Chapter - 3 "Risk Assessment and Internal Control"

Topics Covered:

(1) Audit Risk (SA 315)

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

(3) Identifying and Assessing RoMM (SA 315)

(4) Internal Control (SA 315)

(A) Meaning of Internal Control

(B) Objectives " " "

(C) Benefits of understanding of Internal Control

(D) Limitations of Internal Control

(E) Components of Internal Control

(f) Controls relevant to Audit:

- There is a direct relationship between <mark>Objectives</mark> of the Entity and the <mark>Controls</mark> it implements.

- Controls implemented in the Entity's may or may not be relevant for the purposes of audit.

- To determine whether Controls, individually or in combination with others, are relevant to audit purpose, auditor may consider following factors:

(a) Materiality;

(b) <mark>Significance of Related Risks</mark>;

(c) <mark>Size</mark> of the Entity;

(d) <mark>Nature</mark> of Entity's business, its <mark>Organisation Structure</mark> and <mark>ownership Characteristics</mark>.

(e) Diversity and Complexity of <mark>Entity's Operations</mark>

(f) Applicable <mark>legal and regulatory requirements</mark>

(g) <mark>Nature and Complexity of Systems</mark> forming part of I.C.

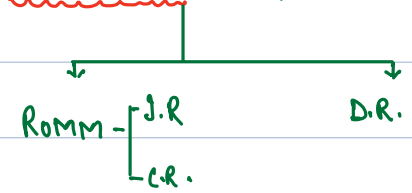(h) Circumstances and Applicable <mark>Components of I.C.</mark>

(g) Other Points: Reading from book

(5) Risks that require Special Consideration: (SA 315)

In Exercising Judgement as to which risks are significant risk, Auditor shall consider the following:

 (a) Whether the risk is a risk of ==fraud==.

 (b) Whether the risk is related to ==Significant economic,== SA-200 Accounting and [==other developments==].

 (c) ==Complexity of transactions==.

 (d) Whether risk involves Significant transactions with ==related parties==.

 (e) ==Degree of Subjectivity== In the measurement of financial information; and

 (f) whether the risk involves significant unusual transactions.

Audit Risk: - Inapp. Audit opinion

Romm - [J.R / C.R.] D.R.

Note: Significant risk often relate to Significant

Imp (A) **Non-routine transactions:**
↓ Matters related with non-routine transactions having Significant risk

AND

(B) **Judgemental Matters**
Matters related with [==Significant judgement==]
↓ having significant risk

(i) Greater Management Intervention to Specify accounting treatment-

(ii) Greater Manual Invention for data Collection and processing.

(iii) Complex calculations or accounting Principles.

(iv) Nature of non-routine transactions which makes it difficult for the Entity to implement effective controls Over the risks.

(i) Accounting Principles for Accounting Estimates or Revenue Recognition may be subject to different ==Interpretation==.

(ii) Required judgement may be ==subjective or complex or require assumptions== about effect of future events.

(6) **Evaluation (Review) and Testing of Internal Control System:**

(A) Evaluation of I.C. System enables the auditor to obtain reasonable assurance that – (i) Acting system is adequate; and

(ii) All accounting information which should be recorded, infact recorded.

(B) Auditor is required to obtain necessary information for the purposes of Evaluation of Internal Control.

→ (Important aspects of business;
Nature of business activities;
Size of Business;
Systems followed in Manufacturing, trading and Other Activities, etc.)

(C) Methods to be used for collection of information for the purposes of Evaluation of Internal Control: — 4 Methods

(i) Narrative Records:

   – Complex and Exhaustive description of system as found in operation, by the auditor.

   – Recommended where no formal control System is in operation.

   – More suited to small business, as to Comprehend the System in operation is a difficult task.

(ii) Check list:

   – Series of Instructions and/or question which a member of auditing staff must follow

I.C.Q. – Sala.

Q.	YES	NO	N.A. ↓
– Credit Appraisal.	✓		irrelevant →
– Invoices - 4	✓		
✓ follow-up-	✓		

↓ Existence   ↓ deficiency
                          ↓
              Explanation

Check List – Instructions / Questions.
              ↓
         Audit team

Narrative records. – Observations.

flow Charts.

and/or answer.

- This is on the job requirement and instructions are framed having regard to desirable elements of control.

- Example : Are tenders invited before placing purchase order ?

Is the purchase Order form Standardised ?

Are Purchase Order forms Pre-numbered ?

(iii) Internal Control Questionnaire :

- Comprises of comprehensive series of questions concerning Internal Control.

- Most widely used form for collecting information as to existence, operation and efficiency of Internal Control.

- Answers are to be given as YES/NO/NA.

- 'Yes' answer indicates Satisfactory performance; 'No' answer indicates weakness and requires further explanation. 'NA' reply is given for questions not relevant to business.

- ICQ is issued to client with a request to get it filled.

Sample ICQ for F.S. Items (Creditors, Cash, Inventory, etc) : Reading from book

(iv) Flow-chart : - Graphic presentation of each part of Internal Control and is considered to be most concise way of recording of review of System.

- Minimises narrative explanations.

- Give bird's eye view of System and flow of transactions and Integration.

(D) Benefits of Evaluation of I.C. System :

(E) Formulating Audit Programme :

Learning + Noting - H.W.

(f) Testing of I.C. System: (SA 330)

- After reviewing internal control system, Auditor needs to examine whether and how far the same is actually in operation - (ie. Existence)

- For this purpose, auditor should plan and perform actual testing of system in operation, in a manner that all important areas are covered in a span of say, 3 years.

- Tests of Controls may include:

  (a) Inspection of documents supporting transactions to collect audit Evidence that Internal control operated effectively.

  for Ex: Verifying that a transaction has been authorised.

  (b) Inquiry and observation of Internal control which leave no audit trail.

  for Ex: Determining who actually performs a function, not merely who is supposed to perform it.

  (c) Re-performance of procedures that were originally performed as part of Internal Control.

  for Ex: Reconciliation of Bank accounts.

  (d) Testing of Internal control on computerised applications or overall IT function.

  for Ex: Access controls or Program change Controls