

Chapter - 3 "Risk Assessment and Internal Control"

Topics covered: (1) Audit Risk (SA-315)

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

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

As per SA-315, auditor is required to obtain understanding of following:

Examples.

(a) Relevant Industry, Regulatory and Other factors including applicable FRF.

Industry factors: Market, competition, Product technology, suppliers, Customers etc.

(b) Nature of Entity: including -
- its operations (e.g. Business activities)
- its ownership and Governance structure
- types of Investments (e.g. Investment activities)
- Entity financing structure. (e.g. Equity/Debt)

Regulatory factors: Legal provisions, Regulation, taxation, Govt. Policies etc.

Other factors: Economic conditions, Interest rates, inflation etc.

(c) Selection and Application of Accounting Policies including, reasons for changes thereto.

(d) Objectives, strategies and Business risk that may result in ROMM

Industry developments
- New Products and Services (increased product liability)
Expansion of Business
(Inaccurate estimates - demand)

(e) Measurement and review of financial performance

→ KPI (Key Performance Indicators)
→ Trends, Ratios
→ Reports of Credit Agencies
→ Budgets, Variance Analysis

MCQ: Auditor is required to obtain an understanding of Entity, its Environment including I.C. as per the requirements of SA 315.

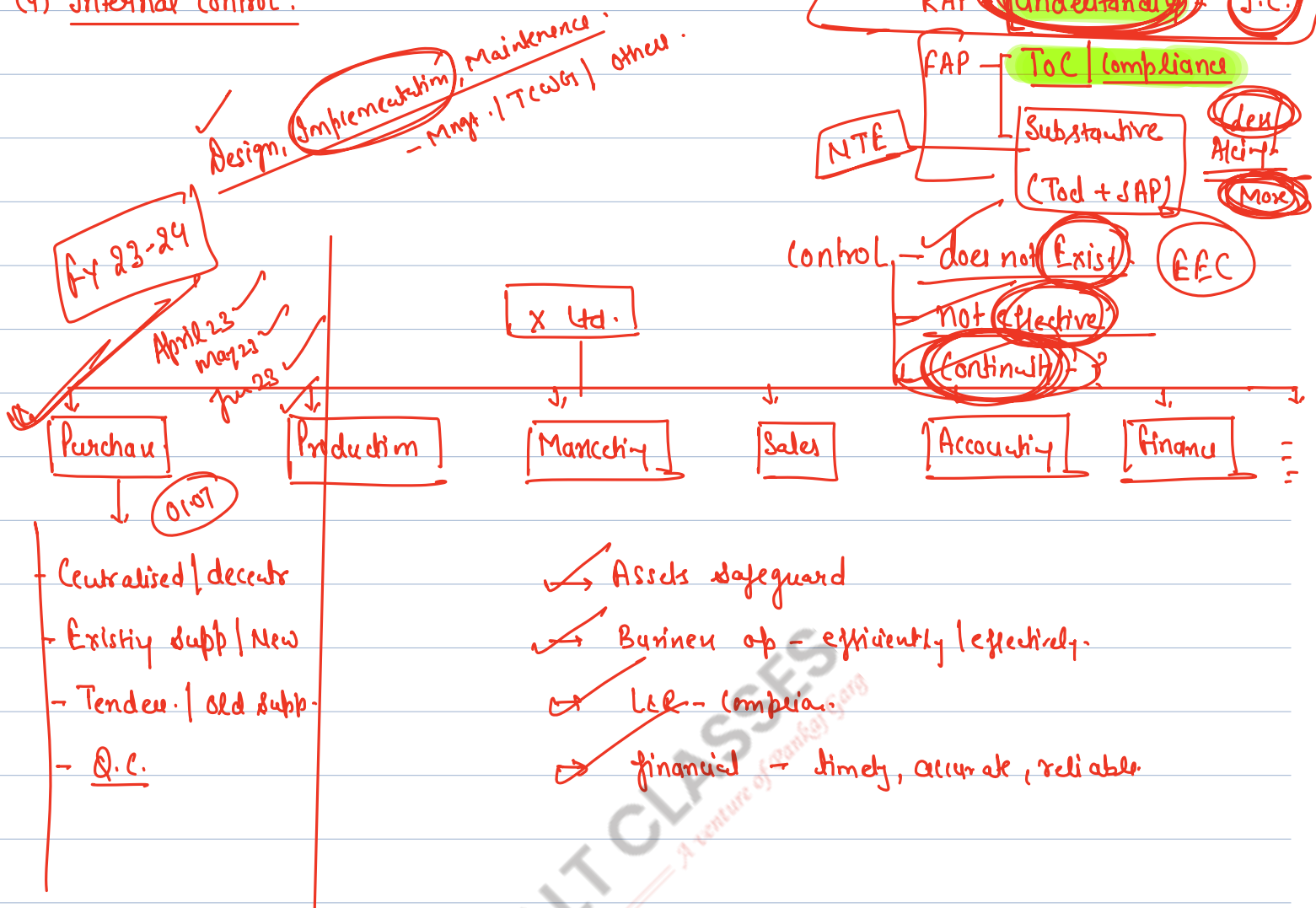
Such activity is :

- (a) One time activity to be carried out at Initial stage.
- (b) " " " " " " " " " " Conclusion stage.
- (c) Both (a) and (b)
- ✓(d) Continuous activity throughout the audit.

Understanding of Entity - a Continuous process :

- Obtaining understanding of Entity, its Environment including Internal Control is a continuous, dynamic process carried out throughout the audit for gathering, updating and analysing information.
- Such understanding helps the auditor in :
 - (a) Assessing ROMM.
 - (b) Determining Materiality
 - (c) Determining appropriateness of selection and application of accounting policies.
 - (d) Identifying areas where special audit considerations may be necessary.
 - ✓(e) Developing expectations of recorded amount while using analytical procedures.
 - (f) Evaluation sufficiency and appropriateness of audit evidences.

(4) Internal Control:



(A) Meaning of Internal Control:

(DIM) SA 315 defines the term "Internal Control" as the processes, designed, implemented and maintained by TCWG | Mngt. | others within the entity to provide reasonable assurance as to the achievement of Entity's

Objectives of :

- (i) Reliability of financial reports;
- (ii) Effective and efficient business operations;
- (iii) Safeguarding of Assets; and
- (iv) Compliance of laws and Regulations.

(B) Objectives of Internal Control:

- (i) Only authorized transactions should enter into accounting system. Authorization may be general or specific.
- (ii) Ensure appropriate recording of transactions i.e. transactions should be recorded with correct amount, recorded in correct account and in correct accounting period.
- (iii) Ensure that assets are being used only for authorized purposes. (i.e. for business use). Assets are safeguarded from unauthorized use.
- (iv) To ensure the existence of assets recorded in books of accounts. (i.e. recorded assets are compared with the actual assets at reasonable intervals and in case of any difference, appropriate action is taken).

(C) Benefits of Understanding of Internal Control to auditor: (RAP)

- (i) To identify types of potential misstatements.
- (ii) " " factors that affect RoMM.
- (iii) To design NTE of FAP. (ToC + Substantive)

(D) Limitations of Internal Control:

- (i) Internal control can provide reasonable assurance as to achieving the objectives of financial reporting only.
- (ii) Involvement of human judgement in decision making. (that can be faulty).
- (iii) Lack of understanding the purpose of Internal Control.
- (iv) Collusion among employees.
- (v) Judgements by management on nature and extent of control (that may be biased).
- (vi) Limitation in case of smaller entities (Owner-Manager is able to override the controls as they are less structured).

(E) Components of Internal Control System: 5 Components

- (i) Control Environment (Governance and Mngt. functions that set the tone of an organisation)
- (ii) Entity's Risk Assessment Process
- (iii) Information System
- (iv) Control Activities
- (v) Monitoring

Name of Component	Elements Covered in the Component	Auditor's understanding of the Component
(i) <u>Control Environment</u>	<ul style="list-style-type: none">(a) <u>Communication and Enforcement of Integrity and Ethical Values.</u>(b) <u>Commitment to Competence</u>(c) <u>Participation by TCOs</u>(d) <u>Management Philosophy and attitude.</u>(e) <u>Organisational structure</u>(f) <u>Assignment of authority and responsibility</u>(g) <u>HR Policies and procedures</u>	Auditor shall obtain an understanding of Control Environment and Evaluate whether: <ul style="list-style-type: none">(a) Mngt. has <u>created a culture of honesty and Ethical behaviour.</u>(b) <u>[Strength] of components of Control Environment provide foundation for [Other components of I.C.]</u>
(ii) <u>Entity Risk Assessment Process</u>	Entity Risk Assessment process involves: <ul style="list-style-type: none">(a) <u>Identifying Business Risk</u> related to financial reporting.(b) Assess <u>Significance</u> of those risk.(c) Assess <u>likelihood</u> of their occurrence.(d) Deciding upon the actions to <u>address</u> such risks.	Auditor should obtain understanding of Entity Risk Assessment Process as it assist the auditor in identifying RoMM.

Impact of satisfactory Control Environment:

- acts as a positive factor while assessing ROMM.
- Not an absolute deterrent to fraud
- Influences auditor's evaluation of effectiveness of other components of control.