

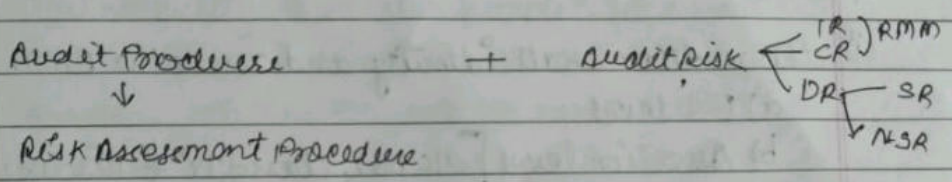
SA 315

SA 300

SA 315 (★)(★)(★)(★)(★)

Identifying & Assessing the RMM through understanding the entity & its environment

Overview



Audit Procedure

RAP (SA 315)

FAP (SA 330)

- a) Inquiry with mgmt or others
- b) Inspection & observation
- c) Analytical Procedures

TORs (SA 330)

Substantive Audit Procedure

TORs (SA 330)

Substantive Analytical Procedures (SA 520)

Vouching - (Ch 5) - verification

Objective of SA 315: ~~SA 315~~
Objective of the auditor as stated in SA 315 is to —
Identify & assess the RMM.

- (i) the auditor shall identify and assess the RMM at:
- FS level
 - Assertion level [alc bal, class of trⁿ & disclosure].
- to provide a basis for designing & performing FAP.

Auditor should follow the steps to identify & assess RMM to provide a basis of designing & performing FAP.

- (ii) For the purpose of identifying & assessing the RMM, auditor shall:
- Identify risks throughout the process of obtaining an understanding of the entity & its environment, (including relevant controls) that relate to the risks, & by considering the assertions in the FS.
 - Assess the identified risks & evaluate whether they relate more pervasively to the FS as a whole & potentially affect many assertions.
 - Relate the identified risks to what can go wrong at assertion level, taking account of relevant controls that the auditor intends to test &
 - Consider the likelihood of MS, including the possibility of multiple MS, & whether the potential MS is of a magnitude that could result in a MMS. (SA 320)

Definition of SA 315: The objective of auditor is to identify & assess the RMM whether due to fraud or error, at the FS level & assertion level, through understanding the entity & its environment including the entity's IC's,

thereby providing a basis of designing & implementing responses to the assessed RMM. This will help auditor to reduce RMM to an acceptably low level.

* Infoⁿ obtained by performing RMM - used as AE →

I. RAP (Risk Assessment Procedure) :-

(i) definition :- The AP performed to obtain an understanding of the entity & its environment, including entity's IC's to identify & assess the RMM, whether due to fraud or error, at the FS level & assertion level.

MCA

(note) RAP alone do not provide SAE on which to base the audit opinion.

∴ it is essential to perform FAP after RAP to obtain SAE.



RAP includes following :-

(a) Inquiry with mgmt and others within the entity [who in the auditor's judgement may have info that is likely to assist in identifying RMM due to fraud or error]

(b) Analytical Procedures (SA 520)

(c) Observation & Inspection

SA

Examples of Inquiry with others

1. Internal Audit Personnel
2. Employees
3. Inhouse legal counsel
4. Marketing or Sales Personnel
5. Risk mgmt function
6. Infoⁿ system Personnel

Examples of Observation & Inspection

1. Entity's operations.
2. Documents (such as Business Plan & strategies), records, & IC manual.
3. Report prepared by mgmt (such as quarterly mgmt report & interim FS) & TCW (such as minutes of BODs meetings)
4. Entity's premises & plant facilities.

May 23
Q-2a
(1/2 marks)

Kinds of infoⁿ
Refer module

see

May 23

Examples of every subheading

II. Understanding the Entity & its Environment.
Auditor shall obtain understanding following →

(a) Relevant industry, regulatory, & other external factors including the AFRF →

• Relevant Industry :

★ Examples →

• Relevant Regulatory :

★ ★ Examples →

• Other External Factors :

★ Examples →

- (b) Nature of Entity, including
- (i) its operation
 - (ii) its ownership & governance structure
 - (iii) the types of investment that the entity is making & plans to make, including investments in special-purpose entities &
 - (iv) the way that entity is structured & how it is financed, to enable the auditor to understand assertions to be expected in the FS.

Understanding the nature of entity helps in:-

- (i) complex structure of entity. (give risk to RMM)
- (ii) matters relating to ownership, & relation betwⁿ owners & other people or entities.
- (iii) determining whether RPT's have been identified & accounted for appropriately.

~~Ex~~ Examples:

- (c) The entity's selection & application of accounting policies, including the reasons for changes thereto:

(d) The entity's objective & strategies, & those related Business risks that may result in RMMs

☆☆ Examples:
☆

(e) The measurement & review of the entity's financial performance

☆☆ Examples:
☆

* Why understanding the entity's & its environment is significant?
Because it helps the auditor in

- ① ~~Plan~~ Planning the audit & in identifying areas requiring special attention.
- ② Gaining knowledge about client's business → audit plan

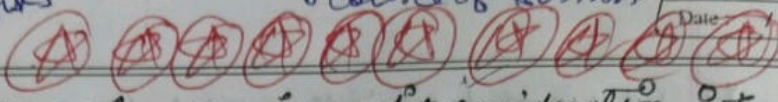
* Understanding the entity - a continuous process & dynamic process of gathering, updating & analysing infoⁿ throughout the audit. This establishes a frame of reference within which the auditor plans the audit & exercises professional judgement throughout audit.

Examples:

1. Assessing RMM in the FS.
2. Determining materiality (SA 320)
3. Considering the appropriateness of the selection & application of a/cmg policies.
4. Identifying areas where special audit consideration may be necessary. (eg - RPT's, going concern etc)
5. Developing expectations for use when performing analytical procedures.
6. Evaluating SAAF obtained such as the appropriateness of assumptions & mgmt's oral & written representations.

memory: focused that RP's of related complex tx economic, along with other development it was a subjective case of outside the normal course of business.

In auditor's judgement identified risks are significant outliers.



* Risks that require special audit consideration :-
 exercising judgement as to which risks are significant risks during RAP auditor shall consider following :-

fore

1. whether the risk is a risk of fraud.
2. whether the risk is related to recent significant economic accounting or other development like in regulatory environment & therefore requires specific attention
3. The complexity of tx
4. whether the risk involves significant tx with RP's.
5. The degree of subjectivity in the measurement of FI related to the risk, especially those measurements involving a wide range of measurement uncertainty.
6. whether the risk involves significant tx that are outside the normal course of business for the entity, so that otherwise appear to be unusual.
 (in short -> whether the risk involves significant unusual tx)

* Identifying Significant risks

Significant Risk

- ① Outside the normal course of business - non-routine transaction
 - ② Judgement matter
 - ③ Judgement found
- ① & ③ -> always significant
 ② not always but sometimes judgment can be appropriate.

① fraud related party of
 ② complex transaction - economic, accounting & other development
 it was a subjective case of outside the normal course of business

may be
 to my eyes

Greater Risk RBMS
 Non routine
 Significant Judgemental matters

Rmm - Greater for significant non-routine trⁿ :->

Examples (Dec 21)

1. Greater mgmt interventions to specify the a/cing treatment.
2. Greater manual intervention for data collection & processing.
3. Complex calculation or accounting Principles
4. The nature of non-routine trⁿ, which may make it difficult for the entity to implement effective controls over the risks.

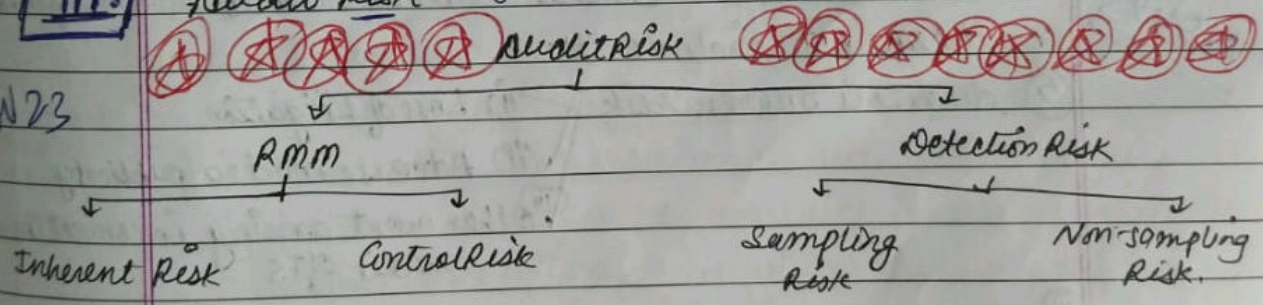
Rmm - Greater for significant judgement matters :->

1. A/c estimates
2. Revenue Recognition
3. Complex or subjective Judgements
4. Assumption about future outcomes.

III.

Audit Riskⁿ negative (विषमिन्द्रिया वोग्द एत उत्पन्न)

Nov 23



Audit Risk :->

- Audit risk means the risk that the auditor gives an inappropriate audit opinion when FS are materially misstated.
- It means that an auditor expresses an unmodified opinion when FS are materially misstated. i.e. auditor should have expressed an unmodified opinion.

• Audit risk is a function of the RMM & detection Risk

• $AR = RMM \times DR$ — (1)

$RMM = IR \times CR$ — (2)

from (1) & (2)

$AR = IR \times CR \times DR$

Actual	Auditor Conclusion	Opinion	Audit Risk
FS - materially misstated	FS - materially misstated	Appropriate	NO
FS - not m misstated	FS - not materially misstated	Appropriate	NO
FS - materially misstated	FS - not materially misstated	Inappropriate	Yes
FS - not m misstated	FS - materially misstated	Inappropriate	NO *

• In case of inappropriate opinion auditor may face a regulatory action from a professional body, can also face legal action by users resulting into reputation loss of the auditor.

*** What is not included in Audit Risk? ***

NOV 23

(1) Audit risk is a technical term related to process of auditing. It does not include :-

- (a) Auditor's business risk
 - (i) Loss of Litigation
 - (ii) Adverse media publicity
 - (iii) Other event arising in connection with audit of FS.

(b) When FS are not materially misstated but auditor concludes that FS are materially misstated.

Can Audit Risk be reduced to Zero?

No, Audit risk can only be reduced to an acceptable low level. Because of inherent limitation of Audit auditor only provides reasonable assurance.

PNTP May 25

Components of Audit Risk.

Inherent Risk (IR)	(CR) Control Risk	(DR) Detection Risk
IR is the susceptibility of an assertion about class of tx ⁿ , a/c bal & disclosure to a MS that could be material, either individually or when aggregated with other MS before consideration of any related controls as described in SA 200.	In accordance with SA 200, CR is the risk that a MS about a class of tx ⁿ , a/c bal or disclosure & that could be material, either individually or when aggregated with other MS, will not be prevented, or detected & corrected, on a timely basis by the entity's IC.	SA 200 defines DR as the risk that the procedures performed by the auditor to reduce audit risk to an acceptably low level will not detect a MS that exists & that could be material, either individually or when aggregated with other MS.

Inherent Risk of Business

Inherent Risk: (mgmt level) exist independently of audit of FS
Influenced by client Entity's Risk

(while considering IR, ICS is not considered)
(There will always be a risk that FS could be misstated)

1. definition
2. There is always a risk before considering existence of any IC in the company, a particular (a/c bal, class of txⁿ or disclosure) have a chance of being misstated & such MS can be material.
3. IR can be higher for some assertion than others (eg: IR may be higher for areas like inventory, revenue etc when compared with other areas like power full exp etc)
4. (other eg: complex txⁿ, international tax matter etc).
4. external factors that gives rise to business risk will influence IR. PESTLE
(eg: change in technology making entity's product obsolete, regulatory actions against the Co or changes in Govt policies)
5. IR will be considered by auditor while designing TOCs & substantive audit procedures.

What factors are to be considered by an auditor while making Control Risk Assessment (NOV 20)

⑥ Examples:

- Business failure in some industry.
- Risk that a new AS or Ind AS may not be appropriately applied by the Co for the 1st time. (New along side)
- Product obsolete
- Technology upgradation.
- Cash tx" ↑↑↑↑

• Exist independently of audit of FS

Control Risk: (mgmt level) • Influenced by client

• Entity's Risk.

① definition

② ~~Control~~ CR is a risk that entity's IC that are existing & operating will not be efficient enough to stop from happening (Preventive) or find (Detective) & then rectified (Corrective) in an appropriate time ony mms in an assertion.

③ There is an inverse relation betw" CR & efficiency of IC of an entity.

④ when efficiency of IC of an entity is ^{efficient, reliable, strong.} ↑, the CR is ↓ & when efficiency of IC of an entity is ↓, the CR is ↑.

⑤ IC cannot be 100% perfect Bcz of inherent limitation of IC
∴ CR cannot be 0%.

Detection Risk: (Auditor's level)

① definition

② Despite of performing all the procedures, all the MS cannot be detected.

③ DR comprises of sampling & non-sampling risk. **→ Explain How** [SA 530]

④ Auditor can influence only DR. Because IR & CR belongs to the entity & only entity can influence them.

⑤ DR can be reduced by increasing areas of checking, testing larger samples & by including component & experienced persons in engagement teams.

⑥ Examples :

- While checking revenue, auditor selected sample which is not representative of whole revenue.
- Auditor is not attending physical verification of inventory (WIP) which is substantial rather relying on alternative procedure.

Relationship betwⁿ IR X CR & DR.

- There is an inverse relationship betwⁿ DR & combined assessment of IR X CR.
- When IR X CR is high, Auditor will perform substantive audit procedure at high scale & this will lead to reduction of DR.
→ means RMM is high
in detail.
- Conversely, if IR X CR is low, Auditor will perform substantive audit procedure at low scale which will increase DR.

* Auditor generally makes a combined assessment of IR & CR since it is assumed that mgmt should design appropriate IC to address respective IR.

(eg - an appropriate purchase process should be designed & implemented to address purchase related risk.)

① ISA's do not refer IR & CR separately, rather they come up with combined assessment of ROM.

② Auditor may make separate or combined assessment of IR & CR depending on auditor's techniques or methodologies.

③ The assessment of RMM express in quantitative or non-quantitative term such as % (quantitative).

④ The need for the auditor to make appropriate risk assessment is more important the diffⁿ approaches by which they may be made.

⑤ conclusion → $ROM = IR \times CR$.

Assessment of risks - A matter of Professional judgement

Rmm?

SA250 states that ~~Rmm~~ Risk of material statement is the risk that FS are materially misstated prior to audit. It simply means that there is a probability of frauds or errors in FS before audit.

ms?

MS refer to a difference betwⁿ [the amount, classification, presentation or disclosure] of a reported FS item & [the amount, classification, presentation or disclosure] that is required for the item to be in accordance with AFRF. MS can arise from errors or fraud.

Examples?

- ① Charging of item of capital expenditure to revenue or vice versa.
- ② Difference in disclosure of a FS item vis-a-vis its requirement in AFRF.
- ③ Selection of application of inappropriate accounting policies.
- ④ Difference in valuation estimate of a FS item vis-a-vis its appropriateness in AFRF.
- ⑤ Intentional booking of fake expenses in Stmt of PL.
- ⑥ old receivables in FS by not w/o irrecoverable debts.
- ⑦ Overstating or understating inventories.

The RMM may exist at two levels :-
 (i) The overall FS level → refer to RMM that relate pervasively to the FS as a whole & potentially affect many assertion.
 (ii) The assessment level for (class of trⁿ, account, & disclosure) → are assessed in order to determine the NTE of FAP necessary to obtain RAAF + The evidence enables the auditor to express an opinion on the FS at an acceptably low level of audit risk.

Assessment of Control Risk

