Understanding the Entity, Risk Assessment and Materiality

Principles of Auditing: An Introduction to International Standards on Auditing - - Ch. 6

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Planning Defined

International Standards on Auditing (ISA) 300, 'Planning', states, “The auditor should plan the audit work so that the audit will be performed in an effective manner. Planning means developing a general strategy and a detailed approach for the expected nature, timing and extent of the audit.”
Planning - Phase II of the Audit Process

Model- OBJECTIVE

The objective of planning is to determine the amount and type of evidence and review required to give the auditor assurance that there is no material misstatement of the financial statements.
## Planning - Phase II of the Audit Process

**PROCEDURES**

1. Perform audit procedures to understand the entity and its environment, including the entity’s internal control.
2. Assess the risks of material misstatements of the financial statements.
3. Determine materiality.
4. Prepare the planning memorandum and audit program containing the auditor’s response to the identified risks.
Assessing risk is the core of the audit. The rest of the audit is designed to provide a response to these identified risks.
ISAs on Audit Risk

- ISA 315 Understanding the Entity and its Environment and Assessing the Risks of Material Misstatement
- ISA 330 The Auditor’s Procedures in Response to Assessed Risks
- ISA 500 Audit Evidence
Responses to Assessed Risk - ISA 330

- Perform risk assessment procedures
  - Procedures to understand entity and environment
- Assess the risks of material misstatement
  - Assess financial statement and assertions
- Respond to assessed risks
- Perform further audit procedures
  - Perform procedures clearly linked to risks
- Evaluate audit evidence obtained
  - Sufficient and appropriate evidence?
Procedures to Obtain a Risk Understanding (ISA 315)

- Inquiries of management
- Analytical procedures
- Observation and inspection
Audit Team Discussion

ISA 315 requires a team-wide discussion of the susceptibility of the financial statements to material misstatements.
Understanding the Entity and its Environment
The auditor should obtain an understanding of relevant industry, regulatory, and other external factors including the applicable financial reporting framework.

- the financial reporting framework (e.g., IFRS)
- the competition, supplier and customer relationships, technological developments
- regulatory environment issues
  - accounting principles
  - taxation
  - environmental requirements,
  - laws and government policies
- general economic conditions, interest rates and availability of capital and debt.
Nature of the Entity

• The assurance team should discuss the susceptibility of the company to material misstatements (especially involving fraud) of the financial statements.
  – Business operations,
  – Types of investments
  – Capital Structure and Financing
  – Financial Reporting

• Objectives and strategies
  – related business risks that may affect the financial statements
Business Operations

Information acquired about *business operations* may include:

- nature of revenue sources
- products and services
- market
- location of company facilities
- employment
- key suppliers and customers
Investments

Important transactions for which information should be gathered include:

- acquisitions, mergers and disposals of business divisions
- use of derivative financial instruments
- type of major investments by the company
- capital investment activities
- investment in non-consolidated entities such as joint ventures, special purpose entities and partnerships.
Capital Structure and Financing

• Sources and methods of financing currently and historically
• Determining ability to continue as a going concern
• Financing arrangements with subsidiaries
• Spin offs
• Off-balance sheet financing
Financial Reporting

- Company accounting policies
  - revenue recognition, inventories, research and development, important expense categories
  - judgmental accounting valuations
  - financial statement presentation and disclosure

- Foreign currency assets, liabilities and transactions

- Accounting for unusual or complex transactions
Investigate Company’s Legal Position

- corporate charter and bylaws,
- minutes of the board of directors and stockholders meetings,
- contracts.
Strategic Audit - A strategic-oriented framework involves these steps:

1. Understand the client’s strategic advantage.
2. Understand the risks that threaten the client’s business objectives.
3. Understand the key processes and related competencies to realize strategic advantage.
5. Document the understanding of the client’s ability to create value and generate future cash flows using a client business model, process analysis, key performance indicators, and a business risk profile.
6. Use the comprehensive business knowledge decision frame to develop expectations about key assertions embodied in the overall financial statements.
7. Compare reported financial results to expectations and design additional audit test work to address any gaps between expectations.
Preliminary Analytical Procedures

✓ Analytical procedures are performed at least twice in an audit - in planning and in completion procedures.

✓ Analytical procedures in planning the audit use both financial and non-financial information.
Based on the Evidence, Assess Risk

To assess the misstatement risks, the auditor performs four tasks.

1. Identify risks by developing an understanding of the company environment, including relevant controls that relate to the risks, key transactions, fairness of account balances and key financial statement disclosures.

2. Relate the identified risks to what could make management’s assertions about completeness, existence, valuation, occurrence, and measurement of transactions or assertions about rights, obligations, presentation and disclosure go wrong.

3. Determine whether the risks are of a magnitude that could result in a material misstatement of the financial statements.

4. Consider the likelihood that the risks will result in a material misstatement of the financial statements.
Business Risk

*Business risks* result from significant conditions, events, circumstances or actions that could adversely affect the entity’s ability to achieve its objectives and execute its strategies.

- Operations in regions that are economically unstable.
- Operations exposed to volatile markets.
- 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.
Audit Risk
Audit Risk

Audit risk is the risk that the auditor gives an inappropriate audit opinion when the financial statements are materially misstated. It includes:

- Inherent risk
- Control risk
- Detection risk

Illustration of Risk

Illustration 6-12 shows a symbolic graphic used by AICPA to illustrate how audit risk works.
Inherent risk

Inherent risk is the risk that an account balance or class of transactions contains a material misstatement, assuming no related internal controls exist.
Control risk

The auditor assesses control risk based on the perceived effectiveness of the entity’s internal control system in preventing and/or detecting material misstatement.
Detection risk

In determining detection risk, the auditor should consider:

- The **nature** of substantive procedures.
- The **timing** of substantive procedures.
- The **extent** of substantive procedures.
Illustration 6.13

Interrelationship of the Components of Audit Risk

The following table shows how the acceptable level of detection risk may vary based on assessments of inherent and control risks, based on the Appendix to International Standard on Auditing 400.

<table>
<thead>
<tr>
<th>Auditor’s assessment of inherent risk</th>
<th>Auditor’s assessment of control</th>
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</thead>
<tbody>
<tr>
<td>High</td>
<td>High</td>
</tr>
<tr>
<td>Medium</td>
<td>Lowest</td>
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<tr>
<td>Low</td>
<td>Lower</td>
</tr>
<tr>
<td></td>
<td>Medium</td>
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<td></td>
<td>Higher</td>
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<td>Highest</td>
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</tbody>
</table>

The darker shaded areas in this table relate to detection risk.

There is an inverse relationship between detection risk and the combined level of inherent and control risks. For example, when inherent and control risks are high, acceptable levels of detection risk need to be low to reduce audit risk to an acceptably low level. On the other hand, when inherent and control risks are low, an auditor can accept a higher detection risk and still reduce audit risk to an acceptably low level.
Significant Risk

- **Significant risks** are often business risks that have the potential to result in material misstatement of the financial statements.
- Significant risks generally relate to judgmental matters and significant non-routine transactions.
- For significant risks the auditor must perform **substantive procedures** that are specifically responsive to the risks.
Planning Materiality

‘Information is material if its omission or misstatement could influence the economic decisions of users taken on the basis of the financial statements.’

Materiality is influenced by size, nature, circumstances, and cost-benefit
Size, Nature, Circumstances & Cost Benefit

**Size of the Item.** The most common application of materiality has to do with the size of the item considered.

**Nature of the Item.** The nature of an item is a qualitative characteristic.

**Circumstances**  The materiality of an error depends upon the circumstances of its occurrence.

**Cost Benefit.** Accounting materiality differs from auditing materiality. Accounting materiality is ex post, or after the fact. Auditing materiality is ex ante, before the fact.
The auditor should consider **materiality** and its relationship with **audit risk** when conducting an audit, according to ISA 320.

In statistical sampling, there is a fixed relationship between:

- the reliability of an assertion based on the sampling (in auditing this is determined by audit risk);
- the precision of this statement (in auditing it is determined by materiality);
- the amount of evidence that should be gathered in order to make this assertion.
Where to set materiality?

Rules of thumb commonly used in practice include:

- 5 to 10 percent of net income before taxes;
- 5 to 10 percent of current assets;
- 5 to 10 percent of current liabilities;
- 0.5 to 2 percent of total assets;
- 0.5 to 2 percent of total revenues;
- 1 to 5 percent of total equity.
Thank You for Your Attention

Any Questions?