INTEGRITY

CONSISTENCY

EAGLE

North Carolina

Office of the State Controller

Enhancing Accountability in Government through Leadership and Education

EAGLE Training Program

Module 4 – Identifying Risk – The Risk Assessment Process

Learning Objectives

In this module, we will:

- Discuss the theory behind Risk Assessments
- Explain the activities in performing a Financial Statement Risk Assessment
- Discuss the role of IT in the Risk Assessment

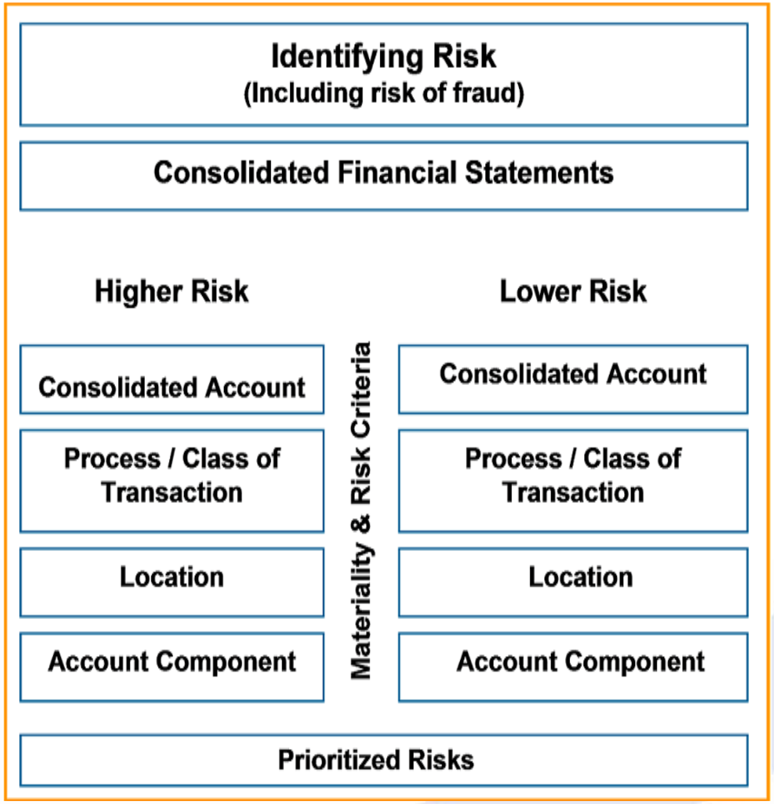
Introduction to the Risk Assessment Process

A **Risk Assessment** helps an organization prioritize its financial reporting risks in order to be more efficient with its documentation and testing efforts by focusing the majority of efforts on the highest risk areas.

Introduction to the Risk Assessment Process (Cont.)

- In a top-down approach, the State Agency begins by identifying, understanding, and evaluating the risk at a financial statement level.

- At the financial statement and process level, the State Agency will identify those accounts and processes that possess the quantitative (i.e. Materiality) and qualitative factors for higher or lower risk to determine the final scope.



Determine Scope of Assessment

- What is the Scope for EAGLE Compliance?

  Agencies are required to document and assess internal control within those accounts with a combined total risk ranking of the following:

  - Group 1 Agencies, Year-2 Moderate and High
  - Group 2 Agencies, Year-1 High

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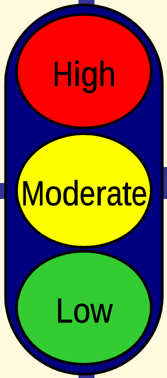
Components of the Risk Assessment

Account Risk

- Size and Composition
- Transaction Volume
- Transaction Complexity
- Subjectivity and Estimation
- Inherent Risk

Financial Statement Assertion Risk

- Completeness
- Existence or Occurrence
- Valuation or Measurement (Allocation)
- Rights and Obligations
- Presentation and Disclosure



Process Risk

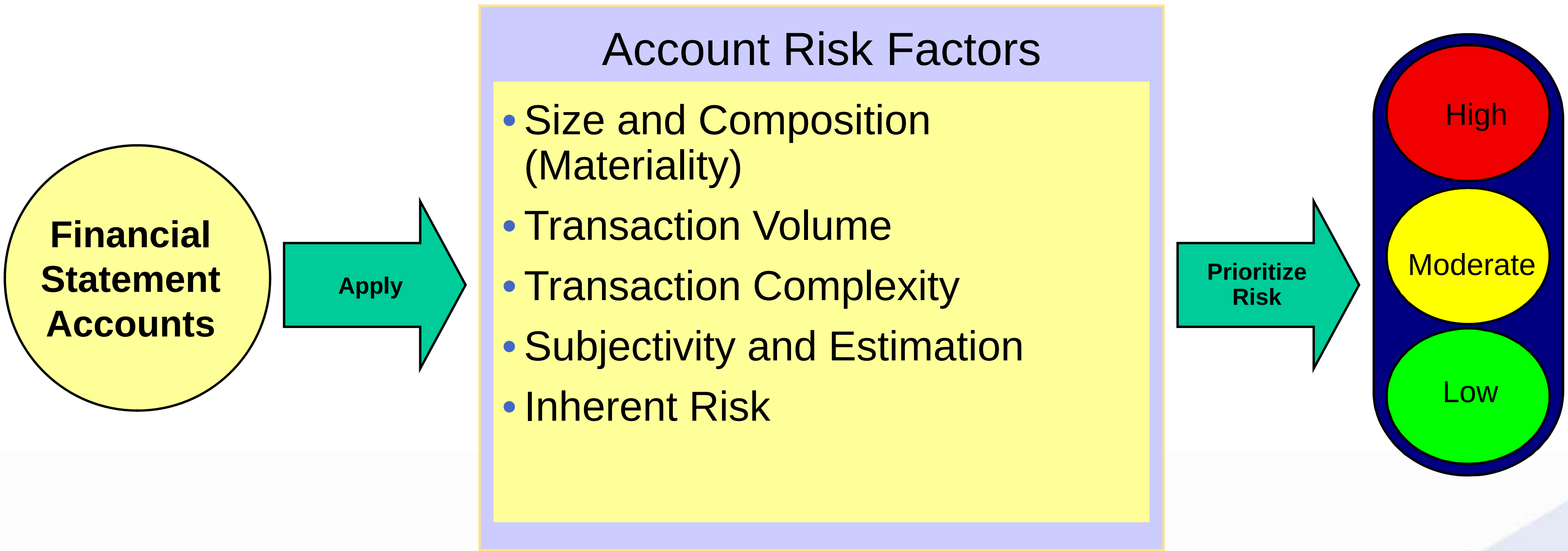
- Size and Composition
- Susceptibility due to Error/Fraud
- Complexity of Transactions
- Similarity of Transactions
- Level of IT Dependency and Manual Intervention
- Degree of Subjectivity and Estimation

Location Risk

- Prior Year Issues
- IT Environment
- Complexity of Business and Accounting Transactions
- Changes in Business or Accounting Transactions
- Quantitative Significance

Account Risk Factors

Purpose: To assess the risk at the financial statement account level



Account Size and Composition

- Account Size and Composition for the EAGLE Program will be assessed using the following:
  - Balance Sheet:
    - Total Assets less Capital Assets
  - Income Statement
    - The greater of Total Revenue or Total Expenditures
- Ratings for both are based on the following chart

See Handout 1

Rating	Percentage
High	≥ 5%
Moderate	5% > X > 1%
Low	≤ 1%

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Account Size and Composition - Example

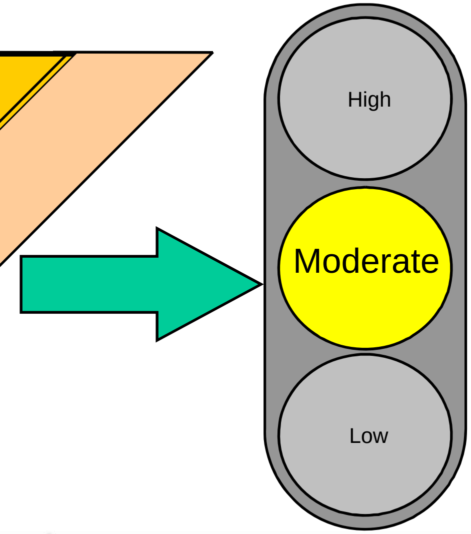
- Balance Sheet:
  - Total Assets = $12 million
  - Capital Assets = $4 million
  - **Measurement = $8 million**
- Income Statement:
  - Total Revenue = $15 million
  - Total Expenditures = $10 million
  - **Measurement = $15 million**

		Balance Sheet		Income Statement	
Rating	**Percentage**	**Measure**	**Thresholds**	**Measure**	**Thresholds**
High	≥ 5%	$8 million	≥ $400,000	$15 million	≥ $750,000
Moderate	5% > X > 1%	$8 million	$80,001 - $399,999	$15 million	$150,001 - $749,999
Low	≤ 1%	$8 million	≤ $80,000	$15 million	≤ $150,000

Assess Account Risk

Example – Capital Assets

Financial Statement Account	Size and Composition	Transaction Volume	Transaction Complexity	Subjectivity and Estimation	Inherent Risk	Total Score
Capital Assets	3	2	1	2	2	10



Account risk for Capital Assets in this example = Moderate

(Moderate = Total Score of 8-11)

The overall rating is judgmentally based on aggregation of the individual risk assessments. Justification for the overall assessment should be documented.

See Handout 2

Determine Scope of Assessment

Agencies are required to document and assess financial statement assertions within those accounts with a combined total risk ranking of the following:

– Group 1 Agencies, Year-2	Moderate and High
– Group 2 Agencies, Year-1	High

See Handout 3

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Financial Statement Assertions

- Within its financial statements, an organization implicitly makes certain claims regarding its financial position, results of operations and cash flows. Such claims are known as *financial statement assertions.*
- Understanding these assertions helps to:
  - Define areas of risk
  - Identify significant accounts

Note: Not all assertions may be relevant or applicable to all financial statement accounts.

Financial Statement Assertions

- **Existence -** A computer is recorded on the asset register. Does it really exist?
- **Occurrence -** Revenue was recorded. Did the organization really make the sale?
- **Valuation** - An account payable is recorded to a supplier. Will the organization have to pay the creditor the full amount?
- **Measurement –** An organization sold a product. Was the sale recorded as revenue at the correct amount and recognized in the proper period?
- **Completeness -** Have all liabilities (e.g., accrued expenses) been recorded and in the proper period?
- **Rights and Obligations –** An organization accrues for professional fees. Is the organization really obligated to pay the amount accrued for?
- **Presentation and Disclosure –** An organization is involved in a lawsuit which it will likely lose. Has the contingent liability been properly disclosed?

Process Risk Factors

Purpose: To identify significant processes, based on risk factors, related to significant accounts.

Financial Statement Accounts

Apply

Process Risk Factors

- Size and Composition of the Process
- Susceptibility due to error and fraud
- Complexity of transactions
- Similarity of transactions
- IT dependency and manual intervention
- Degree of subjectivity and estimation

Prioritize Risk

High

Moderate

Low

Assess Process Risk

Example – Capital Assets

Financial Statement Account	Related Significant Processes	Account Risk	Size & Composition of the Process	Susceptibility due to error / fraud	Complexity of transactions	Similarity of transactions	IT dependency / manual intervention	Degree of subjectivity / estimation	Overall Risk Assessment
Capital Assets	Acquiring Assets	M	2	2	1	1	1	1	8=L
	Calculating Depreciation	M	3	2	3	2	2	3	15=H
	Retirement of Assets	M	2	2	2	3	2	2	13=M

Risk Assessment Output

Financial Statement Account	Account Risk	Financial Statement Assertion Risk					Related Significant Processes	Overall Risk Assessment
		C	E/O	V/M	R&O	P&D	Acquiring Assets	L
Capital Assets	M	L	M	M	L	M	Calculating Depreciation	H
							Retirement of Assets	M

Agencies are required to document and test significant processes with overall risk assessment of the following:

- Group 1 Agencies, Year-2 Moderate and High
- Group 2 Agencies, Year-1 High

See Case Study

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Risk Assessment – Impact on IT

- Technology considerations are embedded within the risk assessment process.
  - Risk ratings for the related significant processes should take IT systems and processes into account.
  - The risk assessment process ultimately drives the scoping of IT applications.

Financial Statement Account	Related Significant Processes	Overall Risk Assessment	Supporting Application(s)
Capital Assets	Acquiring Assets	L	Capital Asset System
	Calculating Depreciation	H	Capital Asset System
	Retirement of Assets	M	Capital Asset System

See Handout 4

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Summary

In this module, we:

- Discussed the theory behind Risk Assessments
- Explained the activities in performing a Financial Statement Risk Assessment
- Discussed the role of IT in the Risk Assessment

Appendix

Financial Statement Assertions: Existence

Existence - an asset or liability exists at a given date.

- Example 1 – A computer is recorded on the asset register. Does it really exist?
- Example 2 – An account receivable (AR) is recorded on the AR subledger. Will the customer pay the full amount owed?

Financial Statement Assertions: Occurrence

Occurrence - a recorded transaction or event that pertains to the organization actually took place during the period.

- Example 1 – Revenue was recorded. Did the organization really make the sale?
- Example 2 – Expense was recorded. Was the expense actually incurred?

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Financial Statement Assertions: Valuation

Valuation - an asset or liability is recorded at an appropriate carrying value.

- Example 1 – An organization owns stock for trading purposes. Can the stock be sold for the value at which it is recorded?
- Example 2 – An account payable is recorded to a supplier. Will the organization have to pay the creditor the full amount?

Financial Statement Assertions: Measurement

Measurement - a transaction or event is recorded at the proper amount and revenue or expense is allocated to the proper period.

- Example 1 – An organization sold a product. Was the sale recorded as revenue at the correct amount and recognized in the proper period?
- Example 2 – An organization pays interest on a loan. Was interest expense recorded in the proper amount?

Financial Statement Assertions: Completeness

Completeness - there are no unrecorded assets, liabilities, transactions or events, or undisclosed items.

- Example 1 – Have all bad debts been included in the allowance for doubtful accounts?
- Example 2 – Have all liabilities (e.g., accrued expenses) been recorded and in the proper period?

Financial Statement Assertions: Rights and Obligations

Rights and Obligations - an asset or liability pertains to the organization at a given date

- Example 1 – An organization has inventory on hand. Is it owned or held on consignment?
- Example 2 – An organization accrues for professional fees. Is the organization really obligated to pay the amount accrued for?

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Financial Statement Assertions: Presentation and Disclosure

Presentation and Disclosure - an item is classified, described, and disclosed in accordance with applicable statutory accounting requirements.

- Example – An organization is involved in a lawsuit which it will likely lose. Has the contingent liability been properly disclosed?