(A) Audit Risk :

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

→ Audit Risk that the auditor may fail to give an appropriate opinion in an audit engagement.

consist two components.

Influenced by client.

Inherent Risk.

Susceptibility of an assertion about a class of transaction, A/c bal or disclosure to a misstatement that could be material, either individually or in aggregate with other misstatements before consideration any related controls.

Control Risk.

a misstatement that could occur in an assertion about a class of txn, acc. bal, & disclosure that could be material, either individually or when aggregate with other misstatement will not be prevented or detected & corrected, on a timely basis by entity's internal control.

Efficiency of internal control. ↑ → Control Risk. ↓

Efficiency of internal control. ↓ → Control Risk. ↑

Audit Risk = Risk of Material Misstatement (Inherent Risk + Control Risk.) + Detection Risk. (influenced by auditor)

Risk that the procedure by the auditor to reduce audit risk to an acceptably low level will not detect a misstatement that exist & that could be material, either individually or in with aggregation with other misstatements.

a diff. betn the amount classification & presentation, or disclosure of a reported fs item & the amt. classification, presentation or disclosure that is required for the item to be in accordance with applicable financial reporting framework.

→ Assessment of Audit Risk is a matter of professional judgement.

→ Audit Risk.

- Risk of MM.
  - Inherent Risk.
  - Control Risk.
- Detection Risk.
  - Sampling Risk
  - Non-Sampling Risk.

Sampling Risk
The risk that the auditor's conclusion based on a sample may be diff. from the conclusion if the entire population were the subject of the same audit procedure.

Non-Sampling Risk.
The Risk that the auditor forms the wrong conclusion, which is unrelated to sampling risk.

→ Risk of Material Misstatement.

at two levels.

The overall FS.

relates pervasively to the FS as to whole & potentially affect many assertions.

At Assertion level.

assessed in order to determine the nature, timing & extent of FAP.

→ Audit Risk.

Includes.

✓ A function of RMM & detection Risk.

Not Includes.

× Auditors business risk.

× Risk that the auditor migh express an opinion that the FS are MM when they are not.

→ Identifying & Assessing the Risk of MM: ~~ob~~

•Objective of auditor as per SA 315:

To identify & assess the risk of material misstatement, whether due to fraud or error, at the FS & asseetion level through understanding the entity & its environment, including the entity's internal control, thereby peoviding a basis foe designing & implementing responses to assessed risk of material misstatement. FAP

• The objective of the auditor as stated in SA 315 is to identify & assessed the RMM.

1) The auditor shall identify & Assessed RMM at:
   - → Financial statement level.
   - → at asseetion level.

2) Foe this puepose, auditor shall:
   - → obtain an understanding of the entity & its environment, including relevant controls that relate to the risks.
   - → Assessed the identified risks & evaluate whether they eelate moee peevasively to the FS as a whole oe potentially affect many assertions.
   - → relate the identified risks to what can go wrong at the asseetion level.
   - → consider the likelihood of misstatement.

→ Risk Assessment Procedure

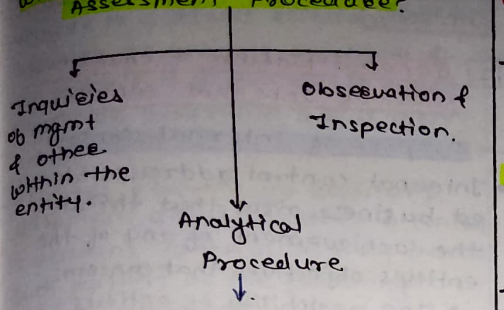
The audit proceduee peeformed to obtain an understanding of the entity & its environment, including the entity's internal control, to identify & assess the risk of MM, whether due to fraud or error, at the FS or at asseetion level.

* Risk assessment procedure do not pouide SA audit evidence on which to base the audit opinion.

Info obtained by performing eisk assessment procedure used as audit evidence:

- → may be used as audit evidence to suppoet assess ment.
- → In addition, auditor may obtain audit evidence, even through such procedures were not planned as substantive peoceduee oe as tests of controls
- → The auditor may also choose to peefoem substantive procedure oe tests of controls concurreently with risk assessment procedure.

What is included in Risk Assessment Procedures?



→ identify aspect of which auditor was unaware, may assist in order to provide a basis for designing & implementing responses to the assessed risks.

→ includes financial & non-financial information.

→ help to identify unusual txn

→ unusual or unexpected relationships that are identified may assists the auditor in identifying risks of MM.

(B) Understanding of the entity - A continuous process.

→ continuous & dynamic process of gathering, updating & analysing info. throughout the Audit.

SA 315 states that the auditor shall obtain an understanding of the following:

→ Relevant industry, regulatory & other external factors including the applicable financial reporting framework.

→ The nature of the entity; including
- → its operations.
- → its ownership & governance structures.
- → the types of investments.
- → the way that the entity is structured & how it is financed.

→ The entity's selection & application of accounting policies, including the reasons for changes thereto.

→ The entity's objectives & strategies & those related business risks that may result in risks of MM.

→ The measurement & review of the entity's financial performance.

Why understanding the entity & it's environment is significant?

It helps the auditor in planning the audit & in identifying areas requiring special attention gaining knowledge about client's business is one of the important principles in developing an overall audit plans.

© Internal Control:

→ As per SA 315, the internal control may be defined as:
'the process designed, implemented & maintained by those charged with governance, management & other personnel.'

→ To provide reasonable assurance about the achievement of an entity's objectives.

→ with regard to reliability of financial reporting, effectiveness & efficiency of operations, safeguarding of assets, & compliance with applicable laws & regulations.

→ The term 'controls' refers to any aspects of one or more of the components of internal control.

Entity's Internal control:

The auditor shall obtain an understanding of internal control relevant to the audit. Although most controls relevant to the audit are likely to relate to financial reporting, not all controls that relate to financial reporting are relevant to the audit. It is a matter of the auditor's professional judgement whether a control is relevant to the audit.

Objectives of Internal control:

→ Transactions are executed in accordance with managements general or specific authorization.

→ All transactions are promptly recorded in the correct amt. in the appropriate accounts & in the accounting period in which executed.

→ Assets are safeguarded from unauthorised access, use or disposit.

→ The recorded assets are compared with the existing assets at reasonable intervals.

Benefits of understanding of Internal controls:

→ Identifying types of potential misstatements.

→ Identifying factors that affect the risk of MM.

→ Designing the nature, timing & extent of further audit procedure.

Various Aspects of Internal Control.

I General Nature & Characteristics of Internal Control:

→ Purpose of Internal control:

- Internal control addresses identified business risks that threaten the achievement of any of the entity's objectives that concern:
  - → The reliability of entity's financial Reporting.
  - → Its compliance with applicable laws & regulations.
  - → The effectiveness & efficiency of its operations.
  - → safeguarding of Assets.

→ Limitations of Internal Controls:

- can provide only reasonable assurance.
- Human judgement in decision making.
- Lack of understanding the purpose
- Collusion among the people.
- Judgements by managements.
- Limitations in case of small entities.

II Controls Relevant to the Audit:

→ There is a direct relationship between an entity's objectives & the controls it implements to provide reasonable assurance about their achievement.

→ Factors relevant to auditor's judgement about whether a control is relevant to the audit may include such matters as the following:

- → Materiality
- → Significance of the related risk.
- → Size of the entity.
- → nature of the entity's business.
- → diversity & complexity of the ~~systems~~ entity's operath.
- → Applicable legal & regulatory requirements.
- → The circumstances & the applicable component of internal control.
- → The nature & complexity of the systems.
- → whether, & how, a specific control, prevents, or detects & corrects, material misstatement.

III Nature & Extent of the understandings of Relevant Controls:

→ Evaluating the design of control involves considering whether the control is capable of effectively preventing, or detecting & correcting, material misstatement.

Implementath of control.
- → control exists
- → & the entity uses it.

→ RAP to obtain audit evidence about the design & implementation of relevant control may include.
- → Inquiring of entity personnel.
- → Observing the applicath of specific controls.
- → Inspecting documents & reports.
- → Tracing transactions thrugh the Info. system relevant to FS. repoeting.

→ obtain an understanding of an entity's control is not sufficient to test their operating effectiveness.

IV Controls over the completeness & accuracy of information.

→ Controls over the completeness & accuracy of information produced by the entity may be relevant to the audit if the auditor intends to make use of the information in designing & peeforming FAP.

→ Controls relating to operations & compliance objectives may also be relevant to an audit if they relate to data the auditor evaluates or uses in applying audit procedures.

V Internal control over Safeguarding of Assets.

→ Internal control over safeguarding the assets against unauthorised acquisition, use, or disposition may include controls relating to both financial repoeting & operations objectives.

→ The auditors consideration of such control is generally limited to those relevant to the reliability of financial Repoeting.

VI Controls Relevant to objectives that are not relevant to the Auditor. for the Audit.

→ need not be considered.

→ In certain circumstances, the statute & the regulation governing the entity may require the auditor to repoet on compliance with certain specific aspects of internal control as a result, the auditor's review of internal control may be broader & more detailed.

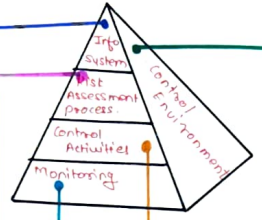
VII Components of Internal Control:

obtain an understanding of the info system, including following area:

- → classes of transactions
- → Procedure by which those txns initiated recorded, processed, etc.
- → Backup records.
- → How events/conditions captured.
- → Financial Reporting process used to prepare FS
- → control surrounding journal entries.
- → how entity communicate Fin. Reporting Roles including.
  - communication bet'n mgmt & Tcwg
  - external communication (regulatory authorities)

Points to be considered in this regard:

- → understanding of Roles & Regulation Responsibilities
- → Relationship activities
- → Policy manual & financial reporting manual.
- → Open communication channels
- → less structured & easier for small entities.



obtain an understanding of whether the entity has process for.

- Identifying business risk.
- Estimating the significance of risk.
- Assessing the likelihood of their occurrence.
- Deciding about the actions to address those risks

To access the effectiveness of controls on timely basis. To take remedial actions.

- Through ongoing activities.
- Separate Evaluation.
- OR combination of both

Control Activities are policies & procedures that help ensure that mgmt activities are carried out.

Examples of specific control activities.

- → Authorization
- → performance review
- → segregation of duties
- → physical controls
- → information processing

- → relevant to Audit.

i) Significant Risk.

ii) Areas for which substantive procedure alone do not provide sufficient & appropriate audit evidence.

performing substantive procedure will not provide auditor with sufficient audit evidence about accuracy of internal calculations.

obtain an understanding of control Environment; for this auditor shall evaluate.

- → mgmt has created & maintained a culture of honesty & ethical behaviour.
- → The strengths in the control environment elements collectively provide an appropriate foundation for the other components of internal control.

- → It influences control consciousness of people.
- → It will either enhance or mitigate effectiveness of control.

Understanding Of Elements Of Control Environment

Organisational Structure

Organisation Structure.
Framework
- Planned
- Executed
- Controlled.
- Reviewed

Assignment of Authority & Responsibility.
How authority are assigned reporting hierarchies, etc.

Communication & enforcement of integrity & ethical value.
influences of effectiveness of controls
- Designed
- Administered
- Monitored.

Management

Participation by Tcwg
- Independence
- Experience
- Involvement & info. they recd.
- Action

Management's philosophy & Op. style.
- Business risk.
- Financial Reporting
- Info processing.

Personnel

Human Resources policies & practices

Commitment to competence.

(D) Risks that Require Special Audit Consideration:

→ significant risk – matter of auditor's professional judgement.

→ In exercising judgement to which risks are significant risks, the auditor shall consider at least the following:

- whether the risk is risk of fraud.
- related to recent significant economic, accounting, or other development.
- complexity of transaction.
- whether the risk involve significant transaction with related party.
- degree of subjectivity in the measurement of fin. info. related to the risk.
- significant transactions, outside the normal course of business, appears to be unusual.

→ Identifying significant risks:

Significant risks are inherent risks with both (a) a higher likelihood of occurrence & (b) a higher magnitude of potential misstatements.

Following are always a significant risks:

→ ROMM due to fraud.

→ Significant transactn with related parties that are outside the normal course of business for the entity.

→ ROMM! Greater for significant Non-Routine Transactions:

Arising from matters:

→ Greater mgmt intervention to specify the accounting treatment.

→ Greater Manual intervention

→ Complex calculation / Acctg policies

→ Nature of non-routine txns.

→ ROMM - Greater for significant Judgemental Matters:

May be greater for significant judgemental matters:

arising from matters such as:

→ Accounting principles may be subject to differing interpretath

→ Require judgement may be subjective or complex (or require assumptions about the effect of future events.

(E) Evaluation of Internal Control

- the auditor should gain an understanding of the accounting system & relate internal control & should study & evaluate the operations of these internal control upon which he wishes to rely in determining the nature, timing & extent of other Audit Procedure.

the Review of internal control will enable auditor to know (Benefits)

→ whether errors & frauds are likely to be located in the ordinary course of operation of the business.

→ whether an adequate internal control system is in use & operating as planned by the mgmt.

→ whether an effective internal auditing department is operating

→ whether any administrative control has bearing on his work.

→ whether the controls adequately safeguards the assets.

→ How far & how adequately the mgmt is discharging its function in so far as correct recording of transactions is concerned.

→ How reliable the reports, records & the certificates to the mgmt can be.

→ the extent & the depth of the examination that he needs to carry out in the different areas of accounting.

→ what would be appropriate audit technique & the audit procedure in the given circumstances.

→ what are the areas where control is weak & where it is excessive.

→ whether some worthwhile suggestion can be given to improve the control system.

Evaluation of Internal Control Methods:

① **Narrative Record:**
→ a complete & exhaustive description of the system as found in operation by the auditor.

② **Flow chart:**
→ a graphical representation of each part of the company's system of internal control.

③ **Check list:**
→ a series of instruction & for questions which a member of a auditing staff must follow & for answer

④ **Internal Control Questionnaire:**
→ This is a comprehensive source of questions concerning internal control. This is the most widely used form for collecting information about the existence, operation & efficiency of internal control in an organization.

(E) Testing of Internal Control

Test of controls are performed to obtain audit evidence about the effectiveness of the:

→ design of the accounting & internal control system, &

→ operation of the internal controls throughout the period.

→ **Test of controls May include:**

1) Inspection of documents, supporting transactions & other events to gain audit evidence that internal control have operated properly.

2) Inquiries about & observations of internal controls which leave no audit trail.

3) Re-performance.

4) Testing of internal control operating on specific computerised applications or over the overall information technology function.

(G) Internal Control & IT Environment:

The characteristics of manual or automated elements relevant to the auditors risk assessment & FAP are explained here under:-

i) **Controls in Manual & IT system:**
→ Controls in manual system may include such procedures as approvals & reviews of transactions & reconciliation & follow-up of reconciling items.

→ an entity may use automated procedure to initiate, record, process, & report transactions, in which case records in electronic format replace paper documents.

→ Controls in IT system consist of a combination of automated controls.

ii) Use of IT:

→ An entity mix of manual & automated elements in it internal control varies with the nature & complexity of the entity's use of IT.

iii) Benefits of IT:

→ Processing of large volumes of transactions or data becomes simple.

→ Enhance the timeliness, availability & accuracy of info.

→ Facilitate the additional analysis of information.

→ Enhance the ability to monitor the performance of the entity's activities & its policies & procedures.

→ Reduce the risk of that controls will be circumvented.

→ Effective segregation of duties through security controls.

iv) Suitability:

→ Manual elements in internal control may be more suitable where judgement & discretion are required.

v) Reliability:

→ Manual elements in internal control may be less reliable than automated elements because they can be more easily bypassed, ignored or overridden.

vi) IT also poses specific risks to an entity's internal control:

→ Reliance on systems or programs that are inaccurately processing data, processing inaccurate data, or both.

→ Unauthorised access to data that may result in destruction of data or improper changes to data.

→ Possibility of personnel gaining access privileges.

→ Unauthorised changes in data.

→ Unauthorised changes to systems.

→ Failure to make necessary changes.

→ Inappropriate manual intervention.

→ Potential loss of data or inability to access data as required.

(H) Documentation:

→ The auditor shall document:

(1) Des Discussion among engmt team & decision reached.

(2) key elements of the understanding

(3) Identified & Assessed RoMM.

(4) The risks identified & related controls about which the auditor has obtained an understanding