Example: Financial statements risk analysis

Foreword

Conducting a risk analysis for each financial statements item and its accompanying notes can assist with:

- prioritising resources for the preparation of the financial statements
- determining the extent of quality assurance processes required, and
- identifying if there is scope to improve controls.

The degree of formality and rigor of the risk assessment will depend on a number of factors, including the overall complexity of the entity's financial statements, the maturity of its financial statements process and the level of financial reporting risk the entity is prepared to accept.

Entities may find it useful to present the summary table (as shown at Steps 3 and 4) to the audit committee for review of progress.

Purpose

The following information is intended to:

- provide explanatory information on the risk analysis process for financial statements, and
- show an example of a risk analysis, conducted using the steps outlined in Example: Risk framework for financial statements.

This example is for the financial statements item Property, Plant and Equipment (PPE). The example is structured using the four risk analysis steps:

Step 1. Conduct an **inherent risk assessment**

Step 2. Conduct a **residual risk assessment**

Step 3. Determine **required treatments** having regard to the entity's risk appetite, and

Step 4. **Summarise the risk ratings** to give an overall view of the reporting risk for financial statement line items and assign a risk owner.

Overview of the risk analysis steps

Step 1: Conduct inherent risk assessment

(a) Assess the financial statements item against key inherent reporting risk factors.

Each entity should decide on the inherent risk factors most appropriate to its own operations and circumstances and the weightings to be applied to each factor.

Examples of factors that can impact inherent risk are materiality, the level of judgement involved, disparity of data sources and results of previous audits by internal audit and the Australian National Audit Office (ANAO).

(b) Based on the results of step (a), determine an overall inherent risk rating of High, Medium or Low. An explanation of each risk level is set out below.

High	Medium	Low
Poses a significant financial reporting risk:	**Poses a moderate financial reporting risk:**	**Poses a minimal financial reporting risk:**
• likely to require ongoing and sustained resource commitment	• likely to require moderate level of resource commitment	• likely to require low level of resource commitment
• likely to involve complex control and accounting issues or balances that require estimation or judgement	• likely to involve less complex control and accounting issues	• likely to involve routine control and accounting issues

Step 2: Conduct residual risk assessment

The effectiveness of existing controls is then assessed and an overall residual reporting risk rating of High, Medium or Low is assigned for each financial statements item. The risk ratings are the same ones used at Step 1.

A 'High' risk rating would mean that there is a reasonable possibility of significant financial reporting misstatements. The item would therefore require ongoing and sustained resource commitment. Conversely, a 'Low' risk rating would mean that there is a minimal financial reporting risk, which can be managed by routine control procedures and is unlikely to need the specific application of resources.

Step 3: Summarise all risk ratings

Collate all individual risk ratings for each financial statements item to give an overall picture of the reporting risk for all financial statements items.

Step 4: Determine actions required

The final step involves determining the action required for the entity taking into account the risk rating for each financial statements item. This may include assigning a risk owner.

Example: Risk analysis

An example risk analysis for the item 'Property, Plant and Equipment (PPE)' is below. The example serves as an illustration only, and does not cover all financial statements items.

Step 1: Conduct inherent risk assessment

Risk Factor (See Note 1)	Key Questions to Consider	Rating (See Note 1)	Reason/Analysis
Materiality	How significant is the item as a percentage of total income, expenses, assets or liabilities?	H	The item represents 12 per cent of total assets.
	How significant is the item to the key users of the financial statements?		The item is topical because of recent Parliamentary interest.
	How material are individual transactions?		About 40 per cent of transactions have high dollar values.
Reporting requirements	Are there any complex or new accounting requirements?	L	None identified.
	Are there any significant compliance issues?		None identified.
Level of judgement	Does the item require considerable judgement to record the account balances and transactions correctly?	H	Judgement is required for capitalisation threshold, useful lives and revaluations.
	Does it require estimates, management judgement or specific knowledge and skills of the item and related accounting standards?		Judgement is required in determining whether the asset belongs to other related entities.
Extent of reliance	Is the accuracy of data dependent on areas, systems, experts or related entities outside the control of the finance team?	H	Significant reliance on business areas to provide information.
	Does experience suggest that such data are provided in a timely and accurate manner?		Data provided in prior year had significant errors.
			Reliance on external experts with respect to valuation.
			Reliance on related entities to manage and correctly record assets in regional offices.
Transaction numbers	Is there a significant number of transactions in the population?	M	A significant number of individual transactions are processed each year.
Level of manual intervention	Is the level of manual intervention used to initiate, record, process or report transactions significant?	M	Manual adjustments are generally required to reflect revaluations and impairments of PPE.
	Is manual intervention appropriate?		The level of manual intervention is appropriate because judgement is required to initiate and record the adjustments.
Disparity of data sources	Can data be easily and reliably retrieved?	M	Three different registers are used to manage and control assets.
Audit issues identified	How significant are previous audit findings in respect of this item?	M	

Risk Factor (See Note 1)	Key Questions to Consider	Rating (See Note 1)	Reason/Analysis
	Have these findings been adequately addressed?		Previous internal audit and ANAO audit findings remain outstanding. Corrective action is in progress.
Inherent Risk Summary			
Inherent risk	Based on the assessment above:	H	Key contributing factors: Materiality of the balance.
	• Have key inherent reporting risk been identified?		Level of judgement required in determining correct asset classification and valuation.
	• What are the key contributing inherent risk factors for the item?		High level of reliance on business areas to correctly identify assets for capitalisation.
	• What is the overall inherent risk rating?		Reliance on other related entities to manage some key assets.

Note 1: Different weightings should be given to each risk factor. The materiality of the financial statements item would be expected to have the greatest weighting.

Step 2: Conduct residual risk assessment

Analysis of existing key controls
Existing key controls in place are:
• Monthly reconciliation of PPE movement schedules showing opening balances, additions, disposals, transfers, depreciation, impairments and closing balances are performed to ensure completeness of all asset movements in the asset registers and FMIS.
• Year-end review is undertaken to ensure assets are categorised by class and appropriately disclosed in the financial statements, including movement tables.
• Asset stocktakes are conducted in accordance with the Policy on Assets and stocktake reports are reconciled to the asset registers and FMIS. Stocktake reports are endorsed by management.
• Year-end reviews of valuation reports are conducted.
• Annual review for impairment in accordance with Accounting Standard AASB 136 Impairment of Assets is carried out to ensure PPE value is not overstated.
• Service agreements with related entities are reviewed annually to ensure that their management controls are adequate to minimise material misstatements in recording and ownership.

Residual risk summary:			
Risk Factor	**Key Questions to Consider**	**Rating**	**Reason/Analysis**
Residual risk	Based on the analysis of existing controls above:	M	Key contributing factors:
	• Have all existing key controls been identified?		Controls in place are relatively mature and are subject to periodic review.
	• What are the key contributing risks remaining after existing controls have been exercised?		However the item is material and improvements are still required by business areas to provide more timely and accurate information.
	• What is the overall residual risk rating?		

Steps 3 and 4: Summarise risk ratings and determine actions required

Note	Item	20X2–X3 Budget ($'000)	20X1–X2 Actual ($'000)	Inherent Risk Rating	Residual Risk Rating	Key Actions Taken/ Required
3A	Revenues from Government	260,700		L	L	See Note 1
3B	Sale of goods and rendering of services	497,900		H	H	Additional resources will be committed to reconcile work in progress and revenue by 31 October. Information collection pack will be reviewed to ensure accurate revenue information is provided by business areas. Prior year audit findings are being followed up.
3C	Other revenue	1,200		L	L	See Note 1
3E	Other gains	77,200		H	M	Additional resources will be used to review 'resources received free of charge' and 'write-down of inventories' which have not been reviewed comprehensively for the past three years.
4A	Employee benefits	136,500		M	L	See Note 1
4B	Suppliers	130,200		M	L	See Note 1
4C	Depreciation and amortisation	18,800		M	L	See Note 1
4D	Finance cost	17,800		L	L	See Note 1
5A	Cash and cash equivalents	7,500		M	L	See Note 1
5B	Trade and other receivables	312,300		H	H	Additional resources will be used to reconcile accounts receivable with cash received. Review for indicators of impairment will be carried out. An examination of control procedures in debt collection has been completed and recommended corrective actions are planned for completion by 31 January.
6A	Land and buildings	398,100		H	M	Documents on ownership of properties will be reviewed to ensure that they are signed by the correct delegates. A comprehensive review of amounts capitalised for leases will be undertaken.

Note	Item	20X2–X3 Budget ($'000)	20X1–X2 Actual ($'000)	Inherent Risk Rating	Residual Risk Rating	Key Actions Taken/ Required
6C	Intangibles	23,100		M	M	A comprehensive review of material invoices will be carried out to verify the capitalised amount.
6D	Other non-financial assets	2,100		L	L	See Note 1
7A	Suppliers	26,900		M	L	See Note 1
8A	Employee provisions	37,700		M	L	See Note 1
8B	Other provisions	3,100		L	L	See Note 1
9	Restructuring					
	-Departmental	21,200		H	M	Transfer of assets and liabilities from the ABC Entity underway. Due diligence review of ABC Entity's data and supporting documentation. Contracts and lease commitments to be examined at hard close. Additional tasks incorporated in the financial statements work plan.
	-Administered	121,200		H	M	
15F	Royalties	65,700		H	M	An internal audit review will be conducted on administered revenue. Control and substantive testing on material revenue items and preparation of business process and control mapping.
16D	Grants	1,587,600		M	M	Material balance. No prior year issues, except for the section 83 (of the Constitution) matter raised by the ANAO. Assess where the grant programs are supported by a head of Commonwealth legislative power (e.g. section 51 of the Constitution). Review to include reconciliation of grant database to FMIS, cut-off testing and review of commitments information.
23	Special Accounts	318,200		H	M	Assessment of section 83 (of the Constitution) matter currently being conducted. Restructuring—additional seven special accounts to be transferred. Due diligence review currently being conducted.

Note 1: To be managed by existing control procedures. No additional resource commitment required.