



Audit Quality Assurance Workshop Mt. Kenya Branch

Theme: Embracing International Auditing Standards in Carrying Out
Audit Engagements

Conducting Risk Assessment and Auditing the Internal
Control System.

Thursday 23rd March 2017

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1. SCOPE

(ISA) 315 - Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment

This International Standard on Auditing (ISA) 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.

2. Objective

- 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 and assertion levels, **through understanding the entity and its environment**, including the entity's **internal control**, thereby **providing a basis for designing and implementing responses to the assessed risks** of material misstatement

3. Definitions

For purposes of the ISAs, the following terms have the meanings attributed below:

- i. **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.
- ii. **Business risk:** – A risk resulting from significant conditions, events, circumstances, actions or inactions that could adversely affect an entity's ability to achieve its objectives and execute its strategies, or from the setting of inappropriate objectives and strategies.

3. Definitions Cont...

- iii. **Internal control:** – The process designed, implemented and maintained by those charged with governance, management and other personnel to provide reasonable assurance about the achievement of an entity's objectives with regard to reliability of financial reporting, effectiveness and efficiency of operations, and compliance with applicable laws and regulations. The term “controls” refers to any aspects of one or more of the components of internal control.
- iv. **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.
- v. **Significant risk:** – An identified and assessed risk of material misstatement that, in the auditor's judgment, requires special audit consideration.

4. Risk Assessment Procedures and Related Activities

The auditor shall perform risk assessment procedures to provide a basis for the identification and assessment of risks of material misstatement at the financial statement and assertion levels.

Note: - Risk assessment procedures by themselves, however, do not provide sufficient appropriate audit evidence on which to base the audit opinion.

4. Risk Assessment Procedures and Related Activities. Cont...

The risk assessment procedures shall include the following:

- (a) **Inquiries of management**, of appropriate individuals within the **internal audit function** (if the function exists), **and of others** within the entity who in the auditor's judgment may have information that is likely to assist in identifying risks of material misstatement due to fraud or error.
- (b) Analytical procedures.
- c) Observation and inspection.

4. Risk Assessment Procedures and Related Activities. Cont...

- The auditor shall consider whether information obtained from the **auditor's client acceptance or continuance process** is relevant to identifying risks of material misstatement.
- If the engagement partner has performed other engagements for the entity, the engagement partner shall consider whether information obtained is relevant to identifying risks of material misstatement.
- Where the auditor intends to use information obtained from the **auditor's previous experience with the entity** and from **audit procedures performed in previous audits**, the auditor shall determine whether changes have occurred since the previous audit that may affect its relevance to the current audit.
- The engagement partner and other key engagement team members shall discuss the susceptibility of the entity's financial statements to material misstatement, and the application of the applicable financial reporting framework to the entity's facts and circumstances. The engagement partner shall determine which matters are to be communicated to engagement team members not involved in the discussion.

5. The Required Understanding of the Entity and Its Environment, Including the Entity's Internal Control.

Understanding the Entity and Its Environment.Cont..

The auditor shall obtain an understanding of the following:

- a) Relevant **industry, regulatory, and other external factors** including the applicable financial reporting framework.
- b) The nature of the entity, including:
 - i. its operations;
 - ii. its ownership and governance structures;
 - iii. the types of investments that the entity is making and plans to make, including investments in special-purpose entities; and
 - iv. the way that the entity is structured and how it is financed,

to enable the auditor to understand the classes of transactions, account balances, and disclosures to be expected in the financial statements.

5. The Required Understanding of the Entity and Its Environment, Including the Entity's Internal Control. Cont...

Understanding the Entity and Its Environment.Cont..

- c) The entity's **selection and application of accounting policies**, including the reasons for changes thereto. The auditor shall evaluate whether the entity's accounting policies are appropriate for its business and consistent with the applicable financial reporting framework and accounting policies used in the relevant industry.
- d) The entity's **objectives and strategies, and those related business risks** that may result in risks of material misstatement.
- e) The **measurement and review** of the entity's financial performance.

5. The Required Understanding of the Entity and Its Environment, Including the Entity's Internal Control. Cont...

Understanding The Entity's Internal Control:

The auditor shall obtain an understanding of internal control relevant to the audit. Although most controls relevant to the audit are likely to relate to financial reporting, not all controls that relate to financial reporting are relevant to the audit. It is a matter of the auditor's professional judgment whether a control, individually or in combination with others, is relevant to the audit.

5. The Required Understanding of the Entity and Its Environment, Including the Entity's Internal Control. Cont...

Nature and Extent of the Understanding of Relevant Controls.

- When obtaining an understanding of controls that are relevant to the audit, the auditor shall evaluate the design of those controls and determine whether they have been implemented, by performing procedures in addition to inquiry of the entity's personnel.

6. Components of Internal Control

1. Control environment.

The auditor shall obtain an understanding of the control environment. As part of obtaining this understanding, the auditor shall evaluate whether:

- (a) Management, with the oversight of those charged with governance, has created and maintained a culture of honesty and ethical behavior; and
- (a) The strengths in the control environment elements collectively provide an appropriate foundation for the other components of internal control, and whether those other components are not undermined by deficiencies in the control environment.

6. Components of Internal Control.

Cont...

2. The entity's risk assessment process

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.

If the entity has not established such a process or has an ad hoc process, the auditor shall discuss with management whether business risks relevant to financial reporting objectives have been identified and how they have been addressed.

6. Components of Internal Control.

Cont...

3. The information system

The auditor shall obtain an understanding of the information system, including the related business processes, relevant to financial reporting, including the following areas:

- (a) The **classes of transactions** in the entity's operations that are **significant** to the financial statements;
- (b) The **procedures, within both information technology (IT) and manual systems**, by which those transactions are initiated, recorded, processed, corrected as necessary, transferred to the general ledger and reported in the financial statements;
- (c) The related **accounting records, supporting information** and specific accounts in the financial statements that are used to initiate, record, process and report transactions; this includes the correction of incorrect information and how information is transferred to the general ledger. The records may be in either manual or electronic form;
- (d) How the **information system captures events and conditions**, other than transactions, that are significant to the financial statements;
- (e) The **financial reporting process used to prepare the entity's financial statements**, including significant accounting estimates and disclosures; and
- (f) **Controls surrounding journal entries**, including non-standard journal entries used to record non-recurring, unusual transactions or adjustments.

6. Components of Internal Control.

Cont...

4. Communication:

- The auditor shall obtain an understanding of how the entity communicates financial reporting roles and responsibilities and significant matters relating to financial reporting, including:
 - a) Communications between management and those charged with governance; and
 - b) External communications, such as those with regulatory authorities

6. Components of Internal Control.

Cont...

5. Control activities relevant to the audit

The auditor shall obtain an understanding of control activities relevant to the audit, being those the auditor judges it necessary to understand in order to assess the risks of material misstatement at the assertion level and design further audit procedures responsive to assessed risks.

Examples:

- (i) Stock count procedures and valuation
- (ii) Assets acquisitions & disposal approval process
- (iii) Credit control activities
- (iv) Supplier reconciliations and payment process
- (v) Bank reconciliations and review
- (vi) Stocks receipts & Issuance controls
- (vii) Performance reviews

6. Components of Internal Control.

Cont...

6. Monitoring of controls

The auditor shall obtain an **understanding of the major activities that the entity uses to monitor internal control** relevant to financial reporting, including those related to those control activities relevant to the audit, and how the entity initiates remedial actions to deficiencies in its controls.

If the entity has an internal audit function, the auditor shall obtain **an understanding of the nature of the internal audit function's responsibilities**, its organizational status, and the activities performed, or to be performed.

The auditor shall obtain an understanding of the **sources of the information used in the entity's monitoring activities**, and the basis upon which management considers the information to be sufficiently reliable for the purpose.

7. Identifying Risks of Material Misstatement

The auditor shall identify and assess the risks of material misstatement at:

- (a) the financial statement level; and
- (a) the assertion level for classes of transactions, account balances, and disclosures, to provide a basis for designing and performing further audit procedures.

7. Identifying the Risks of Material Misstatement Cont..

For this purpose, the auditor shall:

- (a) Identify risks throughout the process of obtaining an understanding of the entity and its environment, including relevant controls that relate to the risks, and by considering the classes of transactions, account balances, and disclosures in the financial statements;
- (a) Assess the identified risks, and evaluate whether they relate more pervasively to the financial statements as a whole and potentially affect many assertions;
- (a) Relate the identified risks to what can go wrong at the assertion level, taking account of relevant controls that the auditor intends to test; and
- (b) Consider the likelihood of misstatement, including the possibility of multiple misstatements, and whether the potential misstatement is of a magnitude that could result in a material misstatement.

8. Assessing the Risks of Material Misstatement.

As part of the risk assessment, the auditor shall determine whether any of the risks identified are, in the auditor's judgment, a significant risk.

In exercising judgment as to which risks are significant risks, the auditor shall consider at least the following:

- (a) Whether the risk is a risk of fraud;
- (b) Whether the risk is related to recent significant economic, accounting or other developments and, therefore, requires specific attention;
- (c) The complexity of transactions;
- (d) Whether the risk involves significant transactions with related parties;
- (e) The degree of subjectivity in the measurement of financial information related to the risk, especially those measurements involving a wide range of measurement uncertainty; and
- (f) Whether the risk involves significant transactions that are outside the normal course of business for the entity, or that otherwise appear to be unusual.

If the auditor has determined that a significant risk exists, the auditor shall obtain an understanding of the entity's controls, including control activities, relevant to that risk

9.Revision of Risk Assessment

The auditor's assessment of the risks of material misstatement at the assertion level may change during the course of the audit as additional audit evidence is obtained.

In circumstances where the auditor obtains audit evidence from performing further audit procedures, or if new information is obtained, either of which is inconsistent with the audit evidence on which the auditor originally based the assessment, the auditor shall revise the assessment and modify the further planned audit procedures accordingly.

10. Documentation- Risks identified

The auditor shall include in the audit documentation:

- (a) The discussion among the engagement team where required and the significant decisions reached;
- (b) Key elements of the understanding obtained regarding each of the aspects of the entity and its environment and each of the internal control components specified;
- (c) the sources of information from which the understanding was obtained; and the risk assessment procedures performed;
- (d) The identified and assessed risks of material misstatement at the financial statement level and at the assertion level as required
- (e) The risks identified, and related controls about which the auditor has obtained an understanding, as a result of the requirements.

11. ISA 330: THE AUDITOR'S RESPONSES TO ASSESSED RISKS

Scope:

This International Standard on Auditing (ISA) deals with the auditor's responsibility to design and implement responses to the risks of material misstatement identified and assessed by the auditor in accordance with ISA 315 (Revised)¹ in an audit of financial statements.

The objective of the auditor is to obtain sufficient appropriate audit evidence regarding the assessed risks of material misstatement, through designing and implementing appropriate responses to those risks.

12. Audit Procedures in response to risks at the Assertion Level

The auditor shall design and perform further audit procedures whose nature, timing and extent are based on and are responsive to the assessed risks of material misstatement at the assertion level.

In designing the further audit procedures to be performed, the auditor shall consider the reasons for the assessment given to the risk of material misstatement at the assertion level for each class of transactions, account balance, and disclosure, including:

- a) The **likelihood of material misstatement** due to the particular characteristics of the relevant class of transactions, account balance, or disclosure (that is, the inherent risk); and
- b) Whether the **risk assessment takes account of relevant controls** (that is, the control risk), thereby requiring the auditor to obtain audit evidence to determine whether the controls are operating effectively (that is, the auditor intends to rely on the operating effectiveness of controls in determining the nature, timing and extent of substantive procedures); and
- c) Obtain more persuasive audit evidence the higher the auditor's assessment of risk.

12. Audit Procedures in response to risks at the Assertion Level. Cont...

1. Tests of Controls.

The auditor shall design and perform tests of controls to obtain sufficient appropriate audit evidence as to the operating effectiveness of relevant controls if:

- (a) The auditor's assessment of risks of material misstatement at the assertion level includes an expectation that the controls are operating effectively (that is, the auditor intends to rely on the operating effectiveness of controls in determining the nature, timing and extent of substantive procedures); or
- (b) Substantive procedures alone cannot provide sufficient appropriate audit evidence at the assertion level.

12. Audit Procedures in response to risks at the Assertion Level. Cont...

2. Nature and Extent of Tests of Controls.

In designing and performing tests of controls, the auditor shall:

- (a) Perform other audit procedures in combination with inquiry to obtain audit evidence about the operating effectiveness of the controls, including:
 - i. How the controls were applied at relevant times during the period under audit;
 - ii. The consistency with which they were applied; and
 - iii. By whom or by what means they were applied.
- (b) Determine whether the controls to be tested depend upon other controls (indirect controls), and, if so, whether it is necessary to obtain audit evidence supporting the effective operation of those indirect controls.

12. Audit Procedures in response to risks at the Assertion Level. Cont...

3. Timing of Tests of Controls.

The auditor shall test controls for the particular time, or throughout the period, for which the auditor intends to rely on those controls, in order to provide an appropriate basis for the auditor's intended reliance.

12. Audit Procedures in response to risks at the Assertion Level. Cont...

4. Using audit evidence obtained during an interim period

If the auditor obtains audit evidence about the operating effectiveness of controls during an interim period, the auditor shall:

- (a) Obtain audit evidence about significant changes to those controls subsequent to the interim period; and
- (b) Determine the additional audit evidence to be obtained for the remaining period.

12. Audit Procedures in response to risks at the Assertion Level. Cont...

5. Substantive Procedures

- Irrespective of the assessed risks of material misstatement, the auditor shall design and perform substantive procedures for each material class of transactions, account balance, and disclosure.
- The auditor shall consider whether external confirmation procedures are to be performed as substantive audit procedures.

12. Audit Procedures in response to risks at the Assertion Level. Cont...

5.1 Substantive Procedures Related to the Financial Statement Closing Process.

The auditor's substantive procedures shall include the following audit procedures related to the financial statement closing process:

- (a) Agreeing or reconciling the financial statements with the underlying accounting records; and
- (a) Examining material journal entries and other adjustments made during the course of preparing the financial statements.

12. Audit Procedures in response to risks at the Assertion Level. Cont...

5.3 Substantive Procedures Responsive to Significant Risks.

If the auditor has determined that an assessed risk of material misstatement at the assertion level is a significant risk, the auditor shall perform substantive procedures that are specifically responsive to that risk.

When the approach to a significant risk consists only of substantive procedures, those procedures shall include tests of details.

12. Audit Procedures in response to risks at the Assertion Level. Cont...

5.4 Examples of Substantive Procedures:

- i. Customer confirmations
- ii. Bank confirmations
- iii. Re-performance of reconciliations
- iv. Inventory stock take attendance and sampling
- v. Fixed assets verification
- vi. Recalculation of depreciation
- vii. Review of support documents for expenses
- viii. Confirmations of ownership through review of title documents
- ix. Tests of IT applications that automatically compute amounts recorded

Interactive Session





Presenter's Contacts



CPA Cyprian Oluoch

Cyprian.angawa@bukasconsultancy.com

Cangawa@gmail.com

Mobile No. 0724-665391