CHAPTER

3

RISK ASSESSMENT AND INTERNAL CONTROL

SYNOPSIS

WHAT IS AUDIT RISK?

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

In auditing, an unmodified opinion is expressed when financial statements are **not** materially misstated. However, if material misstatements are present, the auditor risks damaging their reputation, facing regulatory action, and potential legal consequences. To mitigate these risks, auditors plan and conduct audits in such a way that will reduce audit risk to an acceptable level. SA-200 emphasizes obtaining sufficient and appropriate audit evidence to draw reasonable conclusions for forming an opinion. Audit risk, representing the likelihood of an inappropriate opinion in the presence of material misstatements, is influenced by both the risks of material misstatement and detection risk. For instance, if a company artificially inflates profits with fake sales, it constitutes material misstatement, and the auditor's challenge is to minimize audit risk through effective planning and evidence collection.

Hope you got it

RISKS OF MATERIAL MISSTATEMENT

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.

What is meant by misstatement?

Misstatement refers to a 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. Misstatements can arise from error or fraud.

Following are the examples

- Charging of an item of capital expenditure to revenue or *vice-versa*
- Difference in disclosure of a financial statement item vis-à-vis its requirement in applicable financial reporting framework
- Selection or application of inappropriate accounting policies
- Difference in accounting estimate of a financial statement item vis-à-vis its appropriateness in applicable financial reporting framework
- Intentional booking of fake expenses in statement of profit and loss
- Overstating of receivables in financial statements by not writing off irrecoverable debts
- Overstating or understating inventories

The risks of material misstatement may exist at two levels:—

(i) The overall financial statement level

(ii) The assertion level for classes of transactions, account balances, and disclosures.

Risks of material misstatement at the overall financial statement level refer to risks of material misstatement that relate pervasively to the financial statements as a whole and potentially affect many assertions.

Risks of material misstatement at the assertion level are assessed in order to determine the nature, timing, and extent of further audit procedures necessary to obtain sufficient appropriate audit evidence. This evidence enables the auditor to express an opinion on the financial statements at an acceptably low level of audit risk.

Components of risk of material misstatement

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

Inherent risk, as defined in SA-200, refers to the susceptibility of a statement about a class of transaction, account balance, or disclosure to a potentially material misstatement, either individually or when aggregated with other misstatements, without considering any related controls. This risk is present before assessing the effectiveness of internal controls within an entity. Inherent risk varies across different assertions and categories, being higher for some, such as complex calculations.

Auditors take inherent risk factors into account when designing tests of controls and substantive procedures. These factors influence the auditor's assessment of inherent risk, categorizing it as lower or higher within a range. Even when assessing a lower inherent risk, auditors must carefully consider the reasons behind each identified risk when designing audit procedures.

External circumstances, such as technological advancements or business risks, may contribute to inherent risk. For instance, developments in technology could render a product obsolete, impacting the inherent risk associated with related assertions. Thus, understanding both internal and external factors is crucial for a comprehensive assessment of inherent risk in the audit process.

Examples of Inherent Risks

- An accounting standard provides guidance on some complex issue which might not be understood by the management. Therefore, recording of this issue in financial statements carries inherent risk of being misstated.
- There are large number of business failures in an industry. Therefore, assertions in financial statements of an entity operating in such an industry carry an inherent risk of being misstated.

Control Risk

As per SA-200, control risk is defined as the risk that a misstatement, potentially material either individually or when aggregated with other misstatements, may not be prevented, detected, or corrected in a timely manner by the internal controls of an entity. In other words, control risk represents the possibility that the existing internal controls within an entity are not effective enough to prevent, identify, and rectify material misstatements related to transactions, account balances, or disclosures in the financial statements.

There is an inverse relationship between control risk and the efficiency of internal controls. When the internal controls of an entity are highly efficient, control risk is low, indicating a lower likelihood of material misstatements going undetected or uncorrected. Conversely, if the internal controls are less effective, control risk is higher, suggesting a greater possibility of material misstatements persisting in the financial statements. The assessment of control risk is a crucial aspect of the audit process, influencing the auditor's approach and procedures to ensure the reliability of financial reporting.

Examples of control risk could include

- 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 ₹ 10,000 should be routed through imprest system of petty cash. There is a risk that control is not being followed.

Detection risk

SA 200 defines detection risk as 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.

For example, 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.

Detection risk comprises sampling and non-sampling risk

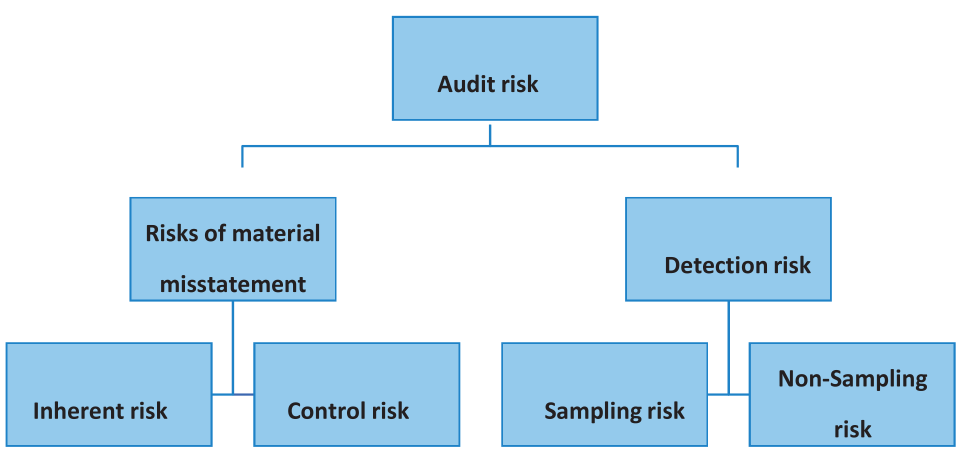
Sampling risk is the risk that the auditor's conclusion based on a sample may be different from the conclusion if the entire population were subjected to the same audit procedure. It simply means that the sample was not representative of the population from which it was chosen.

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.

Examples of detection risk could include

- Sizeable work-in-progress inventories are expected in financial statements of a company. However, auditor of the company does not devote time to attending inventory count. Instead, he chooses to rely upon alternative audit procedures.
- The auditor of a company has audited revenue of a company by taking a sample. However, there is a risk that sample of revenue is not representative of overall revenue.

The auditor can only influence detection risk. Inherent risk and control risk belong to the entity and are influenced by the entity. Therefore, auditor must reduce detection risk in order to keep audit risk at low level. **Detection risk may be reduced by increasing area of checking, testing larger samples and by including competent and experienced persons in the engagement team.**



Combined Assessment of the Risk of Material Misstatement

Standards on auditing typically address the combined assessment of "risks of material misstatement" rather than separately considering inherent risk and control risk. However, auditors have the flexibility to make separate or combined assessments of inherent and control risk based on their preferred audit techniques, methodologies, and practical considerations.

The assessment of risks of material misstatement can be expressed either quantitatively, such as in percentages, or in non-quantitative terms. Regardless of the approach chosen, what matters most is that the auditor makes appropriate risk assessments. The focus is on ensuring that auditors thoroughly evaluate and understand the risks associated with material misstatements, as this is crucial for conducting effective and reliable audits. The specific method used to assess these risks may vary, but the emphasis remains on the importance of the overall risk assessment process.

It can be concluded from the above that:—

Audit risk = Risks of material misstatement X Detection risk

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

Audit risk = Inherent risk X Control risk X Detection risk

Concept Capsule 1

XYZ Ltd is engaged in the business and running several stores dealing in variety of items such as ready made 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.

Suggested 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.

Concept Capsule 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.

Suggested answer

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.

Concept Capsule 3

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?

Suggested 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. Therefore, there is a greater possibility of misstatements. The component of risks of material misstatement involved is "inherent risk."

Concept Capsule 4

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.

Suggested 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. The component of risks of material misstatement is "control risk".

Concept Capsule 5

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?

Suggested answer

There is a possibility that planned audit procedures may not achieve desired result and fail to detect misstatements in revenue recognition. The risk alluded to it is "detection risk".

SA 315
IDENTIFYING AND ASSESSING
THE RISK OF MATERIAL MISSTATEMENT
through UNDERSTANDING the entity & its ENVIRONMENT

Students are requested to revise the concept of **Assertions** explained at the introduction to Standards on Auditing & in SA 500;

This is a beautiful standard to learn. Very important for examination as well for practice purpose.

Just think this

Assume that you have been appointed as an auditor of X Ltd. which is a cement manufacturing company for the first time. You don't have any clients of that industry.

How do you identify which is risky? And how much is the risk (assessment) for this client?

Spend few minutes to think and then later start reading this SA. Then only you can enjoy this SA a lot. This is big but remember my words beautiful also. *Have patience.*

Read the name of the SA carefully – Auditor identifies & assess the risk; How? Answer is given there only – it is **by way of understanding the entity and its environment**.

Responding to the risks is not dealt with by this SA. It is discussed by SA 330 (Remember).

Objective

(a) The objective of the auditor is to **identify** and **assess the risks** of material misstatement, whether due to fraud or error, **at the financial statement level** and **assertion levels**, through understanding the entity and its environment, including the entity's internal control;

(b) This helps to respond to the risk appropriately and so that risk can be reduced to acceptably low level.

Definitions

(a) Assertions:

Representations by management that are embodied in the financial statements. Just for recalling Balance sheet assertions – Existence, rights and obligations, valuation, completeness and presentation and disclosure;

P&L Assertions – Occurrence, completeness, cut-off, measurement and presentation and disclosure;

(b) Internal control:

Internal control refers to the **internal policies and procedures adopted by the management** to assist them in achieving management's objective such as:

- Orderly and efficient conduct of its business;
- Adherence to management policies;
- Safeguarding of assets;
- Prevention and detection of fraud and error;
- Compliance with applicable laws and regulations.
- Accuracy and completeness of the accounting records, and the timely preparation of reliable financial information.

  Internal controls relating to accounting and financial aspects primarily aim at providing the flow of work through various stages so as to segregate the authorising, recording and custodial aspects of the transaction.

(c) Significant risk:

An identified and assessed risk which requires special audit consideration as per auditor's judgment.

(1) Risk Assessment Procedures and Related Activities

By performing Risk assessment procedure, auditor can identify and assess the risk. **These procedures do not help the auditor to obtain sufficient appropriate audit evidence**.

To identify and assess the risk- auditor should understand the entity & its environment.

To understand the risk-prone areas, auditor should perform the following:

(a) **Inquiries** the following persons

Whom to enquire?	Purpose of enquiry
Management / TCWG	Understanding the process and environment of Financial statements preparation; Business risks, competition in the market;
Employees who involved in complex or usual transactions	To evaluate the appropriateness and application of certain accounting policies;
In-house legal department	To understand litigations, compliance of laws and regulations, knowledge of fraud or suspected fraud affecting the entity, warranties, post- sales obligations, arrangements (such as joint ventures) with business partners and the meaning of contract terms.
Marketing and sales personnel	To understand changes in the entity's marketing strategies, sales trends, or contractual arrangements with its customers
Internal audit function	To obtain overall understanding of the entity's operations, any identified control deficiencies, etc

(b) **Analytical procedures**

Analytical procedures, when performed as risk assessment procedures, play a crucial role in uncovering aspects of an entity that the auditor may not have been aware of initially. These procedures aid in evaluating the risks of material misstatement, forming a basis for designing and implementing responses to identified risks. These analytical procedures can involve both financial and non-financial information, such as examining the relationship between sales and the square footage of selling space or the volume of goods sold.

Analytical procedures are valuable in identifying unusual transactions, events, and patterns, including amounts, ratios, and trends that may have audit implications. Discovering unexpected relationships can be particularly helpful in identifying risks of material misstatement, especially those related to fraud. However, when these analytical procedures use aggregated data at a high level, they provide a broad initial indication of potential material misstatement. In such cases, the auditor must consider other information gathered during the risk assessment process to better understand and evaluate the results of the analytical procedures. This holistic approach enhances the auditor's ability to identify and respond to potential risks effectively.

(c) **Observation and inspection**

Observation and inspection may **support inquiries** of management and others. Auditor should observe and inspect the entity's operations/ premises/ plant facilities, documents, business plans, reports prepared by management to TCWG, etc.

Concept Capsule 6

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.

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

Concept Capsule 7

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?

Suggested 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.

(2) Discussion among the Engagement Team

The engagement **partner** and other **key engagement team members** shall discuss

(a) The **susceptibility** of material misstatement in FS due to fraud or error;

(b) Areas which are prone to potential fraud or error **and** actions to be taken;

(c) **Instances of frauds** or errors took place in the PY;

(d) New information obtained during the audit; and

(e) Application of the AFRF to the entity's facts and circumstances.

(3) The Required Understanding of (A) the Entity and Its Environment, Including (B) the Entity's Internal Control

(A) The Entity and Its Environment

The auditor shall understand of the following:

(a) Relevant

- o **Industry** *(Competitive environment, supplier and customer relationships, and technological developments)*
- o **Regulatory** (like RBI, IRDA, SEBI, TRAI, Taxation, Government policies, etc), and
- o Other **external factors** including the applicable FRF *(General economic conditions, interest rates and availability of financing, and inflation or currency revaluation.)*

(b) The **nature of the entity**, including:

- Its operations; *(what does entity produce, provide services, nature of items, place of activity – locations, Key customers / suppliers, Alliances, etc)*
- Its ownership and governance structures; *(Hierarchy of management & TCWG)*
- The **types of investments** that the entity is making and plans to make; and
- The way that the entity is structured and how it is financed; *(Debt: Equity, via subsidiary)*

(c) **Selection and application of accounting policies** with reasons and if there are any **changes** in policies in CY – understand the **reasons** for the changes;

(d) Understand its business risk, competition, market share and its strategies that may result in risks of material misstatement.

(e) The **measurement and review** of the entity's financial **performance**. External information such as **analysts' reports and credit rating agency reports** may be useful information for us to obtain an understanding of an entity's performance measures. Such reports can often be obtained from the entity.

Examples for measuring and reviewing financial performance which may be used by an auditor may include

- Key performance indicators (financial and non-financial) and key ratios, trends and operating statistics;
- Period-on-period financial performance analyses;
- Budgets, forecasts, variance analyses, and departmental or other level performance reports;
- Credit rating agency reports;

Asked in Exam

'Knowledge of Client business' is one of the important principles in developing an overall audit plan. Explain.

(CA IPCC Nov 2017)

Hint answer: Write above (a) to (e) points

Concept Capsule 8

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.

Suggested 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.

Concept Capsule 9

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.

Suggested 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.

Concept Capsule 10

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.

Suggested 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.

(B) The Entity's Internal Control

(a) The auditor shall obtain an understanding of internal control relevant to the audit; *as you know, Internal controls means internal policies and procedures established by management for smooth running of business;*

(b) The auditor shall **evaluate the design** of those controls (*i.e. Regarding sufficiency of controls*); and

(c) Determine **whether** they have been **implemented**. *How to test this?* by performing procedures. *(whether employees are really following these internal policies or not)*