Combined Risk Assessment

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Recap on types of risks

Discuss the considerations when assessing risks and emphasize the link between identified risks and relevant assertions

Explain how combined risk assessments are made for each relevant assertion and the effect that the determined risk has on the nature, extent and timing of the substantive work performed

Engage in group activity based on Perfecta LTD case
## Types of Risk

<table>
<thead>
<tr>
<th>Sources and types of risk</th>
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<tbody>
<tr>
<td><strong>Business risk</strong></td>
<td><strong>Significant risk</strong></td>
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<tr>
<td>A risk resulting from circumstances and events, actions or inactions, that could adversely affect and entity’s ability to achieve its objectives and execute its strategies</td>
<td>An inherent risk with both a higher likelihood of occurrence and higher magnitude of potential misstatement and which requires special audit consideration. Significant risks are a subset of inherent risks</td>
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<tr>
<td><strong>Inherent risk</strong></td>
<td><strong>Fraud Risk</strong></td>
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<td>The susceptibility of an assertion about a class of transaction, account balance or disclosure to a misstatement that could be material either individually or when aggregate with other misstatements, before consideration of any controls</td>
<td>A risk that may result in a material misstatement in the financial statements due to fraud. All risks of material misstatement due to fraud are a significant risks</td>
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</table>
If the auditor has determined that a significant risk exists for a particular audit, then ISA 315, requires that the auditor obtains an understanding of the entity’s controls, including control activities, relevant to that risk.
How should the auditor use the assertions, taking into account the identified risks and design appropriate audit procedures?

- Identified Risks
- Assertions
- Audit Procedures
Combined risk assessment is made for each relevant assertion for each significant account and disclosure.

Audit procedures are designed to address identified risks at relevant assertion level.
Considerations when assessing risks

- Contains significant transactions with related parties
- Related deficiencies in internal control
- Changes in the related information technology environment
- Past misstatements, history of errors or a significant amount of adjustments at period end
- Contains significant amount of non-routine or non-systematic transactions including intercompany transactions and large revenue transactions at period end
- Contains transactions that are recorded based on management’s intent (e.g., debt refinancing, assets to be sold, and classification of marketable securities)
- Application of new accounting pronouncements
- Accounting measurements that involve complex processes
Considerations when assessing risks - continued

- Has events or transactions that involve significant measurement uncertainty, including accounting estimates
- Has pending litigation and contingent liabilities
- Transactions or events recording significant adjustments
- Contains complex transactions or events for which we believe there is a high risk of error
- Contains transactions or events that are subject to an unusual degree of Management involvement or that produce direct or indirect benefit to Management
- Contains transactions or events that are outside the normal course of business for the Entity
- Certain assets and liabilities may represent a risk of material Misstatement owing to their value and liquidity.
Raw materials inventory

A manufacturing company uses few and scarce raw materials as inputs to production. The production activity is seasonal and with reduced production at year end. The Company has few exclusive suppliers for raw materials. Large amounts of inventory are held at year end and supplier discounts are received.

Risks

- Inventories are not recorded
- Inventories are damaged or obsolete
- Possibility to “manipulate” year end inventory transactions

Assertions

- Existence
- Valuation
- Rights and Obligations
Long term borrowing

» A large service organization has several significant long term borrowings. Some of these borrowings have very restrictive financial covenants. Borrowing costs are capitalized for the qualifying assets.

Risks

» Breach of covenants demanding classification into short term debt

» Wrong capitalization of borrowing costs

» Lack of disclosure in the financial statements (e.g. fair value)

Assertions

» Valuation and allocation

» Completeness

» Accuracy and valuation
Audit risk is a product of:

- Inherent Risk (IR)
- Control Risk (CR)
- Detection Risk (DR)

By combining the assessment of inherent risk (IR) and control risk (CR) we arrive at a Combined Risk Assessment for each relevant assertion for each significant account and disclosure.

Once we have determined the CRA for a relevant assertion, we address the remaining audit risk (i.e., detection risk) by designing substantive procedures.
Depending on the IR assessment (Lower or Higher) and the Control risk strategy selected (rely on controls or not) there are four categories of CRA:

- Minimal;
- Low;
- Moderate;
- High

Special audit considerations are required for significant risks.

<table>
<thead>
<tr>
<th>Inherent risk assessment</th>
<th>Control risk assessment</th>
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<tbody>
<tr>
<td>Lower</td>
<td>Minimal</td>
</tr>
<tr>
<td>Higher</td>
<td>Low</td>
</tr>
<tr>
<td>Significant risk</td>
<td>Special audit considerations</td>
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</tbody>
</table>

Source: Ernst and Young
The higher the combined risk assessment, the closer to period-end and the higher the extent of the procedures.
Use the “Combined risk assessment Work Papers” and information provided in the Perfecta LTD case to **link each identified risk with at least one relevant assertion.** Comment on **any additional risk** you have identified outside the provided.

**Make a combined risk assessment for each relevant assertion**

**Be prepared to present your group work and discuss rationale for judgments made** just after lunch (till 12:30)
Thank you

Q&A