CHAPTER 3 - RISK ASSESSMENT & INTERNAL CONTROL

Dr. CA Abhishek Murali

B.Com, M.Com, FCA, MBA, ACMA, CGMA, CIMA(Lon.), LLB, CISA(USA), DISA(ICAI), ADIT (UK), D.Litt.,

MR. X HAS COMPLETED THE AUDIT OF “Y LTD”. HE HAS ISSUED A CLEAN AUDIT REPORT. WILL THE ACCOUNTS BE PERFECT?

Audit Risk

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

- It means that an auditor expresses an unmodified opinion when financial statements are materially misstated. In such a case, not only reputation of auditor would be damaged, but he could also invite regulatory action from professional body and could face probable legal action by intended users.

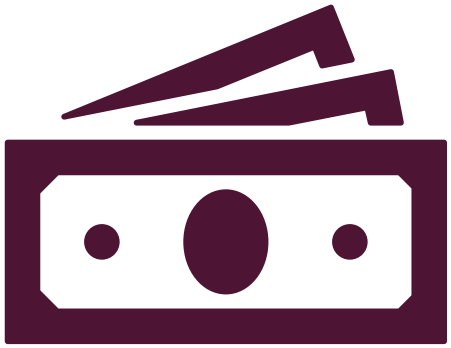
- To avoid such unpleasant consequences, the auditor will plan and perform the audit in such a way that audit risk is reduced to an acceptably low level

WHAT IS MISTATEMENT?

- Difference between the amount, classification, presentation, or disclosure of a reported financial statement item and the amount, classification, presentation, or disclosure that is required for the item to be in accordance with the applicable financial reporting framework.
- Mistatement due to Error
- Mistatement Due to Fraud

I HAVE REPLACED THE ENTIRE FLOORING IN THE BUILDING AND PUT NEW MARBLE FLOORING. THE SAME HAS BEEN WRITTEN OFF IN THE PROFIT & LOSS ACCOUNT. IS THIS RIGHT?

It should be Capitalised



INTENTIONAL BOOKING OF FAKE EXPENSES IN STATEMENT OF PROFIT AND LOSS

FRAUD

DIFFERENCE IN ACCOUNTING ESTIMATE BY MANAGEMENT FROM THAT DONE BY AUDITORS

Error

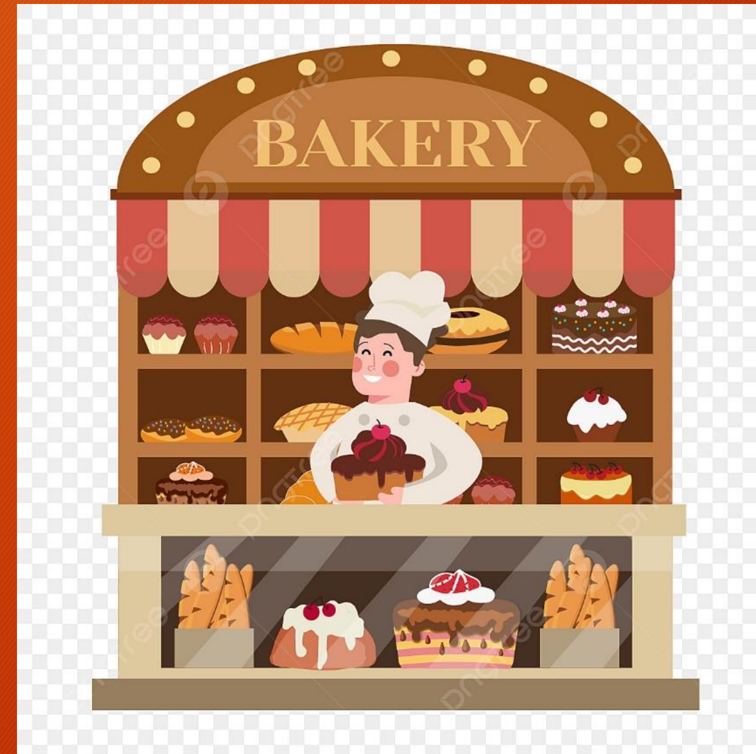
Risk of Material Mistatement

Inherent Risk

Control Risk

Inherent Risk

- Inherent risk is the susceptibility of an assertion about a class of transaction, account balance or disclosure to a misstatement that could be material, either individually or when aggregated with other misstatements before consideration
- 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
- Inherent risk is higher for some assertions and related classes of transactions, account balances, and disclosures than for others. For example, it may be higher for complex calculations.


BAKERY

Control Risk

- control risk is the risk that a misstatement that could occur in an assertion about a class of transaction, account balance or disclosure 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 controls.

- 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

- When efficiency of internal control of an entity is high, the control risk is low and when efficiency of internal control of that entity is low, the control risk is high

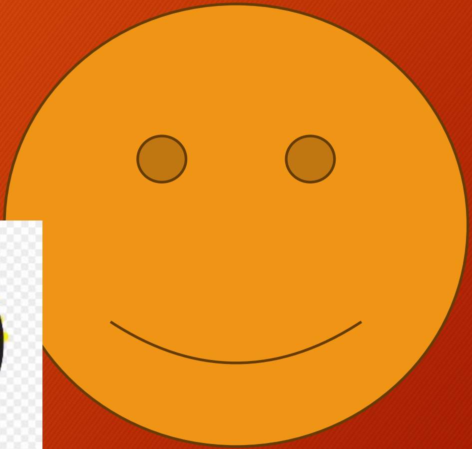

BAKERY


TOKEN


BAKERY


TOKEN


BAKERY




TOKEN


BAKERY


TOKEN


BAKERY


TOKEN

Risk of Material Mistatement

Inherent Risk

Control Risk

Who's Responsibility is this?

Management

More Examples

- A company has devised control that cash and cheque books should be kept in a locked safe and access is granted to authorized personnel only. There is risk that control is not being followed.

- An entity has devised a control that fire extinguishers and smoke detectors are in place and are in working condition at all times to reduce the risk of damage to inventories caused by fire. There is a risk that fire extinguishers in place are expired and are not being refilled. Similarly, there is a possibility that smoke detectors are not working.

- A company has devised a control relating to petty cash that items of expenditure of only less than ` 10000 should be routed through imprest system of petty cash. There is a risk that control is not being followed.

Audit Risk

Inherent Risk

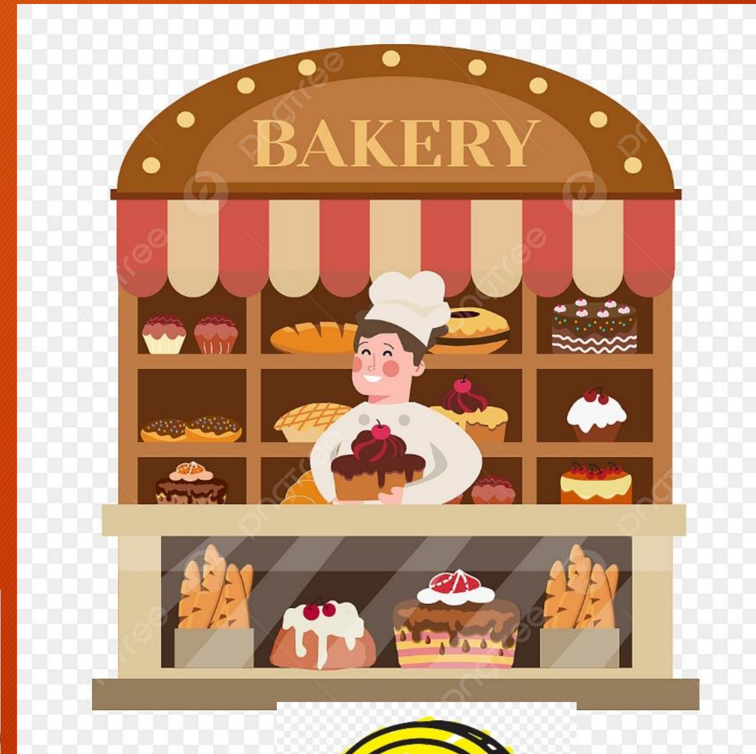
Control Risk

Detection Risk

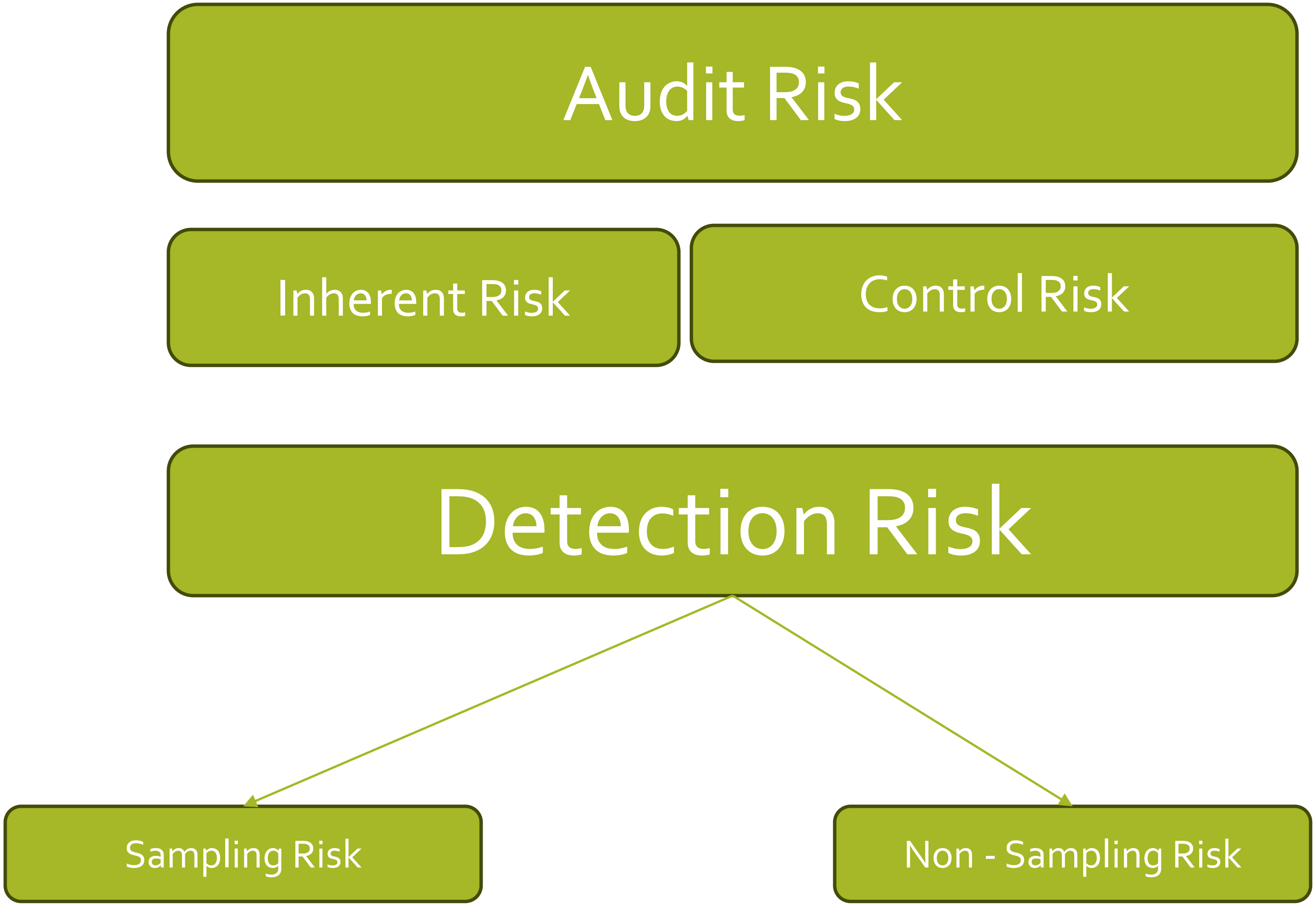
Detection Risk

- the risk that the procedures performed by the auditor to reduce audit risk to an acceptably low level will not detect a misstatement that exists and that could be material, either individually or when aggregated with other misstatements

- auditor of a company uses certain audit procedures for the purpose of obtaining audit evidence and reducing audit risk, but still there will remain a risk that audit procedures used by the auditor may not be able to detect a misstatement which by nature is material, then that risk is known as detection Risk



How will you Audit This

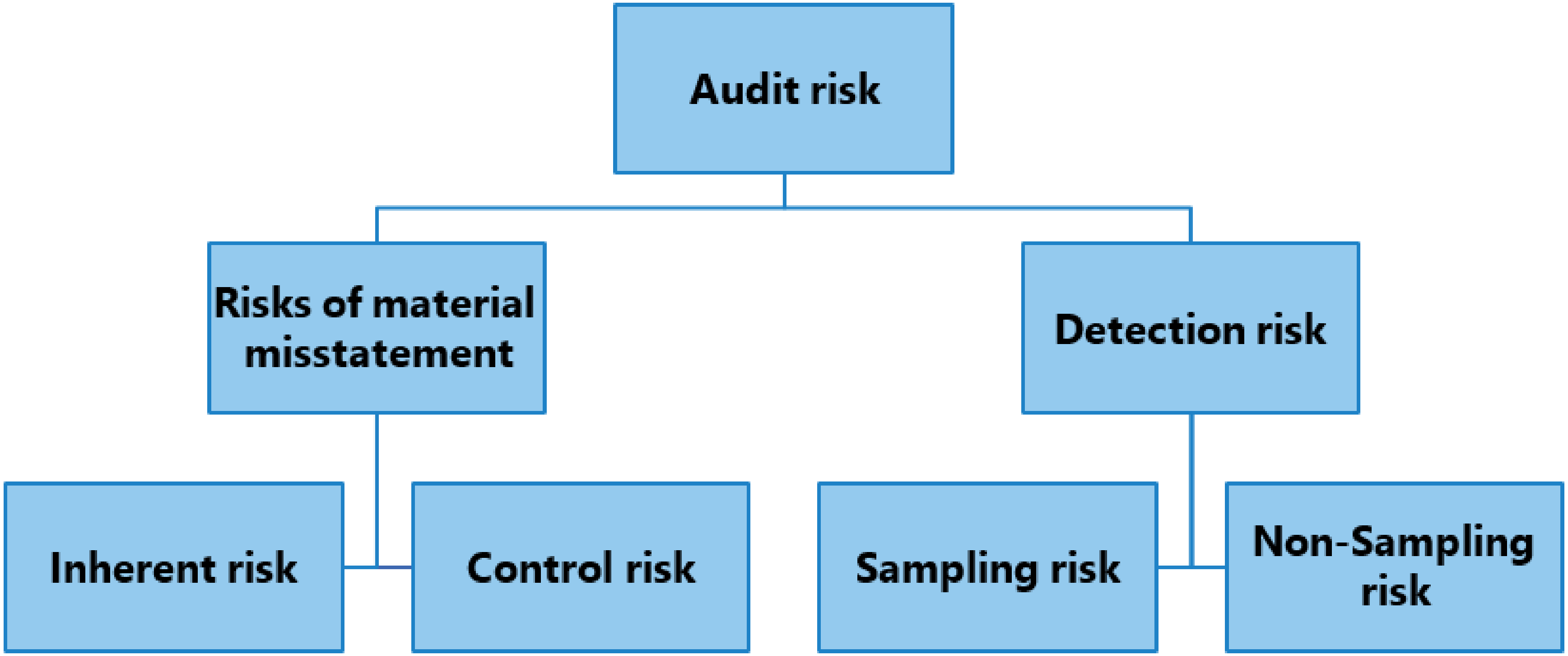

Audit Risk
Inherent Risk
Control Risk
Detection Risk
Sampling Risk
Non - Sampling Risk

Sampling & Non-Sampling Risk

- Sampling risk is the risk that the auditor’s conclusion based on a sample may be different from the conclusion if the entire population were subjected to the same audit procedure. It simply means that the sample was not representative of the population from which it was chosen.

- Non-sampling risk is the risk that the auditor reaches an erroneous conclusion for any reason not related to sampling risk. Like an auditor may reach an erroneous conclusion due to application to some inappropriate audit procedure.

Objective of the Auditor is to reduce the detection risk to keep the audit risk low. Ways to reduce the detection risk is by increasing the area of checking, testing larger samples and using experience in the audit engagement


Audit risk
Risks of material misstatement
Detection risk
Inherent risk
Control risk
Sampling risk
Non-Sampling risk

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.

QUESTION

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.

QUESTION

- **The risk that the financial statements are materially misstated prior to audit is called-**
- (A) Risk of material misstatement
- (b) detection risk
- (c) audit risk
- (d) significant risk

(A)

QUESTION

One of your junior audit team members is confused with the term ‘material misstatement’. You explain him that a material misstatement is untrue information in a financial statement that could affect the financial decisions of one who relies on the statement. Which of the following would constitute material misstatement?

(1) An error of Rs.5,000 in relation to assets of Rs.20 lakhs.

(2) A payroll fraud of Rs.100 in a company where profit before tax is Rs.11,000.

(3) Non-disclosure of a material uncertainty.

(4) Financial statements have been prepared on a going concern basis when the company is in the process of being liquidated.

- (a) 1 and 3
- (b) 3 and 4
- (C) 2 and 3
- (d) 1 and 4

(B)

QUESTION

Audit risk is a function of the

(a) risks of material misstatement and detection risk.

(b) audit risk and detection risk.

(c) control risk and detection risk.

(d) inherent risk and detection risk

(A)

QUESTION

- The risks of material misstatement at the assertion level consist of two components:
- (a) Inherent risk and detection risk
- (b) control risk and detection risk
- (c) audit risk and detection risk
- (d) Inherent risk and control risk

(D)

Identifying and assessing the risk of material misstatement

Identify and assess the risks of material misstatement (SA 315)

- (i) The auditor shall identify and assess the risks of material misstatement at:
- (a) the financial statement level
- (b) the assertion level for classes of transactions, account balances, and disclosures
- to provide a basis for designing and performing further audit procedures

Process of Identification & Assessment of Risks

- Identify risks throughout the process
- Assess the identified risks and evaluate how they will affect assertions
- Relate the identified risks to what can go wrong
- Consider the likelihood of misstatement, including the possibility of multiple misstatements & if it will impact material mistatement

Materiality

SA 320 Materiality in Planning and Performing an Audit

- states that misstatements, including omissions, are considered to be material if they, individually or in the aggregate, could reasonably be expected to influence the economic decisions of users taken on the basis of the financial statements

- The objective of an independent auditor is to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement

- an audit strives to identify significant risks of material misstatement and audit procedures are geared towards it

Materiality is a matter of professional judgement

Materiality

- Judgments about materiality are made in the light of surrounding circumstances, and are affected by the size or nature of a misstatement, or a combination of both; and

- Judgments about matters that are material to users of the financial statements are based on a consideration of the common financial information needs of users as a group. The possible effect of misstatements on specific individual users, whose needs may vary widely, is not considered.

THANK YOU!

YouTube IN

CA Abhishek Murali

@caabhishekmurali1298

STILL HAVE ANY DOUBTS?

LETS DISCUSS!

DR. CA ABHISHEK MURALI,

M.COM, FCA, MBA, ACMA, LLB, CGMA, CIMA(LON.), CISA(USA), DISA(ICAI), D.LITT, ADIT (UK)

ABHISHEKMURALI@GMAIL.COM ;