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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)

SA 300-499

SA 300, 315, 320, 330, 402, 450

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

(a) F.S. level (Pervasive effect) (Overall level)

(b) Assertion level for

- classes of transactions
- account balances
- disclosures

(B) Responses to Assessed Risk (or)

Further Audit Procedures (FAP)

↓

I. Tests of Controls (ToC) or

Compliance Procedures :

Evaluation of Internal Contr

- to determine its Existenc

Effectiveness and continuit

II. Substantive Procedures

(Tod - V + V + SAP)

Examination of Acting 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

↓

Susceptability 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 fails 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:

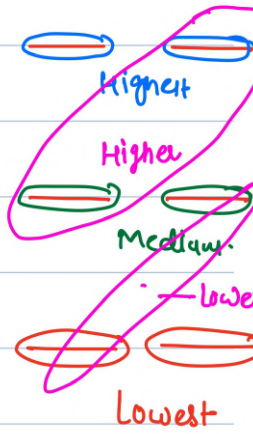
Test-checking

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

Audit Risk : IR × CR × DR

CR \ IR	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" 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
ch-1, 2, 11

Example of Audit Risk: Compute overall audit risk assuming the following:

(a) Chances that 40% of services provided by the client would be defalcated.

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

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

Solution:

Inherent Risk = 40% ✓

Control Risk = 25% ✓

Detection Risk : 40%

Risk of Material Misstatement (RoMM) = IR x CR

= 40% x 25%

= 10%

Overall audit risk = RMM x DR

= 10% x 40%

= 4%

Identifying and Assessing RoMM: Auditor is required to obtain understanding of the Entity, its Environment including Internal Control, so as to identify and assess RoMM at (a) Overall level (F.S. level)

(b) Assertion level.

(a) **Assessing RoMM at Overall F.S. level:** refers to RoMM that relate pervasively to the F.S. as a whole and may affect many assertions.

Assertions: Representations used by Mngt. in preparation and presentation of F.S. (may be Implicit or Explicit)

Examples: Existence, Ownership, Completeness, Measurement, Valuation, Rights and obligations, Cut-off, Presentation and disclosure.

(b) Assessing RoMM at Assertion level: Refers to RoMM for the particular:
(a) class of transactions;
(b) account balances; or
(c) disclosure.

Assessing RoMM at Assertion level assist the auditor in determine nature, timing and Extent of audit procedures to be applied at assertion level.

Steps to be taken to Identify and assess RoMM:

Step - 1	Step - 2	Step - 3	Step - 4
↓	↓	↓	↓
Identify the Risk throughout the process of obtaining understanding.	Assess Identified Risk and Evaluate whether it has pervasive effect.	Relate the Identified Risk to what can go wrong at assertion level.	Consider the likelihood of Misstatement and whether it is mater
Ex: Auditor identified that Related party transactions occurs outside the ordinary Course of business	(A) Limited no. of small transactions. (B) Significant trns of High values (Pervasive effect - B)	(a) Over/under statement of financial items. (b) wrong valuation at year-end	depends upon Existence of I.C. and possibl Mngt. biasness

Risk Assessment Procedures :

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

↓

Audit Procedures ★ performed to obtain an understanding of the Entity, its Environment including Internal control, to identify and assess RoMM, whether caused due to fraud or error, at the F.S. level and Assertion level.

Audit procedures required to be performed include :

(a) Inquiries of Mngt. and others within the Entity;

(b) Analytical Procedures; and

(c) Inspection of Records and observation of business operations

LEARNING and NOTING (H.W.)

(A) Inquiries of Mngt. and Others:

S.No.	Inquiry from _____	Information obtained w.r.t. _____
1.	Internal Audit Personnel	Internal audit procedures relating to design and effectiveness of I.C.
2.		
3.		
4.		
5.		
6.		

(B) Analytical Procedures: (Learning and Noting - H.W)

Share capital - SCR | SA

Comparison -

+ Mngt. Rep - No issue, red[M] buyback.

+ Minutes Books.

	22-23	23-24
G.P Ratio	⊖	⊖
op stock cl. stock Purch Sales	12%	25%

RoMM - Identified | Assess HIGH

- Overall Risk

(C) Inspection of Records and Observation of Business operations:

For Ex: (i) Inspecting documents relating to business plans, Strategies, Records like minute book, Internal control Policy manuals etc.

(ii) Inspecting reports prepared by the management e.g. Quarterly Mngt. reports, Interim financial statements etc.

(iii) Visiting Entity's premises and plant facilities

(iv) Observing Entity business operations.

Chapter - 3 "Risk Assessment and Internal Control"

Topics Covered : (1) Audit Risk

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

Materiality

Accounting - FRF.
↓
Books of A/c + F.S.

Auditing

SA-200 - Overall Objectives.
F.S - free from
- material
- misstatements

AS-1 - Disclosure of Acctg Policies
↓ selection
(a) Substance over form
(b) Prudence (c) Materiality. SA-320.

Fundamental Accounting Assumptions :
(a) Going concern
(b) Consistency
(c) Accrual.

(i) Meaning of Materiality :- As per SA 320, misstatements (including omissions) could be material, if individually or in aggregate with other misstatements, could reasonably be expected to influence the economic decisions of users of financial statements.

- Materiality may be determined on quantitative as well as qualitative aspects; hence materiality is not a matter of relative size, for example, small theft of money by employee can indicate significant deficiency in Internal control.

(ii) Concept of Materiality - based on discussion in FRF:

- As per SA 320, a discussion presented in FRF provides a reference to the auditor in determining materiality for the audit.

  For Example: Schedule III to the Companies Act, 2013, requires separate disclosure of financial items like:

  (a) Shareholding > 5% of share capital;

  (b) Income or Expenditure items that exceeds 1% of Revenue from operations or ₹ 1,00,000, whichever is higher.

- However, in the absence of any such discussion in the FRF, following principles may apply:

  (a) Any misstatement including omission are considered to be material, if they could reasonably be expected to affect the economic decision of users.

  (b) Judgements about materiality to be made based on circumstances; size and nature of misstatements, etc.

  (c) Materiality is to be considered on the basis of common information needs of users of F.S.

  (d) Materiality is a subject of professional judgement and may differ from person to person; any information which is material for a person might not be material for another person.

(iii) Auditor's Consideration as to applying materiality concept:

- Concept of Materiality is required to applied by the auditor both in planning and performing the audit and in forming an opinion on the F.S.
- During planning stage, auditor is required to consider the materiality for the following:

  (a) Determining NTE of RAP;

(b) Identifying and assessing RoMM; and

(c) Determining NTE of FAP.

- While performing the audit, auditor is required to consider the materiality for the following:

(a) Determining sufficiency and appropriateness of audit evidence;

(b) Evaluation of audit Evidence;

(c) Drawing Conclusion on the basis of audit Evidences.

(iv) Auditor's assumptions about Users of f.s. while determining materiality:

(a) Users have a reasonable Knowledge of business and Economic activities; and accounting.

(b) Users are willing to study the f.s. with reasonable diligence.

(c) Users understand that f.s. are prepared, presented and audited to levels of materiality

(d) Users recognise the uncertainties inherent in measurement of Estimates.

(e) Users make reasonable Economic decisions on the basis of f.s.

(v) Performance Materiality:

Amount set by auditor, at less than materiality for the financial statements as a whole

↓

so as to reduce the risk to an appropriate low level, that aggregate of uncorrected and undetected misstatements may exceed materiality for f.s. as a whole.

Materiality for Income | Expense:

1% of Rto or ₹ 1 lakh : Higher

1% of Snr or ₹ 1 lakh : ₹ 5 lakh

While Auditing Expense, misstatements identified - (40% transaction Examined)

(a) ₹ 55,000 — (a) ₹ 40,600

(b) ₹ 62,000 — (b) ₹ 31,150

(c) ₹ 41,000

(d) ₹ 70,600

(identified uncorrected)

Example:

- While planning the audit, auditor fix the materiality for the revenue items - ₹ 5,00,000
- During course of performing audit procedures, auditor observed some misstatements in the samples selected in range of ₹ 30,000 to ₹ 75,000.
- Auditor is of the view, that if ignored, aggregate of such uncorrected and undetected misstatements may exceed ₹ 5 lakh.
- Hence auditor is required to determine performance materiality which may be fixed at any amount on professional judgement of auditor, say for example ₹ 40,000.

Remaining Gor. population - undetected misstatement.

Identified uncorrected + undetected. > 5,00,000

Performance Materiality - ₹ 40,000

10 chapters · x 20 : 200 → 15

5 → Remaining

50

Obj. - x x x x x

(vi) Determining materiality and performance materiality:

Auditor is required to determine the following:

(a) Materiality for the financial statements as a whole (at the time of establishing overall audit strategy)

(b) If required, based on the circumstances, materiality for the particular class of transactions, account balances or disclosures.

(For Ex: Managerial Remuneration, Related Party disclosures, travelling expenses, trade receivable balances etc.)

(c) Performance Materiality, if circumstances do requires.

Revision as the audit progresses:

- If auditor conclude that a lower materiality for the F.S. as a whole. or particular transactions, account balances or disclosures, than that Initially determined, is appropriate, auditor may revised the materiality and consider[a] whether there is a need to revise performance materiality and whether NTE of audit procedures remains appropriate.

- Materiality need to be revised as a result of:
  - (a) Changes in Circumstances;
  - (b) New Information obtained
  - (c) Changes in auditor's understanding of Entity and its operations as a result of performing audit procedures.

MCQ: As per SA 320, in case of revision in materiality level, auditor need to consider:
(a) Need to revise P. Materiality
(b) NTE of Audit procedures remain appropriate.
(c) Either (a) or (b)
(d) Both (a) and (b)

Documentation: Auditor documentation shall include the following:

(a) Materiality for the financial statements as a whole.
(b) " " " particular classes of transactions, account balances or disclosures.
(c) Performance Materiality.
(d) Revision of (a), (b) or (c) as audit progressed.

imp

(vii) **Benchmark of Materiality:** Materiality may be determined as a %age of

- Profit before tax;
- Total Revenue;
- Total Expenses;
- Total Equity,
- Gross Profit
- Net Assets value etc.

Most commonly used Benchmark in case of Profit making Entities are Profit Before tax. In case of other entities, other benchmark may be applied.

Factors affecting identification of appropriate Benchmark:

(a) Elements of the financial statements.
[For Ex: Assets, Liabilities, Equity, Income and Expense]

(b) Items on which the attention of the users of F.S. tends to be focused.
[For Ex: to evaluate financial performance, user may focus on profits]

(c) Nature of the Entity

(d) Industry and Economic Environment in which Entity operates.

(e) Entity Ownership structure and the way in which it is financed.
[For Ex.: In case of finance through debts, more emphasis will be on assets and claims over them].

(f) Relative Volatility of the benchmark.

(viii) **Materiality and Audit Risk:** - Self-study from book -

Chapter - 3 "Risk Assessment and Internal Control"

Topics Covered : (1) Audit Risk (SA-315)

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

Imp

(3) Understanding the Entity and its Environment : (SA 315)

As per SA-315, auditor is required to obtain understanding of following :

(a) Relevant Industry, Regulatory and Other factors including applicable FRF.

Examples.

Industry factors : Market, competitio
Product technology, supplies,
Customers etc.

Regulatory factors : Legal provisio
Regulations, taxation, Govt.
Policies etc.

Other factors : Economic conditions
Interest rates, inflation etc.

(b) Nature of Entity : including -

- its operations (e.g. Business activities)
- its ownership and Governance structure
- types of Investments (e.g. Investment activities)
- Entity financing structure. (e.g. Equity / debt)

(c) Selection and Application of Accounting Policies including, reasons for changes thereto.

(d) Objectives, strategies and Business risk that may result in RoMM

- Industry developments
- New Products and Services (increased product liability
- Expansion of Business (Inaccurate estimates - dema

(e) Measurement and review of financial performance

- KPI (Key Performance Indicators
- Trends, Ratios
- Reports of Credit Agencies
- Budgets, Variance Analysis

MCQ: Auditor is required to obtain an understanding of Entity, its Environment including I.C. as per the requirements of SA 315. Such activity is:

(a) One time activity to be carried out at Initial stage.

(b) " " " " " " " " Conclusion stage.

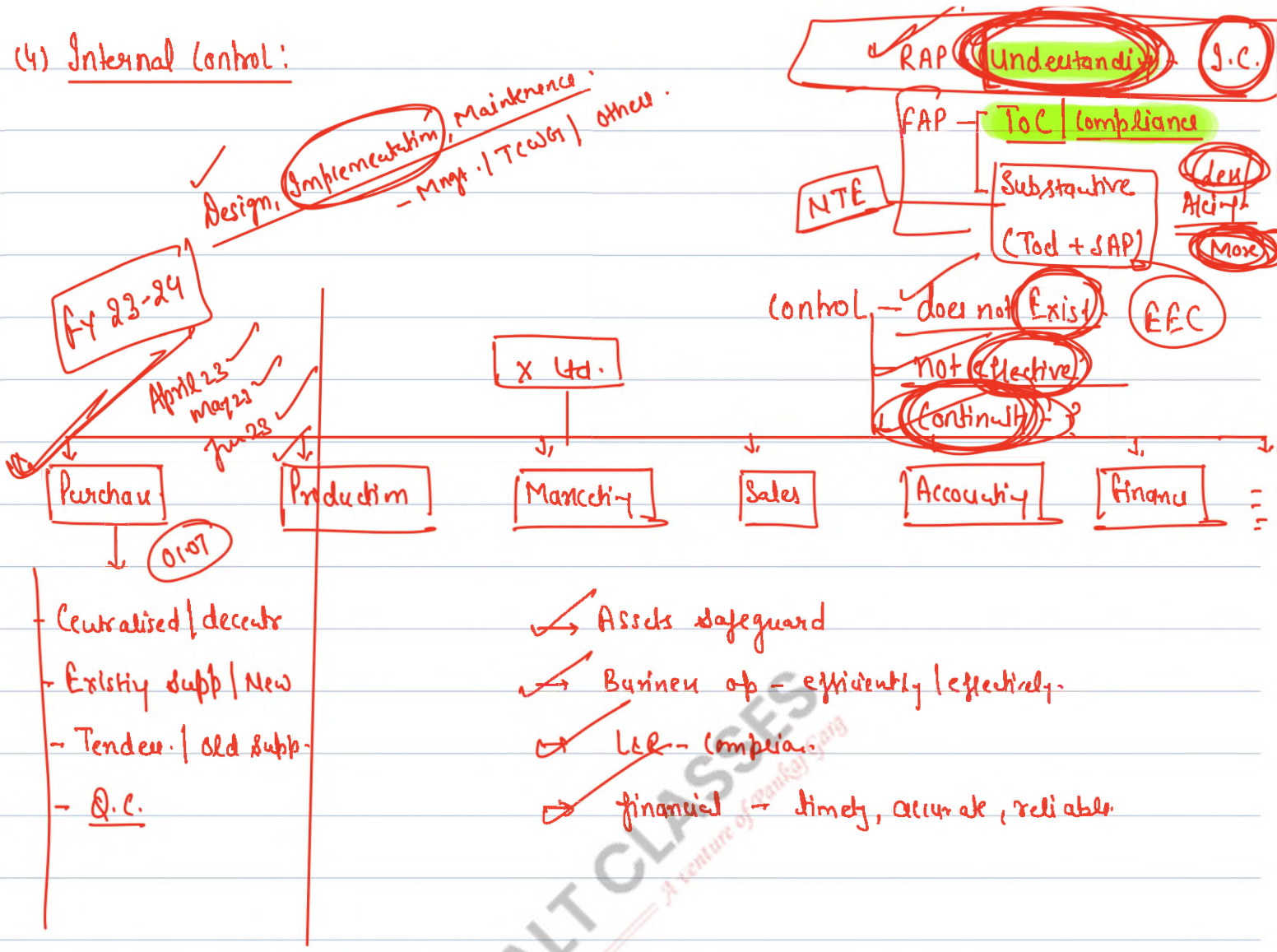
(c) Both (a) and (b)

✓(d) Continuous activity throughout the audit.

Understanding of Entity - a Continuous process:

- Obtaining understanding of Entity, its Environment including Internal Control is a Continuous, dynamic process carried out throughout the audit for gathering, updating and analysing information.
- Such understanding helps the auditor in:
  - (a) Assessing RoMM.
  - (b) Determining Materiality
  - (c) Determining appropriateness of selection and application of accounting policies.
  - (d) Identifying areas where special audit considerations may be necessary.
  - ✓(e) Developing expectations of recorded amount while using analytical procedures.
  - (f) Evaluation Sufficiency and appropriateness of audit Evidences.

(4) Internal Control:



(A) Meaning of Internal Control:

SA 315 defines the term "Internal Control" as the processes, designed, implemented and maintained by TCWG | Mngt. | others within the entity to provide reasonable assurance as to the achievement of Entity's Objectives of : (DIM)

(i) Reliability of financial reports;
(ii) Effective and efficient business operations;
(iii) Safeguarding of Assets; and
(iv) Compliance of laws and Regulations.

(B) Objectives of Internal Control:

(i) Only **authorised transactions** should enter into accounting system. Authorisation may be general or specific.

(ii) Ensure **appropriate recording** of transactions i.e. transactions should be recorded with **correct amount**, recorded in **correct account** and in **correct accounting period**.

(iii) Ensure that assets are being used only for **authorised purposes** (i.e. for business use). Assets are safeguarded from unauthorised use.

(iv) To Ensure the **Existence of assets** recorded in books of accounts. (i.e. recorded assets are compared with the actual assets at reasonable intervals and in case of any difference, appropriate action is taken).

(C) Benefits of understanding of Internal Control to auditor: (RAP)

(i) To identify types of potential misstatements.

(ii) " " factors that affect RoMM.

(iii) To design NTE of FAP. (ToC + Substantive)

(D) Limitations of Internal Control:

(i) Internal control can provide reasonable assurance as to achieving the objectives of financial reporting only.

(ii) Involvement of human judgements in decision making. (that can be faulty).

(iii) Lack of understanding the purpose of Internal control.

(iv) Collusion among employees.

(v) Judgements by management on nature and Extent of Control (that may be biased).

(vi) Limitation in case of smaller Entities (Owner-Manager is able to override the Controls as they are less structured).

(E) Components of Internal Control System: 5 Components

(i) Control Environment (Governance and Mngt. function that set the tone of an organisation)
(ii) Entity's Risk Assessment Process
(iii) Information System
(iv) Control Activities
(v) Monitoring

Name of Component	Elements Covered in the Component	Auditor's understanding of the Component
(i) Control Environment	(a) Communication and Enforcement of Integrity and Ethical Values. (b) Commitment to Competence (c) Participation by TCWG (d) Management Philosophy and attitude. (e) Organisational structure (f) Assignment of authority and responsibility (g) HR Policies and procedures	Auditor shall obtain an understanding of Control Environment and Evaluate whether: (a) Mngt. has created a Culture of honesty and Ethical behaviour. (b) [Strength] of Components of Control Environment provide foundation for [other components of I.C.]
(ii) Entity Risk Assessment Process	Entity Risk Assessment process involves: (a) Identifying Business Risk related to financial reporting. (b) Assess Significance of those risk. (c) Assess likelihood of their occurence. (d) Deciding upon the actions to address such risks.	Auditor should obtain understanding of Entity Risk Assessment Process as it assist the auditor in identifying RoMM.

Impact of satisfactory Control Environment:

- acts as a positive factor while assessing RoMM.
- Not an absolute deterrent to fraud.
- Influences auditor's evaluation of effectiveness of other components of control.

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 Objectives of the Entity and the Controls 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) Significance of related risks;

(c) Size of the Entity;

(d) Nature of Entity's business, its Organisation structure and ownership characteristics.

(e) Diversity and complexity of Entity's operations

(f) Applicable legal and regulatory requirements

(g) Nature and complexity of systems forming part of I.C.

(h) Circumstances and Applicable components of I.C.

(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, accounting and other developments** SA-200

(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. Auditopinion

- RoMM - I.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 effects 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) Acctg System is adequate; and
(ii) All accounting information which should be recorded, in fact 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:
- Complete 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 questions which a member of auditing staff must follow

I.C.Q. - Sales

Q.	YES	NO	N.A.
- Credit Appraisal.	✓		irrelevant
- Invoices - 4	✓		
✓ Follow-up-	✓		
	↓	↓	
			deficiency
	Existence		
			↓
			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 - (i.e. 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

Chapter - 3 "Risk Assessment and Internal Control"

Topics Covered:
(1) Audit Risk (SA 315)
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(3) Identifying and Assessing RoMM (SA 315)
(4) Internal Control (SA 315)
(5) Risks that require special consideration
(6) Evaluation and Testing of Internal Control System

(7) Automated Environment:

(A) BASICS
- (i) Meaning and Nature of Automated Env.
- (ii) Key Features of Automated Environment

(B) Risk, Control and Testing
- (iii) Understanding and Documenting
- (iv) Risk arising from use of I.T.
- (v) Impact of IT Related Risks
- (vi) Types of Controls
- (vii) Testing Methods

(C) Miscellaneous
- (viii) Audit Approach
- (ix) Data Analytics
- (x) Digital Audit

(i) Meaning and Nature of Automated Environment:

- Business Environment where the processes, operations, accounting and decisions are being carried out using the computer systems (also known as Info. System).
- Such Environments are more System driven; with less manual Intervention.
- Complexity of such environment depends upon level of automation.

✓ For Example: Integrated ERP Systems (e.g. SAP, Oracle) are considered more complex to audit as compared to off the shelf accounting software (e.g. tally, busy)

(iv) Key features of Automated Environment:

(a) Faster Business operations
(b) Accuracy in data processing and Computation.
(c) Ability to process volumnious data.
(d) Integration of Business operation.
(e) Better Security and Controls
(f) Less Manual Intervention
(g) Provides latest Information.
(h) Connectivity and Networking Capabilities.

PART B - Risk, Control and Testing

(iii) Understanding and Documenting the Environment:

SA 315 - Identifying and Assessing RoMM through understanding the Entity and its Environment.

Automated Environment - Business Env. - P O A D — Com. system (Info. system)

understanding the Entity and
(a) Industry, Reg. - FRF.
(b) Nature - , its operatio
Investment, financ
(c) Alcg Policies
(d) objectives | Strategic
Business Risk
(e) M/R of financial per

Auditor is required to obtain understanding of following:

(a) Information systems being used. (i.e. Applications like Finnacle)
(b) Purpose of Info. System (Financial and Non-financial)
(c) Location of I.T. System (Local or Global)
(d) Architecture (Desk top; Cloud based, web application; Mobile based etc.)
(e) Versions (Diff. version have varied functions and risks)
(f) Interfaces within the system (e.g. Multiple system exist for data processing)
(g) Inhouse vs. Packaged.
(h) Outsourced Activities (IT Maintenance and Support)
(i) Key Persons (e.g. CIO; CISO; DBA)

Note: Auditor should document the understanding.

Imp:

(iv) **Risk arising from use of IT System:** Consider the following risk:

(a) Inaccurate processing of data; or processing inaccurate data or both;
(b) Unauthorised access to data;
(c) Data security;
(d) Excessive / Privileged access (Super Access);
(e) Lack of adequate segregation of duties;
(f) Unauthorised changes to programs;
(g) Failure to make necessary changes to Programs.
(h) Potential loss of data (due to system failure or other reasons)

(v) **Impact of IT Related Risk:**

(A) On controls

- Non reliance on
  - (a) Automated Controls
  - (b) System Calculations
  - (c) Accounting Procedures
- Requires more Substantive Testing

(B) on Substantive Testing

- Non reliance on data Obtained from the System
- Requires increased Substantive Testing of data, Information and reports to ensure their accuracy and completeness

(C) on Reporting

Modifications in Auditor's Report may be required.

(vi) Types of Controls:

(A) Based on Nature

(a) Automated Controls → Controls embedded within the Systems

(b) Manual Controls → Controls based on reports / Info. generated by I.T. System

(B) Based on Technical Aspects

(a) General IT Controls

- Policies / procedures related to many applications and support effective functioning of application controls.
- Ensure Integrity of Information and Security of data.
- Includes Control over
  (i) Data Center and Network Operations
  (ii) Program changes
  (iii) Access Security
  (iv) Application system - Acquisition, development and Maintenance

(b) Application Controls

- Manual or automated Procedures that operate at business Process level ⟶ to ensure accuracy, Completeness and Integrity of data.
- Examples:
  (i) Edit Check and Validation of Input data.
  (ii) Sequence number check.
  (iii) User limit check.
  (iv) Reasonable check.
  (v) Mandatory data field.

(c) IT dependent Controls

Manual Controls based on reports produced from IT System.

- Design and effectiveness of such controls depends on reliability of source data.

Relationship among Elements of Control:

- Effectiveness and reliability of Application and IT Dependent controls depends upon the effectiveness of General IT controls.
- General IT controls needed to support the functioning of Application Controls.
- Both General IT controls and Application controls are needed to ensure complete and accurate information processing.

Components of General IT Controls:

Component	Objectives	Activities
(i) Data Center and Network Operations	To Ensure that production System are processed to meet financial reporting (FR) Objectives.	(a) Overall management of computer Operation Activities (b) Backups - Monitoring ; storage; retention. (c) Recovery from failures - Business Continuity Plans (BCP); Disaster Recovery Plan (DRP)
(ii) Program change	To Ensure modified programs Continue to meet FR Objectives.	(a) (b) (c)
(iii) Access Security	To ensure access to programs and data is authenticated and Authorised to meet FR Objectives.	(a) (b) (c)
(iv) Application System- Acquisition, development and Maintenance	To ensure that systems are developed, configured and implemented to meet FR objectives.	(a) (b) (c)

(vii) Testing of controls: Following testing methods can be used:

(a) Inquiry

(b) Inspection

(c) Observation

(d) Re-performance

Inquiry: Most efficient method ; but provides least audit evidence.
Hence, using inquiry alone is not sufficient.

✓ Inquiry in combination with Inspection: Most efficient and effective.

Re-performance: Most effective and gives best audit evidence. But time consuming and least efficient most of the time.

Commonly used methods:

(i) obtain an understanding of how an automated transaction is processed using a combination of Inquiry, Observation and Inspection.

(ii) Observe how a user, process transactions under different scenarios.

(iii) Inspect the configuration defined in application.

(iv) Conduct Re-performance using raw source data.

eg. Reconciliation Statement

Part C - Miscellaneous

(viii) **Audit Approach:** 4 Stages

↓

Risk Assessment ⟶ Consider Risk arising from use of IT
(e.g. Inaccurate processing, Inaccurate data, Loss of da
unauthorised access; unauthorised changes to programs)

↓

Understand and Evaluate ⟶ Controls to Mitigate IT Related Risk
(e.g. General IT Controls, Application Controls)

↓

Test for operating Effectiveness ⟶ To Ensure Reliability and Completeness of Information.
(e.g. Inquiry, Observation, Inspection, Re-performa

↓

Reporting ⟶ Reporting of deficiencies in I.C. to Mngt.
(Through letter of weakness)

(ix) **Imp Data Analytics:** - It is a Analytical Process through which meaningful information is generated from raw data.

- Data Analytic methods used in an audit are known as Computer Assisted Audit Techniques (CAATs)
- **Examples:** (a) Spreadsheets like MS-Excel
  (b) Specialised Audit Tools like IDEA and ACL

Application of data Analytics:

(a) Check Completeness of data and population that is used in ToC | Tod | SAP
(b) Selection of Audit Samples - Random sampling / Systematic sampling.
(c) Re-computation of balances - (e.g. Construction of trial balance)
(d) Re-performance of Calculations - (e.g. depreciation, Interest etc.)
(e) Analysis of Journal Entries (f) Fraud Investigation

(x) **Digital Audit:** Placing Assurance on effectiveness of IT System implemented in an Organisation.

Use of Digital technology by

Entities

- To revamp business operations.
- To rethink the way business is conducted.
- To restructure the business models.
- To automate the business processes

Auditor

- Use of Artificial Intelligence, data Analytics etc. to understand the business in a better way.
- To conduct audit in a more efficient and effective manner.
- To identify the Risks.

Chapter - 3 "Risk Assessment and Internal Contro"

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)

(5) Risks that require special consideration

(6) Evaluation and Testing of Internal Control System

(7) Automated Environment

(8) Auditor's Responses to Assessed Risks (SA 330):

Audit Engagement (SA 210) → Perform Preliminary Engagement Activities (SA-300) → Establish Audit Strategy (SA 300)

↓

Develop an Overall Audit Plan (SA 300)

N, T, E

RAP | FAP | Other

↓

Perform RAP To Identify and Assess RoMM – understanding - Entity. (SA-315) – its Environment including I.C.

↓

Design and Perform Responses to Assessed Risk (FAP) (SA 330) [ToC + Substantive]

↓

To Collect sufficient appropriate Audit Evidences – whether F.S. are free from material misstatements

- **No Misstatements Exist**
  - ↓
  - Draw Conclusion and Issue Audit opinion (unmodified) as per SA-700.
- **Misstatement Exist**
  - **Fraud**
    - ↓
    - Apply procedures as stated in SA-240.
  - **ERROR**
    - ↓
    - Apply the procedures as stated in SA-450.

(i) Types of Responses: SA 330 requires the auditor to design and perform audit procedures which are appropriate to assessed risks

↓

for the purpose of collection of sufficient appropriate audit evidences.

Responses are classified in two categories — (a) Compliance procedures (Tests of Controls - ToC)
(b) Substantive " (Tests of details - ToD + Substantive Analytical Pro. - SAP)

(ii) Designing and Performing ToC:

- Tests of Controls may be defined as audit procedures designed to evaluate Operating effectiveness of Controls in preventing or detecting and correcting material misstatements at the assertion level.
- Auditor shall design and perform ToC to obtain SAAE as to the operating effectiveness of Controls when:
  (a) he expects that Controls are operating effectively; or
  (b) Substantive procedures alone cannot provide SAAE.
- In designing and performing ToC, auditor shall perform other audit procedures in combination with Inquiry to obtain audit evidence about operating effectiveness of Controls, including:
  (a) How the Controls were applied at relevant times during the audit.
  (b) Consistency with which they are applied.
  (c) By whom and by what means they were applied.
- Inquiry alone is not sufficient to test operating effectiveness of Controls. Inquiry combined with Inspection or re-performance may provide more assurance than Inquiry combined with observation, as observation is pertinent only at the point in time at which it is made.

- **Matters to be considered in determining the Extent of tests of Controls:**

(a) Frequency of performance of Controls
(b) Length of time
(c) Expected rate of Deviation
(d) R|R – Audit Evidences
(e) Extent to which A.E obtained from Tests of other Controls.

Imp:

Factors to be considered while using Audit Evidences obtained in previous audits.

(a) Effectiveness of Other Elements of Control – C.E, Monitoring, E.R.P.
(b) " " General I.T. Controls
(c) " " Controls and its application by the Entity.
(d) Risk arises from characteristics of Controls (Manual or automated)
(e) RoMM and Extent of Reliance on Controls.
(f) Personnel changes that significantly affect the application of Controls.
(g) lack of a change in a particular Controls required due to changed Circumstance

- **Specific Inquiries by auditor when deviations from Controls are detected:**

When deviations from Controls upon which the auditor intends to rely are detected, auditor shall make specific inquiries to understand these matters, their potential consequences and determine whether

(a) ToC performed provide appropriate basis for reliance on Controls
(b) Additional ToCs are necessary.
(c) Potential risk of Misstatement need to be addressed using Sub. procedures.

(iii) **Substantive Procedures:** Procedures designed to detect material misstatements at the assertion level are known as Substantive Procedures.

- Sub. Procedures Comprises of (a) Tests of details – Tod (of transactions (Vouching) and Balances (Verification))
(b) Substantive Analytical Procedures (SAP)

Examples: Tests of details of Transactions (Vouching)

(a) Payment of Electricity Bills – Vouching –
- (i) Electricity Bill – Amount Payable
- (ii) Receipts / Bank Statement – Paid
- (iii) Authorisation

Electricity Exp – 2022-23 – ? 12.00 lakh. } Assurance – Comparison
2021-22 – ? 11.50 lakh. } SAP.

Tests of details of Balances (Verification)

e.g. Trade Receivable. 50,00,500 (Existence, Valuation)

(List of Receivables)

A	Amount wise.	15,70,000	Request letter ↓ Confirmation. (E.C.)
B		12,06,000	
C		10,01,000	
D		4,09,500	

Appropriateness / Reasonableness:

Trade Receivable / Sales	2022-23	2023-24	
⟶	15%	16%	→ S.A.P.

✓ SAP – More applicable to large volume of transactions that can be be predicted over time.

For Ex: Rental Income of a Bldg: No. of Apartments × Rental Rate p.m. × Occupancy Ratio × 12 Months.
= 50 × 50,000 × 100% × 12 M
= 3,00,00,000

Substantive Procedures: – LEARNING and NOTING –

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)
(5) Risks that require special consideration
(6) Evaluation and Testing of Internal Control System
(7) Automated Environment
(8) Auditor's Responses to Assessed Risk (SA - 330)

SA 200 - 299 - General Principles		⑥ SA 300 - 499 - Planning and Risk Response
SA - 200	SA - 250 - X	SA - 300 - Planning; 450 - Misstatements
SA - 210	SA - 260 - TCWG	- 315 - RoMM
SA - 220	SA - 265 - Deficiency in I.C.	- 320 - Materiality
SA - 230 - "Audit Documentation"	"	- 330 - Responses to Assessed Risk
SA - 240 - X	SA - 299 - Joint Audit	- 402 - X

(9) Misc. Topics:
(a) Manual and Automated Elements in I.C.
(b) Internal Financial Controls
(c) Documenting the Risk
(d) Assessing and Reporting of Audit findings

- From Book -

(a) Manual and Automated Controls:

- An Entity Internal Control System comprises of Manual and automated controls. Whether to use manual or automated controls, is a matter to be decided by the management, based on the circumstances, level of automation etc.
- Manual controls include procedures like - Approval and Review of transactions;
  - Reconciliations on periodic Basis;
  - follow-up of reconciling items; etc.
- Automated controls include General IT controls like controls over data center and network operations, access security controls; and Application IT controls.
- Manual controls are considered more suitable where judgements are required, for example - (a) Unusual or non recurring transactions;
  (b) Circumstances where error are difficult to predict or defined;
  (c) Circumstances requiring response outside the scope of automated environment; and
  (d) monitoring the effectiveness of automated Environment.
- Manual controls are considered less suitable in following cases:
  (a) High volume or recurring transactions;
  (b) Situations where errors can be anticipated or predicted.
  (c) Control activities where specific way to perform the control can be adequately designed and automated.

(b) Internal financial Controls: Policies and procedures adopted by the company for ensuring:- Reliability of financial reporting;
- Efficiency and effectiveness of operations;
- Compliance with laws and regulations;
- Safeguarding of Assets; and

- Prevention and Detection of fraud and Error.

Statutory Requirements w.r.t. Internal financial Controls:

(A) Sec. 134(5): Listed Companies - Director's Responsibility Statement.

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Statement that the directors have laid down IFC to be followed by the company and such controls are adequate and operating effectively.

(Establish; Adequate; Effectively operate)

Internal control.

- I: Accounting System and financial records. → Authorised, Safeguard, LIR-compliance.
- II: Administrative Controls → R.M-Purchase, Employee-Hire -&/Promo, etc.

(B) Sec. 143(3)(i): Auditor is required to report whether company has adequate Internal controls w.r.t. financial statements in place and operating effectiveness of such controls.

(Existence and Adequacy; Effectively operate)

Exemptions: Reporting not applicable in case of a private company which is

(a) OPC or Small company#; or

(b) having T/o < 50Cr as per latest audited F.S. and aggregate borrowings from banks, F.I or Body Corporate. at any point of time* during the FY < 25 Cr.

* throughout the year

Paid up capital ≤ 4Cr + T/o ≤ 40Cr

Examples -					Max-ols Borrowing.	Reporting
	A(P) Ltd	OPC	Paid up - 50 lakh	Turnover - 51 Cr	B-Bank/FI/B.C - 10 Cr	NO
	B(P) Ltd.	other than OPC	Paid up - 3 Cr.	T/o - 35 Cr.	Borrowing - 31 Cr	NO (Small Co)
	C(P) Ltd.	"	Paid up - 5 Cr.	T/o - 45 Cr.	Borrowing - 26 Cr.	YES
	D(P) Ltd.	"	Paid up - 3.99 Cr.	T/o - 41 Cr	Borrowing - 24 Cr	No
	E(P) Ltd.	"	Paid up - 2 Cr.	T/o - 49.80 Cr.	Borrowing - 24.6 Cr.	No
	FPO Ltd.	"	Paid up - 2.68 Cr	T/o - 35 Cr.	Borrowing - 8 Cr	YES

(c) Sec. 177(4)(vii): Audit Committee: shall act in accordance with terms of reference as specified by Board, which shall include - Evaluation of IFC and Risk Mngt. System.

(d) Sec. 149(8): Company and Ind. directors shall abide by provision specified in Schedule IV - [Code for Independent Directors]

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Role and Function of Ind. directors.

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Ind. directors shall satisfy themselves - Integrity of financial information and that financial controls and risk Mngt. system are robust and defensible.

(c) Documenting the Risk: (a) Discussion among ET and conclusions

(b) Key Elements of Understanding - Entity.
- Environment
- Components of I.C.
Source of info. from which understanding obtained
RAP Performed.

(c) Identified and Assessed RoMM < F.S. level / Assertion level.

(d) Identified Risk and related Controls

(D) Assessing and Reporting - Audit findings: Learn Question from Q. Bank (Noting - H.W.)

SCAN

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