A Presentation on-

Sri Lanka Auditing Standards 315

Understanding the Entity and its Environment and Assessing the Risks of Material Misstatement.

Sri Lanka Auditing Standards 315-Understanding the Entity and its Environment and Assessing the Risks of Material Misstatement.

Introduction

Obtain

An understanding the entity and its environment, including internal controls

SLAuS 315- Understanding the Entity and its Environment and assessing the risks of Material Misstatement.

Identify & Assess

Risk of material misstatements of F/S due to Fraud or Error at the F/S & assertions level

SLAuS 200- Objectives & General Principals Governing an Audit of F/S (Audit Risk)

SLAuS 240- The Auditor's Responsibility to Consider Fraud in and Audit of Financial Statements.

Design &Implement

Responses to the assessed risks of material misstatement.

SLAuS 500= Audit Evidence

Sri Lanka Auditing Standards 315-Understanding the Entity and its Environment and Assessing the Risks of Material Misstatement.

SLAuS 315 vs Clarified SLAuS 315

- There have not been any substantial changes to the requirements in SLAuS 315, but text relating to the description of key financial statement assertions has been lifted from SLAuS 500 **Audit Evidence** into the clarified SLAuS 315.
- Clarified SLAuS is expected to be effective from 1/1/2014.
- IFAC has issued a practical guide based on Clarified ISA. The Presentation will be based on this guide, using the existing requirements of SLAuS 315.

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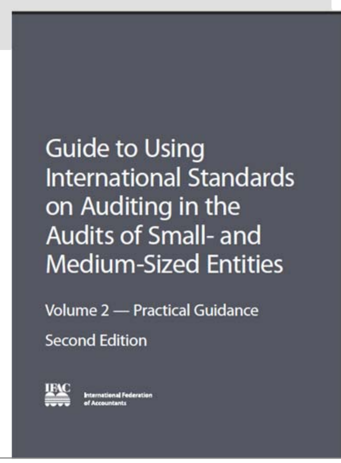
Requirements of SLAuS 315

- *Risk assessment procedures and sources of information about the entity and its environment, including its internal control. –Risk Identification*
- *Understanding the entity and its environment, including its internal control.- Understand the Risks*
- *Assessing the Risks of Material Misstatement.(RMM)- Risk Assessment*
- *Communicating with those charged with governance and management.*
- *Documentation.*



This Implementation Guide was prepared by the Small and Medium Practices Committee of the International Federation of Accountants (IFAC). The committee represents the interests of professional accountants operating in small- and medium-sized practices and other professional accountants who provide services to small- and medium-sized entities.
This publication may be downloaded free of charge from the IFAC website: www.ifac.org.
The approved text is published in the English language.

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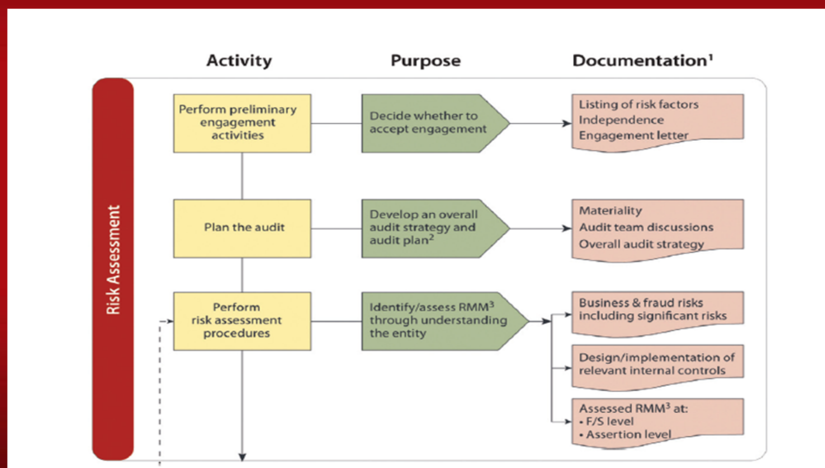
Risk Assessment – Overview.



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Identifying & Assessing the Risk of Material Misstatement.

A simpler way of describing the three elements is illustrated below.

Exhibit 3.0-1

* An "event" is simply a business or fraud risk factor (see descriptions in Volume 1, Chapter 3, Exhibit 3.2-2) that, if it actually occurred, would adversely affect the entity's ability to achieve its objective of preparing financial statements that do not contain material misstatements resulting from error and fraud. This would also include risks resulting from the absence of internal control to mitigate the potential for material misstatements in the financial statements.

Audit Risk= Inherent Risk x Control Risk x Detection Risk

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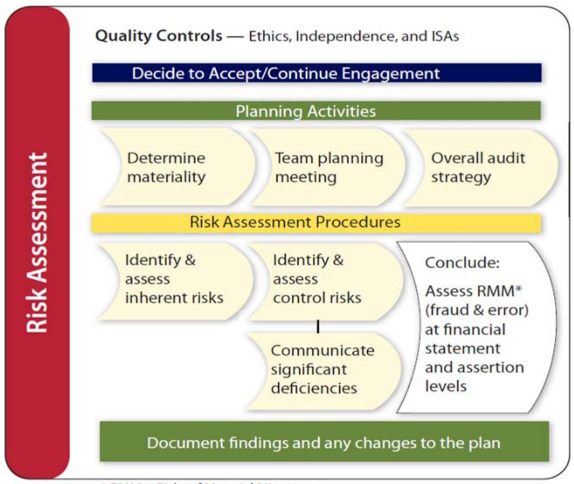
Risk Assessment Phase- Major Steps



* RMM = Risks of Material Misstatement

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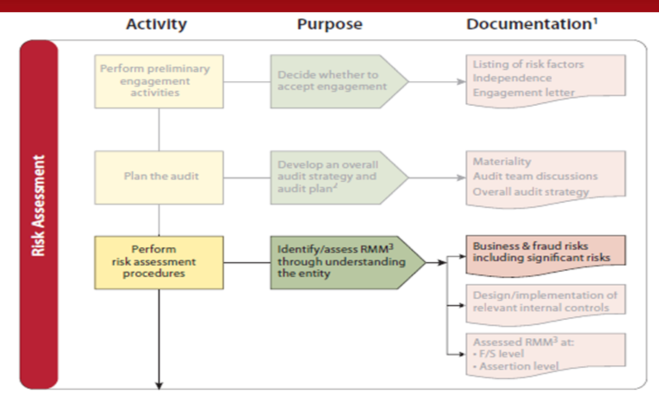
Risk assessment procedures and sources of information



Notes:
1. Refer to ISA 230 for a more complete list of documentation required.
2. Planning (ISA 300) is a continual and iterative process throughout the audit.
3. RMM = Risks of material misstatement.

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Risk Identification

- Identification of risk is the foundation of the audit. Without a solid understanding of the entity, the auditor may miss certain risk factors. e.g increase in client's sales when the industry sales have declined.
- Effective identification & assessment of risk provides the auditor with the information needed to direct audit effort to areas where the risk of material misstatement is the highest, and away from less risky areas.

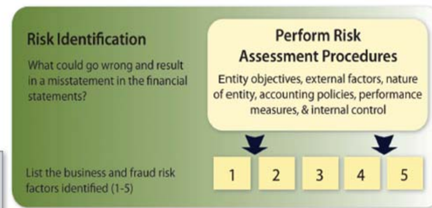
Risk assessment has two distinct parts:

- Risk identification (asking "what can go wrong")
- Risk assessment (determining the significance of each risk).

CONSIDER POINT

First, identify the risks
You cannot assess a risk that has not first been identified. Avoid the temptation to assume that because the entity is small, there are no relevant risks or that the risks of material misstatement will be the same as the previous period. New risks may now exist, and the nature/significance of some previously identified risks may have changed.

After the first engagement, focus on what has changed from previous period
After the first engagement, focus on what has changed within each of the six risk sources (i.e., external nature of entity, etc.) as opposed to starting all over again. This will save time, and focuses attention on the nature and effect of new risks that may now exist and revisions to risks previously identified.



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Risk Identification – Types of Risks

There are two major classifications of risk:

- **Business risk**
- **Fraud risk.**

The difference between business risk and fraud risk is that fraud risk results from a person's deliberate actions. **In many instances, a risk can be both a business and a fraud risk.**

The business and fraud risks (inherent risks) are identified before any consideration of any internal controls that might mitigate such risks.

The introduction of a new accounting system creates uncertainty (errors could be made as personnel learn the new system) and would be classified as a **business risk.** However, it could also be classified as a **fraud risk**, because someone could take advantage of the uncertainty to misappropriate assets or manipulate the financial statements.

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Risk Identification -Types of Risks(contd.)

Business Risk	Fraud Risk
•significant conditions, events, circumstances, actions, or inactions that could adversely affect the entity's ability to achieve its objectives and execute its strategies. •inappropriate objectives and strategies. •events that arise from change, complexity, or the failure to recognize the need for change. ❖ The development of new products that may fail; ❖ An inadequate market, even if new products are successfully developed; or ❖ Flaws in the products that may result in liabilities and damage to the entity's reputation.	Fraud risk relates to events or conditions that indicate an incentive or pressure to commit fraud or provide an opportunity to commit fraud.

The auditor's understanding of business and fraud risk factors increases the likelihood of identifying the risks of material misstatement. However, there is no responsibility for the auditor to identify or assess all of the possible business risks.

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Inherent Risk Identification -Sources of Information

CONSIDER POINT

A major source of information that is often overlooked is the auditor's working paper files from previous periods' engagements. They often contain valuable information on matters such as:

- Considerations or issues to address in planning this period's audit;
- Evaluation and source of possible adjustments and uncorrected errors;
- Areas where there are recurring disagreements, such as the assumptions used for accounting estimates;
- Areas which appear to be susceptible to error; and
- Matters raised in the auditor's communication with management and those charged with governance.

The information gained from risk assessment procedures conducted before engagement acceptance or continuance can be used as part of the audit team's understanding of the entity.

- ***Inquiries***
- ***Analytical Review Procedures***
- ***Observations & Inspections***
- ***Engagement Team Discussions***

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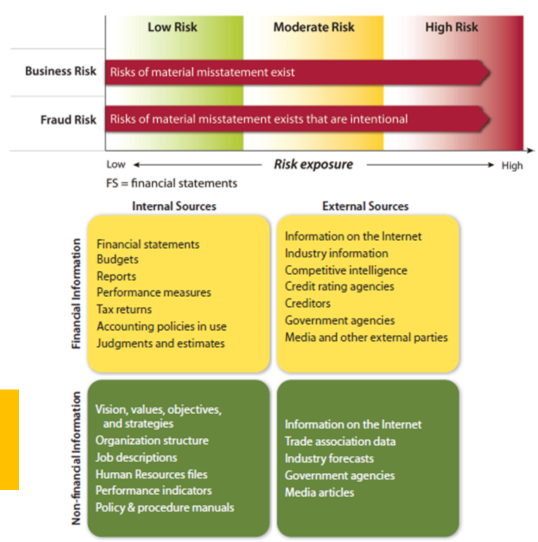

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Understand The Risks- The Key Areas

	Provides a Frame of Reference
Benefits Obtained from Understanding the Entity	**Identifying risks and developing responses** • Making judgments about the risk assessments. • Developing appropriate responses to identified risks of material misstatement in the financial statements. • Establishing materiality (refer to Volume 2, Chapter 6). • Developing expectations needed for performing analytical procedures. • Designing/performing further audit procedures to reduce audit risk to an acceptably low level. • Evaluating sufficiency/appropriateness of audit evidence obtained (e.g., appropriateness of assumptions used and management's oral and written representations). **Financial statement review** • Assessing management's selection and application of accounting policies. • Considering the adequacy of financial statement disclosures. • Identifying audit areas for special consideration (e.g., related party transactions, unusual or complex contractual arrangements, going-concern or unusual transactions).

CONSIDER POINT

Obtaining an understanding of the entity is not a discrete task that can be completed early in the audit and then put to one side. It is important to keep learning about the entity throughout the audit, and to remain alert to risk factors not previously identified or where the original assessment of risk needs updating.

A. External Factors	Nature of industry Regulatory environment Financial reporting framework
B. Nature of Entity	Operations and key personnel Ownership and governance Investment, structure and financing
C. Accounting Policies	Selection and application Reasons for changes Appropriateness to entity
D. Entity Objectives & Strategies	Business plans and strategies Financial implications and risks undertaken
E. Measurement/ Review of Financial Performance	What is measured Who reviews financial results
F. Internal Control Relevant to the Audit	Processes and relevant controls to mitigate risks at the entity level and at the transactional level

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Understand The Risks- The Key Areas Examples

Sources of Business and Fraud Risk	
Business Objectives and Strategies	• Inappropriate, unrealistic, or overly aggressive objectives and strategies. • New products or services, or moving into new lines of business. • Entering into business areas/transactions with which the entity has little experience. • Inconsistencies between IT and business strategies. • Response to rapid growth or decline in sales that can strain internal control systems and people's skills. • Use of complex financing arrangements. • Corporate restructurings. • Significant transactions with related parties.
External Factors	• State of the economy and changes in government regulation. • Declining demand for the entity's products or services. • High degree of complex regulation. • Changes in the industry. • Inability to obtain required resources (materials or skilled personnel). • Deliberate sabotage of an entity's products or services. • Constraints on the availability of capital and credit.

Sources of Business and Fraud Risk	
Nature of Entity	• Poor corporate culture and governance. • Incompetent personnel in key positions. • Changes in key personnel, including departure of key executives. • Complexity in operations, organizational structure, or products. • Product or service flaws that may result in liabilities and reputation risk. • Failure to recognize the need for change (skills required or technology). • Weaknesses in internal control, especially those not addressed by management. • Poor relationships with external funders, such as banks. • Going-concern and liquidity issues, including loss of significant customers. • Installation of new systems related to financial reporting.
Performance Indicators	• Performance measures not used by management to assess the entity's performance and achievement of objectives. • Measures not used to improve operations or take corrective actions.
Accounting Policies	• Inconsistent application of accounting policies. • Inappropriate use of accounting policies.
Internal Control	• Inadequate management oversight of day-to-day operations. • Poor or nonexistent controls over entity-level activities such as human resources, fraud, and preparation of accounting information such as estimates and financial reports. • Poor or nonexistent controls over transactions such as revenues, purchases, expenses, and payroll. • Poor safeguarding of assets.

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Fraud Risk- Characteristics of Fraud.

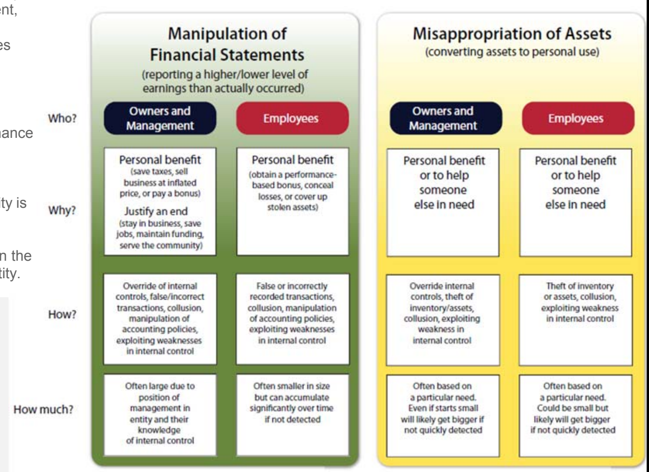
The term "fraud" refers to an intentional act by one or more individuals among management, those charged with governance, employees, or third parties involving the use of deception to obtain an unjust or illegal advantage.

Fraud involving one or more members of management or those charged with governance is referred to as **"management fraud."**

Fraud involving only employees of the entity is referred to as **"employee fraud."**

In either case, there may be collusion within the entity or with third parties outside of the entity.

CONSIDER POINT
For each risk factor identified, consider whether it is a business risk, a fraud risk, or both. Many sources of risk can result in both business and fraud risks. For example, a change in accounting personnel can result in errors being made (business risk), but may also provide an opportunity for someone to commit a fraud.



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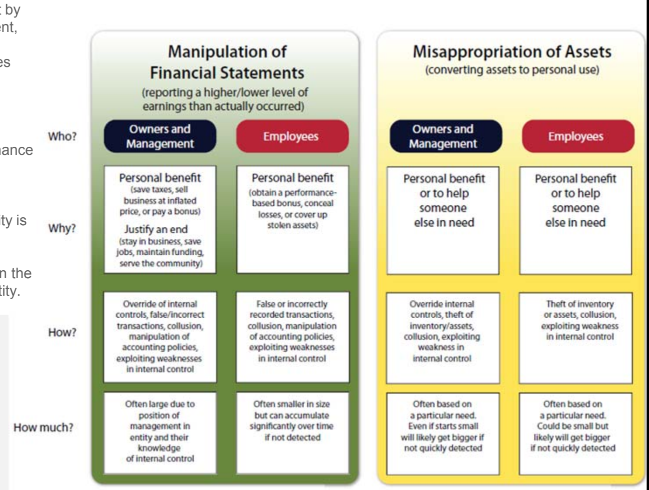

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Risk Identification Process

Risk Identification	
Step 1 Gather Basic Information about the Entity	The starting point is to obtain a basic understanding or frame of reference for designing the risk assessment procedures to be performed. Without this understanding, it would be difficult, if not impossible, to identify what errors and fraud could occur in the financial statements. • Obtain (or update) relevant basic information about the entity, its objectives, culture, operations, key personnel, and the internal organization and control.
Step 2 Design, Perform and Document Risk Assessment Procedures	• Risk assessment procedures/activities (see Volume 1, Chapter 8) are required to be performed so that: – The sources of risks of material misstatement are identified, – An appropriate understanding of the entity is obtained, and – The necessary supporting audit evidence is obtained. • Using the basic understanding of the entity obtained in step 1 above, design and perform risk assessment procedures and related activities. • Hold discussions among the audit team regarding the susceptibility of the entity's financial statements to material misstatement, caused by error or fraud (see Volume 2, Chapter 7). • Make inquiries of management as to how they identify and manage risk factors (particularly fraud), and what risk factors have in fact been identified and managed. Also ask management if errors or fraud have actually occurred. • Document all risk factors identified.

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Risk Identification Process

Risk Identification	
Step 3 Relate or Map the Risks Identified to Material Financial Statement Areas	For each risk factor (risk cause) identified, identify the effect (specific misstatements such as fraud and error) that could occur in the financial statements as a result. Note that a single risk factor can result in a number of differing types of misstatements that may affect more than just one financial statement area. (See the Consider Point below for some examples.) • Identify the material account balances, class of transactions, and disclosures in the financial statements. • Relate or map the risks identified to the specific financial statement areas, disclosures, and assertions affected. If the risk identified is pervasive, then relate it to the financial statements as a whole. Identifying the effect of risks by financial statement area helps in assessing risks at the assertion level. Identifying the effect of pervasive risks helps in assessing risks at the financial statement level.

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Documenting the Risk Identification Process

Document	Description
Information about the Entity	Document information obtained under the appropriate area of understanding, such as the entity's objectives, external factors, nature of the entity, etc. Documentation may vary from very simple to complex, depending on the size of the entity, and could include: • Client-prepared information (such as business plans and analysis); • External data (industry reports, internal staff communications, documented policies and procedures); • Relevant correspondence (legal, government agencies, etc.), emails, consultants' reports, memoranda; and • Firm's checklists.

Document	Description
Risk Assessment Procedures	Document details of the risk assessment procedures performed. This would include: • Discussions among the audit team regarding the susceptibility of the entity's financial statements to material misstatement caused by error or fraud, and the results; • Key elements of the understanding of the entity obtained, including: - Each of the aspects of the entity and its environment outlined above, - Each of the five internal control components, as outlined in Volume 1, Chapter 5, and - Sources of information from which the understanding was obtained; and • The identified and assessed risks of material misstatement at the financial statement level and assertion level.
Relate Identified Risks to Possible Errors and Fraud in the Financial Statements	Document the material account balances, class of transactions, and disclosures in the financial statements; and then, for each source of risk identified, indicate whether it is: • Pervasive to the financial statements as a whole; or • Confined to specific financial statement areas, disclosures, and assertions.

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Documenting the Risk Identification Process -Example

Risk Source	Impact of Risk on Financial Statements (Errors or Fraud)	Financial Statement Area Affected or Pervasive Risk
Entity's Objectives		
Introduction of a new product during the year	Errors in cost allocation and inventory valuation.	Inventory valuation
	New product costing and pricing methodologies/systems could create opportunities for fraud to occur.	Inventory accuracy
	The new financing required will make it difficult to comply with existing bank covenants. If the entity is in breach of covenants, the loan may actually be payable on demand.	Note disclosures on financing, debt covenants, and loan classification
	Management may be tempted to manipulate financial statements to ensure compliance with the bank covenants.	Pervasive risk
Nature of the Entity		
Senior accountant not trained properly	Errors in the financial statements.	Pervasive risk
	Opportunity for fraud.	Pervasive risk

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Documenting the Risk Identification Process -Example

Case Study A — Dephtha Furniture, Inc.

Business Risks		
Risk Event/Source	**Implication of Risk Factor**	**Assertions**
	What financial statement areas could be misstated and in what way?	P CAEV
Downturn in economy	*Receivables may be difficult to collect*	*V*
Downturn in economy	*Inventory write-downs may be required*	*V*
Inventory clerk known to make errors	*Inventory balances may be overstated/understated and possibly impact valuation*	*CAEV*
Continued growth (despite downturn) and poor inventory control	*Breach of debt covenants*	*P*
General IT controls are weak in a number of areas	*Data integrity may be compromised or data may even be lost*	*P*
New sales being sought in other countries	*Foreign exchange risks in receivables*	*A*

Key:
P = Pervasive (all assertions)
C = Completeness
A = Accuracy
E = Existence
V = Valuation

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Continued growth (despite downturn) and poor inventory control	*Breach of debt covenants*	*P*
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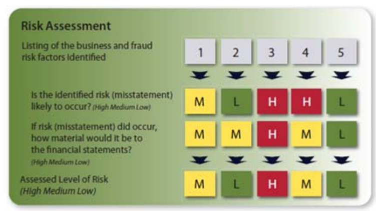
Assessment of Inherent Risks

The next step is to assess the identified risks and determine their significance for the audit of the financial statements. Again, it is preferable to assess the inherent risks before considering any internal control that might mitigate such risks. Risk assessment involves consideration of two attributes about the risk:

- What is the likelihood of a misstatement occurring as a result of the risk?
- What would be the magnitude (monetary impact) if the risk did occur?

Likelihood of a Misstatement Occurring
What is the probability that the risk will occur? The auditor could evaluate this probability simply as high, medium, or low, or could assign a numerical score, such as 1 to 5. A numerical score provides a slightly more precise assessment. The higher the score, the more likely the risk would occur.

Magnitude (Monetary Impact) if the Risk Did Occur
If the risk occurred, what would be the monetary impact? This judgment needs to be assessed against a specified monetary amount, such as performance materiality. This assessment can also be evaluated simply as high, medium, or low, or by assigning a numerical score, such as 1 to 5. The higher the score is, the higher the magnitude of the risk.



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Assessment of Inherent Risks -Example

Period ended: December 31, 20X2 Materiality 50,000€

Risk Event/Source	Implication of Risk Factor	Assertions PCAEV	Inherent Risk Assessment: Likeli-hood to Occur	€ Impact	Com-bined Score
Salespersons' compensation based on sales commissions	*Sales could be fictitious, recorded in the wrong period, overstated, or at terms different from the standard terms and conditions in order to achieve bonus targets*	EA	4	4	16
Failure to comply with debt covenants is covered up to avoid bank inquiries	*Unauthorized journal entries to defer expense, bias in management estimates, etc.*	P	2	5	10
Fictitious suppliers inserted by employees	*Acme pays for expenses at inflated prices or for which no services/goods were rendered*	EA	2	4	8
Related party transactions not identified. Shareholders not involved in business could be disadvantaged	*Revenue and expenses not recorded at FMV (Fair Market Value)*	P	3	5	15
Cash sales for parts and service may go unrecorded and undeposited	*Revenue and assets are understated*	CAE	4	1	4

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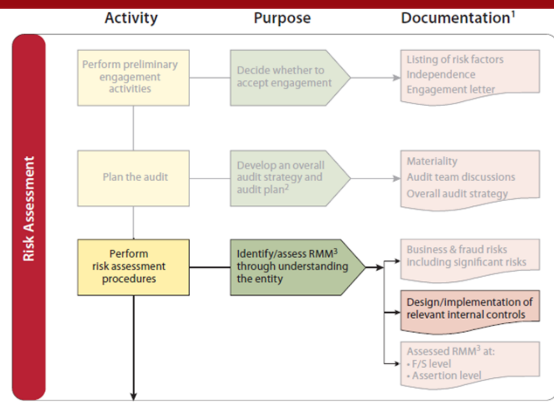
Understanding Internal Control



Notes:
1. Refer to ISA 230 for a more complete list of documentation required.
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Understanding Internal Control

CONSIDER POINT

The sole purpose of a control is to mitigate risk. A control without a risk to mitigate is obviously redundant. So, a risk has to exist before it can be mitigated by a management control. However, some auditors ignore this fact. They start their evaluation of internal control by documenting the system and controls that exist before taking the time to identify what risks actually require mitigation. This approach can result in a lot of unnecessary work in documenting processes and controls, which may later prove to be totally irrelevant to the audit objectives.

Audit Risk= Inherent Risk x Control Risk x Detection Risk

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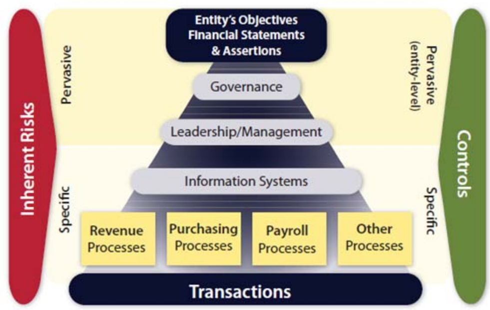
Understanding Internal Controls- Pervasive & Specific Internal Controls

Pervasive and Specific Internal Controls

Internal controls can be broadly categorized as pervasive (or entity-level) controls that address pervasive risks,
and specific (transactional) controls that address specific risks.



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Understanding Internal Controls- 5 Elements of Internal Control

Each of these components is to be addressed by the auditor as:

- Part of the understanding of the internal control (over financial reporting)
- Information for considering how the different aspects of internal control may affect the audit

CONSIDER POINT
How an entity actually designs and implements its internal control will vary with an entity's size and complexity. In smaller entities, the owner-manager may perform functions that address several of the components of internal control.

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Sri Lanka Auditing Standards 315-Understanding the Entity and its Environment and Assessing the Risks of Material Misstatement.

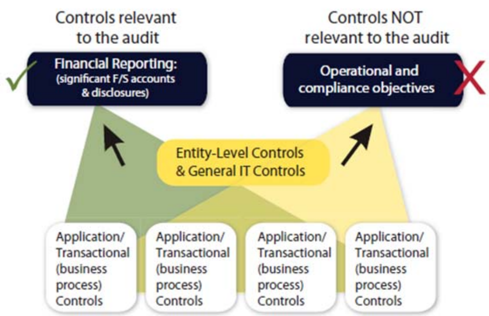
Internal Controls Relevant to the Audit (the scope of understanding)

Not all controls are relevant to the audit and require understanding. The auditor is only concerned with understanding and evaluating those controls that would mitigate a risk of a material misstatement (due to fraud or error) in the financial statements. This means that certain types of controls can be scoped out of the audit altogether.

These are controls that:

• Do not drive financial reporting (such as operational controls and controls that address compliance with regulations); and

• Even if non-existent, a material misstatement in the financial statements would be unlikely.



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Internal Controls Relevant to the Audit -Example

Business Process	Material Financial Statement Areas Affected
Receivables/receipts	Revenue, trade receivables & other, cash and cash equivalents
Valuation of overdue accounts receivable	Trade receivables & bad debt expense
Sales process (cash sales, sales orders)	Revenue
Purchases, payables, payments	Trade payables & other, property, plant and equipment, inventories, income statement expense categories
Payroll	Payroll expenses
Taxes payable and remittances	Income, payroll, and sales taxes
Inventory valuation and management	Purchases and inventories
Bank account reconciliations	Cash and cash equivalents, interest-bearing loan, interest expense
Calculation of depreciation and amortization	Property, plant, and equipment, and depreciation/ amortization expense

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Assessment of Internal Controls – 4 Step Process

	Description
Step 1 What Risks Require Mitigation?	Identify the inherent risks of material misstatement (business and fraud risks), and whether they are pervasive risks affecting all assertions, or specific risks that affect particular financial statement areas and assertions.

Regardless of the whether tests of controls will ultimately be performed to gather audit evidence, it is still necessary for the auditor on every engagement to evaluate control design and implementation. This involves a four-step process.

What can go wrong?	Sources of risk	Mitigating controls
Unreliable financial reports *(pervasive risks)*	External industry factors Nature of entity Accounting policies Objectives and goals Performance measures Fraud	Entity-level controls and processes General IT controls Transactional controls
Misstatements arising from financial statement preparation *(pervasive risks)*	Accounting estimates Provisions Accounting policies Use of spreadsheet Non-routine transactions Journal entries, reconciliations Information neccessary for financial statement disclosures	Entity-level controls General IT controls Transactional controls
Transactions not processed or recorded accurately *(specific risks)*	Identification/recording of authorized transactions Transaction classification Measurement, cut off Safeguarding of assets	Transactional controls IT application controls Some specific entity-level controls

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Assessment of Internal Controls – 4 Step Process

Step 2 Do the Controls Designed by Management Mitigate the Risk?	Identify what business processes are in place (if any). • Interview entity personnel to identify what controls mitigate the risks identified in **Step 1** above. • Review results and assess whether the controls do in fact mitigate the risks. • Communicate any significant deficiencies identified in the entity's internal control to management and those charged with governance. In larger entities, this step may require reference to or preparation of some system documentation (see **Step 3** below) to provide some context regarding the operation of certain controls.

One-Risk-to-Many Controls

Under this approach, each risk factor is considered by itself. All the controls that address that particular risk factor are identified. This approach is particularly useful for mapping the pervasive (entity-level) risk factors to controls

Risk/Control Objective	Assertion	Mitigating Controls
1. Risk factor	C	1. Control procedure A
		2. Control procedure B
		3. Control procedure C
		4. Control procedure D

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Many-Risks-to-Many Controls

For specific c and transactional risks, the most common approach to evaluating design is through the use of what is sometimes called a "control design matrix."

Process = Sales						
Material Risk Factors		Risk A	Risk B	Risk C	Risk D	Key Controls
	Assertions	C	EA	AC	CE	
Controls	*Internal Control Component*					
Procedure #1	*Control Environment*	D				
Procedure #2	*Information Systems*		D			
Procedure #3	*Control Activity*	P	P		P	Yes
Procedure #4	*Monitoring*	D				
Procedure #5	*Control Activity*		P		P	Yes
Procedure #6	*Control Activity*					
Procedure #7	*Information Systems*	D	D		D	
Is control design OK? That is, will the identified controls mitigate the risk factors?		Yes	Yes	No	Yes	

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Procedure #7	*Information Systems*	D	D		D	
Is control design OK? That is, will the identified controls mitigate the risk factors?		Yes	Yes	No	Yes	

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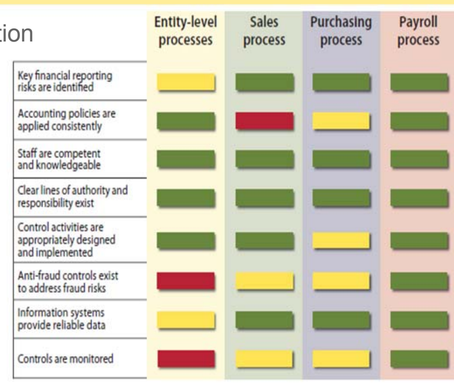
Assessment of Internal Controls – 4 Step Process (contd.)

A summary of the overall control evaluation



Key:

Green = the underlying risks have been appropriately mitigated

Yellow = some problems may exist

Red = potentially significant deficiencies

CONSIDER POINT

For smaller entities, there is an even simpler way of assessing transactional controls. First, identify the risk factors (see Step 1 above) and the assertion(s) affected. Then, instead of mapping identified controls to each individual risk factor, identify controls that address the assertions affected by the risk.

If no controls are identified for a particular assertion, a substantive audit response would need to be developed. If the controls identified are expected to operate reliably, the audit response could include a test of relevant key controls. For example, the risk of unrecorded sales addresses the completeness assertion. Identification of relevant controls could be limited to those that address the completeness assertion in general, rather than the one specific risk.

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Assessment of Internal Controls – 4 Step Process (contd.)

	Description
Step 3 Are the Controls That Mitigate the Risks Factors in Operation?	Observe or inspect the operation of relevant internal controls to ensure that they have indeed been implemented. Note that inquiry of management is not sufficient to evaluate whether a relevant control has in fact been implemented. This step can often be combined with **Step 2** above.

	Description
Assessing Control Implementation	• Inquiring of entity personnel; • Observing or re-performing the application of specific controls; • Inspecting documents and reports; and • Tracing one or two transactions through the information system relevant to financial reporting. This is often called a walkthrough.

CONSIDER POINT

If there is any doubt about whether some controls identified in Step 2 above have not in fact been implemented, do not assess control design and document the operation of the controls until some work has been performed to determine that they exist and operate. Alternatively, do not take time to assess controls that are unlikely to be relevant to the audit or have been inappropriately designed.

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Assessment of Internal Controls – 4 Step Process (contd.)

Step 4 Has the Operation of Relevant Controls Been Documented?	This step can consist of a simple narrative description of the major processes (prepared by the entity's management or auditor), describing the operation of the relevant internal controls identified. This documentation does *not* have to include: • A detailed description of the business process or the way paper flows through the entity; or • Internal controls that may exist but are not relevant to the audit.

Documenting Relevant Internal Controls
• How significant transactions are initiated, authorized, recorded, processed, and reported; • The flow of transactions in sufficient detail to identify the points at which material misstatements caused by error or fraud could occur; and • Internal controls over the period-end financial reporting process, including significant accounting estimates and disclosures.

CONSIDER POINT

Documentation of controls does not have to be complex or comprehensive. There is no requirement for the auditor to document an entire business process, or to describe the operation of any controls that are not relevant to the audit.

The most common forms of documentation prepared by management or the auditor are:

- Narrative descriptions or memoranda;
- Flow charts;
- A combination of flow charts and narrative descriptions
- Questionnaires and checklists.

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Assessment of Internal Controls –4 Step Process (contd.)

	Description
Updating Control Documentation Prepared in Previous Periods	• Make a copy of the previous period's working papers on controls as the starting point for updating in the current year. If nothing has changed, evaluate control implementation before design. If the control has been implemented and the risk did not change, the design will be acceptable; • Update the listing of risks that require mitigation by control; • Identify changes in internal control at the entity and transactional levels. This is achieved by procedures that address control implementation; • Where changes are identified (risk or controls), determine whether new internal controls have been designed and implemented; • Update the linkage of internal controls with the appropriate risk factor; and • Update the conclusions on control risk.

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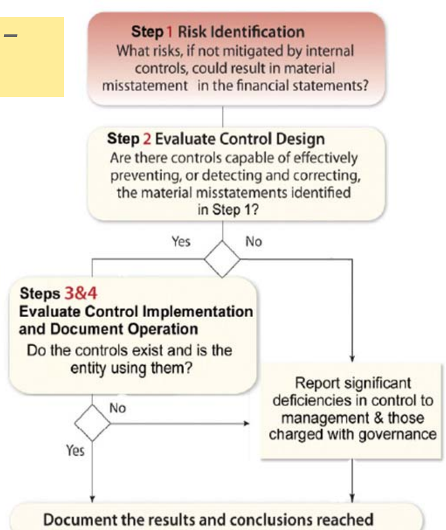
Assessment of Internal Controls – 4 Step Process (contd.)

Regardless of how well a control is designed and implemented, it can only provide reasonable assurance about the achievement of an entity's objectives with regard to reliability of financial reporting due to certain inherent limitations.

	Description
Internal Control Limitations	• Human judgments and simple human failures such as errors or mistakes. • Circumvention of internal control by the collusion of two or more people. • Inappropriate management override of internal control, such as revising the terms of a sales contract or overriding a customer's credit limit.



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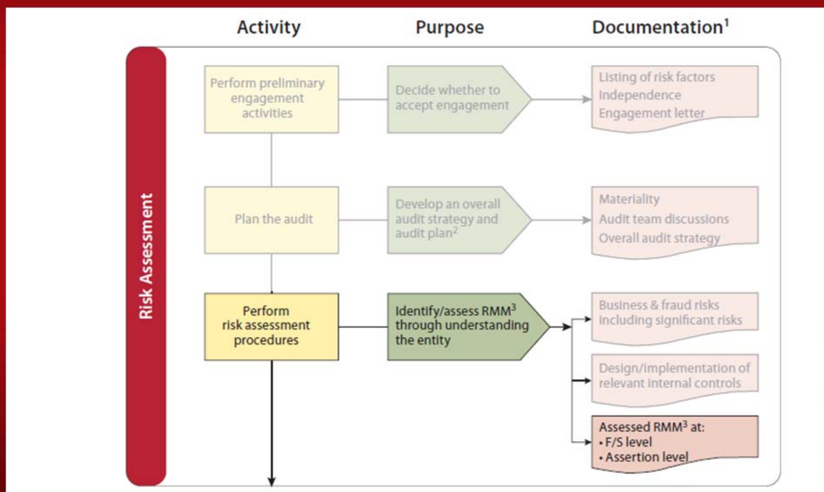
Concluding the Risk Assessment Phase



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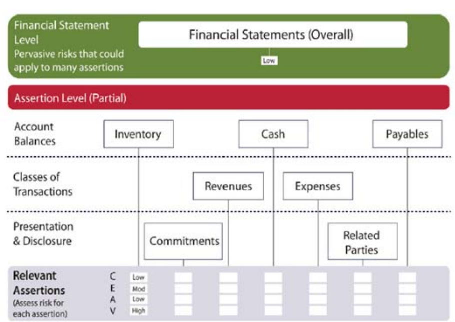
Concluding the Risk Assessment Phase

The final step in the risk assessment phase of the audit is to review the results of the risk assessment procedures performed, and then assess (or, if already assessed, summarize) the risks of material misstatements at:

- The financial statement level; and
- The assertion level for classes of transactions, account balances, and disclosures.

The resulting list of assessed risks will form the foundation for the next phase in the audit, which is to determine how to respond appropriately to the assessed risks through the design of further audit procedures.



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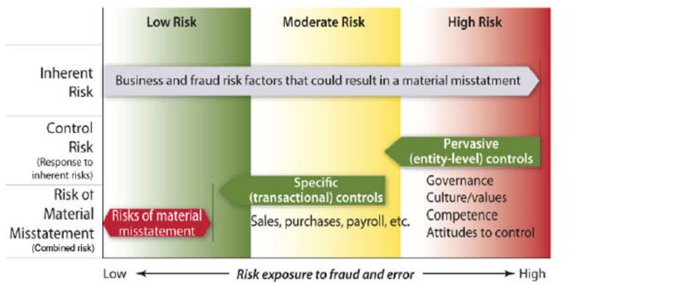
Audit Evidence Obtained to Date

The evidence obtained to date, by performing risk assessment procedures, consists of identification and assessment of inherent risks, and the design and implementation of internal controls that address those risks.
What is left is the risk of material misstatement. This is simply the remaining risk after taking into account the effect of internal controls put in place to mitigate the inherent risks..



Note: The length of the horizontal bars in this exhibit is purely for illustrative purposes and would vary from entity to entity.

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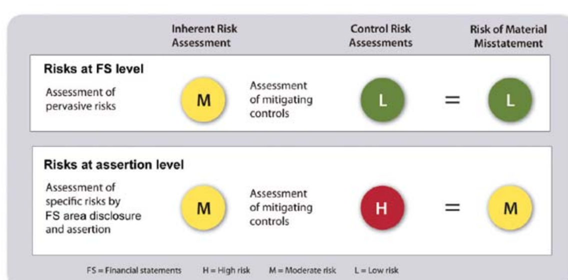
Summarizing the Various Risk Assessments

The purpose of assessing risks is to provide the foundation and a reference point for what is needed to respond appropriately with well-designed and efficient further audit procedures.

The summary of assessed risks brings together the inherent risk factors identified and the evaluation of any internal control designed to mitigate such risks.

Note: There is a moderate level of risk at the financial statement level which is mitigated by good entity-level and possibly other controls. The result is a low assessed risk at the financial statement level.

The summary of assessed risks at the assertion level is a combination of the assessment of inherent and control risks that apply to individual financial statement balances, transactions, and disclosures. The inherent risks are moderate, and there are no relevant internal controls, so the control risk is high. The result is therefore a moderate residual risk for this particular assertion.



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Documentation

Discussion	Key elements
Engagement Team discussion and decision reached	Understanding of entity and its environment , including internal controls and Risk assessment procedures

Documentation

Risks	Special audit consideration
Identified & assessed risks at F/S level and assertions level	Risk identified and related controls about special audit considerations

Sri Lanka Auditing Standards 315

Thank You