CHAPTER 3 – RISK ASSESSMENT & INTERNAL CONTROL

1. AUDIT RISK

Meaning	Risk that the auditor gives an inappropriate audit opinion when the financial statements are materially misstated.
Consideration	Audit Risk need to be considered at Overall Level as well as at the level of Individual account balance or classes of transactions

Components

	Meaning	Factors to be considered
Inherent	Susceptibility of an account balance or class of transaction to a material misstatement, assuming that there are no internal controls.	• Experience on prior audits. • Controls established by Mngt. • Significant changes from last assessment.

	Meaning	Steps in Assessment of Control Risk
Control	Risk that material misstatements will not be prevented or detected and corrected on a timely basis by the internal control system.	1. Preliminary assessment of control risk. 2. Documentation of understanding & assessment of control risk. 3. Performing Tests of Controls 4. Final Assessment of Control Risk.

Detection	• Risk that the substantive procedures performed by auditor fails to detect material misstatements. • Some detection risk would always be present even if an auditor was to examine 100% of the account balance or class of transactions.

Relationships

IR & CR	• IR and CR are highly interrelated as in many cases management reacts to IR by designing accounting and internal control systems to prevent or detect and correct misstatements. • As a result, auditor needs to make a combined assessment of IR & CR as RMM.
RMM & R	• Inverse relationship between RMM and DR. • When RMM is high, DR needs to be low to reduce audit risk to an acceptable low level. • When RMM is low, auditor can accept a higher DR. • Mathematically AR = IR X CR X DR

Risk Based Audit

Meaning	Stages
An audit Approach that 1. Analyses Audit Risks, 2. Set materiality thresholds based on audit risk analysis and 3. develop audit programmes that allocates a larger portion of resources to high risk areas.	1. Understanding the auditee operations. 2. Determination of residual Risk 3. Manage residual Risk. 4. Reporting to Auditee.

2. INTERNAL CONTROL

Definition	The process designed, implemented and maintained, by TCWG and Management, to provide reasonable assurance about the achievement of an entity's objectives with regard to reliability of financial reporting, effectiveness and efficiency of operations, safeguarding of assets, and compliance with applicable laws and regulations.
Control Objectives of Accounting Control System	1. Whether all transactions are recorded; 2. Whether recorded transactions are real; 3. Whether all recorded transactions are properly valued; 4. Whether all transactions are recorded timely; properly posted; 5. Whether all transactions are properly classified summarized & disclosed.

Methods of Collecting info to review I.C.

Narrative Records	Complete and exhaustive description of system as found in the operation by the auditor
Check List	Series of instructions and/or questions which a member of auditing staff must follow.
IC Questionnaire	Set of Questions designed to provide a thorough view of state of I.C.

Flow Chart

- Graphic presentation of I.C. of various sections in form of a diagram full with lines & Symbols.
- Provide most concise and comprehensive way to review I.C.
- Provide a neat visual picture of various activities involving flow of documents through various stages, authorizations required, filing of documents, final disposal .

Surprise check in Internal Control

- Useful method to determine whether errors exist and where they exist
- ICAI Recommendation – Surprise checks should form part of normal audit.
- Surprise check should be made at least once in the course of an audit.

Letter of weakness

- Weaknesses in I.C. identified during the audit should be communicated to mngt & TCWG.
- Helps TCWG to improve the systems.
- Must indicate that evaluation of I.C. is done to determine NTE of further audit procedures.

3. INTERNAL CHECK

Meaning	Checks on day to day transactions, which operate continuously as a part of routine system, whereby work of one person is proved independently to work of another, the object being prevention and earlier detection of error or fraud.
Objectives	• To detect fraud and error with ease. • Avoid & minimize possibility of occurrence of fraud & error. • Increase efficiency of staff. • Protect integrity of business. • Prevent misappropriation of cash & falsification of accounts.
Consider-ations	• No single person should have an Independent Control. • Duties of staff members should be changed from time to time. • Every member should be encouraged to go on leave atleast once. • Persons having physical custody of assets must not be allowed access to books of accounts. • Implement Budgetary control procedures. • Judicious distribution of financial and administrative powers. • Procedures should be laid down for physical verification. • Accounting procedures should be reviewed periodically.

Frameworks of Internal Control

COSO Framework	CoCo	COBIT	SOX – Sec. 404
COSO Framework is designed to be used by organizations to assess the effectiveness of the system of internal control to achieve objectives as determined by management. The Framework lists 3 categories of objectives as below: (a) **Operations Objectives:** Operation objectives are related to the effectiveness and efficiency of the entity's operations, including operational and financial performance goals, and safeguarding of assets. (b) **Reporting Objectives:** Reporting objectives are related to internal and external financial and non-financial reporting to stakeholders, which would encompass reliability, timeliness, transparency, or other terms as established by regulators, standard setters, or the entity's policies. (c) **Compliance objectives:** Compliance objective are related to the entity's compliance with applicable laws and regulations.	The CoCo (c) framework was first published by the **Canadian Institute of Chartered Accountants** in 1995. This model builds on COSO and is thought by some to be more concrete and user-friendly. CoCo describes internal control as actions that foster the best result for an organization. These actions, which contribute to the achievement of the organization's objectives, focus on: • effectiveness and efficiency of operations; • reliability of internal and external reporting; • compliance with applicable laws and regulations and internal policies. CoCo indicates that control comprises: "Those elements of an organization (including its resources, systems, processes, culture, structure, and tasks) that, taken together, support people in the achievement of the organization's objectives." The CoCo framework outlines criteria for effective control in the following four areas: • Purpose • Commitment • Capability • Monitoring and Learning In order to assess whether controls exist and are operating effectively, each criterion would be examined to identify the controls that are in place to address them.	• COBIT stands for **Control Objectives for Information and Related Technology.** It is a framework created by the ISACA (**Information Systems Audit and Control Association**) for IT governance and management. It is meant to be a supportive tool for managers and allows bridging the crucial gap between technical issues, business risks and control requirements. • Business managers are equipped with a model to deliver value to the organization and practice better risk management practices associated with the IT processes. • It is a control model that guarantees the integrity of the information system. Today, COBIT is used globally by all managers who are responsible for the IT business processes. It is a thoroughly recognized guideline that can be applied to any organization across industries. • Overall, COBIT ensures quality, control and reliability of information systems in organization, which is also the most important aspect of every modern business.	SOX Section 404 (Sarbanes-Oxley Act - Section 404) 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. The purpose of SOX is 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 Internal Controls over Financial Reporting. • The external auditors provide two opinions as part of a single integrated audit of the company: 1. An independent opinion on the effectiveness of the system of Internal Controls over Financial Reporting. 2. The traditional opinion on the financial statements.