

CA INTER (New Syllabus)

CHAPTER: - 3

Risk

Assessment and

Internal Control

Q&A BOOK

By HM sir

**(Covering all Case Studies, MCQs, Correct/incorrect, TYUs,
Illustrations and Theoretical Questions of Study Material by ICAI)**

Case Study- 1

CA Paritosh is auditor of a company. The financial statements of the company have just been received for audit. Following issues have been flagged pertaining to the financial statements of the company for purpose of risk assessment: -

1. The revenue of company has fallen from ` 50 crore in last year to ` 5 crore in current year (for which financial statements have been received for audit) due to lack of demand in the market for company's products.
2. Due to advent of new products in the market, company's products are fast becoming outdated.
3. A large customer having an outstanding balance of ` 5 crore has failed to pay to the company despite efforts made by the company.
4. Inventory holding period has increased from 30 days in last year to 90 days.
5. The company also gets carried out job operations from third parties. Therefore, parts of inventories are lying with third parties.

Based on above, answer the following questions: -

1. Regarding drastic fall in revenue of the company, which of the following is an audit risk?
 - a) Fall in revenue would result in fall of profits for the company.
 - b) Drastic fall in revenue may imply that company is not able to carry out its operations in foreseeable future due to lack of demand in the market for company's products. There is a risk that going concern disclosure is omitted to be made in financial statements.
 - c) The company can explore some new line of activity, if demand of its products is falling.
 - d) Fall in revenue would mean lower tax liabilities for the company.
2. The company's products are getting outdated in the market. Which of the following is an audit risk?
 - a) The company should devise strategies to sell products in the market.

- b) Inventories may be understated in such a scenario.
 - c) Inventories may be overstated in such a scenario.
 - d) The company should launch a 1+1 free offer for its customers.
3. A large customer has failed to pay to the company. Identify audit risk from below:
- a) Receivables may be misstated if irrecoverable debt is not written off.
 - b) Receivables may be overstated if irrecoverable debt is not written off.
 - c) Writing off irrecoverable debt would impact profits of company adversely.
 - d) Failure to recover outstanding debt would impact cash flows of company adversely.
4. Identify audit risk involved when inventory holding period has increased from 30 days to 90 days.
- a) There is a risk of overstatement of inventories.
 - b) There is a risk relating to existence of inventories.
 - c) There is a risk that slow movement of stocks would increase tax liability when GST rates are increased.
 - d) There is a risk relating to holding and storage cost of inventories.
5. Part of inventories are lying with third parties. Identify audit risk involved.
- a) There is a risk that third parties do not manufacture according to specifications of the company.
 - b) There is a risk that by getting job work done from third parties, company is increasing its costs.
 - c) There is a risk that sufficient and appropriate evidence would not be available in respect of quantity and condition of inventories lying with third parties.
 - d) There is a risk that sufficient and appropriate evidence would not be available for quality control in respect of inventories lying with third parties.

Answer to Questions involving Case Studies: -

1. (b), 2. (c), 3. (b), 4. (a), 5. (c)

Case Study- 2

Me CA Piyush is understanding internal controls as part of audit exercise of a company. It is a new client. He has studied controls in place in various operational areas of the company. After studying and gaining an understanding of such controls, he has decided to test few controls to actually see whether these are operating as intended by the management.

Till now, he has studied controls over inventories and bank. Few of such controls are listed below: -

Nature of Control	Control description
Control over inventories	Inventories of the company lying at each location should be insured.
Control over inventories	There should be inventory counts on a regular basis for each location of the company.
Control over Bank operations	Bank reconciliations are to be performed at regular intervals.

Based on above, answer the following questions: -

- Which of the following most appropriately describes test of control regarding insurance of inventories?
 - Inspect insurance policies to verify that inventories at each location are insured for fire and burglary. The sum insured and period of validity of policy are not relevant.

- b) Inspect insurance policies to verify that inventories at each location are comprehensively insured. Ensure adequacy of sum insured by comparing it with value of inventories. Also ensure policy period has not expired.
 - c) Inspect insurance policies to verify that inventories at each location are comprehensively insured. Ensure policy period has not expire
 - d) Inspect insurance policies to verify that inventories at each location are insured for fire and burglary. Ensure policy period has not expired.
2. Which of the following most appropriately describes test of control regarding inventory counts?
- a) Obtain detail of inventory counting procedure and ensure that inventory count is carried out according to laid down procedure.
 - b) Obtain detail of inventory counting procedure and ensure that inventory count is carried out according to laid down procedure. Attend inventory count.
 - c) Obtain detail of inventory counting procedure and ensure that inventory count is carried out according to laid down procedure. Attend inventory count and perform test count.
 - d) Attend inventory count and perform test count.
3. While testing control over bank reconciliations, it has been noticed that bank reconciliations are not being performed at regular intervals. Identify the most appropriate description of “control deficiency” in this regard: -
- a) Bank reconciliations are not being performed regularly as concerned staff is overburdened.
 - b) Bank reconciliations are not being performed regularly as concerned staff is overburdened. It could result in errors.
 - c) Bank reconciliations are not being performed regularly as concerned staff is overburdened. It could result in errors. It may result in misstatement of cash and bank balance in financial statements.
 - d) Bank reconciliations are not being performed regularly as concerned staff is overburdened. These should be performed monthly and reviewed by senior accountant.
4. Since the company is a new client, which of the following statements is most appropriate?

- a) There is reduced detection risk.
 - b) There is increased detection risk.
 - c) There is no effect on detection risk.
 - d) Detection risk should be increased to lower audit risk.
5. Which of the following statements is most appropriate regarding auditor's response to assessed risk of a new client?
- a) More substantive procedures would require to be performed.
 - b) Less substantive procedures would require to be performed.
 - c) There is no effect on substantive procedures.
 - d) There is no effect on substantive procedures as audit risk is low.

Answer to Questions involving Case Studies: -

1. (b), 2. (c), 3. (c), 4. (b), 5. (a)

MCQs based Questions

1. Which of the following is true regarding materiality?
- a) It is unaffected by nature of an item.
 - b) It is unaffected by requirements of law or regulations.
 - c) It is not a matter of professional judgment.
 - d) It is not always a matter of relative size.
2. The operations of a company are automated substantially. Which of the following statements is most appropriate in this respect?
- a) It results in complex business environment.
 - b) It results in simple business environment and easier audit.
 - c) Automation has no relationship with complexity of business environment.
 - d) It results in simple business environment. However, it increases complexity of audit.
3. Who is responsible for maintaining effective internal financial controls?

- a) Statutory auditor
 - b) Audit Committee
 - c) Management
 - d) Shareholders
4. Which of the following is not a risk to a company's internal control due to its IT environment?
- a) Potential loss of data
 - b) Inability to access data when required
 - c) Unauthorized access to data
 - d) Processing of large volumes of data
5. Which of the following is not an example of "General IT controls"?
- a) Controls pertaining to Disaster recovery plan
 - b) Controls pertaining to batch preparation
 - c) Controls pertaining to data security
 - d) Controls pertaining to validation of input data in an application

Answers to the MCQs based Questions

1. (d) 2. (a) 3. (c) 4. (d) 5. (d)

Correct/Incorrect

State with reasons (in short) whether the following statements are correct or incorrect:

1. There is direct relationship between materiality and the degree of audit risk.
2. Control risk is the susceptibility of an account balance or class of transactions to misstatement that could be material either individually or, when aggregated with misstatements in other balances or classes, assuming that there were no related internal controls.
3. Tests of control are performed to obtain audit evidence about the effectiveness of Internal Controls Systems.

4. Maintenance of Internal Control System is the responsibility of the Statutory Auditor.

Answers to Correct/Incorrect

1. **Incorrect:** There is an inverse relationship between materiality and the degree of audit risk. The higher the materiality level, the lower the audit risk and vice versa. For example, the risk that a particular account balance or class of transactions could be misstated by an extremely large amount might be very low but the risk that it could be misstated by an extremely small amount might be very high.
2. **Incorrect:** Inherent risk is the susceptibility of an account balance or class of transactions to misstatement that could be material either individually or, when aggregated with misstatements in other balances or classes, assuming that there were no related internal controls. Control risk, on the other hand is the risk that a misstatement that could occur in an assertion about a class of transaction, account balance or disclosure and that could be material, either individually or when aggregated with other misstatements, will not be prevented, or detected and corrected, on a timely basis by the entity's internal control.
3. **Correct:** Tests of Control are performed to obtain audit evidence about the effectiveness of:
 - a) the design of the accounting and internal control systems that is whether, they are suitably designed to prevent or detect or correct material misstatements and
 - b) the operation of the internal controls throughout the period.
4. **Incorrect:** The management is responsible for maintaining an adequate accounting system incorporating various internal controls to the extent appropriate to the size and nature of the business. Maintenance of Internal Control System is responsibility of management because the internal control is the process designed, implemented and maintained by those charged with governance/management to provide reasonable assurance about the achievement of entity's objectives.

Test Your Understanding (1 to 10)

Test Your Understanding 1

Wear & Tear Private Limited is a “start-up” engaged in providing holistic solutions to problem of paddy stubble burning mainly catering to needs of farmers of North western India. Due to importance given by governments to this issue, companies have entered in the market in past few years. Many of these companies have not been successful and have gone bust. As an auditor of the company, can you spot the component of risks of material misstatement involved in above?

Answer: It has been stated that many companies engaged in providing holistic solutions to problem of stubble burning have not been successful.

It shows that line of activity is inherently risky.

Conclusion: Therefore, there is a greater possibility of misstatements. The component of risks of material misstatement involved is “**inherent risk**”.

Test Your Understanding 2

A company has devised a control that its inventory of perishable goods is stored in appropriate conditions- in a controlled environment to prevent any damages to inventory. Responsibility is fixed on two persons to monitor environment using sensors and to report on deviations. Identify the component of risks of material misstatement involved as an auditor of the company.

Answer: The company has devised a control that its inventory of perishable goods is stored in appropriate conditions and responsibility is fixed on two persons to monitor environment using sensors and to report on deviations.

There is a possibility that persons given responsibility do not perform their work and report deviations.

Conclusion: The component of risks of material misstatement is “**control risk**”.

Test Your Understanding 3

Shree Foods Private Limited is engaged in manufacturing of garlic bread. The auditors of company have planned audit procedures in respect of recognition of revenues of the company. Despite that, there is a possibility that

misstatements in revenue recognition are not identified by planned audit procedures. Which risk is being alluded to?

Answer: There is a possibility that planned audit procedures may not achieve desired result and fail to detect misstatements in revenue recognition.

Conclusion: The risk alluded to it is “**detection risk**”.

Test Your Understanding 4

Jo Jo Limited is planning to list on Bombay Stock Exchange next year. As an auditor of Jo Jo Limited, identify any one reason of increased audit risk due to listing of the company next year.

Answer: Jo Jo Limited is planning to list on Bombay Stock Exchange next year. There is a greater chance of misstatements in the financial statements due to planned listing next year.

There could be a possibility of intentional manipulation of financial statements so that good response is received to proposed issue.

Conclusion: Therefore, there is increased audit risk i.e., risk of expressing inappropriate opinion by the auditor when financial statements are materially misstated.

Test Your Understanding 5

On perusing financial statements of Jo Jo Limited put up for audit, it is observed by the auditor that current ratio has improved from 1.20:1 (in preceding year) to 1.75:1 (in current year). Identify what kind of risk assessment procedures are being performed by auditor? Has it any relation with listing of the company next year on Bombay Stock Exchange?

Answer: It is noticed by the auditor that current ratio has improved from 1.20:1 (in preceding year) to 1.75:1 (in current year).

The auditor is using “**analytical procedures**” as risk assessment procedures. Current ratio has improved from previous year. There could be a possibility of misstatement in current assets and current liabilities.

It is possible that improvement in current ratio is artificial due to misstatements and has been done to secure good response to the proposed issue of company next year.

Test Your Understanding 6

CA A. Raja is auditor of Build Well Forgings Private Limited having a revenue of ` 25 crore. The company has been sanctioned a term loan of ` 50 lacs from a bank. However, as at end of the year, only ` 1 lac was availed due to delay in procurement of asset. The financial statements of the company do not disclose nature of security against which loan has been taken. Schedule III of Companies Act, 2013 requires disclosure in this respect. Discuss, whether, non-disclosure of nature of security is material for auditor.

Answer: If there is any statutory requirement of disclosure, it is to be considered material. Schedule III mandates disclosure of nature of security in relation to loan.

Conclusion: The amount involved is irrelevant.

Test Your Understanding 7

CA Smriti is auditor of a company. As part of audit, she is going through company policies and practices regarding employee recruitment, training, orientation and related matters. She seems to be very much interested in finding out whether company hires best candidates from applicant pool. Identify what she is trying to do? How gaining knowledge about this aspect is useful to her as an auditor?

Answer: The study of company policies and practices regarding employee recruitment, training, orientation and related matters including hiring of best candidates is part of understanding HR function of the company. It, in turn, helps in understanding control environment of the company.

By gaining such a knowledge, she can better understand internal control of the company.

Test Your Understanding 8

During the audit of same company, CA Smriti is keen to find out whether there exists a proper system of segregation of duties in the company. She wants to be sure that a person responsible for recording a transaction is different from the person authorising it. Discuss what she is trying to do and how its understanding is significant to her as an auditor.

Answer: She is keen to find out whether there exists a proper system of segregation of duties in the company. She is gaining an understanding of internal control of the company. In particular, she is understanding “control activities”.

When a person recording a transaction is different from one authorizing it, she gains confidence that there exists a system for preventing misstatements.

It helps her in gaining insight into the internal control system of the company.

Test Your Understanding 9

Zomba Products Private limited is a small company. The control systems in the company are rudimentary. How, you as an auditor of the company, would proceed to evaluate internal control of the company?

Answer: In a small company, control systems are basic and not formalized.

Conclusion: Therefore, auditor should proceed to evaluate internal control using narrative record.

Test Your Understanding 10

A Chartered accountant during course of audit of a company finds that cash is not deposited into bank frequently although concerned staff of company was required to do so. Further, the official responsible for ensuring performance of above function, has also not paid any attention to it. Discuss what does it represent from auditor’s perspective.

Answer: Cash is not deposited into bank frequently, although, concerned staff of company was required to do so. Further, the official responsible for ensuring performance of above function, has also not paid any attention to it. It means

that control is not working as planned. It would not be able to prevent misstatement and very purpose of control is defeated.

It represents a “control deficiency”.

Illustrations (1 to 12)

Illustration 1

XYZ Ltd is engaged in the business and running several stores dealing in variety of items such as readymade garments for all seasons, shoes, gift items, watches etc. There are security tags on each and every item. Moreover, inventory records are physically verified on monthly basis.

Discuss the types of inherent, control and detection risks as perceived by the auditor.

Answer:

Inherent Risk: Because items may have been misappropriated by employees, therefore, risk to the auditor is that inventory records would be inaccurate.

Control Risk: There is a security tag on each item displayed. Moreover, inventory records are physically verified on monthly basis. Despite various controls being implemented at the stores, still collusion among employees may be there and risk to auditor would again be that inventory records would be inaccurate.

Detection Risk: Auditor checks the efficiency and effectiveness of various control systems in place. He would do that by making observation, inspection, enquiry, etc. In addition to these, the auditor would also employ sampling techniques to check few sales transactions from beginning to end. However, despite all these procedures, the auditor may not detect the items which have been stolen or misappropriated.

Illustration 2

A Partnership Firm of Chartered Accountants HT and Associates was appointed to audit the books of accounts of Wind and Ice Limited for the financial year

2020-21. There was a risk that HT and Associates would give an inappropriate audit opinion if the financial statements of Wind and Ice Limited are materially misstated. State the Risk mentioned in the question.

Answer: Audit risk means the risk that the auditor gives an inappropriate audit opinion when the financial statements are materially misstated.

The risk mentioned in the question is known as **Audit Risk**, because risk that auditor of a company will give an inappropriate audit opinion if the financial statements of that company are materially misstated is known as Audit Risk.

Illustration 3

One of the team members of auditors of Highly Capable Limited was of the view that Materiality and Audit Risk are only considered at planning stage of an audit.

Comment as an auditor.

Answer: The concept of **materiality** is applied by the auditor both in planning and performing the audit, and in evaluating the effect of identified misstatements on the audit and of uncorrected misstatements, if any, on the financial statements and in forming the opinion in the auditor's report.

Illustration 4

The auditor of ABC Textiles Ltd chalks out an audit plan without understanding the entity's business. Since he has carried out many audits of textile companies, there is no need to understand the nature of business of ABC Ltd. Advise the auditor how he should proceed.

Answer: Obtaining an understanding of the entity and its environment, including the entity's internal control (referred to hereafter as an "understanding of the entity"), is a continuous, dynamic process of gathering, updating and analysing information throughout the audit.

The auditor should proceed accordingly.

Illustration 5

While auditing the books of accounts of Heavy Material Limited for the financial year 2022-23, a team member of the auditor of Heavy Material Limited showed no inclination towards understanding the business and the business environment of the above-mentioned company. Is the approach of team member of the auditor of Heavy Material Limited correct or incorrect? Also give reason for your answer.

Answer: The approach of team member of the auditor of Heavy Material Limited is **incorrect** because understanding the business and the business environment of company whose audit is to be conducted is very important, as it helps in planning the audit and identifying areas requiring special attention during the course of audit of that company.

Illustration 6

Prince Blankets is engaged in business of blankets. Its major portion of sales is taking place through internet. Advise the auditor how he would proceed in this regard as to understanding the entity and its environment.

Answer: While understanding entity and its environment, internet sales is being perceived as risky area by the auditor and thereby would be spending substantial time and extensive audit procedures on this particular area.

Illustration 7

Auditor GR and Associates, appointed for audit of PNG Ltd, a manufacturing company engaged in manufacturing of various food items. While planning an audit, the auditor does not think that it would be necessary to understand internal controls. Advise the auditor in this regard.

Answer: 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 judgment whether a control, individually or in combination with others, is relevant to the audit.

Illustration 8

The team member of the auditor of Simple and Easy Limited was of the view that understanding the internal control of the company would **not** help them in any manner in relation to audit procedures to be applied while conducting the audit.

Answer: The view of the team member of the auditor is **incorrect** because understanding the internal control of the company would **help** the auditor and his team members in designing the nature, timing and extent of audit procedures to be applied while conducting the audit of the company.

Illustration 9

Mr. Y, one of the team member of the auditors of What and Where Limited was very keen in knowing whether the internal control of the company would safeguard the company's assets. Advise Mr. Y.

Answer: The review of internal controls will enable the auditors to know whether the controls adequately safeguard the assets.

Illustration 10

Mr. H, a team member of the auditor of There and Here Limited was of the view that evaluation of internal control of the company would help in identifying the areas where internal control is weak. Advise

Answer: The review of internal controls will enable the auditor to know what are the areas where control is weak and where it is excessive.

Illustration 11

In order to evaluate the Internal Control of Your and My Limited, a team member of the auditors used a method according to which, number of questions relating to internal control of the company were required to be answered by the employees of the company. After obtaining the answers there was a discussion relating to those answers between team member of the

auditor and employees of the company for a clear picture. State the method of evaluation of internal control as discussed above.

Answer: The method of evaluation of internal control used in the above question is known as Internal Control Questionnaire because in questionnaire method, a number of questions relating to internal control of a company are required to be answered by employees of that company and when answers to the questions are obtained, there is a discussion relating to those answers between team members of the auditors and employees of that company for a clear picture.

Illustration 12

Healthy and Useful Limited is into small manufacturing as well as trading business. For the purpose of evaluating the internal control of Healthy and Useful Limited, a team member of the auditors of the company used a method according to which the whole description of internal control that was operating in the said company was to be recorded. Identify the method of evaluation of internal control as mentioned above.

Answer: The method of evaluation of internal control referred above is known as Narrative Record because in Narrative Record method, a whole description of internal control operating in an entity is recorded. Narrative Record method is also appropriate for small manufacturing as well as trading business as is mentioned in the question above case.

Theoretical Questions

1. Discuss how “analytical procedures” performed as “risk assessment procedures” can be useful to an auditor.

Answer: -

1. The risk assessment procedures shall include the following:

- a) Inquiries of management and of others within the entity who in the auditor’s judgment may have information that is likely to assist in identifying risks of material misstatement due to fraud or error.
- b) Analytical procedures.
- c) Observation and inspection.

2. Analytical Procedures:

- a) Analytical procedures performed as risk assessment procedures may identify aspects of the entity of which the auditor was unaware and may assist in assessing the risks of material misstatement in order to provide a basis for designing and implementing responses to the assessed risks.
- b) Analytical procedures performed as risk assessment procedures may include both financial and non-financial information, for example, relationship between sales and square footage of selling space or volume of goods sold.
- c) Analytical procedures may help identify the existence of unusual transactions or events, and amounts, ratios, and trends that might indicate matters that have audit implications. Unusual or unexpected relationships that are identified may assist the auditor in identifying risks of material misstatement, especially risks of material misstatement due to fraud.
- d) However, when such analytical procedures use data aggregated at a high level (which may be the situation with analytical procedures performed as risk assessment procedures), the results of those analytical procedures only provide a broad initial indication about whether a material misstatement may exist.
- e) Accordingly, in such cases, consideration of other information that has been gathered when identifying the risks of material misstatement together with the results of such analytical procedures may assist the auditor in understanding and evaluating the results of the analytical procedures.

2. Is materiality required to be documented by the auditor? What factors have to be considered this regard?

Answer: - 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.

3. Discuss relationship between “General IT controls” and “application controls” in an automated environment.

Answer: These two categories of control over IT systems are interrelated.

The relationship between the application controls and the General IT Controls is such that 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.

4. A company functions in an automated environment. Discuss in what areas data analytics can be useful for auditor of the company.

Answer: Data analytics can be used in testing of electronic records and data residing in IT systems using spreadsheets and specialised audit tools viz., IDEA and ACL to perform the following:

- a) Check completeness of data and population that is used in either test of controls or substantive audit tests.
- b) Selection of audit samples – random sampling, systematic sampling.
- c) Re-computation of balances – reconstruction of trial balance from transaction data.
- d) Reperformance of mathematical calculations – depreciation, bank interest calculation.
- e) Analysis of journal entries
- f) Fraud investigation.
- g) Evaluating impact of control deficiencies.

5. What is understood by “non-routine” transactions? Briefly outline why risks of material misstatement is greater for such transactions.

Answer: - Significant risks often relate to significant non-routine transactions or judgmental matters. Non-routine transactions are transactions that are unusual, due to either size or nature, and that therefore occur infrequently.

Judgmental matters may include the development of accounting estimates for which there is significant measurement uncertainty.

Significant risks are inherent risks with both a higher likelihood of occurrence and a higher magnitude of potential misstatement. The auditor assesses assertions affected by a significant risk as higher inherent risk.

The following are always significant risks:

- a) Risks of material misstatement due to fraud

- b) Significant transactions with related parties that are outside the normal course of business for the entity.

6. The auditor shall obtain an understanding of the major activities that the entity uses to monitor internal control over financial reporting” Explain.

Answer:

- a) The auditor shall obtain an understanding of the major activities that the entity uses to monitor internal control over financial reporting.
- b) Monitoring of controls is a process to assess the effectiveness of internal control performance over time. It helps in assessing the effectiveness of controls on a timely basis. It involves assessing the effectiveness of controls on a timely basis and taking necessary remedial actions.
- c) It includes considering whether controls are operating as intended and that they are modified as appropriate for change in conditions. Management accomplishes monitoring of controls through ongoing activities, separate evaluations, or a combination of the two.
- d) Ongoing monitoring activities are often built into the normal recurring activities of an entity and include regular management and supervisory activities.
- e) Management’s monitoring activities may include using information from communications from external parties such as customer complaints and regulator comments that may indicate problems or highlight areas in need of improvement.

7. “Risk of material misstatement consists of two components” Explain clearly defining risk of material misstatement.

Answer: Definition of Risk of Material Misstatements:

SA 200 states that risk of material statement is the risk that the financial statements are materially misstated prior to audit. It simply means that there is a probability of frauds or errors in financial statements before audit.

The risk of material misstatement at assertion level comprises of two components i.e., inherent risk and control risk. Both inherent risk and control risk are the entity’s risks and they exist independently of the audit of financial statements. Inherent risk and control risk are influenced by the client. These are entity’s risks and are not influenced by the auditor.

Inherent risk:

- a) Inherent risk is the susceptibility of an assertion about a class of transaction, account balance or disclosure to a misstatement that could be material, either individually or when aggregated with other misstatements before consideration of any related controls as described in SA-200.
- b) There is always a risk that before considering any existence of internal control in an entity, a particular transaction, balance of an account or a disclosure required to be made in the financial statements of an entity have a chance of being misstated and such misstatement can be material. This risk is known as inherent risk.

Control risk:

- a) In accordance with SA-200, control risk is the risk that a misstatement that could occur in an assertion about a class of transaction, account balance or disclosure and that could be material, either individually or when aggregated with other misstatements, will not be prevented, or detected and corrected, on a timely basis by the entity's internal control.
- b) Control risk is a risk that internal control existing and operating in an entity would not be efficient enough to stop from happening, or find and then rectify in an appropriate time, any material misstatement relating to a transaction, balance of an account or disclosure required to be made in the financial statements of that entity.

8. "The SAs do not ordinarily refer to inherent risk and control risk separately, but rather to a combined assessment of the "risks of material misstatement""
Explain

Answer: The Standards on auditing do not ordinarily refer to inherent risk and control risk separately, but rather to a combined assessment of the "risks of material misstatement".

However, the auditor may make separate or combined assessments of inherent and control risk depending on preferred audit techniques or methodologies and practical considerations.

The assessment of the risks of material misstatement may expressed in quantitative terms, such as in percentages, or in non-quantitative terms. In any case, the need for the auditor to make appropriate risk assessments is more important than the different approaches by which they may be made.

It can be concluded from the above that: -

$$\text{Audit risk} = \text{Risks of material misstatement} \times \text{Detection risk}$$

Since risks of material misstatement is a function of inherent risk and control risk, it can also be shown as: -

$$\text{Audit risk} = \text{Inherent risk} \times \text{Control risk} \times \text{Detection risk}$$

9. “The auditor shall obtain an understanding of the control environment”
Explain stating what is included in control environment.

Answer:

1. The auditor shall obtain an understanding of the control environment. As part of obtaining this understanding, the auditor shall evaluate whether:
 - a) Management has created and maintained a culture of honesty and ethical behaviour and
 - b) The strengths in the control environment elements collectively provide an appropriate foundation for the other components of internal control.

2. What is included in Control Environment?

The control environment includes:

- a) the governance and management functions and
- b) the attitudes, awareness, and actions of those charged with governance and management.
- c) the control environment sets the tone of an organization, influencing the control consciousness of its people.

10. Internal control over safeguarding of assets against unauthorised acquisition, use, or disposition may include controls relating to both financial reporting and operations objectives. Explain stating clearly the objectives of Internal Control.

Answer: - The Objectives of Internal Control Internal control over safeguarding of assets against unauthorised acquisition, use, or disposition may include controls relating to both financial reporting and operations objectives.

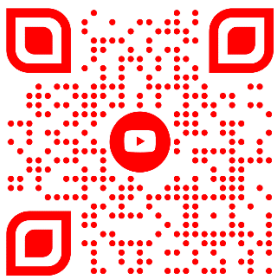
The auditor’s consideration of such controls is generally limited to those relevant to the reliability of financial reporting. For example, use of access

controls, such as passwords, that limit access to the data and programs that process cash disbursements may be relevant to a financial statement audit.

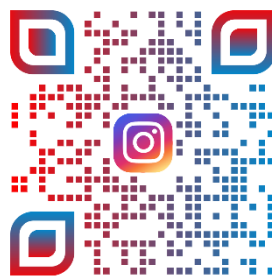
Conversely, safeguarding controls relating to operations objectives, such as controls to prevent the excessive use of materials in production, generally are not relevant to a financial statement audit.

Objectives of Internal Control are:

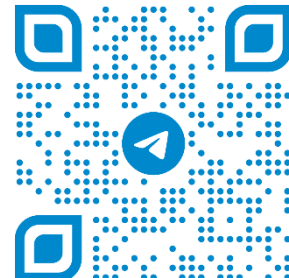
- (i) transactions are executed in accordance with managements general or specific authorization;
- (ii) all transactions are promptly recorded in the correct amount in the appropriate accounts and in the accounting period in which executed so as to permit preparation of financial information within a framework of recognized accounting policies and practices and relevant statutory requirements, if any, and to maintain accountability for assets;
- (iii) assets are safeguarded from unauthorised access, use or disposition; and
- (iv) the recorded assets are compared with the existing assets at reasonable intervals and appropriate action is taken with regard to any differences.



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