Institute of Chartered Accountants of India

Standards on Auditing

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SA 315 - Identifying and Assessing the Risk of Material Misstatement Through Understanding the Entity and its Environment

Scope - deals with the auditor's responsibility to identify and assess the risks of material misstatement in the financial statements, through understanding the entity and its environment, including the entity's internal control.

Effective Date - for periods beginning on or after April 1, 2008.

Objective - identify and assess the risks of material misstatement

- whether due to fraud or error
- at the financial statement and assertion levels
- through understanding the entity and its environment, including the entity's internal control
- providing a basis for designing and implementing responses to the assessed risks of material misstatement

Key Definitions

- **Assertions** – Representations by management, explicit or otherwise, that are embodied in the financial statements, as used by the auditor to consider the different types of potential misstatements that may occur.

- **Risk assessment procedures** – The audit procedures performed to obtain an understanding of the entity and its environment, including the entity's internal control, to identify and assess the risks of material misstatement, whether due to fraud or error, at the financial statement and assertion levels.

- **Significant risk** – An identified and assessed risk of material misstatement that, in the auditor's judgment, requires special audit consideration.

Requirements

The Entity and Its Environment

The auditor shall obtain an understanding of the following:

- Relevant industry, regulatory, and other external factors including the applicable financial reporting framework.

- The nature of the entity, including
  - ✓ its operations;
  - ✓ its ownership and governance structures;
  - ✓ the types of investments that the entity is making and plans to make, <u>including investments in special-purpose entities</u>
  - ✓ the way that the entity is structured and how it is financed

- The entity's selection and application of accounting policies, including the reasons for changes thereto.

- The measurement and review of the entity's financial performance

Requirements (contd…)

Entity's Internal Control system

Nature and Extent of the Understanding of Relevant Controls

- Evaluating the design effectiveness and operating effectiveness of controls.
- Inquiring of entity personnel.
- Observing the application of specific controls.
- Inspecting documents and reports.
- Tracing transactions through the information system relevant to financial reporting.

Components of Internal Control

- Control Environment
- Risk Assessment
- Control Activities
- Information and communication
- Monitoring activities

Components of Internal Control

Control environment

- organization's integrity and ethical values
- independent board of directors
- appropriate authorities and responsibilities to pursuit of objectives
- accountability

Risk assessment process

- Identifying business risks relevant to financial reporting objectives;
- Estimating the significance of the risks;
- Assessing the likelihood of their occurrence; and
- Deciding about actions to address those risks.

Control Activities

- Authorization
- Performance reviews
- Information processing
- Physical controls
- Segregation of duties
- Entity's response on risk arising from Information Technology

Components of Internal Control (contd…)

Information system and communication

- The financial reporting process used to prepare the entity’s financial statements
- Automated vs manual procedures?
- How the information system captures events and conditions
- Controls surrounding journal entries,
- Communications between management and those charged with governance
- External communications

Monitoring of controls

- an understanding of the major activities that the entity uses to monitor internal control over financial reporting
- Best example - Internal Audit

Risks that Require Special Audit Consideration

To identify risks which are significant risks, the auditor shall consider at least the following:

- Whether the risk is a risk of fraud;
- Whether the risk is related to recent significant event or development
- The complexity of transactions
- Related party transactions
- Estimates and judgement used by the management
- significant transactions that are outside the normal course of business

Various procedures

Risk Assessment Procedures and Related Activities

Risk assessment procedures include:

- Inquiries of management
- Analytical procedures
- Observation and inspection
- Changes since the previous audit and their affect on the current year audit.
- Susceptibility of the entity’s financial statements to material misstatement
- Application of the applicable financial reporting framework to the entity’s facts and circumstances.

Documentation

- Significant decisions reached by audit team
- Key elements of the understanding obtained regarding each of the aspects of the entity and its environment
- The identified and assessed risks of material misstatement at the financial statement level and at the assertion level
- The risks identified, and related controls about which the auditor has obtained an understanding

SA 500 – Audit Evidence

Scope –

- What constitutes an audit evidence
- Audit procedures to obtain sufficient appropriate audit evidence
- Draw reasonable conclusions on which to base the auditor's opinion.

Effective Date - for periods beginning on or after April 1, 2009

Objective –

- to design and perform audit procedures
- to obtain sufficient appropriate audit evidence
- to draw reasonable conclusions on which to base the auditor's opinion.

Key Definitions

- **Audit evidence** – Information used by the auditor in arriving at the conclusions on which the auditor's opinion is based. Audit evidence includes both information contained in the accounting records underlying the financial statements and other information

- **Sufficiency (of audit evidence)** – The measure of the **quantity** of audit evidence. The quantity of the audit evidence needed is affected by the auditor's assessment of the risks of material misstatement and also by the quality of such audit evidence.

- **Appropriateness (of audit evidence)** – The measure of the **quality** of audit evidence; that is, its relevance and its reliability in providing support for the conclusions on which the auditor's opinion is based.

Sufficient appropriate audit evidence

- Should reduce the audit risk to acceptably low level
- Should support audit opinion and report
- Should be in adequate quantity and quality
- Should be Relevant and reliable

Information used as audit evidence

Relevance and Reliability

Relevance –

- Logical connection to the purpose of testing
- May not address all the relevant assertions

Example: Fair value of an unlisted investment

Reliability –

- Source of the evidence
- Nature of the evidence
- Circumstances under which it is obtained and prepared
- Information provided by entity need to be tested for accuracy and completeness

Information used as audit evidence

Sources of audit evidence

Inhouse

- Accounting records

- Others like board minutes, management representation

External

- External confirmations

- Use of Management expert

  - Objectivity, Independence and competence of Management expert impacts the reliability of information

Sufficient appropriate audit evidence

Procedures to obtain audit evidences

Risk assessment procedures (Planning)

Tests of controls

Substantive procedures

- Substantive analytical procedures
- Tests of details

Sufficient appropriate audit evidence

Various techniques for procedures

- Inquiry
- Inspection
- Observation
- Confirmation
- Recalculation
- Re performance
- Analytical Procedures
- Combination of any of the above

Audit sampling

Audit Sampling

When designing an audit sample, the auditor shall consider the purpose of the audit procedure and the characteristics of the population from which the sample will be drawn.

The means available to the auditor for selecting items for testing are:

- Selecting all items (100% examination);

- Selecting specific items; and

- Audit sampling.

SA 520 – Analytical Procedures

Scope – This standard deals with the auditor's use of analytical procedures as substantive procedures ("substantive analytical procedures"), and as procedures near the end of the audit that assist the auditor when forming an overall conclusion on the financial statements.

Effective Date - For periods beginning on or after April 1, 2010

Objective –

- To obtain relevant and reliable audit evidence when using substantive analytical procedures; and
- To design and perform analytical procedures near the end of the audit that assist the auditor when forming an overall conclusion as to whether the financial statements are consistent with the auditor's understanding of the entity.

Key Definition

"Analytical Procedures" means **evaluations of financial information** through **analysis** of **plausible relationships** among both financial and non-financial data. Analytical procedures also encompass such **investigation** as is necessary of **identified fluctuations** or **relationships** that are **inconsistent** with other relevant information or that **differ from expected values by a significant amount**. The auditor's choice of procedures, methods and level of application is a matter of **professional judgment**.

Different stages

Analytical procedures may be applied at:

-Planning stage

-Substantive stage

-Completion stage

Techniques

Analytical procedures may include any or all the following:

-Variance analysis

- Trend analysis

-Ratio analysis

-Financial vs. non financial parameters

-Complex statistical calculations

Substantive Analytical Procedures

When designing and performing substantive analytical procedures the auditor shall follow the four step approach:

1. Suitability for relevant assertions

2. Evaluate the reliability of data

3. Develop an expectation

4. Probe differences by comparing with actuals

Investigating Results of Analytical Procedures

If analytical procedures performed identify fluctuations or relationships that are inconsistent with other relevant information or that differ from expected values by a significant amount, the auditor shall investigate such differences by:

- Inquiring of management and obtaining appropriate audit evidence relevant to management's responses; and
- Performing other audit procedures as necessary.

Thank you