

## RISK ASSESSMENT AND INTERNAL CONTROL

### AUDIT RISK

Risk that the auditor gives an inappropriate audit opinion when the financial statements are materially misstated.

### RISK OF MATERIAL MISSTATEMENT (ROMM)

### DETECTION RISK

#### INHERENT RISK

Inherent risk is the susceptibility of an assertion about a class of transaction, account balance or disclosure to a misstatement that could be material, before consideration of any related controls

#### CONTROL RISK

Control risk is the risk that a misstatement that could occur in an assertion about a class of transaction, account balance or disclosure, will not be prevented, or detected and corrected, on a timely basis by the entity's internal control.

Risk that the procedures performed by the auditor to reduce audit risk to an acceptably low level will not detect a misstatement that exists and that could be material

#### EXCLUSIONS

- Audit risk does not refer to the auditor's business risks
- For purposes of the SAs, audit risk does not include the risk that the auditor might express an opinion that the financial statements are materially misstated when they are not.

### IDENTIFYING AND ASSESSING THE RISK OF MATERIAL MISSTATEMENT

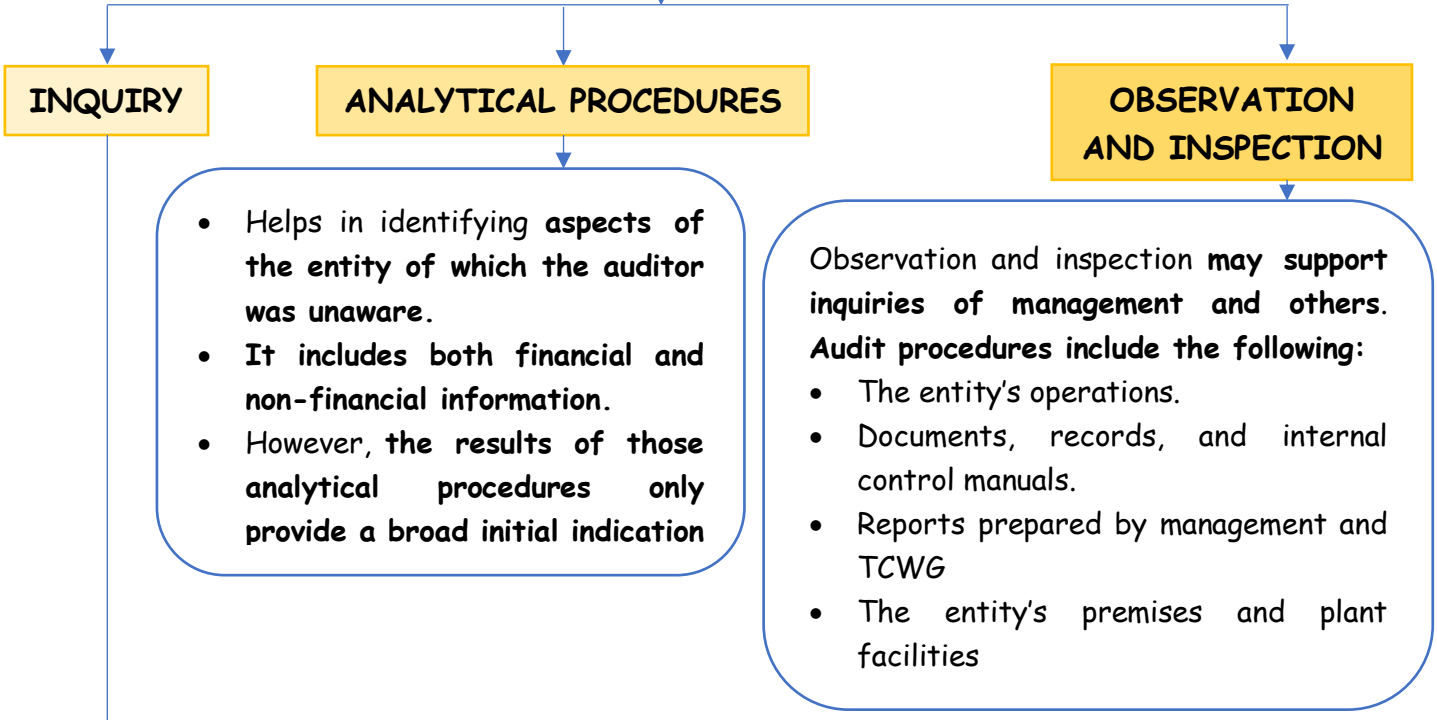
Identify risks throughout the process of obtaining an understanding of the entity and its environment and internal control

Assess the identified risks, and evaluate whether they relate more pervasively to the financial statements

Relate the identified risks to what can go wrong at the assertion level

Consider the likelihood of misstatement, including the possibility of multiple misstatements and material misstatement

**RISK ASSESSMENT PROCEDURE**



INQUIRY OF	INQUIRY ABOUT
Internal audit personnel	<b>Internal audit procedures</b> performed during the year relating to the design and effectiveness of the <b>entity's internal control</b> and whether management's response on that
Employees involved in initiating, processing or recording complex or unusual transactions	Appropriateness of the selection and application of certain <b>accounting policies</b> .
In-house legal counsel	<b>Litigation, compliance with laws and regulations</b> , knowledge of fraud or suspected fraud affecting the entity, warranties, post-sales obligations, arrangements (such as joint ventures)
Marketing or sales personnel	Changes in the entity's <b>marketing strategies, sales trends, or contractual arrangements</b> with its customers
Risk management function	<b>Operational and regulatory risks</b> that may affect financial reporting
Information systems personnel	System <b>changes, system or control failures</b> , or other <b>information system-related risks</b> .

The understanding entity and its environment, including the entity's internal control establishes a frame of reference within which the auditor plans the audit and exercises **professional judgement** throughout the audit, for example, when:

- **Assessing risks of material misstatement** of the financial statements
- Determining **materiality** in accordance with SA 320
- **Considering the appropriateness** of the selection and application of accounting policies
- **Identifying areas where special audit consideration** may be necessary,
- **Developing expectations for use** when performing analytical procedures
- **Evaluating the sufficiency and appropriateness of audit evidence**

**UNDERSTANDING THE ENTITY AND ITS ENVIRONMENT**

<p>Relevant industry, regulatory, and other external factors including the applicable financial reporting framework</p>	<ul style="list-style-type: none"> <li>• Relevant industry factors include industry conditions such as the <b>competitive environment, supplier and customer relationships, and technological developments.</b></li> <li>• The industry in which the entity operates may give rise to <b>specific risks of material misstatement.</b></li> <li>• <b>The regulatory environment includes, among other matters, the applicable financial reporting framework and the legal and political environment.</b></li> </ul>
<p>The nature of the entity</p>	<ul style="list-style-type: none"> <li>• its operations;</li> <li>• its ownership and governance structures;</li> <li>• the types of investments that the entity is making and plans to make, including investments in special-purpose entities; and</li> <li>• the way that the entity is structured and how it is financed;</li> </ul> <p>An understanding of nature of <b>entity enables the auditor to understand whether entity has a complex structure, matters relating to the ownership, and relations between owners and other people or entities, related party transactions have been identified and accounted for</b> appropriately.</p>
<p>The entity's selection and application of accounting policies, including the reasons</p>	<p>The auditor shall evaluate whether the <b>entity's accounting policies are appropriate for its business and consistent with the applicable financial reporting framework and accounting policies used in the relevant industry.</b></p>
<p>The entity's objectives and strategies, and those related business risks that may result in risks of material misstatement.</p>	<p>The entity's <b>management define objectives, which are the overall plans</b> for the entity. Strategies are the approaches by which management intends to achieve its objectives. The entity's <b>objectives and strategies may change over time.</b></p> <p>An understanding of the business risks facing the entity increases the likelihood of identifying risks of material misstatement, <b>since most business risks will eventually have financial consequences and,</b> therefore, an effect on the financial statements.</p>
<p>The measurement and review of the entity's financial performance</p>	<p>Performance measures, whether external or internal, <b>create pressures on the entity.</b> These pressures, in turn, may motivate management to take action to improve the <b>business performance or to misstate the financial statements.</b> Accordingly, an understanding of these assists the auditor in considering whether pressures to achieve performance targets <b>may result in management actions that increase the risks of material misstatement</b></p>

**SIGNIFICANT RISK**

Significant risks often relate to **significant non-routine transactions or judgmental matters.** Significant risks are **inherent risks with both a higher likelihood of occurrence and a higher magnitude of potential misstatement**

<p><b>Risks of Material Misstatement - Greater for Significant Non-Routine Transactions</b></p> <p>[REASONS]</p> <ul style="list-style-type: none"> <li>• Greater management intervention</li> <li>• Greater manual intervention</li> <li>• <b>Complex calculations</b> or accounting principles.</li> <li>• The <b>nature of non-routine transactions</b>, which may make it difficult for the entity to implement effective controls over the risks.</li> </ul>	<p><b>Risks of material misstatement- Greater for Significant Judgmental Matters</b> [REASONS]</p> <ul style="list-style-type: none"> <li>• Accounting principles for accounting estimates or revenue recognition may be <b>subject to differing interpretation.</b></li> <li>• <b>Required judgment may be subjective</b> or complex, or require assumptions about the effects of future events, for example, judgment about fair value.</li> </ul>
<p><b>Factors to be considered by auditor for significant risk -</b></p> <p>(a) Whether the risk is a risk of <b>fraud</b></p> <p>(b) Whether the risk is related to <b>recent significant economic, accounting, or other developments like changes in regulatory environment,</b></p> <p>(c) The <b>complexity</b> of transactions</p> <p>(d) Whether the risk involves <b>significant transactions with related parties</b></p> <p>(e) <b>The degree of subjectivity</b> and uncertainty in the measurement of financial information related to the risk</p> <p>(f) Whether the risk involves significant transactions that are <b>outside the normal course of business for the entity,</b> or that otherwise appear to be unusual.</p>	

**MATERIALITY**

<p><b>What is meant by materiality?</b></p> <p>Misstatements, including omissions, are considered to be material if they, individually or in the aggregate, could <b>reasonably be expected to influence the economic decisions of users</b> taken on the basis of the FS.</p> <p>Materiality is <b>not always a matter of relative size.</b> Further, if there is any statutory requirement of disclosure, it is to be considered material irrespective of the value of amount.</p>	
<p><b>How does materiality help in planning the audit?</b></p> <p>(a) Determining the nature, timing and extent of <b>risk assessment procedures;</b></p> <p>(b) Identifying and assessing the <b>ROMM;</b> and</p> <p>(c) Determining the nature, timing and extent of <b>further audit procedures</b></p>	<p><b>What is the significance of materiality?</b></p> <p>The auditor has to obtain reasonable assurance that FS as a whole are <b>free from material misstatement whether due to fraud or error.</b></p>
<p><b>Assumptions of auditor while calculating materiality regarding users: -</b></p> <p>(a) They have a <b>reasonable knowledge of business and economic activities and accounting;</b></p> <p>(b) They understand that FS are <b>prepared, presented and audited</b> to levels of materiality;</p> <p>(c) They <b>recognize the uncertainties inherent in the measurement</b> of amounts based on the use of estimates, judgment and the consideration of future events; and</p> <p>(d) They <b>make reasonable economic decisions</b> on the basis of the information in the FS.</p>	<p><b>Materiality Level or Levels for Particular Classes of Transactions, Account Balances or Disclosures</b></p> <p>(a) Whether law, regulations or the applicable FRF affect users' expectations regarding that particular item</p> <p>(b) The <b>key disclosures in relation to the industry</b> in which the entity operates</p> <p>(c) Whether <b>attention is focused on a particular aspect</b> of the entity's business</p>

**% of chosen benchmark = Materiality for FS**

Factors that may affect the identification of an appropriate benchmark include the following	<ul style="list-style-type: none"> <li>• The <b>elements of the financial statements</b></li> <li>• Whether there are items on which the <b>attention of the users of the particular entity's financial statements tends to be focused.</b></li> <li>• The <b>nature of the entity, where the entity is at in its life cycle, and the industry and economic environment in which the entity operates, the entity's ownership structure and the way it is financed.</b></li> <li>• The <b>relative volatility of the benchmark.</b></li> </ul>
Chosen Benchmark - Relevant financial data	<ul style="list-style-type: none"> <li>• <b>Prior periods'</b> financial results and financial positions,</li> <li>• The <b>period to-date</b> financial results and financial position, and</li> <li>• <b>Budgets or forecasts</b> for the current period,</li> <li>• <b>Adjusted for significant changes</b> in the circumstances of the entity</li> </ul>
Examples of Benchmark	<ul style="list-style-type: none"> <li>• Profit before tax, Gross profit</li> <li>• Total revenue, Total expenses, Total equity</li> <li>• Net asset value.</li> </ul>
Relationship between percentage and chosen benchmark	Amount ↓ Percentage ↑ and vice versa

**PERFORMANCE MATERIALITY**

Performance materiality means the amount or amounts set by the auditor **at less than materiality for the financial statements as a whole** to reduce to an appropriately low level the probability that the aggregate of uncorrected and undetected misstatements exceeds materiality level

**Revision in Materiality level as the Audit Progresses**

Materiality may need to be revised as a result of

- a change in circumstances that occurred during the audit,
- new information,
- or a change in the auditor's understanding of the entity and its operations as a result of performing further audit procedures.

If the auditor concludes that a **lower materiality for the financial statements as a whole than that initially determined** is appropriate, the auditor shall determine

- whether it is necessary to **revise performance materiality**, and
- whether the **nature, timing and extent** of the further audit procedures remain appropriate

**Documentation of materiality**

The audit documentation shall include the following amounts and the factors considered in their determination:

- (a) Materiality for the **financial statements as a whole**
- (b) If applicable, the materiality level or levels for **particular classes of transactions, account balances or disclosures**
- (c) **Performance materiality** and
- (d) **Any revision** of (a)-(c) as the audit progressed

**Materiality and Audit Risk**

There is a **inverse relationship between materiality and audit risk**. They are considered when -

- (a) **Identifying and assessing** the risks of material misstatement;
- (b) Determining the **nature, timing and extent** of further audit procedures; and
- (c) Evaluating the **effect of uncorrected misstatements**

**INTERNAL CONTROL**

**Meaning of Internal Control**

The internal control may be defined as "the process designed, implemented and maintained by TCWG, management and other personnel to provide reasonable assurance about the achievement of an entity's objectives with regard [SAFE]

- to reliability of financial reporting,
- effectiveness and efficiency of operations,
- safeguarding of assets, and
- compliance with applicable laws and regulations

**Benefits of Understanding of Internal Control**

An understanding of internal control assists the auditor in: -

- Identifying types of potential misstatements;
- Identifying factors that affect the risks of material misstatement, and
- Designing the nature, timing, and extent of further audit procedures.

**Limitations of Internal Control**

- Internal control can provide only reasonable assurance
- Human judgment in decision-making
- Lack of understanding the purpose
- Collusion among People
- Judgements by Management
- Limitations in case of Small Entities

**IMPORTANT POINTS IN RELATION TO INTERNAL CONTROL**

<p>Are all Controls Relevant to the audit?</p>	<p>Factors <b>relevant to the auditor's judgment about whether a control</b>, individually or in combination with others, is relevant to the audit may include such matters as the following: <b>Materiality</b>, the significance of the <b>related risk</b>, the <b>size</b> of the entity, the nature of the <b>entity's business</b>, including its <b>organisation and ownership</b> characteristics, the <b>diversity and complexity</b> of the entity's operations, <b>Applicable legal and regulatory</b> requirements, the <b>circumstances and the applicable component</b> of internal control.</p>
<p>Are controls over the completeness and accuracy of information produced by the entity relevant to the audit?</p>	<p>Only if the auditor <b>intends to make use of the information</b> in designing and performing further procedures</p>
<p>Are internal control over safeguarding of assets against unauthorised acquisition relevant to audit?</p>	<p><b>These controls may include controls relating to both financial reporting and operations objectives.</b> The auditor's consideration of such controls is generally limited to those relevant to the reliability of financial reporting</p>
<p>Are controls relating to objectives that are not relevant to an audit to be considered by the auditor?</p>	<p>An entity generally has controls relating to objectives that are not relevant to an audit and therefore need not be considered. However, in certain circumstances, the <b>statute or the regulation governing the entity may require the auditor to report on compliance with certain specific aspects of internal controls as a result</b>, the auditor's review of internal control may be broader and more detailed.</p>
<p>Should the audit program be evaluated after understanding of internal control?</p>	<p>The auditor can formulate his entire audit programme only after he has had a satisfactory understanding of the internal control systems and their actual operation. If he does not care to study this aspect, it is very likely that <b>his audit programme may become unwieldy and unnecessarily heavy</b> and the object of the audit may be altogether lost</p>

## COMPONENTS OF INTERNAL CONTROL

### A) Control Environment

- (i) Management has created and maintained a **culture of honesty and ethical behaviour**
- (ii) The strengths in the control environment elements collectively **provide an appropriate foundation for the other components of internal control.**

The control environment includes:

- (i) the **governance and management functions** and
- (ii) the attitudes, awareness, and actions of those **charged with governance and management.**
- (iii) the control environment **sets the tone of an organization, influencing the control consciousness of its people.**

#### **Elements of the Control Environment**

- (a) Communication and enforcement of integrity and ethical values, (b) Commitment to competence,
- (c) Participation by those charged with governance, (d) Management's philosophy and operating style,
- (e) Organisational structure, (f) Assignment of authority and responsibility, (g) Human resource policies and practices,

### (B)The Entity's Risk Assessment Process

It assists the auditor in identifying risks of material misstatement.

It involves - (a) **Identifying business** risks relevant to financial reporting objectives (b) **Estimating the significance** of the risks (c) **Assessing the likelihood** of their occurrence (d) **Deciding about actions** to address those risks

### C) The information system, including the related business processes, relevant to financial reporting and communication

An information system consists of infrastructure (physical and hardware components), software, people, procedures, and data.

The auditor shall obtain of following areas: -

- (a) The **classes of transactions** in the entity's operations that are significant to the FS
- (b) The procedures by which those transactions are **initiated, recorded, processed, corrected** as necessary, transferred to the general ledger and reported in the FS
- (c) The **related accounting records, supporting information and specific accounts** in the FS that are used to initiate, record, process and report transactions
- (d) How the **information system captures events and conditions** that are significant to the FS
- (e) The **financial reporting process** used to prepare the entity's FS
- (f) **Controls surrounding** journal entries.

### D) Control Activities

Control activities are the policies and procedures that help ensure that management directives are carried out.

Control activities relevant to audit generally include -

1. **Policies and procedures** relating to performance reviews, 2. **Information processing**, 3. **Physical controls**,
4. **Segregation of duties**

### (E) Monitoring of Controls

Monitoring of controls is a process to assess the **effectiveness of internal control performance over time and take necessary remedial actions.**

Management accomplishes monitoring of controls through ongoing activities, **separate evaluations, or a combination of the two.**

**REMEMBER -**

The existence of a satisfactory control environment can be a positive factor when the auditor assesses the ROMM. However, although it may help reduce the risk of fraud, a satisfactory control environment is **not an absolute deterrent to fraud.**

**EVALUATION OF INTERNAL CONTROL**

**DESIGN**

**IMPLEMENTATION**

**(A) The Narrative Record**

This is a **complete and exhaustive description** of the system as found in operation by the auditor.

**DISADVANTAGE -**

- (i) To **comprehend the system** in operation is quite difficult.
- (ii) To **identify weaknesses or gaps** in the system.
- (iii) To **incorporate changes** is difficult

**(C) Flow Chart**

It is a **graphic presentation** of each part of the company's system of internal control.

**ADVANTAGE -**

- It **minimises** the amount of **narrative explanation**
- It **gives bird's eye view** of the system and the flow of transactions and integration and in documentation, can be easily spotted and improvements can be suggested.
- It helps to understand the **significant features of the business** carried on by the concern

**(B) Check List**

This is a **series of instructions and/or questions** which a member of the auditing staff must follow and/or answer. When he completes instruction, he initials the space against the instruction

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

**(D) Internal Control Questionnaire**

This is a **comprehensive series of questions concerning internal control** usually issued to the client and the client is requested to get it filled by the concerned executives and employees

**ADVANTAGE -**

- **Oversight or omission of significant internal control review procedures** is less likely to occur with this method.
- **All internal control evaluation can be completed** at one time or in sections.
- Provides an **orderly means of disclosing control defects.**

- **Inspection of documents supporting transactions** and other events
- **Inquiries about, and observation of, internal controls** which leave no audit trail [ most efficient, least effective]
- **Re-performance** involves the auditor's independent execution of procedures or controls that were originally performed as part of the entity's internal control [ most effective, least efficient]
- **Testing of internal control operating on specific computerised applications** or over the overall

**AUTOMATED ENVIRONMENT**

**MEANING**

An automated environment basically refers to a business environment where the **processes, operations, accounting and even decisions** are carried out by using **computer systems** - also known as Information Systems (IS) or Information Technology (IT) systems

**RISKS**

- **Inaccurate processing** of data, processing inaccurate data, or both.
- **Unauthorized access** to data.
- **Direct data changes** (backend changes).
- **Excessive access / Privileged access** (super users).

**IMPACT OF IT RISKS**

- **Impact on substantive checking**  
It could lead to increased substantive checking
- **Impact on controls**  
It may result in additional audit work.
- **Impact on reporting**  
It may lead to modification of auditor's report

**CONTROLS IN AUTOMATED ENVIRONMENT**

**GENERAL IT CONTROLS**

Policies and procedures that **relate to many applications** and support the effective functioning of application controls. Also, known as **"pervasive" controls** or **"indirect" controls**

- Data centre and network operations
- Program change
- Access security
- Application system acquisition, development, and maintenance

**APPLICATION CONTROLS**

Application controls include both **automated or manual controls** that operate at a **business process level**. Automated Application controls are **embedded into IT applications**

**IT DEPENDENT CONTROLS**

IT dependent controls are basically **manual controls** that make use of some form of **data or information or report produced from IT systems and applications**.

**General IT Controls vs. Application Controls**

These two categories of control over IT systems are interrelated. General IT Controls are needed to support the functioning of application controls, and both are needed to ensure complete and accurate information processing through IT systems.

**TESTING OF AUTOMATED ENVIRONMENT**

**METHODS**

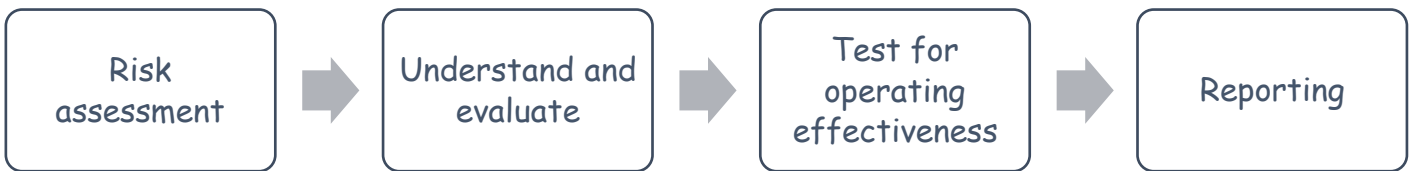
**Method**

- Inquiry ---→ Most efficient, least effective
- Observation
- Inspection
- Reperformance ---→ Least efficient, most effective

**PROCESS**

1. Obtain an understanding of **how an automated transaction is processed by doing a walkthrough**
2. **Observe** how a user processes transactions under different scenarios.
3. **Inspect the configuration** defined in an application

**AUDIT APPROACH IN AUTOMATED ENVIRONMENT**



**MANUAL CONTROLS**

Controls in a **manual system** may include such procedures as **approvals and reviews of transactions, and reconciliations and follow-up of reconciling items.**

**SUITABILITY**

- Large, unusual or non-recurring transactions.
- Circumstances where errors are difficult to define, anticipate or predict.
- In changing circumstances that require a control response outside the scope of an existing automated control.
- In monitoring the effectiveness of automated controls

**NON- SUITABILITY**

- High volume or recurring transactions, or in situations where errors that can be anticipated or predicted can be prevented, or detected and corrected, by control parameters that are automated.
- Control activities where the specific ways to perform the control can be adequately designed and automated.

**DATA ANALYTICS**

**MEANING**

The combination of processes, tools and techniques that are used to tap vast amounts of electronic data to obtain meaningful information is called data analytics. The tools and techniques that auditors use in applying the principles of data analytics are known as **Computer Assisted Auditing Techniques** or **CAATs** in short.

**APPLICATION**

- Check completeness of data and population
- Selection of audit samples
- Re-computation of balances -
- Reperformance of mathematical calculations
- Analysis of journal entries

**DOCUMENTING THE RISK**

- (a) The discussion among the engagement team and the significant decisions reached
- (b) Key elements of the understanding obtained regarding each of the aspects of the entity and its environment and of each of the internal control components
- (c) The identified and assessed risks of material misstatement at the financial statement level and at the assertion level and
- (d) The risks identified, and related controls about which the auditor has obtained an understanding.

**INTERNAL FINANCIAL CONTROLS AS PER REGULATORY REQUIREMENTS**

**Meaning -**

Refers to the policies and procedures put in place by companies for ensuring:

- Reliability of financial reporting
- Effectiveness and efficiency of operations
- Compliance with applicable laws and regulations
- Safeguarding of assets
- Prevention and detection of frauds

**Reporting Responsibilities**

Section 134 (5)(e) of Companies Act,2013 - Director's responsibility under **Directors' responsibility statement**

Section 143(3)(i) of Companies Act,2013 - Auditor's responsibility under **auditor's report**. [Exception - Private company with Turnover < 50 cr and borrowing < 25 cr, One person company, small company]

Section 177(4)(vii) of Companies Act,2013 - **audit Committee's responsibility**

Section 149(8) of Companies Act,2013 - **Independent directors' responsibility under Schedule IV**

**THE AUDITOR'S RESPONSES TO ASSESSED RISKS**

- (a) The auditor shall design and implement **overall responses** to address the assessed ROMM at the **financial statement level**.
- (b) The auditor shall design and perform **further audit procedures** whose nature, timing and extent are based on and are responsive to the assessed ROMM at the **assertion level**.

**FURTHER AUDIT PROCEDURES**

**TEST OF CONTROL (TOC)**

**SUBSTANTIVE PROCEDURE**

**What is TOC?**

(a) Perform other audit procedures in combination with inquiry to obtain audit evidence about the operating effectiveness of the controls, including:

1. How the controls were applied at relevant times during the period under audit.
2. The consistency with which they were applied.
3. By whom or by what means they were applied.

(b) Determine whether the controls to be tested depend upon other controls

**When is TOC needed?**

(a) The auditor's assessment of ROMM at the assertion level includes an expectation that the controls are operating effectively or

(b) Substantive procedures alone cannot provide sufficient appropriate audit evidence

**Matters the auditor may consider in determining the extent of test of controls:**

- The frequency of the performance of the control by the entity during the period.
- The length of time during the audit period that the auditor is relying
- The expected rate of deviation from a control.
- The relevance and reliability of the audit evidence to be obtained.
- The extent to which audit evidence is obtained from tests of other controls

**Timing of Test of Controls**

- The auditor shall test controls for the particular time, or throughout the period, for which the auditor intends to rely on those controls
- Audit evidence pertaining only to a point in time may be sufficient for the auditor's purpose
- If, on the other hand, the auditor intends to rely on a control over a period, tests that are capable of providing audit evidence that the control operated effectively

**TEST OF DETAILS**

Further classified into **tests of transactions** i.e., vouching and **tests of balances** i.e., verification.

**ANALYTICAL PROCEDURE**

Evaluations of financial information through analysis of plausible relationships among both **financial and non-financial data**

**Using Audit Evidence Obtained in Previous Audits**

- (a) The **effectiveness of other elements** of internal control, including the control environment, the entity's monitoring of controls, and the entity's risk assessment process
- (b) The **risks arising from the characteristics** of the control, including whether it is manual or automated
- (c) The effectiveness of **general IT-controls**
- (d) The effectiveness of the **control and its application** by the entity, including the nature and extent of deviations in the application of the control noted in previous audits
- (e) Whether the **lack of a change in a particular control** poses a risk due to changing circumstances
- (f) The **risks of material misstatement** and the extent of reliance on the control

**The best way to predict your future is to create it**