

# Risk Assessment Procedure → Audit Pro.

- to obtain **understanding** of Entity / Its Environment & I.C.
- to **Identify & assess R.O.M.M** (due to F/E)
- at F.S. & assertion level.



## Achieves?

- Identify risks through understanding E/Env/I.C.
- Assess risks & evaluate if they potentially affect many assertions. (F.S. level).
- Relate risks to  $\begin{matrix} \rightarrow \\ \rightarrow \end{matrix}$  what can go wrong (WCGW) at assertion level. considering controls auditor intends to test.

eg if no process of checking Qty (Goods) recd. (Risk)

lead to WCGW

Control?

Company Inv. Qty to G.R.N.  
(Goods receipt Note)

- Consider  $\begin{matrix} \rightarrow \\ \rightarrow \end{matrix}$  Likelihood (i) & Magnitude (ii) of risk that could lead to m.m.

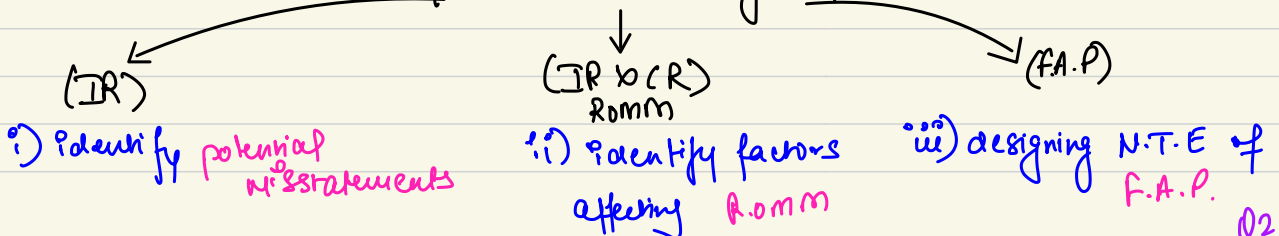
## Internal Control

Process → **Designed, Implemented & Maintained (DIA)** by **mgmt/Executives/other**

- to provide **R.A.** about ⇒ achievement of **entity's objectives**.

- Safeguarding of assets. (cash → locker → keys → Authorised B)
- Compliance with L/R (B duty → TDS deposit timely)
- Reliability of F.R. (B FS. prepare → comply with Atc. Stats)
- Effectiveness & efficiency of operations. (Training of workers)

## "Benefits" of Understanding of I.Cs.



## Limitations of J.C.

J.Cs can provide only R.A. about achieving F.R. objectives due to J.L. of J.C.

Reasons: ① mgt judgment: Its mgt judgment to decide where to assume risks & Nature & Extent of controls to implement.  
 eg No controls for issuance of stationery.

② Human decisions can be faulty & JCs can breakdown due to human error.  
 eg error in design of J.C. kaam nahi kiya

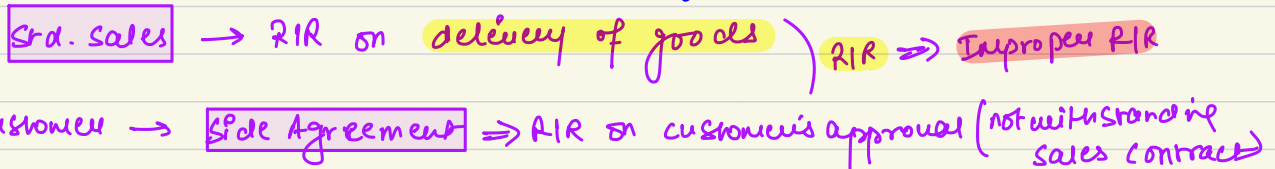
<u>P.O. Authorisation (limits)</u>	<u>Authorise?</u>	P.O. 1009000.50 → B? ↓ Exception Report (B)
0 - 100000	Mgr	
1,00,001 - 10,00,000	Sr. mgr	
10,00,001 - 1cr	CFO	
> 1cr	CEO/MD	

③ (Rudhe Person) JCs may be ineffective if info. produced for J.Cs

(Exception Reports)  
 ↓  
 not effectively used.  
 ∴ person receiving info. doesn't understand purpose / fails to take corrective action.

④ a) collusion: controls can be circumvented (avoided) by collusion of 2/more persons.

eg Side Agreement entered with customer to alter T&Cs of std. sales contract, resulting in improper R/R.



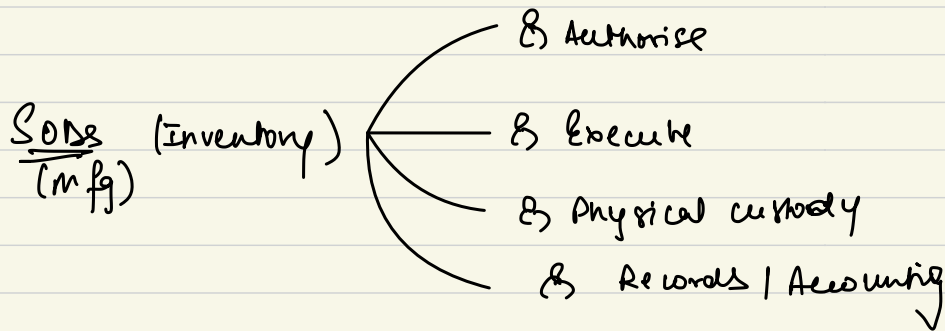
b) Inappr. mgt override of controls: Edit checks in software designed to

'Identify & report trans' > specified cr. limit.

↓  
 maybe overridden / disabled by mgt.

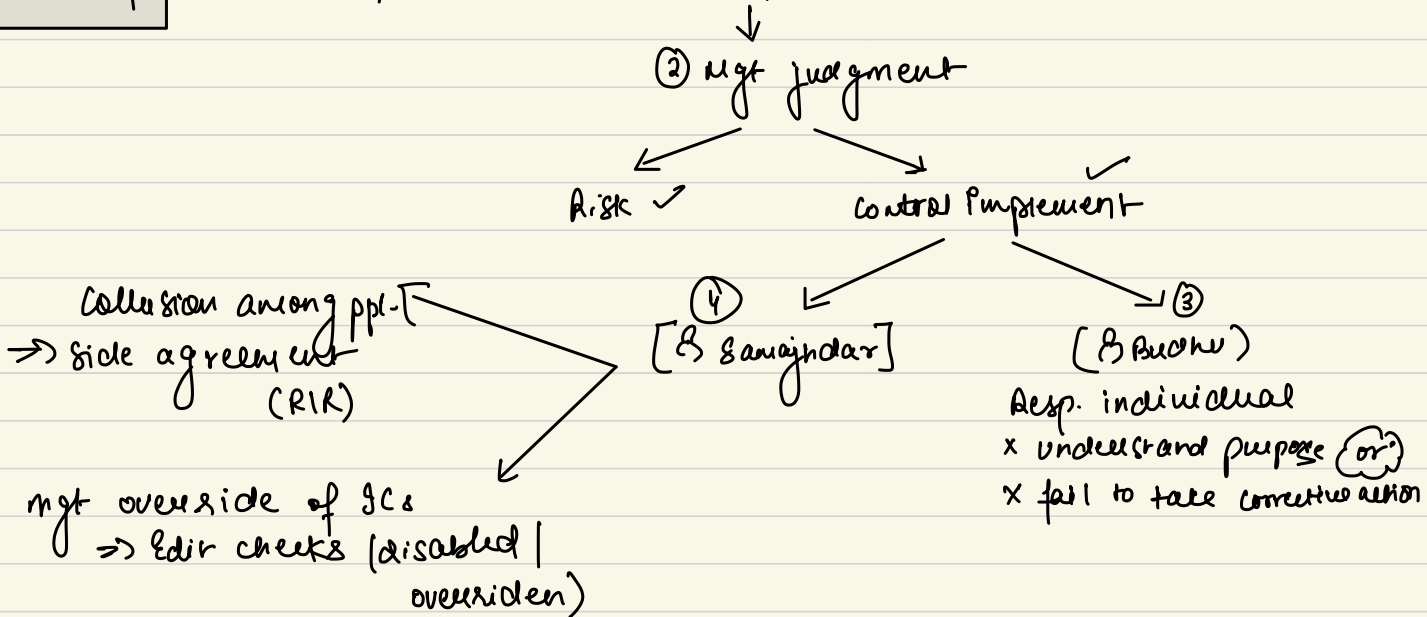
mgt (BIL → Another ir how) ⇒ Sale ₹15 lakh (> cr. limit) ⇒ Report override → Approve feature Disable

⑤ Small Entities: They have fewer employees, Segregation of Duties (SODs) not possible.  
 ∴ owner mgr exercise effective oversight over entity.



**Summary**

① R.A. for g.c. (due to S.L. of I.C)



⑤ Small Entities [x SODs ⇒ ∴ owner mgr. effective oversight]

# Components of Internal Control (Body Parts)

## 1. Control Environment (Rooj / Arma)

- a) Evaluate? a) mgt created & maintained culture of { Honesty  
& Healthy  
Ethical Behaviour.
- b) Strength of C.E. provides foundation for other components.

### b) What's included in C.E.?

- 1) Governance & mgt fr → 2) Attitude, Awareness & Actions of mgt & Twp  
↓
- 3) CE sets tone of organisation.

### c) Elements

- 1) Communication & enforcement of <sup>(Honesty)</sup> Integrity & Ethical values
- JCs effectiveness depends on integrity & ethical values of ppl.  
eg. policies, code of conduct etc.

- 2) Commitment to Competence: Mgt considers competence levels for jobs & translates it to reqd. skills & knowledge.  
[eg. Atc jobs ⇒ AS + Tally]

- 3) Participation by Twp ⇒ Attributes (Qualities) of Twp
- Independent from mgt
  - Experience & Stance
  - Extent of Involvement & Scrutiny of acts.

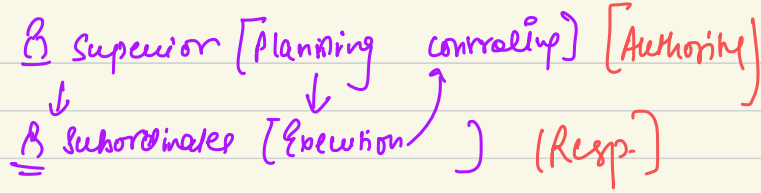
- 4) Mgt's philosophy & operating style: Mgt's attitude towards
- F.R.
  - & Atc fr & persons.

- 5) Org. Structure: Framework in which Acts. are
- Planned,
  - Executed &
  - Controlled.

- 6) Assigning Authority & Responsibility: How A & R assigned & reporting relationships made.

- 7) H.R. policies: P&P eg Recruitment, training, Evaluation, Compensation, Promotion etc.

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Existence of Satisfactory C.E. ⇒ Not Absolute Determinant to Fraud

{ C.E. not enough to P/D/C M.M. due to fraud }  
 ⇒ we need other components also

(Achha)

(Bura)

① Existence of Satisfactory C.E. ✓  
 can be a positive factor  
 in assessing Ro.M.M. ↓

② It may help in reducing Risk of fraud.

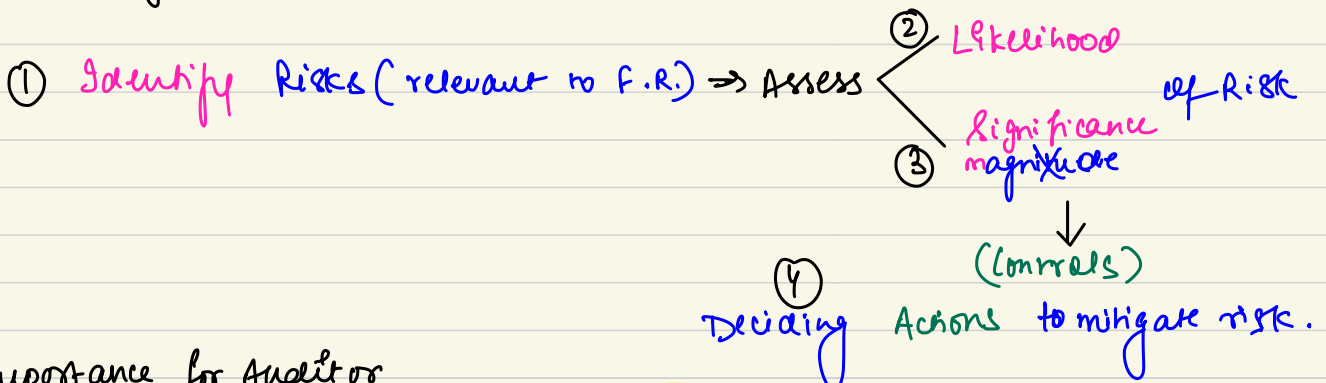
③ Conversely, deficiency in C.E., can reduce effectiveness of I.C.s.

eg. mg's failure to commit resources for IT security  
 ↓  
 can lead to improper changes in data.

Conclusion: • C.E. doesn't P/D/C M.M.  
 • It may influence evaluation of effectiveness of I.C.s. & Ro.M.M.

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② Entity's Risk Assessment Process (R.A.P)



Importance for Auditor

Entity's R.A.P provides basis for risks to be managed.

Assists auditor to identify Ro.M.M. if R.A.P is appt.

whether R.A.P. is appt. is a matter of P.J. operating environment

eg Risk can arise due to New technology ← Business Models products.

# Monitoring of controls

Process to assess effectiveness of performance of ICS.

Benefit? Helps to assess effectiveness on timely basis & take remedial actions.

How? • Through ongoing activities, <sup>and Internal Audit</sup> separate evaluations or combination of the two.

• Ongoing Acts. include using info. from External parties like

customer complaints + Regulator comments.  
which highlight problems/areas for improvement.

## Significant Risks

(I.R ↑ i.e. high likelihood & magnitude of potential mistreatment)

[Examples from Book]

⇒ Fraud & R.P. Trans<sup>n</sup> of S.N.C.O.B always. Sig. Risks.

### Sig. Risks include Significant

Non-Routine Trans<sup>n</sup>  
(Unusual & occur infrequently)

eg Acquisition of subssy & consolidation.

Greater Intervention

• Management → to specify ac treatment.

• Manual → for data collection & processing

• Complex calculations or ac principles

• Nature of Non-Routine trans<sup>n</sup> makes difficult to implement controls for them.

Judgmental matters  
(Sig. Ac Estimates)

• Ac principles for ac estimates or R/R having Different Interpretations.

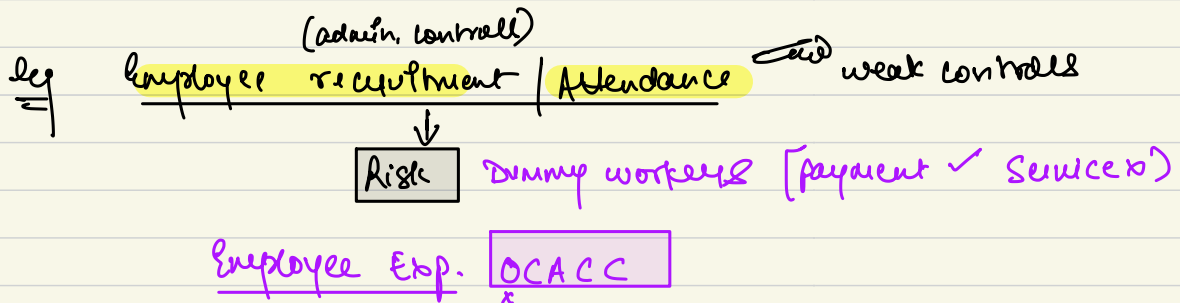
• Required judgment maybe subjective/complex, or require Assumptions about Past Events.

eg fair value judgment.  
{ P.V. → discounting future cash flows }

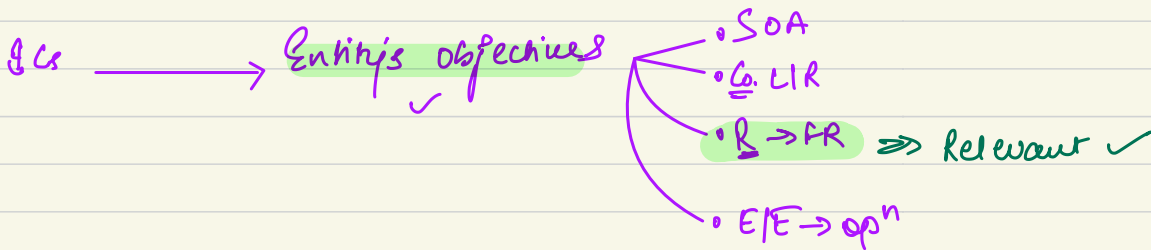
# \* Benefits of Evaluation of Internal Control \*

- ① Adequate I.C. system is in use & operating as mgt planned?
- (Non) ② Errors/Frauds likely to be located in N.C.O.B?
  - ③ Controls safeguard the assets?
  - ④ Efficiency of audit dept operating?
  - (Nahi) ⑤ where are Areas where I.Cs. are weak & excessive
  - ⑥ Suggestions be given to improve I.Cs.

lawyer



## Controls Relevant to Audit



⇒ Auditor tests only those <sup>relevant</sup> controls ⇒ that mitigate (PIDIC) Risk in FS.

"factors" ⇒ consider ⇒ control is relevant to Audit?

- Materiality
- Nature & Complexity of ICS including use of Service Org. (S.O.)  
client → payroll accounting outsource → S.O. → I.C. Relevant ✓
- Diversity & complexity of operations.

ITC → Fmcyl | hotel | packaging etc. → controls of each seg. separately  
R ✓

- Nature of Business (organisation & ownership characteristics)
  - mfg. entity → Inventory controls R ✓
- Significance of Risk (Fraud, RPTs, O/S NCOB etc → Controls R ✓)
- Circumstances & applicable component of I.C.
  - New J.T. Acc System → General IT controls ⇒ R ✓
- Applicable legal & regulatory requirements.
  - Sec 143(3)(i) Cost Act 2013 → ICA Reporting.

### General Points:

Completeness  
+  
Accuracy.

1. Revenue Audit ⇒ Sales volume × Std. Price

⇒ ICs over completeness & accuracy of GPE (Info. produced by entity)  
maybe relevant if auditor uses that info for "FAP".

2. ICs over safeguarding of Assets against unauthorised "DUA"  
(disposition, use or access)

Related to Both

Financial Reporting  
eg Access controls (passwords) to access data/programs that process cash payments  
↓  
may be relevant to audit.

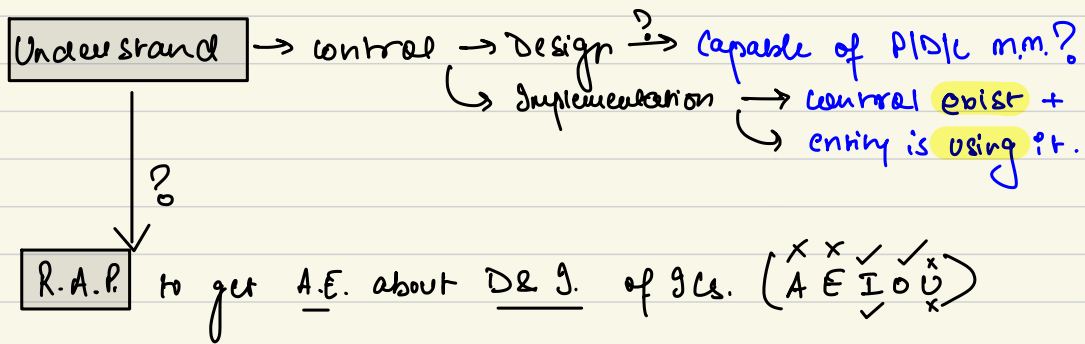
Operational objectives  
eg controls to prevent excessive use of material in prodn  
↓  
generally not relevant to fs. audit.

3. ICs relating to objectives not relevant to Audit

• not considered.

eg. Automated controls for effective & efficient operations  
(airline's automated system for flight scheduling)

Relevant for audit? No



- Inquiry of Entity personnel (but it is not sufficient)
- Inspection of docs & reports.
- Observing appl<sup>n</sup> of controls

⊕ Tracing trans<sup>n</sup> through Info. System relevant to FR (all system)

Note: Understanding is not enough to test op. effectiveness of GCs. unless it's automated.

## Methods of Evaluating G.C. (v. Easy)

(Narration)

### 1. Narrative Record

Complete & exhaustive description of system found in operation by auditor.

Why? ◦ Where no formal system in operation, eg. small business.

How? Actual testing & observation necessary before developing record.

### Disadvantages

- ① Difficult to comprehend the system in operation. comprehensively describe
- ② To identify weakness/gaps in system.
- ③ To include changes due to reshuffling of manpower.