

# Chapter - 4 "Materiality, Risk Assessment and Internal Control"

## Part A - "Audit Risk"



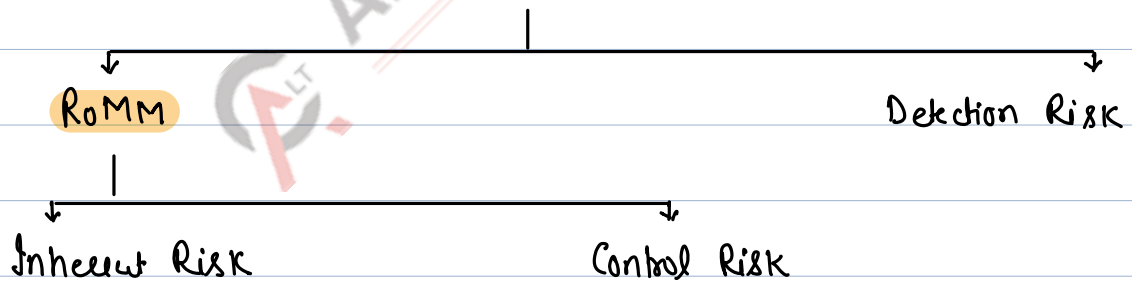
- (1) Audit Risk
- (2) Risk Based Audit Approach

## Part B. "Internal Control"



- (3) I.C. System - Nature, scope, Objectives and Structure.
- (4) Components of I.C. System
- (5) Review of System of I.C.
- (6) Internal Controls Assessment and Evaluation
- (7) Reporting to clients on I.C. weaknesses (SA-265 and 330)
- (8) Frameworks of Internal Controls.

(1) Audit Risk: Risk of Expressing inappropriate audit opinion when f.s. are materially misstated. 2 components



Inherent Risk: - Susceptibility of an assertion to a misstatement that could be material (individually or when aggregated with other misstatements), assuming that there are no related controls.

(Non-Existent I.C.)

- Inherent Risks are generally business risks that may arise from

- (a) Entity's objectives;
- (b) Nature of operations;
- (c) Size and complexity of business operations;
- (d) Regulatory Environment in which the Entity operates.

- Auditor is concerned with following types of Inherent Risk:

- (a) Complex calculations;
- (b) High Value Inventory;
- (c) Accounting Estimates involving significant estimation uncertainties;
- (d) Lack of sufficient working capital to continue business operations;
- (e) Volatile or declining Industry due to business failures;
- (f) Technological developments that may cause a product, obsolete

Control Risk: - Risk that Entity I.C. system will not prevent, or detect and correct on a timely basis, mistatements that could be material either Individually or when aggregated with other mistatements.  
(Ineffective I.C.)

- Entity should identify its business risk and respond by designing and implementing a system of Internal Control which comprises of Entity level controls and Activity level controls.
- Control Risk will always exist because of Inherent limitations of Internal Control system.

Detection Risk: Risk that auditor will not be able to detect a material mistatement; may be due to following reasons:

- (a) Selecting an Inappropriate audit procedure;
- (b) Misapplying an appropriate " " ;
- (c) Misinterpreting results from an " " .

Relationship among Components of Audit Risk:

$$\begin{aligned}\text{Audit Risk} &= \text{RoMM} \times \text{Detection Risk} \\ &= (\text{IR} \times \text{CR}) \times \text{DR}\end{aligned}$$

Acceptable level of detection risk bears an Inverse relationship to RoMM.

CR \ IR	HIGH	Moderate	Low
HIGH	Highest ROMM Lowest DR	Higher ROMM Lower DR	Moderate ROMM Moderate DR
Moderate	Higher ROMM Lower DR	Moderate ROMM Moderate DR	Lower ROMM Higher DR
Low	Moderate ROMM Moderate DR	Lower ROMM Higher DR	Lowest ROMM Highest DR

Example: Compute Audit Risk considering the following:

- There are chances that 40% of bills would be defalcated due to nature of business activities.
- Mngt. assured that I.C. can prevent such defalcation by 25%.
- Auditor procedures assures him satisfaction level of detection of fraud to the extent of 60%.

Sol:

$$\begin{aligned}
 \text{Audit Risk} &= \text{ROMM} \times \text{DR} \\
 &= (\text{IR} \times \text{CR}) \times \text{DR} \\
 &= (40\% \times 25\%) \times 40\% \\
 &= (10\%) \times 40\% \\
 &= 4\%
 \end{aligned}$$

Assessment of Audit Risk: Auditor is required to identify and assess ROMM at two levels:

- (a) Overall f.s. level: ROMM that relate pervasively to f.s. as a whole and potentially affect many assertions.
- (b) Assertion level: ROMM that relate to particular classes of transactions, account balances and disclosures.

Assertions to be examined by auditor:

- (A) For transactions occurred during the year: Occurrences; Completeness; Accuracy; Cut-off; Classification.
- (B) For Account Balances at Period end: Existence; Rights and Obligations; Completeness, Valuation and Allocation.
- (C) For Presentation and Disclosure: Occurrence; Rights and Obligations; Completeness; Classification and understandability; Accuracy and Valuation.

Steps for Risk Identification: (LEARNING + NOTING)

- Significance of Assessed Risk
- Likelihood for Assessed Risk to occur
- Documentation of Assertion.
- Impact of Risk of each Assertion - r. to  $\begin{matrix} \text{Acc-} \\ \text{trn} \\ \text{D} \end{matrix}$
- Degree of sig. Risk - sp. Attention.
- Enquire. Mngt. Responu.
- Unique characteristics of risk / Particular ch. - I.R.

## (a) Risk Based Audit approach:

- ✓ An Audit approach that analyses audit risks; sets materiality thresholds based on risk analysis; and develop audit programmes that allocate a larger proportion of audit response to high risk areas.
- ✓ Auditor's objective in a risk based audit is to obtain reasonable assurance that no material misstatements whether caused by error or fraud exists in the f.s.
- ✓ Risk Based audit involves performing three steps:
  - ✓ Step-1: Risk Assessment: Assessing Risk of Material Misstatement in the financial statements.
  - ✓ Step-2: Risk Response: Designing and performing FAP (ToC + ToD + SAP) that respond to assessed risk and reduce the ROMM in the f.s to an acceptable low level.
  - ✓ Step-3: Reporting: Issuing an appropriate audit report based on audit findings.

(3) Internal Control - Nature, Scope, Objectives and Structure: - from book -

(4) Components of Internal Control System:

- (A) - Control Environment
- (B) - Entity Risk Assessment Process
- (C) - Control Activities
- (D) - Information System and Communication
- (E) - Monitoring