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Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement

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We, as auditors, are responsible for identifying and assessing the risks of material misstatement in the financial statements (whether caused by error or fraud) through understanding the entity and its environment, *including the entity's internal controls*.

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We Want To Reduce Risk to An Acceptable Level

Understanding the Entity & Its Environment

- Do you understand the types of transactions your client should be entering into, i.e., a *usual transaction*
- If you don't know what a usual transaction should be, you won't recognize an *unusual transaction*

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Understanding the Entity & Its Environment

Our objective is to *identify and assess* the risk of material misstatement (RMM), either due to error or fraud, at the financial statement and relevant assertion levels through *understanding the entity and its environment*, ***including the entity's internal controls***, thereby *providing a basis* for *designing and implementing* responses to assessed RMM

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Understanding the Entity & Its Environment

Some definitions:

- *Assertions:* Representations by management
- *Business Risk:* A risk resulting from *significant* conditions, events circumstances, actions, or inactions that could adversely affect an entity's ability to achieve its objectives

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- *Internal Control:* A *process* effected by those charged with governance, management, and other personnel that is designed to provide *reasonable assurance* about the achievement of the *entity's objectives* with regard to the reliability of financial reporting, effectiveness of operations, and compliance with applicable laws and regulations

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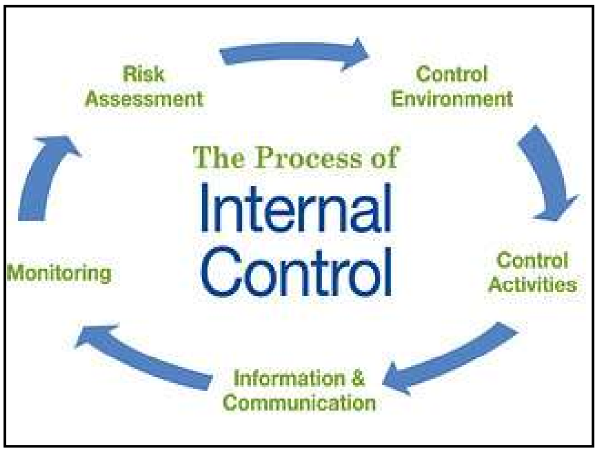

Understanding the Entity & Its Environment

- *Relevant Assertion:* A financial statement assertion that has a reasonable possibility of containing a misstatement or misstatements that would cause the financials statements to be material misstatement.

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- *Risk Assessment Procedures:* The audit procedures performed to obtained an *understanding of the entity and its environment*, *including the entity's internal control*, to identity and assess the RMM, whether due to fraud or error, at the financial statement and relevant assertion levels.

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- *Significant Risk:* An identified and assessed RMM that, in the auditor's professional judgment, requires special audit consideration

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Requirements

- The auditor *should* perform risk assessment procedures to provide a basis for the identification and assessment of RMM at the financial statement and relevant assertion levels.
- NOTE: Risk assessment procedures by themselves do not provide sufficient appropriate audit evidence on which to base the audit opinion

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Risk Assessment Procedures should include the following:

- Inquires of management *and others* within the entity who, in the auditor's professional judgment, may have information that is likely to assist in identifying RMM due to fraud or error – *But Remember*
- Analytical procedures
- Observation and inspection

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- Consider whether information obtained from client acceptance or continuance process is relevant to identifying RMM
- Assuming a continuing engagement, consider whether prior information obtained is relevant to identifying RMM

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- During planning, consider results of RMM
- If you rely on information obtained in prior audits, document any changes
- *Engagement partner* and other key team members should discuss susceptibility of financial statements to RMM
  - Decide which teem members to inform

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The Entity and Its Environment

The auditor *should* obtain an understanding (SOAU) of the following:

- Relevant industry, regulatory, and other factors, including applicable financial reporting framework
- The *nature* of the entity, including:
  - Its operations

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- Its ownership and governance structures;
- The type of investments that the entity is making or plans to make;
- Entity's selection and application of accounting policies
  - Auditor should evaluate whether such are appropriate and consistent with applicable financial reporting in the relevant industry
- Entity's objectives and strategies and related business risk that may result in RMM

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The Entity's Internal Control

- The auditor *SOAU* of the internal control *relevant to the audit*

Nature and Extent of the Understanding of Relevant Controls

- Auditor should evaluate the design of such controls and determine whether …

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- … they have been implemented by performing procedures *in addition* to inquiry of the entity's personnel

Components of Internal Control

Control Environment

- The auditor *SOAU* of the control environment and in the process *should* evaluate whether:

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- Management, with the oversight of those charged with governance, has created and maintained a culture of honesty and ethical behavior and
- *The strengths in the control environment elements collectively provide an appropriate foundation for the other components of internal control and whether those other components are not undermined by deficiencies in the control environment*

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The Entity's Risk Assessment Process

The auditor SOAU of whether the entity has a process for:

- Identifying business risks relevant to financial reporting objectives,
- Estimating the significance of the risks,
- Assessing the likelihood of their occurrences, and
- Deciding about actions to address those risks.

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- If the entity has a risk assessment process, the auditor SOAU of such
- If the auditor identifies RMM that management failed to identify, they SOAU of why management's process did not work

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- Should determine if a *significant deficiency* or a *material weakness* exists in internal control regarding the entity's risk assessment process
- If the entity has no such process, the auditor should evaluate whether the absence of such is appropriate or determine whether it represents a significant *deficiency* or a *material weakness* in entity's internal control

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The Information System, Including the Related Business Processes Relevant to Financial Reporting

The auditor *SOAU* of the information system, including the related business processes relevant to financial reporting, including the following areas:

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1. Classes of significant transactions,
2. IT and manual systems to initiate, authorize, record, process, corrected as necessary, transferred to the general ledger, and reported in the financial statements.
3. Related accounting records, either manual or electronic, supporting #2

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4. Financial reporting process used to prepare the entity's financial statements, *including significant accounting estimates and disclosures*
5. Controls surrounding journal entries, including nonstandard, used to record nonrecurring, *unusual transactions*, or adjustments

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Control Activities Relevant to the Audit

- Auditor SOAU of control activities related to understanding RMM at the assertion level and design further audit procedures responsive to assessed risks
  - It is not a requirement that the auditor understand all control activities or every assertion relevant to them

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- Auditor SOAU of the process of reconciling detailed records to the general ledger for material balances

Monitoring of Controls

- SOAU of the major activities that the entity uses to monitor internal control over reporting and how the entity initiates remedial actions to deficiencies in its controls

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- If the entity has an internal audit function, SOAU of the following in order to determine whether the IA function is likely to be relevant to the audit (i.e., can it be relied on):
  - The nature of the IA function's responsibilities and how it fits in the entity's organizational structure
  - Activities performed by the IA function

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Identifying and Assessing the RMM

In order to provide a basis for designing and performing further audit procedures, the auditor should identify and assess the RMM at:

- The financial statement level
- The relevant assertion level for classes of transactions, account balances, and disclosures

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For this purpose, the auditor should:

- Identify risk by OAU of the entity's and its environment re: relevant controls related to risks
- Assess risks related to the financial statements
- Relate risks to what could go wrong at the relevant assertion level in areas to be tested
- Consider the likelihood of misstatement and if so, would it be the magnitude that could result in a material misstatement

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Risks That Require Special Audit Consideration

Auditor should determine if, in their professional opinion, any of the risk identified are a significant risk by at least considering;

- Whether the risk is a risk related to fraud;
- Whether the risk is related to recent significant economic, accounting, or other developments and, therefore, requires specific attention;

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- The complexity of transactions;
- Whether the risk involves significant transactions with related parties;
- The degree of subjectivity in the measurement of financial information related to the risk, and;
- Whether the risk involves significant transactions that are outside the normal course of business for the entity or that otherwise appear to be unusual.

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- If it is determined that a significant risk exist, the auditor should obtain an understanding of the entity's controls and activities relevant to such risk
- Based on such understanding, evaluate whether such controls have been suitably designed and implemented to mitigate such risks

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Revision of Risk Assessment

- Original assessment of RMM may change during the course of the audit due to additional audit evidence
- Such evidence may be obtained from performing further audit procedures or new information, either which is inconsistent with evidence the auditor originally based the assessment on

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- In such situations the auditor should revise the assessment and modify the further planned audit procedures accordingly

Documentation

Auditor should include:

- Discussion among team members in risk assessment meeting
  - Significant decisions reached
  - How and when discussion occurred

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- Audit team members who participated
- Key elements related to the understanding of:
  - Relevant industry
  - Nature of entity re:
    - Operations
    - Ownership and governance structure
    - Types of investments entity has

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- Structure of entity and how it's financed
- Classes of transactions, account balances, and disclosure in the financial statements
- Entity's selection and application of GAAP
- Entity's objectives and strategies and related business risk that may result in risks of material misstatement
- Source of information and risk assessment procedures performed

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Application and Other Explanatory Material

Risk Assessment Procedures and Related Activities

Gaining an understanding of the entity and its environment, including its internal controls, is a continuous, dynamic process of gathering, updating, and analyzing information throughout the audit

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- Such understanding establishes a basis from which the auditor plans the audit and exercises professional judgment throughout the audit when, for example:
  - Assessing the RMM of the financial statements
  - Determining *materiality*
    - Quantitatively
    - Qualitatively
  - Appropriateness of selection and application of accounting policies

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- Adequacy of financial statement disclosures
- Identifying areas for special audit consideration
- Developing expectations related to analytical procedures
- Designing effective audit procedures based on RMM
- Evaluating *sufficiency and appropriateness* of audit evidence such as assumptions and management's oral & written representations

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Information obtained by performing risk assessment procedures may be used to:

- Support assessments of RMM

May also:

- Obtain audit evidence re: classes of transactions
- Account balances
- Disclosures
- Relevant assertions
- Operating effectiveness of controls

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May also choose to perform substantive procedures or tests of controls concurrently with risk assessment procedures in order to improve audit efficiency

- The risks to be assessed include both those due to fraud and those due to error

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Inquiries of Management and Others Within the Entity

Much of the information obtained by the auditor's inquiries is from management and those responsible for financial reporting

- May also obtain information or a different perspective through inquires of others within the entity such as:
  - Those charged with governance

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- Internal audit personnel re: IA procedures
- Employees involved in initiating, authorizing, processing, or recording complex or unusual transactions may help to evaluate the appropriateness of selection and application of certain accounting principles

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Understanding the Entity & Its Environment

- Internal audit personnel re: IA procedures
- Employees involved in initiating, authorizing, processing, or recording complex or unusual transactions may help to evaluate the appropriateness of selection and application of certain accounting principles
- In house legal counsel re: matters related to litigation, compliance with laws and regulations, knowledge of fraud or suspected fraud affecting the entity, warranties, post sales obligations

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- Marketing or sales personnel re: information about changes in the entity's marketing strategies, sales trends, or contractual arrangements with customers

- Analytical Procedures
  - As performed as part of the risk assessment, such procedures may assist in identifying risk of material misstatement
  - May also assist in enhancing the auditor's understanding of the client's business and significant transactions and events that have occurred since the prior audit

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Understanding the Entity & Its Environment

- Observation and Inspection
  - May support inquiries of management and others and also may provide information about the entity and its environment such as:
    - The entity's operations
    - Documents, records, and internal control manuals
    - Various reports prepared by management, those charged with governance, and internal audit
    - The entity's premises and plant facilities

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Understanding the Entity & Its Environment

- Information Obtained in Prior Periods
  - Auditor's past experience with the entity may provide information such as:
    - Past misstatements and whether they were corrected on a timely basis
    - The nature of the entity and its environment and the entity's internal controls
    - Significant changes re: the entity or its operations have undergone since the prior financial period

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- The auditor is required to determine whether information obtained in prior periods remains relevant if the auditor intends to use the information for the purposes of the current audit
  - RE: Changes in the control environment
- Discussion among the engagement team about the susceptibility of the entity's financial statements to material misstatement
  - Provides opportunity for more experienced team members, including engagement partner, to share their past experience with the entity

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- Allows the engagement team members to exchange information re: entity's business risk and where and how the financial statements might be susceptible to material misstatement due to fraud or error
- Allows team members to understand the areas of potential misstatement and how their work may affect other aspects of the audit including the nature, timing and extent of further audit procedures
- Provides a basis for audit team members to communicate and share new information and ideas obtained throughout the audit which may affect the assessment of risk of material misstatement

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- Such discussion maybe held concurrently with the required discussion related to the susceptibility of the entity's financial statements to material misstatement due to fraud
  - Must have separate documentation related to both the susceptibility of material misstatement due to error and/or fraud
  - It is not necessary in all instance to have every discussion team member present for such discussions

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- Some small audits may be performed by the engagement partner or sole practitioner
  - In such instances, they should include documentation that they considered susceptibility of the entity's financial statements to material misstatements due for error or fraud
- Understanding the Industry, Regulatory, and Other External Factors
  - Relevant industry factors include industry conditions such as:

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- Competitive environment
- Supplier and customer relationships
- Technological developments
- Market and competition re: demand, capacity and price
- Cyclical or seasonal activity
- Product technology relating to entity's products
- Energy supply and cost

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Understanding the Entity & Its Environment

- Regulatory Factors/Environment
  - Includes applicable financial reporting framework and the legal and political environment, such as:
    - GAAP and industry-specific practices
    - Regulatory framework for a regulated industry
    - Laws and regulations that *significantly* affect the entity's operations
    - Taxation
    - Government policies/incentives/aid/tariffs/trade restrictions

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- Environmental requirements affecting the industry and the entity's business
- Other external factors may wish to be considered such as:
- Interest rates
- General economics conditions
- Availability of financing
- Inflation or currency revaluation

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Understanding the Entity & Its Environment

An understanding of the nature of an entity enables the auditor to understand such matters as:

Business Operations

- Nature of revenue sources
- Alliances, joint ventures, and outsourcing activities
- Location of production facilities, warehouses, offices, and location and quantities of inventories
- Key customer and important supplies

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Understanding the Entity & Its Environment

- Research and development activities and expenditures
- Transactions with related parties

Investments and investment activities such as:

•Planned or recently executed acquisitions or divestitures

•Investments and loans

Financing and financing activities such as:

•Major subsidiaries and associated entities, included consolidated and non consolidated structures

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- Debt structure and related terms, including off balance sheet financing arrangements and leasing agreements
- The use of derivative financial instruments

Financial reporting such as:

- GAAP and industry specific practices
- Revenue recognition practices
- Foreign currency assets, liabilities, and transactions
- Accounting for unusual and complex transactions

Any significant changes in the entity from prior periods may give rise to, or changes of RMM

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The Entities' Selection and Application of Accounting Policies

May encompass such matters as:

- Method to account for significant and unusual transactions
- Effect of significant accounting policies in controversial or emerging areas for which a lack of authoritative guidance or consensus exits
- Significant changes in the entity's accounting policies and disclosures and why the change

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Understanding the Entity & Its Environment

- *New financial reporting standards*, laws and regulations and when and how they will be adopted
- The financial reporting competencies of personnel involved
- *In selecting and applying significant new or complex accounting standards*

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Understanding the Entity & Its Environment

Business risk is broader than the risk of material misstatement of the financial statements and may arise as a result of:

- Development of new products or services that fail

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Understanding the Entity & Its Environment

Business risk is broader than the risk of material misstatement of the financial statements and may arise as a result of:

- Development of new products or services that fail
- Inadequate market/demand to support a product or service
- Flaws in a product or service that may result in liabilities and reputational risk

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Regina Vacuum Cleaner Company

February 1989: Former Regina Officers Admit Fraud

February 08, 1989|From Times wire services

NEWARK, N.J. — Two former top executives of Regina Co. pleaded guilty today to defrauding investors in the vacuum cleaner company of more than $100 million by issuing inflated earnings reports.

. First, a few customers returned the machines, claiming the internal gears had stripped. Then there were scattered reports that the vacuum's innards were melting. Regina's experts quickly pinpointed the problem: plastic. In his greed to increase profitability, Sheelan had the original vacuum's sturdy metal parts replaced with plastic ones. The new vacuums, as Sheelan would quickly discover, simply couldn't take the heat.

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Share

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What started out as a trickle of returns turned into a raging torrent. Before long, the warehouse supervisor called with disturbing news: there was no more room to store the returned vacuums. Sheelan's CFO then called to report more bad news: The auditors were coming. It didn't take Sheelan long to identify the crisis. If the auditors saw the boxes stacked in the warehouse, they would surely figure out what was going on.

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In desperation, the company rented off-site storage space to hide the worthless merchandise. One of Sheelan's lieutenants made sure that all of the documentation reflecting the returns was removed—no bills of lading, no warehouse count sheets, no inventory return forms.

- In August the company's shares were at $27
- At the end of September, they were at $4

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In this instance, the auditors failed to recognize a HUGE risk …

The Risk of Failure

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If one understands the business risks facing a client, the higher the probability of identifying such risks

Example of matters that the auditor may consider when obtaining an understanding of the entity's objectives, strategies, and related business risk that may result in a MM of the financial statements are:

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- Industry developments
- New products and services
- Expansion of the business
- New accounting requirements
- Regulation requirements
- Current and prospective financing requirements
- Use of IT…..Systems and process are incompatible

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The Entity's Internal Control

An understanding of internal control assists the auditor in identifying types of potential misstatements and factors that affect the RMM and in designing the nature, timing, and extent of further audit procedures

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Understanding the Entity & Its Environment

General Nature and Characteristics of Internal Control

Purpose of Internal Control

- Internal control is designed, implemented, and maintained to address identified business risks that threaten the achievement of any of the entity's objectives that concern:

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- Reliability of the entity's financial reporting
- Effectiveness and efficiency of its operations
- Its compliance with applicable laws and regulations

- The way in which internal control is designed, implemented, and maintained varies with an entity's size and complexity

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- Smaller entities may use less structured means and simpler process and procedures to achieve their objectives
- The owner-manager may perform functions that in a large entity would be regarded as belonging to several of the components of internal control
- As a result, the components of internal control may not be clearly distinguished within a smaller entity, but their underlying purposes are equally valid

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Limitations of Internal Controls

- Even the very best can only provide *reasonable assurance* of achieving objective
  - There is no internal control to prevent stupidity or an honest mistake
  - Can always be circumvented by collusion
  - Cost vs Benefit must always be considered
- In designing internal controls, management may make judgments on the nature and extent of the controls it chooses to implement and the nature and extent of the risks it chooses to assume

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Understanding the Entity & Its Environment

Manual and Automated Internal Controls

Use of manual or automated elements in internal control can affect the manner in which transactions are initiated, authorized, recorded, processed, and reported

- In a manual system, may include such procedures as approvals and reviews of transactions and reconciliations

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- An entity may use an automated procedures to initiate, authorize, record, process, and report transactions in which case records in electronic format replace paper documents

An entity's mix of manual and automated elements in internal control varies with the nature and complexity of the entity's use of IT

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Understanding the Entity & Its Environment

- Generally, IT benefits an entity's internal control by enabling an entity to:
  - Consistently apply predefined business rules and perform complex calculations in processing large volumes of transactions or data
  - Enhances the timeliness, availability, and accuracy of information
  - Facilitate the additional analysis of information
  - Reduce the risk that controls will be circumvented

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- Enhance the ability to monitor the performance of the entity's activities and its policies and procedures; and
- Enhance the ability to achieve effective segregation of duties by implementing security controls in applications, databases, and operating systems

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- *For every action there is an equal and opposite reaction* in that IT poses specific risks to an entity's internal controls, including, for example:
  - Reliance on systems or programs that are inaccurately processing data, processing inaccurate date, or both
  - Unauthorized access to data that may result in destruction of data or improper changes to date. Particular risk may arise when multiple users access a common database

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- The possibility of IT personnel gaining access privileges beyond those necessary to perform their assigned duties, thereby breaking down segregation of duties
- Unauthorized changes to data in master files, systems and programs
- Failure to make necessary changes to system or program's
- Improper manual intervention
- Potential of data or inability to access data as required

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Understanding the Entity & Its Environment

- When judgement and discretion are required, manual controls may be more suitable in situations such as:
  - Large, unusual, or nonrecurring transactions
  - Circumstances in which errors are difficult to define, anticipate, or predict
  - Changing circumstances that require a control response outside the scope of an existing automated control
  - Monitoring of the effectiveness of automated controls

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- Because manual elements of internal control may be less reliable than automated elements, they can be more easily bypassed, ignored, or overridden, and they are also more prone to simple errors and mistakes
- Consistency of application of a manual control element cannot be assumed

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Understanding the Entity & Its Environment

- Manual control elements may be less suitable for the following circumstances:
  - High volume of recurring transactions or in situations in which errors that can be anticipated or predicted can be prevented, or detected and corrected, by control parameters that are automated
  - Control activities in which the specific ways to perform the control can be adequately designed and automated

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Understanding the Entity & Its Environment

The extent and nature of the risks to internal control vary depending on the nature and characteristics of the entity's information system

- Multiple, users, either external or internal, may access a common database of information that affects financial reporting
  - Lack of control of a single user point might compromise the security of the entire database

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Understanding the Entity & Its Environment

- Although internal control applies to the entire entity, an understanding of internal control relating to each of the entity's operating units and business functions may not be necessary to the performance of the audit
- Factors relevant to the auditor's professional judgment about whether a control is relevant to the audit may include matters as the following:

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- *Materiality*
- The significance of the related risk
- The size of the entity
- The nature of the entity's business, including its organization and ownership characteristics
- The diversity and complexity of the entity's operations
- *Applicable* legal and regulatory requirements
- The circumstances and the applicable component of internal control

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- The nature and complexity of the systems that are part of the entity's internal control, including the use of service organizations
- Whether and how a specific control, individually or in combination with other controls, prevents, or detects and corrects, *material* misstatements

- Controls over the completeness and accuracy of information produced by the entity may be relevant to the audit if the …

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- ...auditor intends to make use of the information in designing and performing further audit procedures
- An entity generally has controls relating to objectives that are not relevant to an audit and therefore, need not be considered
  - Example airline reservation system

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Understanding the Entity & Its Environment

- **Governmental auditors often have additional responsibilities with respect to internal control I that they may have to report on the *compliance with laws and regulations***

Nature and Extent of the understanding of Relevant Controls

- Risk assessment procedures to obtain audit evidence about the design and implementation of relevant controls may include:

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- Inquiring of entity personnel
- Observing the application of specific controls
- *Inspecting document and reports*
- Tracing transactions through the information system relevant to financial reporting

- **Inquiry alone, however, is not sufficient for such purposes**

Obtaining an understanding of an entity's controls is not sufficient to test their operating effectiveness

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Understanding the Entity & Its Environment

Components of Internal Control

The Control Environment

Includes the governance and management functions and the attitudes, awareness, and action of those charged with governance and management concerning the entity's internal control and its importance in the entity.

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The control environment set the tone of an organization, influencing the control consciousness of its people. It is the foundation for all other components of internal control, providing discipline and structure

The Tone At The Top

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Things to look for in positive control environment:

- Communication and enforcement of integrity and ethical values
- Commitment to competence
- Participation by those charged with governance re:
  - Their independence from management
  - Their experience and stature
  - The extent of their involvement and the information they receive and the scrutiny of activities

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  - The appropriateness of their actions, including the degree to which difficult questions are raised and pursued with management
  - Their interaction with internal and external auditors
- Management's philosophy and operating style such as:
  - Approach to taking and managing business risks
  - Attitudes and actions toward financial reporting
  - Attitudes toward information processing and accounting functions and personnel

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  - Assignment of authority and responsibility
  - Human resource policies and practices
- Audit Evidence for Elements of the Control Environment
  - May be obtained from a combination of inquiries and risk assessment procedures such as:
    - Corroborating inquiries through observation or inspection of documents

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Understanding the Entity & Its Environment

- Effect of the Control Environment on the Assessment of the Risks of Material Misstatement
  - Some elements of an entity's control environment have a pervasive effect on assessing the RMM such as:
    - An entity's control consciousness is influenced significantly by those charged with governance
    - The effectiveness of the control environment with regard to participation by those charged with governance is therefore influenced by:

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- The independence from management and their ability to evaluate the actions of management
- Whether they understand the entity's business transactions
- The extent to which they evaluate whether the financial statements are prepared in accordance with the applicable financial reporting framework

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Understanding the Entity & Its Environment

- An active and independent board of directors may influence the philosophy and operating style of senior management
- The existence of a satisfactory control environment can be a positive factor when the auditor assesses the RMM
  - However is not an absolute deterrent to fraud
  - Conversely, deficiencies in the control environment may undermine the effectiveness of controls

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- Conversely, deficiencies in the control environment may undermine the effectiveness of controls, particularly with regard to fraud
- As previously noted, the control environment influences the nature, timing and extent of the auditor's further procedures

- The control environment in itself does not prevent, or detect and correct, a MM
- It may, however, influence the auditor's evaluation of the effectiveness of other controls, and thereby the assessment of the RMM

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Components of Internal Control

The Entity's Risk Assessment Process

An entity's risk assessment process for financial reporting purposes is its identification, analysis, and management of risks relevant *to the preparation and fair presentation of financial statements*

- Whether the entity's risk assessment process is appropriate is a matter of professional judgment

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Understanding the Entity & Its Environment

Risk relevant to *financial reporting* include externals and internal events and circumstances that may occur and adversely affect an entity's ability to initiate, authorize, record, process, and report *financial data* consistent with assertions of management in the *financial statements* and may arise or change due to circumstances such as:

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- Changes in operating environment
- New personnel
- New or revamped information systems
- Rapid growth
- New technology
- New business models, products, or activities
- Corporate restructurings
- Expanded foreign operations
- New accounting pronouncements
- Changes in economic conditions

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Components of Internal Control

The Information System

The information system *relevant to financial reporting objectives*, which includes the accounting system, consist of the procedures and records designed and established to:

- Initiate, authorize, record, process, and report entity transactions, events and conditions and to maintain accountability for the related assets, liabilities and equity

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Understanding the Entity & Its Environment

- Process and account for system overrides or bypasses to controls
- Transfer information from transaction processing systems to the general ledger
- Capture information relevant to financial reporting for events and conditions other than transactions, such as depreciation and amortization of assets
- Ensure information required to be disclosed in financial reporting is accumulated, recorded, processed and summarized, and appropriately reported *in the financial statements*

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Understanding the Entity & Its Environment
Journal Entries

- An entity's information system typically includes the use of standard JEs to record entries that are required on a recurring basis to record transactions such as:
  - Sales
  - Purchases
  - Cash disbursements in the GL or,
  - To record accounting estimates that are periodically made by management such as change in the estimate of uncollected accounts receivable

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Understanding the Entity & Its Environment

- Usually have nonstandard JEs to record nonrecurring, unusual transactions or adjustments such as:
  - Consolidating adjustments
  - Entries for a business combination or disposal
  - Nonrecurring estimates, such as the impairment of an asset

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Understanding the Entity & Its Environment
Communication

Communication by the entity of the *financial reporting* roles and responsibilities and significant matters relating *to financial reporting* involves providing an understanding of individual roles and responsibilities pertaining to internal control over *financial reporting*

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Understanding the Entity & Its Environment

- Includes such matters as the extent to which personnel understands how their activities in the financial reporting information system relate to the work of others and the means of reporting exceptions to an appropriated higher level within the entity
  - May take the form of policy and financial reporting manuals
- Open communication channels help ensure that exceptions are reported and acted on

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Understanding the Entity & Its Environment

Components of Internal Control

Control Activities

Are the policies and procedures that help ensure that management directives are carried out

- Control activities have various objectives
- The auditor's knowledge about the presence or absence of control activities obtained from the understanding of the other components of ….

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Understanding the Entity & Its Environment

- …. internal control assists the auditor in determining whether it's necessary to devote additional attention to obtaining an understand of control activities

Risks Arising From IT

- The use of IT affects the way that control activities are implemented
- Controls over the IT system are deemed to be effective when they maintain the integrity of information and the security of the data such systems possess

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Understanding the Entity & Its Environment

- *General IT Controls* are policies and procedures that relate to many applications and support the effective functioning of application controls
- They apply to the mainframe, miniframe, and end-user environments
- Such include controls over:
  - Data center and network operations
  - System software acquisition, change, and maintenance
  - Program change
  - Access security
  - Application system acquisition, development, and maintenance

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Understanding the Entity & Its Environment

- Ineffective General IT controls do not by themselves cause misstatements
  - They may permit application controls to operate improperly and allow misstatements to occur and not be detected
  - General IT controls are assessed with regard to their effect on applications and date that become part of the *financial statements*
- *Application Controls* are manual or automated procedures that typically operate at a business process level and apply to the processing of transactions by individual applications

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Understanding the Entity & Its Environment

- Application controls *can prevent or detect* and are designed to ensure the integrity of the accounting records
- Relate to procedures used to initiate, authorize, record, process and report transactions or other financial data

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Understanding the Entity & Its Environment

Components of Internal Control

Monitoring of Controls

- A process to assess the effectiveness of internal control performance over time *on a timely basis* and taking necessary remedial actions if necessary

Internal Audit Function

- An entity's IA function is likely to be relevant to the audit if the nature of the IA function's relate to the entity's financial reporting

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Understanding the Entity & Its Environment

- And the auditor expects to use the work of the internal auditors to modify the nature or timing or reduce the extent of audit procedures to be performed
- But the external auditor must first determine ….

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Understanding the Entity & Its Environment

- And the auditor expects to use the work of the internal auditors to modify the nature or timing or reduce the extent of audit procedures to be performed
- But the external auditor must first determine ….
- Second – Determine the responsibilities of IA
- May relate only to review of economy, efficient, and effectiveness of operations and have no relationship to the entity's financial reporting

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Understanding the Entity & Its Environment

Assessment of RMM at the Financial Statement Level

- Refers to risks that relate pervasively to the financial statements as a whole and potentially affect many assertions
  - Example: Management Override
- Such risks may be especially relevant to the auditor's consideration of the RMM arising from fraud

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Understanding the Entity & Its Environment

- May derive from a deficient control environment or declining economic conditions
  - Is management competent
  - Remember, there is no internal control that prevents stupidity
- The auditor's understanding of IC may raise doubts about the auditability of the entity's financial statements
- For example concerns about:
  - The integrity of management *(Tone At The Top)*
  - Condition and reliability of the entity's records

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Understanding the Entity & Its Environment

Assessment of RMM at the Relevant Assertion Level

- For classes of transactions, account balances, and disclosures
- Such consideration assists in determining the nature, timing and extent of further audit procedures at the assertion level necessary to obtain sufficient appropriate audit evidence

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Understanding the Entity & Its Environment

- Management makes assertions that the financial statements are in accordance with the applicable financial reporting framework
  - RE: recognition, measurement, presentation, and disclosures
- Auditor's assertions used to consider different types of potential misstatements fall into three categories and may take the following form:
  - Assertions about classes of transactions and events for the period under audit, such as the following:

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- *Occurrence:* Transactions and events have occurred and pertain to the entity
- *Completeness:* All transaction and events that should have been recorded have been recorded
- *Accuracy:* All transactions and events have been recorded appropriately
- *Cutoff:* Transactions and events have been recorded in the correct accounting period
- *Classification:* Transactions and events have been recorded in the proper accounts

- Assertions about account balances at the period-end, such as the following:

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- *Existence:* Assets, liabilities, and equity interests exit
- *Rights and Obligations:* The entity holds or controls the rights to assets, and liabilities are the obligations of the entity
- *Completeness:* All assets, liabilities, and equity interests that should have been recorded have been recorded
- *Valuation and Allocation:* Assets, liabilities, and equity interests are included in the financial statements at appropriate amounts and any resulting valuation or allocation adjustments are appropriately recorded

- Assertions about presentation and disclosure, such as the following:
  - *Occurrence and Rights and Obligations:* Disclosed events, transactions, and other matters have occurred and pertain to the entity

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- *Completeness:* All disclosures that should have been included in the financial statements have been included
- *Classification and Understandability:* Financial information is appropriately presented and described, and disclosures are *clearly* expressed

- Assertions about account balances at the period-end, such as the following:
  - *Existence:* Assets, liabilities, and equity interests exists
  - *Rights and Obligations:* The entity holds or controls the rights to assets, and liabilities are obligations of the entity
  - *Completeness:* All assets, liabilities, and equity interests that should have been recorded have been recorded

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- *Valuation and Allocation:* Assets, liabilities, and equity interests are included in the financial statements at appropriate amounts, and any resulting valuation or allocation adjustments are appropriately recorded

- Assertions about presentation and disclosure, such as the following:
  - *Occurrence and Rights and Obligations:* Disclosed events, transactions, and other matters have occurred and pertain to the entity
  - *Completeness:* All disclosures that should have been included in the financial statements have been included

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Understanding the Entity & Its Environment

- *Classification and Understandability:* Financial information is appropriately presented and described, and disclosures are clearly expressed
- *Accuracy and Valuation:* Financial and other information is disclosed fairly and in appropriate amounts

- The auditor may choose to combine the assertions about transactions and events with assertions about account balances
  - Several other assertions that could be combined – Duel purpose testing

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Relevant Assertions

are assertions that have a *reasonable possibility* of containing a misstatement or misstatements that would cause the financial statements to be materially misstated and, as such, are assertions that have a meaningful bearing on whether the account is fairly stated

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Understanding the Entity & Its Environment

- The auditor is required by paragraph .26b to use relevant assertions for classes of transactions, account balances, and disclosures *in sufficient detail to form a basis for the assessment of RMM and the design of performance of further audit procedures*
- Not all assertions for an account balance may be relevant

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Understanding the Entity & Its Environment

- Such as valuation of the cash account when currency is not involved
- However, existence and completeness are always relevant

Considerations Specific to Governmental Entities

- When making assertions about the financial statements of a governmental entity, in addition to the previously discussed assertions, the auditor may be required to obtain assertions related to compliance with laws or regulations

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Understanding the Entity & Its Environment

Significant Risks

- Often relate to significant nonroutine transactions and matters that reqjuire significant judgment
  - Nonroutine transactions are transactions that are unusual, either due to size or nature, and that occur infrequently
  - Matters that require significant judgment may include the development of accounting estimates for which a significant measurement of uncertainty exists

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Understanding the Entity & Its Environment

- Risks of MM may be greater for significant nonroutine transactions arising from matters such as:
  - Greater management intervention to specify the accounting treatment
  - Greater manual intervention for data collection and processing
  - Complex calculating or accounting principles

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Understanding the Entity & Its Environment

Can You Say

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Understanding the Entity & Its Environment

- RMM may be greater for significant nonroutine transactions arising from matters such as:
  - Greater management intervention to specify the accounting treatment
  - Greater manual intervention for data collection and processing
  - Complex calculating or accounting principles
  - The nature of nonroutine transactions, which may make it difficult for the entity to implement effective controls over the risks
  - Relate party transactions

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Understanding Controls Related to Significant Risks

- Risks related to significant nonroutine transactions or matters that require significant judgment are often less likely to be subject to routine controls
- Management may have other ways to deal with such risks

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Understanding the Entity & Its Environment

- The auditor’s understanding of whether the entity has designed and implement controls for significant risks arising from nonroutine transactions or matters that require significant judgment includes whether and how management responds to the risks and might include:
  - Control activities, such as a review of assumptions by senior management or specialists

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- Documented processes for estimations
- Approval by those charged with governance

- Failure by management to implement such controls may be viewed as a significant deficiency or a material weakness
- If such is the case, the auditor should consider the implications for his assessment

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Risks for Which Substantive Procedures Alone Do Not Provide Sufficient Appropriate Audit Evidence

RMM may relate directly to the recording or routine classes of transactions, account balance and the preparation of reliable financial statements and may include such risks as:

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Understanding the Entity & Its Environment

- Inaccurate or incomplete processing for routine and significant classes of transactions such as an entity's:
  - Revenue
  - Purchases
  - Cash receipts
  - Cash payments

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- Examples of situations in which the auditor may find it impossible to design effective substantive procedures that, by themselves, provide sufficient appropriate audit evidence that certain relevant assertions are not materially misstated include the following:
  - An entity's IT system initiates the purchase and delivery of good based on predetermined inventory levels
  - No other documentation exists

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Revision of Risk Assessment

- During the audit, information may come to the auditor's attention that differs significantly form the information on which the risk assessment was based
  - Internal controls not operating as expected
  - More mistakes than anticipated
  - Incorrect management assertions

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Documentation

- The nature and extent of documentation related to risk assessment is a matter of professional judgment
  - Form and extent is influenced by the nature, size, and complexity of the entity and its internal control; availability of information from the entity; and the audit methodology and technology used in the course of the audit

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- The extent of documentation may also reflect the experience and capabilities of the members of the audit engagement team
- For recurring audits, certain documentation may be carried forward and updated as necessary to reflect changes in the entity's business or processes

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