

The Importance of Understanding the Entity and Its Environment in a Review Engagement

This article outlines the importance of understanding the entity when conducting a review engagement under Canadian Standard on Review Engagements CSRE 2400 – *Engagements to Review Historical Financial Statements*. CSRE 2400 becomes effective for reviews of financial statements for periods ending on or after December 14, 2017, with no option for early adoption.

In CSRE 2400, understanding the entity is a vitally important part of the review process as the new standard places more emphasis on practitioners to identify areas in financial statements where material misstatements are likely to arise compared to the prior standard, Section 8200. Practitioners should avoid the temptation to skip the understanding of the entity part of the review engagement, or simply copying these working papers from the prior year file on the basis that this information was acquired in prior years and nothing has changed, as this is rarely the case.

THE IMPORTANCE OF KNOWLEDGE OF THE ENTITY

A thorough understanding of the entity will enable the practitioner to identify areas where material misstatement can occur. It also assists the practitioner in determining the procedures to use in the inquiry and analysis of the financial statements and in gathering, updating and analyzing information throughout the engagement. Sufficient knowledge of the entity and the business in which it is involved will enable the practitioner to make relevant inquiries and a reasonable assessment of responses and other information obtained. The practitioner needs to obtain a general understanding of the manner in which the entity operates and an appreciation of matters that could have a significant effect on the information being reported on.

Obtaining a good understanding of the entity also helps the practitioner to, amongst other things:

- Understand the internal controls and the accounting processes, procedures and systems used for recording, classifying and summarizing transactions.
- Develop expectations about the financial statement amounts in order to perform analytical procedures and identify unusual transactions.
- Understand the related parties and related party transactions, and also identify undisclosed related parties.
- Understand how inventory is priced, counted and valued.
- Determine if further inquiries are needed to assess going concern.

- Assess the accounting policies used by the entity and the financial statement presentation and disclosures.
- Determine if materiality needs to be revised.

REQUIREMENTS TO GAIN AN UNDERSTANDING OF THE ENTITY

Understanding the entity provides the basis for evaluating whether sufficient appropriate evidence has been obtained from the procedures performed. For example, when reviewing financial statements, the practitioner should be aware of the organizational structure of the enterprise, the nature of its assets and liabilities, the sources of its revenues and the types of its expenses. Required knowledge includes a general understanding of the accounting matters peculiar to the entity and its industry. As per CSRE 2400 paragraph 44, areas that are required to be documented in the file include (the list below may not be complete):

- a) relevant industry, regulatory and other external factors, including the applicable financial reporting framework;
- b) the nature of the entity, including:
 - (i) its operations;
 - (ii) its ownership and governance structure;
 - (iii) the types of investments that the entity is making and plans to make;
 - (iv) the way that the entity is structured and how it is financed; and
 - (v) the entity's objectives and strategies;
- c) the entity's accounting systems and accounting records; and
- d) the entity's selection and application of accounting policies.

The practitioner's understanding of the entity and its environment is also key to the determination of whether data to be used for analytical procedures is appropriate for the intended purpose(s) of those procedures and also influences the nature and source of the data and circumstances in which the data is obtained.

CONCLUSION

Obtaining an understanding of the entity should be an ongoing process throughout the review engagement. As indicated above, without obtaining a sufficient understanding of the entity, a practitioner may not discover material misstatements or could end up doing too much work.

FURTHER GUIDANCE

For further guidance, members are encouraged to contact a Practice or Member Advisor.

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