

Chapter - 3 "Risk Assessment and Internal Control"

Topics to be covered : ✓(1) Audit Risk (SA 315)

(2) Materiality in planning and performing an audit (SA-320)

✓(3) Understanding the Entity and its Environment (SA 315)

✓(4) Internal Control (SA 315)

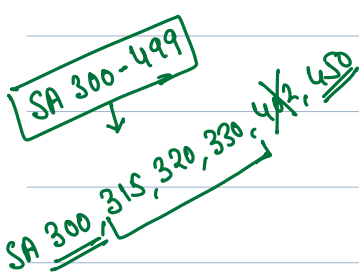
✓(5) Risk that require special consideration (SA 315)

(6) ✓ Evaluation of Internal Control System (SA 315 + 330)

(7) ✓ Testing " " " " (SA 315 + 330)

(8) ✓ Automated Environment, Digital Audit and IFC

(9) ✓ Auditor's responses to assessed risks (SA 330)



Overview of Audit Execution Stage: (Performing Audit procedures → to collect evidences)

(A) Risk Assessment Procedures (RAP)

Obtain an understanding of - Entity

(Inquiry, Inspection and observation - its Environment

Analytical Procedures)

- including Internal Control

To Identify and Assess - Risk of Material Misstatement

(ROMM) ↓ at
(Pervasive effect)

✓(a) F.S. level (Overall level)

✓(b) Assertion level for

- classes of Transactions

- Account balances

- disclosures

(B) Responses to Assessed Risk (R)

Further Audit Procedures (FAP)

I. Tests of Controls (ToC) on
Compliance Procedures:

Evaluation of Internal Control

- to determine its Existence,
Effectiveness and Continuity.

II. Substantive Procedures

(ToC - V+V + SAP)

Examination of Afling Info

- to establish - Completeness;
Accuracy and validity.

(1) Audit Risk: Risk of Expressing Inappropriate audit opinion when f.s. are materially misstated. Audit Risk is a function of

✓ (A.) - Risk of Material Misstatement (ROMM)

Risk that f.s. are materially misstated prior to audit

2 Components

Inherent Risk

Susceptibility of an assertion (Existence, Valuation, Measurement) about a class of transaction, account balance or disclosure to a Misstatement that could be material assuming that there are no related controls.

(Non-Existent Internal Control)

Control Risk

Risk that misstatement could occur in an assertion about a class of transaction, account balance or disclosure that could be material, if Internal controls fail to prevent, detect and correct irregularities on timely basis.

(Ineffective Internal Control)

✓ (B.) Detection Risk

Risk that auditor's procedures may be ineffective to identify the material misstatements.

For Example:

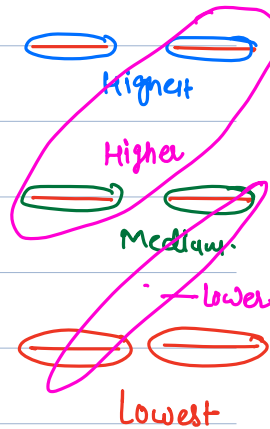
Test-checking

Note: Both Inherent and Control Risk are Entity Risk and are influenced by client; not influenced by Auditor.

SA 200 requires that auditor shall obtain sufficient appropriate audit evidences to reduce audit risk to an acceptable low level and thereby enable the auditor to draw reasonable conclusion on which to base the opinion.

$$\text{Audit Risk} = \text{IR} \times \text{CR} \times \text{DR}$$

(IR) →	Low	Medium	High
CR ↓	Low	Medium	High
Low	Lowest ROMM Highest DR	Lower ROMM Higher DR	Medium ROMM Medium DR
Medium	Lower ROMM Higher DR	Medium ROMM Medium DR	Higher ROMM Lower DR
High	Medium ROMM Medium DR	Higher ROMM Lower DR	Highest ROMM Lowest DR



Misstatement: SA-450 "Evaluation of Misstatements Identified during the audit of f.s." defines the term Misstatement as difference between

Amount, classification, presentation and disclosure of a reported f.s. item (Actual info.)

↓ and the Amount, classification, presentation and disclosure that is required for the item in accordance with applicable FRF.

(Required info.)

10 Sep. -- Monthly test
ch-1, 2, 11

Example of Audit Risk: Compute Overall audit risk assuming the following:

- (a) chances that 40% of services provided by the client would be defalcated.
- (b) Management assures the auditor that S.C. can prevent such defalcation by 75%.
- (c) Audit procedures performed by auditor gives satisfaction as to detection of fraud and error to the extent of 60%.

Solution: Inherent Risk = 40% ✓

Control Risk = 25% ✓

Detection Risk : 40%

Risk of Material Misstatement = IR x CR

(RMM) = 40% x 25%

= 10%

Overall audit risk = RMM x DR

= 10% x 40%

= 4%

Identifying and Assessing ROMM: Auditor is required to obtain understanding of the Entity, its Environment including Internal Control, so as to identify and assess ROMM at (a) Overall level (f.s. level)
(b) Assertion level.

- (a) Assessing ROMM at Overall f.s. level: refers to ROMM that relate pervasively to the f.s. as a whole and may affect many assertions.

Assertion: Representations used by Mngt. in preparation and presentation of F.S. (may be Implicit or Explicit)

Examples: Existence, Ownership, Completeness, Measurement, Valuation, Rights and Obligations, Cut-off, Presentation and disclosure.

- (b) Assessing ROMM at Assertion level: refers to ROMM for the particular:
- (a) class of transactions;
 - (b) account balances; or
 - (c) disclosure.

Assessing ROMM at Assertion level assist the auditor in determine nature, timing and extent of audit procedures to be applied at assertion level.

Steps to be taken to Identify and assess ROMM:

Step-1	Step-2	Step-3	Step-4
↓	↓	↓	↓
<u>Identify the Risk</u> throughout the process of obtaining understanding.	Assess Identified Risk and Evaluate whether it has <u>pervasive effect</u> .	Relate the Identified Risk to <u>what can go wrong at</u> <u>assertion level</u> .	Consider the <u>likelihood of</u> <u>Misstatement</u> and whether it is <u>material</u>

Ex: Auditor identified that Related party transactions occurs outside the ordinary course of business

- (A) limited no. of small transactions.
- (B) Significant txns of high values (Pervasive effect - B)

(A) Over/under statement of financial items. depends upon Existence of J.C. and possible Mngt. biasness

(B) wrong valuation at year-end

Risk Assessment Procedures :

SA 315 "Identifying and Assessing RoMM through understanding the Entity and its Environment" defines the term "Risk Assessment Procedures" as :



Audit Procedures ^{*} performed to obtain an understanding of the Entity, its Environment including Internal Control, to identify and assess RoMM, whether caused due to fraud or error, at the f.s. level and Assertion level.

Audit procedures required to be performed include :

- ✓ (a) Inquiries of Mngt. and others within the Entity;
- (b) Analytical Procedures; and
- (c) Inspection of Records and Observation of business operations.

LEARNING
and NOTING
(H.W.)

✓ (A) Inquiries of Mngt. and others:

S.No.	Inquiry from _____	Information obtained w.r.t. _____
1.	<u>Internal Audit Personnel</u>	Internal audit procedures relating to design and effectiveness of I.C.
2.		
3.		
4.		
5.		
6.		

(B) Analytical Procedures: (Learning and Noting - How)

Share Capital - 5 Cr $\left[\begin{array}{c} \text{Sec} \\ \text{Sec} \end{array} \right]$

Comparison:

+ Mngt. Rep - $\left[\begin{array}{c} \text{No Issu, red}^m \\ \text{buyback} \end{array} \right]$

+ Minute Books.

	22-23	23-24
G.P Ratio	⊖	⊖
opstoc	12%	25%
ch. mode		
Parent - 1 & 2		

RoMM - Identified / Asset - HIGH
- Overall Risk

(C) Inspection of Records and Observation of Business Operations:

- For Ex:
- (i) Inspecting documents relating to business plan, strategy, records like minute books, Internal control Policy manuals etc.
 - (ii) Inspecting reports prepared by the management e.g. Quarterly Mngt. reports, Interim financial statements etc.
 - (iii) Visiting Entity's premises and plant facilities
 - (iv) Observing Entity business operations.