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Brahmastra Revision CA Final Audit- New Syllabus

Chapter 4 SAs by CA Pragnesh Kanabar

Risk Assessment as per SA 315, Concepts of Internal Control, Evaluation of Internal Controls, SA 265, SA 330, Frameworks governing Internal Controls

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SA 315- Identifying and Assessing RoMM through understanding the entity and its environment

Risk Assessment Procedure

Obtain an understanding of the entity and its environment

Evaluate accounting system and related internal controls

To identify and assess RoMM

RoMM at overall FS Level & RoMM at assertion level

Concept of Audit Risk

Risk of expressing an inappropriate audit opinion
When FS are materially misstated
(All other possibilities are excluded from Audit Risk concept)

Audit Risk is a function of (combination of) RoMM and Detection Risk

Steps for Risk Identification

Assess the significance of the assessed risk

Determine the likelihood for assessed risk

Identify the degree of significant risks that would require separate attention and response by the auditor

Document the assertions that are effected.

Enquire and document the management's response.

Risk Based Audit Approach

Risk-based audit (RBA) is an approach to audit that analyzes audit risks, sets materiality thresholds based on audit risk analysis and develops audit programmes that allocate a larger portion of audit resources to high-risk areas..

Three Phases of Risk Based Audit

Risk Assessment:

- A) Perform client acceptance and continuance
- B) Copy Risk Assessment procedure points here

Risk Response:

Perform Further Audit Procedures such as Test of Controls, Test of Details, Analytical procedures etc.
Incorporate unpredictability.
Respond to areas of significant risk

Reporting:

- A) Whether conclusions drawn from work performed are appropriate
- B) If any suspicious circumstances have been encountered. Discuss report with mgmt. and TCWG.
Form an audit opinion

Components of Audit Risk

Inherent Risk
(what can go wrong)

Control Risk
(what if Internal Controls fail?)

Risk of Material Misstatement (RoMM)

Detection Risk
(What if auditor fails to detect?)

Audit Risk

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Concepts of Internal Control

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Concepts of Internal Control

Meaning and objective

Limitations of Control

Control Policies and Procedures

Components of Internal Control

Internal Check System

Concept of SOP

Meaning and objective

A Process DIM (Designed, Implemented and Maintained)

By Mgmt, TCWG and other personnel

to provide reasonable assurance about achievement of entity's objectives related to FOLA

F- Financial reporting- Reliability of FR
O- Operations- Efficiency and effectiveness of operations
L- Laws- Compliance with Laws and Regulations
A- Assets- Safeguarding the assets

Objectives of internal controls relating to the accounting system are: TATA
T- Transactions- proper authorization
A- Assets- safeguarded from unauthorized access
T- Transactions- promptly recorded, timely recorded etc.
A- Assets- verified at reasonable intervals.

Limitations- HUCCA

H- Human- potential for human error
U- Unusual- most internal controls do not tend to be directed at transactions of unusual nature
C- Cost- cost of an internal control does not exceed the expected benefits to be derived
C- Collusion- circumvention of internal controls through collusion with employees or with parties outside the entity
A- Abuse- person responsible for exercising an internal control could abuse that responsibility

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Control policies and procedures cover the following- SAAAI

Segregation of duties

Authorization of Transaction

Adequacy of Records and Documents

Accountability and Safeguarding of Assets

Independent Checks

The following functions are segregated –
(a) authorization of transactions;
(b) execution of transactions;
(c) physical custody of related assets; and
(d) maintenance of records and documents

Accounting controls should ensure that –
TATA (As discussed above)

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Components of Internal Control

Control **Environment**- culture set up by mgmt. and tcwg

I. Elements of Control

Environment: *Human Philosophy* → *Commit Communicate Participate Organise*

- A) Communicating Ethical Values
- B) Commitment to competence- asking employees to be competent in their job
- C) Participation by TCWG
- D) Mgmt's philosophy and operating style
- E) Organisation structure- who reports to whom?
- F) Human Resource Policies

Entity's **Risk Assessment** process- How entity identifies and responds to the RoMM

I. The auditor shall obtain an understanding of whether the entity has a process for::

- (a) Identifying business risks relevant to financial reporting objectives;
- (b) Estimating the significance of the risks;
- (c) Assessing the likelihood of their occurrence; and
- (d) Deciding about actions to address those risks

II. Risk can arise or change due to following:

- A. Changes in operating environment
- B. New personnel.
- C. New or revamped information systems.
- D. Rapid growth
- E. New technology

Information system including FR process- How transactions/ events are initiated, recorded and reported in FS

The information system relevant to financial reporting objectives, which includes the financial reporting system, includes methods and records that:

- A) Identify and record all valid transactions
- B) Describe on a timely basis the transactions in sufficient detail
- C) Measure the value of transactions
- D) Determine the time period in which transactions occurred
- E) Present properly the transactions and related disclosures in the financial statements.

Control Activities- techniques used by mgmt. for implementing internal control

Control activities that may be relevant to an audit may be categorised as policies and procedures that pertain to the following:

IPS Performs

- A) Information processing-** application controls, which apply to the processing of individual applications, and general IT-controls, which are policies and procedures that relate to many applications
- B) Physical controls-** E.g. physical security of assets, authorisation for access to computer programs
- C) Segregation of duties-** Assigning different people the responsibilities of authorising transactions, recording transactions, and maintaining custody of assets.
- d) Performance reviews-** reviews and analyses of actual performance versus budgets, forecasts, and prior period performance;

Monitoring
Techniques to check the effectiveness of the controls

A) It includes whether controls are operating as intended and that they are modified as appropriate for changes in conditions
B) Monitoring activities- SEPARATELY EVALUATE EX- ON ONGOING BASIS

i) SEPARATE EVALUATION: internal auditors or personnel performing similar functions establish and maintain internal control on an ongoing basis.

ii) EXTERNAL COMMUNICATION WITH EXTERNAL THIRD PARTIES: using information from communications from external parties that may indicate problems or highlight areas in need of improvement

iii) ONGOING ACTIVITIES:

Internal Check System

arrangement of Staff duties in such a way that no one person can carry through a transaction and record every aspect thereof

Objectives of internal check system → Why?

- A) **To** detect error and frauds with ease.
- B) **To** avoid and minimize the possibility of commission of errors and fraud by any staff.
- C) **To** increase the efficiency of the staff working within the organization
- D) **To** locate the responsibility area or the stages where actual fraud and error occurs
- E) **To** protect the integrity of the business by ensuring that accounts are always subject to proper scrutiny and check.
- F) **To** prevent and avoid the misappropriation or embezzlement of cash and falsification of accounts

effectiveness of an efficient system of internal check depends on

RADS

- A) Clarity of Roles and Responsibilities
- B) Appraisal
- C) Division of duties
- D) Standardization

General conditions pertaining to internal check system

- A) no single person should have complete control
- B) Staff duties should be rotated from time to time
- C) staff should be encouraged to go on leave at least once a year
- D) Mechanical devices should be used, to prevent misappropriation of cash.
- E) The financial and administrative powers should be distributed.
- F) Budgetary control should be exercised.
- G) Procedures should be laid down for periodical verification

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SOP- Standard operating Procedures

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A well-defined set of SOPs helps define role, responsibilities, process & controls

SOP should address the following matters
Desi- Job

- D → Delegation of financial powers document** → A clearly defined document on delegation of powers allows controls to be clearly operated without being dependent on individuals
- E → Enterprise Risk Management** → robust process to identify & mitigate risks across the enterprise & its periodical review
- S → Segregation of Job Responsibilities** → multiple activities in a transaction/decision should not be concentrated with one individual.
- I → Information technology-based controls** → The failure rate for IT embedded controls is likely to be low, is likely to have better audit trail & is thus easier to monitor.
- Job → Job rotation in sensitive areas** → in key commercial functions, the job rotation is regularly followed to avoid degeneration (failure) of controls

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Evaluation of Internal Control

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Review of Internal Control System and Procedures

The review of the internal control system enables the auditor –

- A)** to formulate his opinion as to the reliance he may place on the system itself
- B)** to locate the areas of weakness in the system so that the audit programme and the nature, timing and extent of substantive and compliance audit procedures can be adjusted

Techniques of evaluation of Internal control

N-Narrative Record (NR)

- A)** Description of the understanding of Internal Control
- B)** Suitable for small entities with unstructured internal control system
- C)** Disadvantage- Difficult to understand system by reading NR, difficult to include changes in NR

C- Checklist

- A)** series of instructions which audit team should follow while evaluating a system
- B)** After following the instruction, ticks/initials are put by the audit team member

Q- Questionnaire- Internal Control Questionnaire

- A)** series of questions concerning Internal control
- B)** most widely used technique
- C)** Questions are framed for each stage of the system
- D)** Answer is either 'YES' 'NO' or 'Not Applicable'
- E)** It also discloses defects with 'No' answers
- F)** It is issued to the client who should get it filled up by their employees which is audited by the auditor.

FlowChart

- A)** a graphic presentation of each part of the company's system of internal control
- B)** most concise way of recording
- C)** minimises the amount of narrative explanation
- D)** bird's eye view of the system and the flow of transactions and integration
- E)** necessary for the auditor to study the significant features of the business carried on by the concern.

Following basic assumptions about elements of good control are taken into account while using standard ICQ:

- A)** Certain procedures in general used by most business concerns are essential in achieving reliable internal control. E.g. reconciliations.
- B)** Organisations are such that permit an extensive division of duties and responsibilities.
- C)** No single person is thrust with the responsibility of completing a transaction all by himself.
- D)** There is proper documentation and recording of the transactions.
- E)** work performed by each one is expected to come under review of another in the usual course of routine.

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SA 265

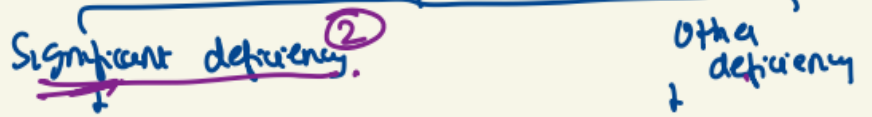
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During the course of audit

① Deficiency has been identified in internal control

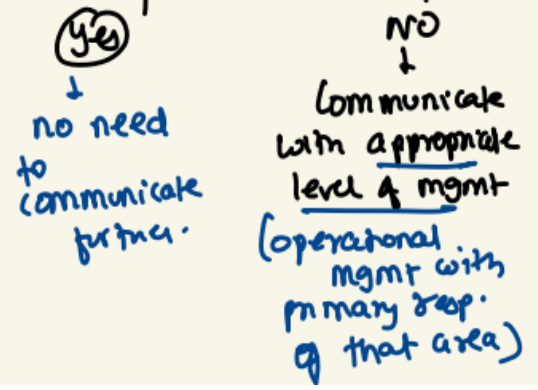
Is it a significant deficiency?



③ Communicate with TCWG & appropriate level of mgmt (e.g. CEO/CFO)

* unless mgmt itself is involved

Is it communicated by other persons? (e.g. internal auditor)



① Deficiency?

A necessary control is missing

A necessary control exists but it is unable to prevent or detect & correct misstatements on a timely basis

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② Significant deficiency?

which requires the attention of TCWG

Examples of matters to be considered in determining which deficiencies are considered significant deficiencies factors to be

- ① Ineffective control environment
- ② Misstatements

Like volume & amount of SUs & control it

T.B

- ③ Identified by auditor prior period mis

7.8

'Letter of weaknesses' | 'Mgmt Letter'

③

Contents of Communication (Significant deficiencies)

To

TCWG & [CEO/CFO unless they are involved]

- ① Description of deficiencies
- ② Potential effect of deficiencies
- ③ Why it is significant?

④ Clarifications

- ① Purpose → Express an opinion on FS
- ② Purpose ≠ Express an opinion on internal controls
- ③ Internal controls relevant to preparation of FS are considered
- ④ Limited to deficiencies identified during the course of audit of FS

⑤ May → Recommendations for improvement

Timing of Communication

Listed entities

↓
On or before the date of approval of FS

Unlisted entities

↓
On or before the date of assembly of audit file (60 days from the date of auditors report)

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SA 330

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Auditor's Responses to the Risks Assessed in SA 315, include the following:

Substantive Procedure:
Procedure designed to detect material misstatements at the assertion level

Test of details of
TBD

SAP → Substantive
Analytical Procedures

Test of Controls (Compliance Procedure):

Procedure designed to evaluate the OE (operating effectiveness) of controls in preventing or detecting and correcting material misstatements at the assertion level.

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Responses at two levels:

Responses at Overall FS Level

- Emphasizing to the audit team the need to maintain professional skepticism.
- Assign more experienced staff.
- Provide more supervision.
- Incorporating elements of unpredictability.
- Making general changes to the NTE of Further Audit procedures.

Responses at assertion level

- Determine the approach to be used
 - (i) Only TOC
 - (ii) Only TOD
 - (iii) Combined approach.
- Nature of procedure → purpose and type
- Timing of procedure → when?
- Extent of procedure → quantity (sample size)
- NTE of these procedures should be responsive to the assessed RoMM

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**Chapter 4 SAs by CA Pragnesh Kanabar
Internal Control Frameworks**

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A) Internal Control - Integrated Framework issued by Committee of the Sponsoring Organisations of the Treadway Commission (COSO Framework)

- more than 17 basic principles representing the fundamental concepts associated with its five component
- Five components as discussed earlier
- three categories of objectives- PRC- operations, reporting and compliance.

B) Guidance on Assessing Control published by the Canadian Institute of Chartered Accountants (CoCo)

- framework includes 20 criteria for effective control in four areas of an organization: purpose (direction), commitment (identity and values), capability (competence), and monitoring and learning (evolution)

C) Control Objectives for Information and Related Technology (COBIT)

- It is a framework created by the ISACA (Information Systems Audit and Control Association) for IT governance and management
- 34 high-level processes that cover 210 control objectives categorized in four domains: planning and organization, acquisition and implementation, delivery and support, and monitoring and evaluation

D) Internal Control: Guidance for Directors on the Combined Code, published by the Institute of Chartered Accountants in England & Wales (known as the Turnbull Report)

- board should maintain a sound system of internal control to safeguard shareholders' investment and the company's assets.
- directors should, at least annually, conduct a review of the effectiveness of the group's system of internal control and should report to shareholders that they have done so
- Companies which do not have an internal audit function should from time to time review the need for one.

E) Sarbanes-Oxley Section 404 United States of America

- mandates that all publicly-traded companies must establish internal controls and procedures for financial reporting and must document, test and maintain those controls and procedures to ensure their effectiveness
- to reduce the possibilities of corporate fraud by increasing the stringency of procedures and requirements for financial reporting
- The SEC rules and PCAOB standard require that:
 - Management perform a formal assessment of its controls over financial reporting including tests that confirm the design and operating effectiveness of the controls.
 - Management include in its annual report an assessment of ICFR
 - The external auditors provide two opinions as part of a single integrated audit of the company:-
 - - An independent opinion on the effectiveness of the system of ICFR.
 - The traditional opinion on the financial statements.