SA-315

Identifying & assessing risk of RoMM through understanding the entity & its environment including inherent Risk

Audit Risk

↓

an inappropriate opinion by auditor

↓

when financial statements : materiality misstated

↓

at
- Financial statement level
- Assertion level

Misstatement : from — fraud or error

difference b/w
- ⇒ amount
- ⇒ classification
- ⇒ Presentation
- ⇒ disclosure

} of reported F/S & applicable FRF

NOT an Audit Risk

Auditor's opinion : F/S are materially misstated

↓

when there are not

- Audit risk does not refer to the auditor's business risks such as loss from litigation, adverse publicity.

Assessing CR & IR } separately X ⟶ Combined assessment

* I.R (Entity & Business risk) ⇒ Govt. Policy, A/C Policy ⇒ I.R
  - ↳ L
  - ↳ M
  - ↳ H

(#)

Walk through
- → Process understanding
- → Risk understanding
- → Control understanding

} Decision making : Control design

Test of Control (ToC) ⟶ Control checking ↳ (I, C, E, E)

↓

Compliance Procedure

⇒ Decision : Control Risk ⇒ CR
- ↳ L
- ↳ M
- ↳ H

(#)

ROMM (IR x CR) → Risk of material misstatement

if IR = Low, CR = Low → Less ROMM → Less audit Procedure

if IR = High, CR = High → High ROMM → More audit Procedure

* Substantive Audit Procedure

ToD — Sample checking
Other Audit Procedure

1) Data (IPE)
2) Mat. (SA 320)
3) CR
4) IR
5) Min Sample
Trans = 5,00,000

→ Sample = 500 ↓ Extent of checking

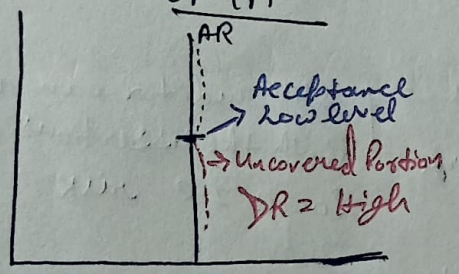
(IR x CR) + Materiality → NTE of audit procedure

→ N = Nature of Audit procedure (ToD / Analysis / other audit procedure)

→ T = Time of Audit Procedure — LR, Interim, 31st March, After year end

→ E = Extent of Audit Procedure

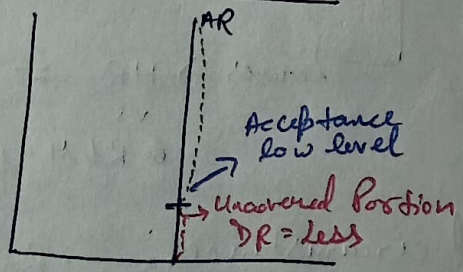
TATA



IR = Low
CR = Low
ROMM = Low

(NTE) of Audit Procedure = Less
DR = High
Opinion = True & fair

Reliance



IR = High
CR = High
ROMM = High

(NTE) of Audit Procedure = More
DR = Less
Opinion True & fair

ROMM vs DR → Inverse Relation

Levels of RoMM

Financial Statement level

↓

Affect pervasively to the f/s as a whole

Eg: 1) Law requirement changed
2) Chng. in Accounting Policy
3) Fraud by mgt.
4) Pressure on mgt.

Assertion level

↓

Auditor's opinion

↓

at an acceptably low level of audit risk

- Both IR & CR are the entity's risk & they exist independently of audit of f/s.
- IR & CR are influenced by the client & are not influenced by auditor.

* Inherent risk

- Inherent risk is the susceptibility (vulnerable) of an assertion to a misstatement that could be material, either individually or when aggregated with other misstatements before consideration of any related controls.
- Considered while designing TOC — higher or lower for different assertion

IR
- Higher ⇒ Revenue = High vs Bank & Cash = Low
- Lower ⇒ HR = HR risk is high as compare vs R & M = Low

Still auditor can assess Both the assertions as Lower IR risk

- External circumstances
  - Product obsolete
  - Technology changed
  - Environment

* Control Risk

- The risk that a misstatement that could occur in an assertion and could be material, either individually or when aggregated with other misstatement, will not be prevented or detected or corrected on timely basis by the entity's internal control.
- CR & efficiency of internal control ⟶ inverse relation

* Detection Risk

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

* Assessment of Risks

- Assessment of risks is a matter of professional judgement, rather than a matter capable of precise measurement.
  - ↓ of auditor having skill, training, knowledge, experience

* Identifying & assessing the ROMM

Auditor shall —
- i) Identify risks (Planning level)
- ii) Assess the identified risks (financial level)
- iii) Relate the identified risks (Assertion level)
- iv) Consider likelyhood of misstatement
  - → whether material or not
  - → design audit procedure to reduce D.R.
  - → to take audit risk on an acceptable low level

* Risks assessment procedures (RAP)

Audit Procedures performed to obtain understanding of entity & its environment.

RAP by themselves do not provide sufficient appropriate audit evidence on which to base the audit opinion.

* RAP includes

- → Inquiries of management or others in entity
  - ↳ with
    - TCWG
    - Internal audit procedure
    - finance head
    - Marketing or Sales personnel
- → Analytical procedures
  - ↳ to identify unusual transactions, events, trends that have audit implications
- → Observation & inspection
  - ↳ to support inquiries

Eg: of observation:

1) Entity's operation
2) Entity's premises & plant facilities

Eg of inspection

1) Documents, records & internal control manual
2) Reports prepared by mgt. & TCWG

* Information obtained by performing RAP - used as audit evidence
  - to support assessments of RoMM ← Low, Moderate, High
  - Audit evidence about ← Assertions, operating effectiveness of control

RAP = Substantive procedures ✗

* [redacted]

* Documentation —— SA 230

Auditor shall document ——
i) Discussion among the engagement team
ii) Key elements of understanding, internal control components
iii) Identified & assessed risks
iv) Related controls

* Why understanding the entity & its environment is significant?
  - helps auditor in planning audit
    - according to areas requiring special attention
  - helps in developing an overall audit plan
- Without adequate knowledge of client's business, a proper audit is not possible.

* Auditor shall obtain an understanding of the following:

a) Relevant industry factors: Industry conditions
   Eg: → Market Competition
   → Supplier & Customer relationship
   → technological developments

b) Relevant regulatory factor: → Applicable FRF
   → Regulation & legislation
   → taxation & govt. policies
   → Accounting policies

c) External factors: → Economic conditions
   → Interest rates
   → Inflation
   → Availability of financing

d) Nature of entity: → its operations
   → its ownership & governance structures
   → types of investment
   → How its financed

e) Selection & application of accounting policies & reasons for change
   → whether Accounting policies are appropriate for its business
   ↳ consistant with applicable FRF
   ↳ Disclosure as per Accounting standards

f) Objectives, strategies & business risks which may result in ROMM
   management's objectives — overall plans for the entity
   Related business risks arised from change or complexity & may result in ROMM

- The auditor does not have a responsibility to identify all business risks because not all business risks gives rise to ROMM.

Eg: → Industrial developments — no expertise to deal with changes in industry
→ New products & services — increased product liability
→ Expansion of the business — Demand has not been accurately estimated

9) Measurement & review of financial performance

Performance measurements creates pressure on mgt. which may motivate management to take action to improve the performance or to misstate the financials. } Company

Helps auditor to decide if pressure to achieve performance targets may results in management action that increase ROMM. } Auditor

Eg:→ Key performance indicators
→ Budgets, forecasts
→ Credit rating agency
→

* [redacted]

* Understanding of the entity —— Continous Process

- Understanding of entity is a continous, dynamic process of gathering, updating & analysing information throughout the audit.

Understanding includes ——→ assessing ROMM
→ Determining materiality
→ Considering appropriateness of Accounting policies selected
→ Identifying areas where special audit may be necessary
→ Developing expectations
→ Evaluation of sufficiency & appropriateness of audit evidences obtained

* Risks that require special audit consideration

High risk ——→ More Audit Procedure
Low risk ——→ Less Audit Procedure

factors: i) risk of fraud
ii) risk related to recent significant economic, accounting changes
iii) Complexity of transactions → trans. routing through Co. in tax haven
iv) Transaction related to related party
v) wide range of measurement uncertainty
vi) significant transaction —— outside the normal course

* Identifying significant risks

Significant risks — relates to — non-routine transactions (unusual + infrequently) or judgemental matters

Eg: ROMM due to fraud
Trans. with related party — which are o/s the normal course of business

* ROMM — greater for significant non-routine transaction

Greater ROMM can be arise from:

i) Greater mgt. intervention to specify accounting treatment → Eg: Ind AS 115 Revenue Recognition

ii) Manual intervention for collecting & processing data

iii) Complex calculations

iv) Difficulty in implementing effective controls over risks

* ROMM — greater for significant judgemental matters

Greater ROMM can be arise from:

i) Accounting principles

ii) Accounting estimates

iii) Revenue recognition

iv) Required judgement — Subjective / Complex

v) Required assumption — about effect of future event
↳ Eg: judgement about fair value

* INTERNAL CONTROL

Meaning → Process desined, implemented & maintained by mgt. to provide reasonable assurance with regard to —

- Reliability of financials
- Effectiveness of operations
- Safeguarding of assets
- Compliance with applicable laws

* Objectives of Internal Control in relation to financials

↳ identified business risks that threaten entity's objectives that concern:

i) transaction executed — mgts general or specific authorization

ii) transactions are recorded in → Correct amount
Appropriate account
Appropriate Accounting period

iii) Assets are safeguarded from unauthorised access

iv) Recorded assets compared with existing assets → at reasonable intervals (Physical verification)

* Which controls are relevant to Audit?

Entity's objectives & Controls implemented → Direct relationship

Factors relevant to auditors judgement about relevance of risk:

i) Materiality
ii) Significance of risk
iii) Size of entity
iv) Nature, organisation & ownership
v) Complexity & diversity of operations
vi) Legal & regulatory requirement
vii) Component of internal control

* Inherent limitations of Internal Control System

i) Provide reasonal assurance only: No matter how effective, provides only reasonable asurance about financial objectives

ii) Human judgement in decision making: Can be faulty because of human error.

iii) Judgement by management: In designing & implementation of controls
→ may be effective
→ may be not effective

iv) Lack of understading of purpose: control may not be effective
↳ as reviewer doesn't understand the purpose of control
↳ or fails to take appropriate action
Eg: Difference Report, Debtor ageing analysis

v) Collusion among people: Inappropriate management override of internal control (fraud)
Eg: Side agreements with customers
Edit checks in software programs

vi) Limitation in case of small entities: — fewer employees
↳ Segregation of duties — Not Practicable
→ Owner-managers — may have more effective oversight
— may be more able to override controls

* Benefits of understanding of I.C.

Identifying — types, factors — of ROMM
— NTE of Audit procedures

- Auditor shall obtain an understanding of internal control relevant to Audit. Most controls relevant to audit are likely to relate to financial reporting, but not all controls relevant to financial reporting are relevant to audit.

* I.C. over Safeguarding of assets
↳ against unauthorised acquisition, use or disposition
— financial control — Relevant for audit
— operational control — Not Relevant for audit

⇒ Use of access control — limit access to data — financial control — Relevant
⇒ Prevention of excessive use of materials — Safeguarding related to operation — operational control — Not Relevant
⇓
Eg: Attendance of Employees

1 Person → Preparing financial
another 1 Person → Reviewing financials
→ Preparer - Reviewer Control or Maker - checker Control

* EVALUATION OF I.C. BY THE AUDITOR

Examination & evaluation — indispensable part of audit Programme
(Auditor ko reasonable assurance chahiye hoti h ki accounting system adequate h or sari accounting information recorded h)
Internal control contributes to such assurance.

* Methods to review I.C. system

Narrative Record | Check List | Questionnaire | Flowchart | Placement (used in Real Life and in syllabus)

* Benefits of evaluation of I.C. to the Auditor

i) Mgt. is discharging its functions — how far & how adequately
ii) Riability of reports
iii) Extent & depth of examination that needs to be carried out
iv) Appropriate audit technique
v) Areas where control is weak & where its excessive
vi) Whether some worthwhile suggestions can be given to improve control system

* Methods to review the I.C. System

1) Narrative Records :—

- Complete description of system as found in operation by auditor
- Actual testing & observation — necessary before developing record
- Recommended where no formal control system is in operation; small business

Eg: KG ek small business ke audit ke liye client place par gaye or jaha koi written data nahi tha to unhe mgt. se puchh kar khud hi sab note kiya.

2) Checklist

- Series of instructions or questions — auditing staff must follow or answer.
- Instructions framed regard to desirable elements of control
- Studied by manager/Principle — ascertain existance of I.C.
  evaluate its implementation

Eg: R&K checklist leke client place par gaye as articles & asked questions like are tenders called befor placing orders before purchase or are purchases made on basis of written order etc. & marked yes/No/Not applicable.

3) Internal Control Questionnaire

- Comprehensive series of questions
- Most widely used form
- Questionnaire issued to client & requested to get it filled
- If weeknesses identified — further discussed
- Auditor prepares a report of deficiencies & recommendations

Eg: Instead of sending articles to client place with checklist, KG sent the checklist to client through email.

4) Flow chart

- Graphic presentation of I.C.
- Most concise & minimises narrative explaination
- Easy understandable but consumes time to be prepared

Q) Testing of Internal Control system.

1) Inspection of documents supporting transactions to gain audit evidence
2) Enquiry & observation about I.C. which leaves no audit trail.
3) Reperformance of IC
4) Testing of IC on specific computerised applications

* Audit trail

- Documented flow of transactions
- Establishes authentication & integrity of transaction
- Maintains record of system & user activity
- Helps to enchance IC & data security
- Involves cost in terms of — system expenditure, time involved in analysing data
- Inspires confidence in auditor
- Auditor while performing AP thus increasing reliability of audit evidences obtained. (used by)

Q) Components of Internal Control

- Control Environment
- Risk Assessment
- Information system
- Control Activity
- Monitoring

A) Control Environment

a) What is included in control environment?

Governance & management function, Attitudes, awareness & action, tone of organization ——— influencing people

b) Elements of Control environment.

i) Communication & enforcement of integrity & ethical value
→ to influence the effectiveness of
→ Design
→ Administration
→ Monitoring
→ of Control

ii) Commitment to competence
→ Competent level for particular job
→ How these level translate in to requisite skill & knowledge

iii) Participation by TCWG
- Independence, experience, stature
- Involvement, Information received by them
- Scrutiny of activity
- Appropriate action
- Interaction with auditor
  - External
  - Internal

iv) Management philosophy & operating style
- Approach of taking & managing risk
- Attitude towards financial reporting
- Attitude towards information processing & personnel

v) Organisational structure → framework for achieving its objective are planned
- Executed, controlled, reviewed

vi) Assignment of Authority & responsibility
- How authority & responsibility assigned
- Reporting Relationship
- Authorisation hierarchies

vii) Human resource policy & practices → Policy for

Recruitment, orientation, training, evaluation, Promotion compensation & remedial action

Note: The auditor should obtain the understanding of control environment and evaluate,
- → Whether mgt. has created a culture of honesty & ethical behaviour
- → The strength in the control environment elements → to provide foundation for other component of internal control

Note: Satisfactory control environment work as
→ Positive factor but it is not an absolute deterrent to fraud
→ Influences [the N.T.E of audit Procedure
Effectiveness of other control

- Control environment in Itself don't prevent, detect and correct material misstatements.

B) Risk Assessment

Auditor will obtain understanding of whether entity has a process for —

i) Identify business risk related to F.R.
ii) Estimate significance of Risk
iii) Likelyhood of occurance
iv) deciding about Action

- It will help the auditor in identifying of ROMM

C) Information System

Auditor will obtain understanding of Information system related to F.R.

i) Significant class of transaction
ii) Procedure of I.R. P.R.
iii) Related Accounting record
iv) Significant event & condition — Capture
v) Financial statement preparation process
vi) Control over journal entry.

D) Control Activity

Auditor will obtain understanding of
→ Relevant control over F.R.
→ Eg. of control — Authorisation, review, Information process, segregation

E) Monitoring of Control

Auditor will obtain understanding of
⇒ How entity monitor Internal Control over F.R.

⇒ How management assess the effectiveness of internal control

⇒ Action on timely basis

⇒ It can be on-going activity or separate evaluation

⇒ It can also be monitoring activity from external party. Eg: Customer complaints

⇒ Small entity ⇒ Owner + management can involve in operation

⇒ Internal audit function ⟹ SA 610