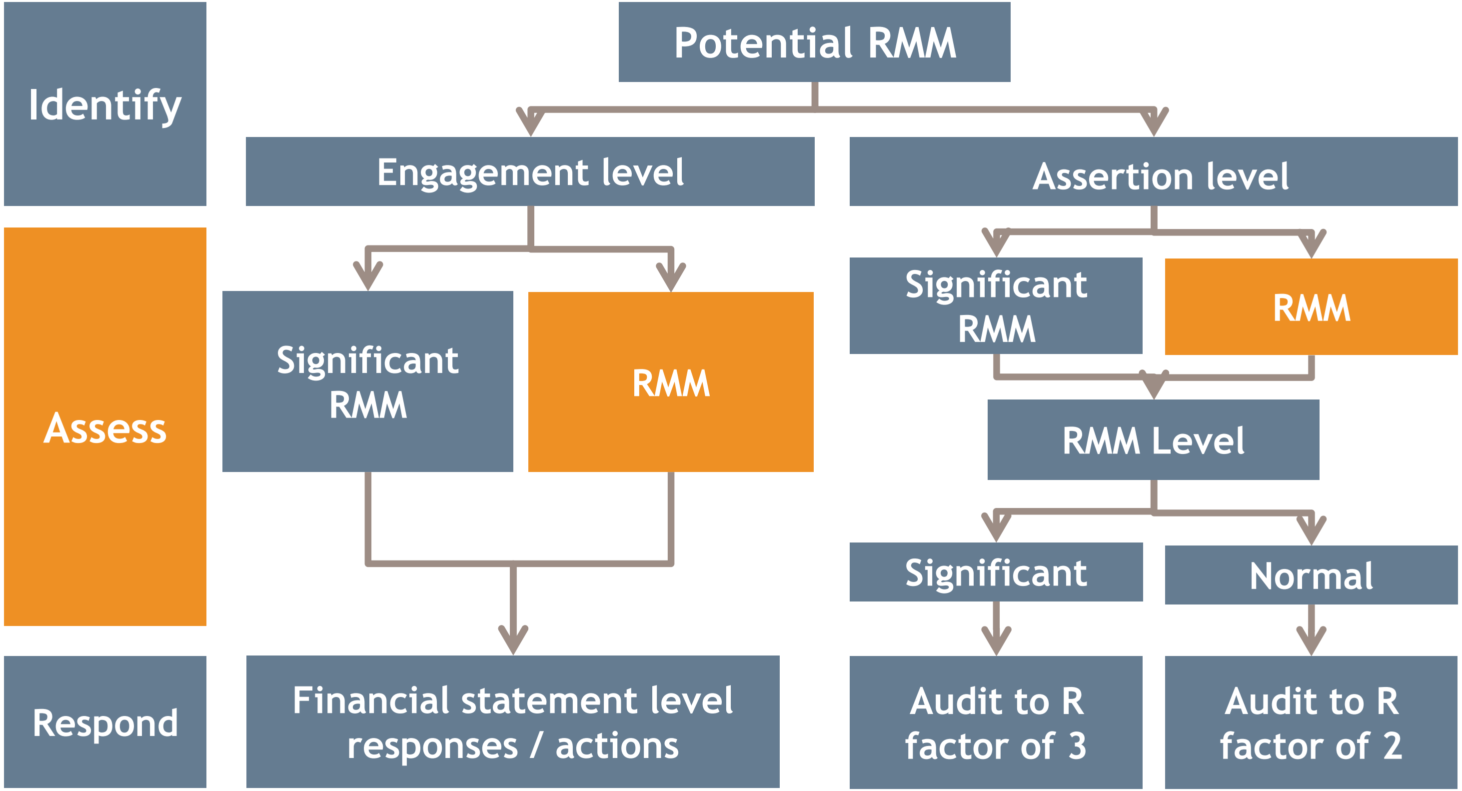

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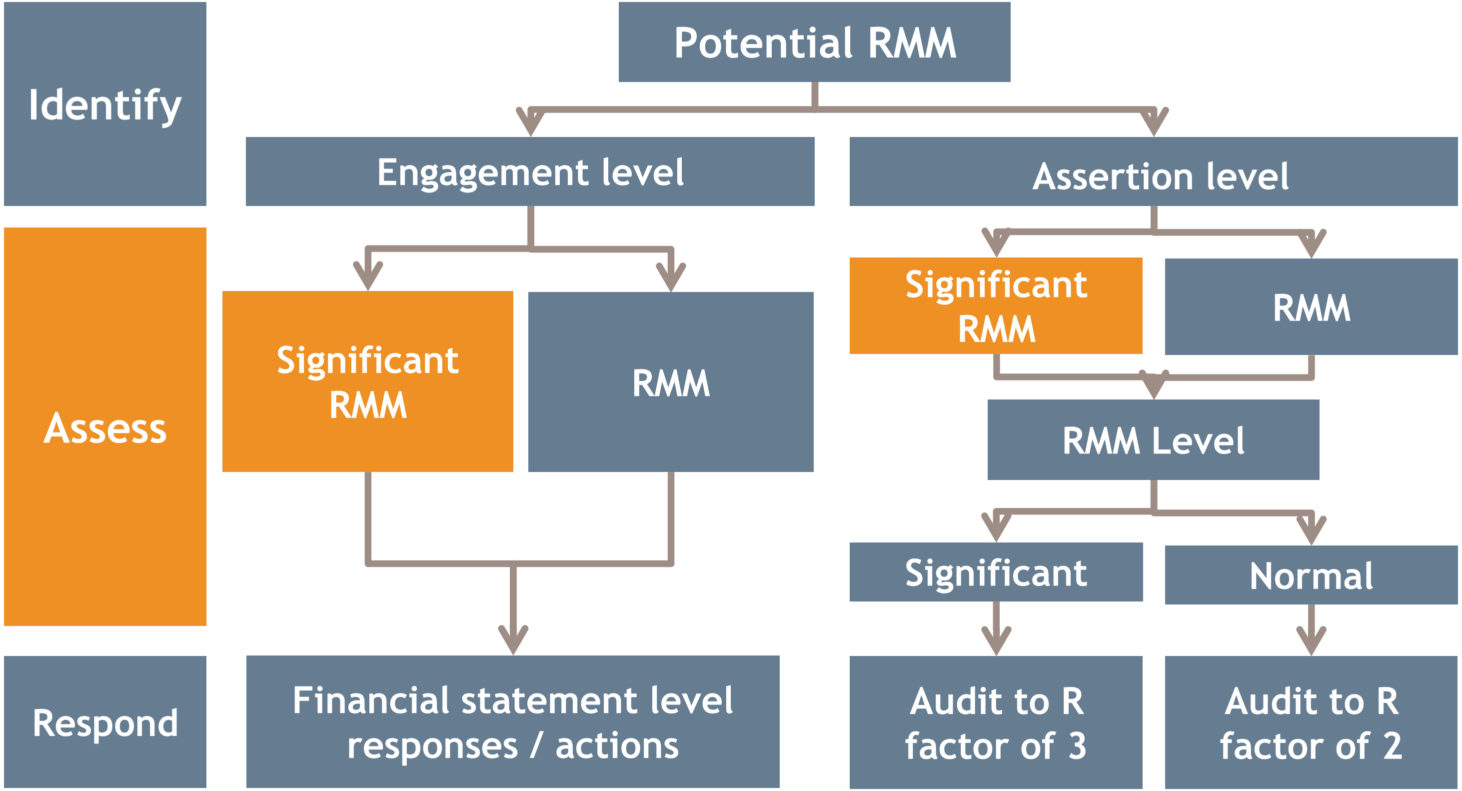

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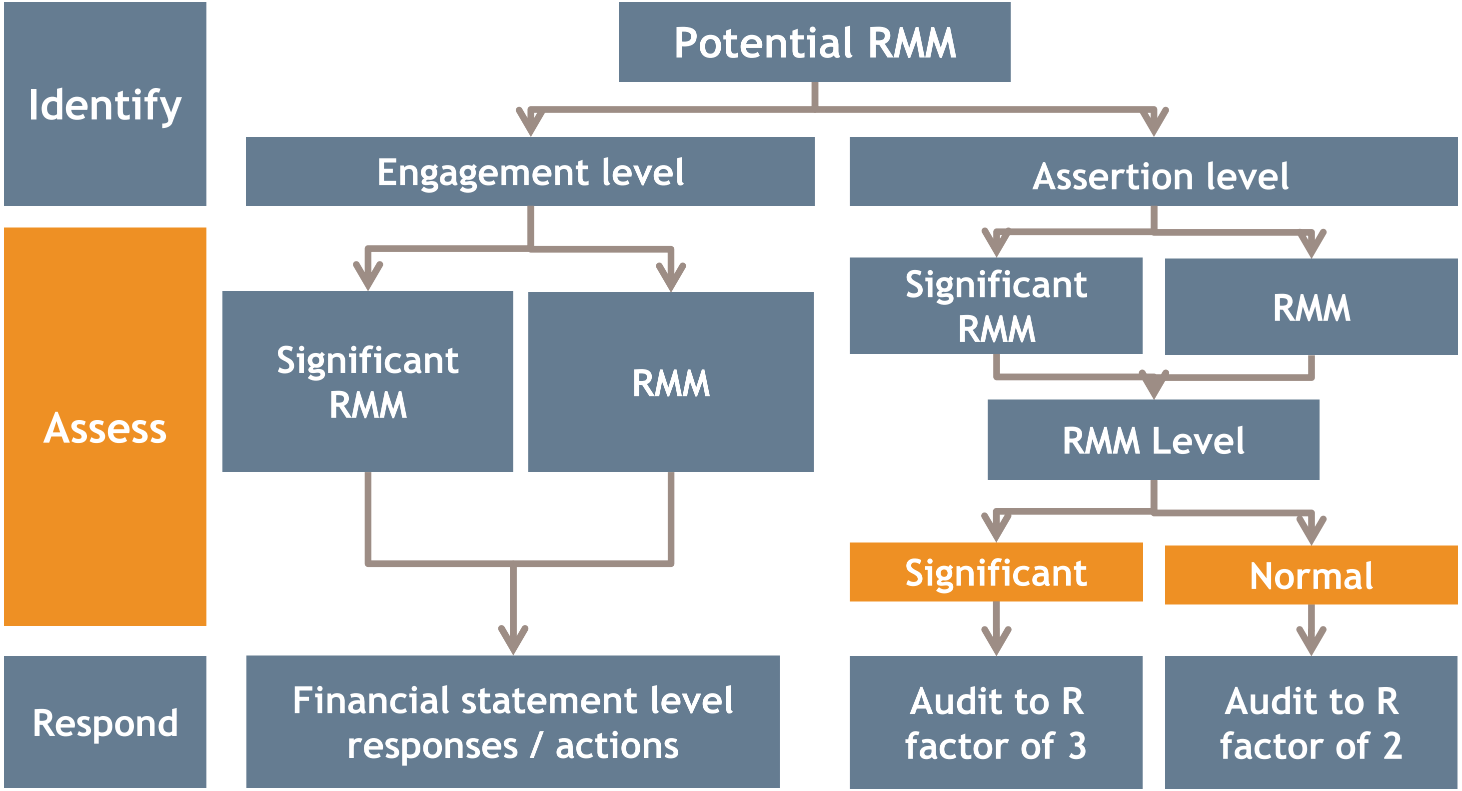


# RISKS OF MATERIAL MISSTATEMENT

## 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

Risk identification procedures

- Understand the entity
- PAR
- RADA
- Entity level controls
  - Control environment
  - Entity's risks assessment process
  - Information & communication
  - Monitoring of controls
- CARA

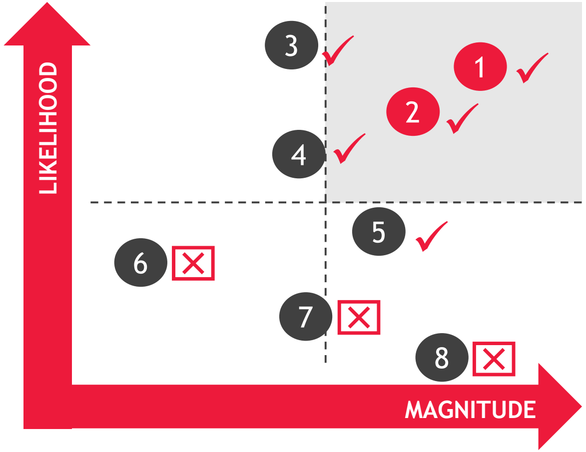
Potential RMM

Identify

- Engagement level
- Assertion level

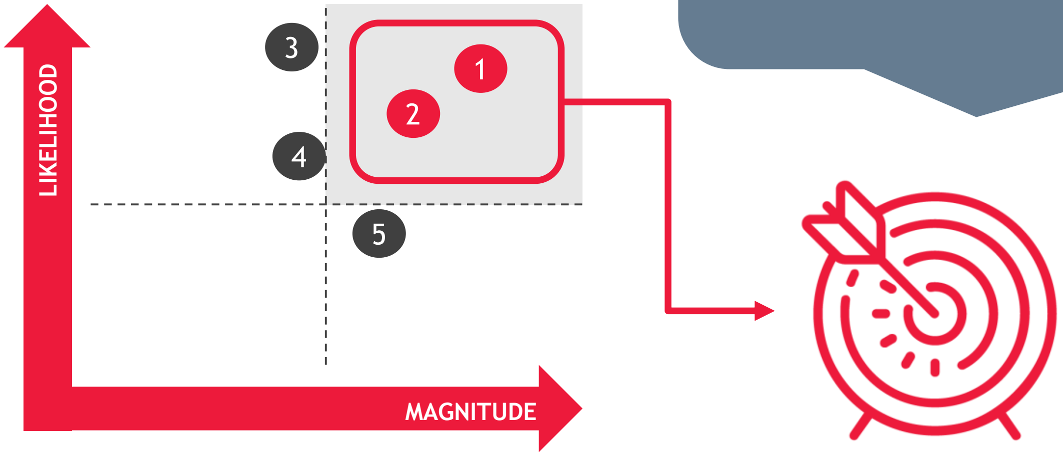
# RMM (NO LONGER JUST '*POTENTIAL*')

*"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

# EPORTING ON GOING CONCERN ISSUES

General purpose financial statements are prepared on a going concern basis unless management either intends to liquidate the entity or to cease operations or has no realistic alternative but to do so. Under the going concern basis of accounting, an entity is viewed as continuing in business for the foreseeable future.

When the continued existence of an entity is threatened, there is heightened concern about the recoverability and classification of assets and the amounts and classification of liabilities.

IAS 1 requires management to make an assessment of an entity's ability to continue as a going concern.

If management has significant concerns about the entity's ability to continue as a going concern, the uncertainties must be disclosed.

If management concludes that the entity is not a going concern, the financial statements should not be prepared on a going concern basis, in which case IAS 1 requires a series of disclosures. [IAS 1.25]

The objectives of the auditor are:

- To obtain sufficient appropriate audit evidence regarding, and conclude on, the appropriateness of management's use of the going concern basis of accounting in the preparation of the financial statements;

- To conclude, based on the audit evidence obtained, whether a material uncertainty exists related to events or conditions that may cast significant doubt on the entity's ability to continue as a going concern; and

- To report in accordance with ISA 570.

## Objectives of the auditor

During the risk assessment phase of an audit, the auditor shall consider whether there are any events or conditions that may cast significant doubt on the entity's ability to continue as a going concern.

In so doing, determine whether management has already performed a preliminary assessment of the entity's ability to continue as a going concern. (ISA 570.10)

If management has conducted their assessment, discuss it with them and determine whether management has identified any events or conditions, both individually and collectively, that may cast significant doubt on the entity's ability to continue as a going concern.

If events and conditions have been identified, discuss management's plans to address them.

If the assessment has not been performed yet, discuss with management the basis for intended use of the going concern basis of accounting.

Also inquire of management whether events or conditions exist that, individually or collectively, may cast significant doubt on the entity's ability to continue as a going concern.

# Examples of indicators of an entity's inability to continue as a going concern

## Financial

- Substantial or recurring operating losses;
- Net liability or net current position;
- Fixed term borrowings approaching maturity without realistic prospects of renewal or repayment;
- Excessive reliance on short term borrowings to finance long term assets;
- Inability to pay accounts payable on the due dates;
- Adverse key financial ratios such as low liquidity ratios and high ratio of debt to equity;
- Difficulty in complying with the terms of loan agreements or breach of borrowing limits in debenture trust deeds;
- Non-compliance with debt covenants detailed in bank loan agreements and the most recent banking facilities letter;
- Arrears or discontinuance of dividends;
- Change from credit to cash on delivery terms with suppliers;
- Inability to obtain financing for necessary new product development or other necessary investments;
- Financing the business out of overdue suppliers and other accounts payable;
- Under capitalization;
- Excessive or obsolete inventory;
- Long overdue receivables;
- Financial failures of similar businesses;
- Negative operating cash flows indicated by historical or prospective financial statements;

## Examples of indicators of an entity’s inability to continue as a going concern

**Operating**

- Loss of key management or staff without replacement;
- Loss of a key franchise or patent;
- Loss of a major market, franchise, principal supplier or major customer;
- Labor difficulties or shortages of important supplies;
- Technological developments which threaten a key product;
- Deteriorating order book;
- Substantial dependence on the success of a particular project or new product;
- Emergence of a highly successful competitor; or
- Management intentions to liquidate the entity or to cease operations.

## Notes :

1. The indicators are not assessed in isolation as the significance of such events or conditions often is mitigated by other factors.

For example, the effect of an entity being unable to make its normal debt repayments may be counter balanced by management's plans to maintain adequate cash flows by alternative means, such as by disposing of assets, rescheduling loan repayments, or obtaining additional capital.

Similarly, the loss of a principal supplier may be mitigated by the availability of a suitable alternative source of supply.

2. The assessment of the entity as a going concern is not restricted to the risk assessment phase. We shall remain alert throughout the audit for audit evidence of events or conditions that may cast significant doubt on the entity's ability to continue as a going concern.

# Audit procedures

## 1. Analyzing

- ✓ Analyzing and discussing cash flow, profit and other relevant forecasts with management; or
- ✓ Analyzing and discussing the entity's latest available interim financial statements.

## 2. Reading

- Reading the terms of debentures and loan agreements and determining whether any have been breached; or
- Reading minutes of the meetings of shareholders, those charged with governance and relevant committees for reference to financing difficulties.
- Reading key agreements to identify potential cash outflows, including redemption of preferred stock and early repayments that may be triggered by covenant violations.

## Audit procedures

**3.** Inquiring

Inquiring of the entity's legal counsel regarding the existence of litigation and claims and the reasonableness of management's assessments of their outcome and the estimate of their financial implications.

4. Confirming

Confirming the existence, legality and enforceability of arrangements to provide or maintain financial support with related and third parties and assessing the financial ability of such parties to provide additional funds; or

Confirming the existence, terms and adequacy of borrowing facilities.

5. Evaluating and Performing

Evaluating the entity's plans to deal with unfilled customer orders;

Performing audit procedures regarding subsequent events to identify those that either mitigate or otherwise affect the entity's ability to continue as a going concern; or

Determining the adequacy of support for any planned disposals of assets.

# Audit procedures

## 3.Inquiring

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## 5. Evaluating and Performing

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Determining the adequacy of support for any planned disposals of assets.

# Audit procedures

## 6.Obtaining

Obtaining and reviewing reports of regulatory actions.