

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)

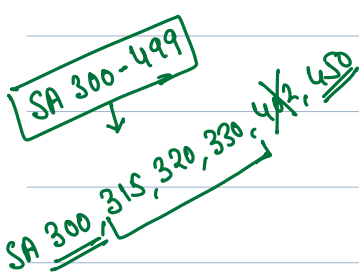
✓(5) Risk that require special consideration (SA 315)

(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

(ToD - 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:

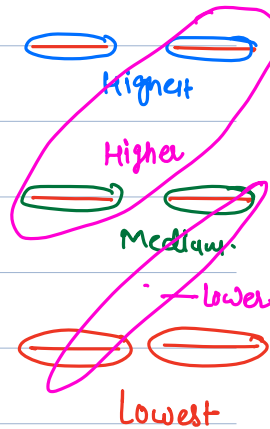
Test-checking

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
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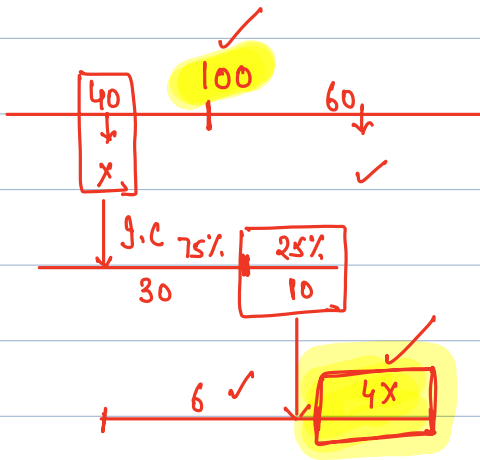
Example of Audit Risk:

Compute Overall audit risk assuming the following:

(a) Chances exist that 40% of services provided by the client would not be recorded properly as related controls do not exist.

(b) Management assures the auditor that I.C. can prevent such inadequacies by 75%.

(c) Audit procedures performed by auditor gives satisfaction as to detection of fraud and error to the extent of 60%.



Solution:

$$\text{Inherent Risk} = 40\%$$

$$\text{Control Risk} = 25\% \quad (100\% - 75\%)$$

$$\text{Detection Risk} = 40\% \quad (100\% - 60\%)$$

$$\begin{aligned} \text{ROMM} &= \text{IR} \times \text{CR} = 40\% \times 25\% \\ &= 10\% \end{aligned}$$

$$\begin{aligned} \text{Overall Audit Risk} &= \text{ROMM} \times \text{DR} \\ &= 10\% \times 40\% \\ &= \underline{4\%} \end{aligned}$$

Identifying and Assessing ROMM:

Auditor is required to obtain understanding of Entity; its Environment; including Internal Control



so as to identify and assess ROMM (a) Overall level (f.s. level)

(b) Assertion level for transactions; Account balances; Disclosures.

(a) Assessing ROMM at Overall F.S. level: It 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. (Implicit or Explicit)

Examples: Existence; Ownership; Completeness; Measurement; Valuation; Cut-off; Presentation and disclosures.

(b) Assessing ROMM at Assertion level: It refers to ROMM for particular:
i) Class of transactions;
ii) Account Balances; or
iii) Disclosures.

Note: Assessing ROMM at assertion level assist the auditor to determine NTE of audit procedures to be applied at assertion level.

Steps to be taken to Identify and assess ROMM: (Risk Assessment Process)

		Example.
Step - 1	Identify the <u>Risk</u> throughout the process of <u>obtaining understanding</u> .	Auditor identified the <u>related party transaction</u> that occurs <u>ols ordinary course of business</u> ↓
Step - 2	<u>Assess Identified Risk</u> and Evaluate whether it has pervasive effect.	Such transactions are limited with very small amount → Low Risk Such transactions are <u>significant</u> with <u>high values</u> → High Risk ↓ (Approx 10% of total sales) → <u>Assertion level</u> (Approx 70% of total sales) → <u>Pervasive level</u> .

Step-3 Relate the Identified risk to what can go wrong at assertion level.

- (a) Over/under statement of financial statement items
- (b) Wrong valuation of trade receivables at year-end.

Step-4 Consider the likelihood of Misstatements and whether it is Material

- It depends upon existence and effectiveness of I.C. and Mngt. biasness.
- (a) Effective control with no Mngt-biasness - Less chances
 - (b) Ineffective control with Mngt-biasness - More chances of Misstatement.

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

↓
Audit Procedures performed to obtain an understanding of Entity; its Environment including Internal control

↓
to identify and assess ROMM, whether caused due to fraud or error, at (a) f.s. level; and (b) Assertion level.

Audit procedures required to be performed for this purpose include the following:

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

(Learning + Noting - How)

Inquiries of Mngt. and others:

	Inquiry directed towards —	Information obtained w.r.t.
1.	<u>Internal Audit Personnel</u>	Internal audit procedures relating to design and effectiveness of Internal Control.
2.	<u>Employees involved in Initiating, processing or recording complex or unusual transactions.</u>	Evaluating appropriateness of selection and application of accounting policies.
3.	<u>In-house legal Counsel</u>	litigation, compliance with laws and regulations, knowledge of fraud etc.
4.	<u>Marketing or Sales Personnel</u>	Changes in Marketing strategies, sales trends, contractual arrangements with customers.
5.	<u>Risk Management Function</u>	Operational and regulatory risk
6.	<u>Information System Personnel</u>	System changes ; System failures ; other system related risks.