

Risk Based Audit, Materiality & Sampling

**By:
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Introduction

- Audit is not just about ticking boxes; it's about focusing on **high-risk areas** that can materially misstate financial statements
- A **risk-based audit** approach allows the auditor to allocate more resources to areas with greater risk and reduce work in low-risk areas
- It improves audit **efficiency, effectiveness, and audit quality**
- The auditor's report shall state whether he has sought and obtained all the **information** and **explanations** which to the **best of his knowledge and belief** were **necessary for the purpose of his audit** and if not, the details thereof and the effect of such information on the financial statements – Section 143(3)(a)

Understanding the Concept of Risk in Audit

- **Audit Risk** is the risk that auditor may issue an incorrect opinion on F.S.
- It comprises of:
 - **Inherent Risk (IR):** Risk of material misstatement assuming no internal controls
 - **Control Risk (CR):** Risk that internal controls fail to prevent/ detect errors
 - **Detection Risk (DR):** Risk that auditor fails to detect a material misstatement
- **Formula:** Audit Risk (AR) = IR × CR × DR

Risk Assessment in Practice

- Risk assessment involves:
 - Understanding **business operations** and **internal controls**
 - Identifying **significant accounts** and **vulnerable processes**
 - Considering **fraud risk**, changes in management, estimates, and complexity
- High-risk areas often include:
 - Revenue recognition
 - Inventory valuation
 - Related-party transactions

Concept of Materiality

- Materiality guides the scope of audit and extent of audit procedures.
- Misstatements are material if they can influence the decision-making of users of financial statements.
- Types:
 - **Planning Materiality (PM):** Basis for setting audit scope
 - **Performance Materiality (PerfM):** Lower threshold to reduce aggregation risk
 - **Specific Materiality:** For individual balances/ transactions (e.g., fraud-prone areas)

Benchmark for determining Materiality Levels

- **Benchmark** = Percentage criteria often applied as a starting point in determining materiality of F.S.;
- **Identification of Benchmark depends upon the following factors:**
 - 1) F.S. elements (e.g. assets, liabilities, equity, revenue, expense);
 - 2) The purpose of evaluating financial performance;
 - 3) Entity's ownership and capital structure

Schedule III

Any item of income or expenditure which exceeds 1% of the revenue from operations or Rs.1,00,000, whichever is higher ~ AS compliant companies;

Any item of income or expenditure which exceeds 1% of the revenue from operations or Rs.10,00,000, whichever is higher ~ Ind AS compliant companies (other than NBFCs);

Any item under the sub-head 'Other Income' which exceeds 1% of the total income to be presented separately ~ Ind AS compliant NBFCs;

Any item under the sub-head 'Others expenditure' which exceeds 1% of the total income to be presented separately ~ Ind AS compliant NBFCs

S. No.	Nature of the Entity	<u>Other</u> Benchmarking Criteria
1.	Small Entities – where owner takes much of the profit before tax in the form of remuneration	profit before remuneration and tax may be more relevant
2.	Central/ State Govt. and related Govt. entities (for example, agencies, boards, commissions) i.e. the entities doing public utility programs/ projects – such as: Accelerated Irrigation Benefit Programme, Pradhan Mantri Gram Sadak Yojana	<ul style="list-style-type: none"> ▪ total cost or net cost (expenses less revenues or expenditure less receipts) may be appropriate benchmarks for that particular program/project activity ▪ where an entity has custody of the assets, assets may be an appropriate benchmark.

How to Calculate Materiality

Benchmarks used:

- 5% of Profit Before Tax (PBT)
- 1% of Revenue
- 2% of Total Assets

Example Calculation:

- Revenue = ₹100 crore; PBT = ₹4 crore
- PM = 5% × ₹4 crore = ₹20 lakhs
- PerfM = 75% × ₹20 lakhs = ₹15 lakhs
- If any error > ₹15 lakhs – significant, and needs extended audit procedures

What is the clearly trivial threshold? 1/2

- Audit teams should establish a “clearly trivial threshold”, which is usually calculated as a percentage of overall materiality (e.g., 5% of overall materiality).
- Audit teams need to define this threshold because there may be errors that are below overall materiality, that when aggregated with other misstatements, may result in a material misstatement.
- If overall materiality is Rs. 10,000, and the audit firm establishes the “clearly trivial threshold” by applying 5% (each firm will have their own methodology), then the clearly trivial threshold would be Rs. 500.
- Now that we know the clearly trivial threshold is Rs. 500, each member of the audit team should understand that if there is an error that is less than Rs. 10,000 but greater than Rs. 500, it needs to be recorded to a list (typically tracked in the audit software). While the difference or error won't result in a material misstatement on an individual basis, when combined or aggregated with other errors, there could be a material misstatement.

What is the clearly trivial threshold? 2/2

- At the end of the audit, the audit team should combine all of the errors or differences that are less than Rs. 10,000 but greater than Rs. 500 by the financial statement line item they impact.
- For example, if the audit team identified the 3 errors that all related to revenue, i.e.,
 - a) Rs. 4,000 difference for Hyderabad Revenue
 - b) Rs. 6,000 difference for Mumbai Revenue
 - c) Rs. 750 difference for Gujarat Revenue
 - d) Rs. 300 difference for Bangalore Revenue
- then the aggregated impact is Rs. 10,750, which is above overall materiality of Rs. 10,000. Now there is a material misstatement to revenue!

Sampling in Audit

Why sampling: Full checking is impractical and uneconomical

Objective: Draw valid conclusions about a population from a subset

Types:

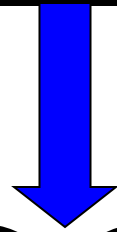
- **Statistical Sampling:** Probability-based, quantifiable confidence
- **Non-statistical Sampling:** Based on auditor's judgment

Selection Methods:

- Random/ Haphazard Sampling
- Systematic Sampling

- **Sampling risk**

Risk that auditor's conclusion based on sample may be different from the conclusion if the entire population were subjected to same audit procedure



Leads to two types of erroneous conclusions

Test of Controls – More effective than actually are
Test of details – Material Misstatement does not exist when in fact it does exist

{ Leads to inappropriate Audit opinion }

Test of Controls – Less effective than actually are
Test of details – Material Misstatement exists when In fact it does not exist

{ Leads to additional work }

Case Study on Audit Sampling

Background:

- **Company:** XYZ Manufacturing Ltd.
- **Audit Area:** Accounts Payable
- **Audit Objective:** To test the existence and accuracy of trade payables. Specifically, to determine if there is a material misstatement due to unrecorded liabilities or incorrect invoice values.
- **Audit Period:** Financial Year ended 31st March 2025.
- **Population:** The list of all trade creditors with a total balance of ₹1,50,00,000 as of 31st March 2025. The population consists of **2,000 individual creditors**.
- **Audit Procedure:** The auditor will perform a substantive test of details by vouching a sample of creditor balances to supporting documentation (invoices, goods received notes, etc.).

Step 1 - Define the Audit Objectives & Population

- **Audit Objective:** To determine if the misstatement rate in the accounts payable population is within an acceptable limit.
- **Population:** The entire list of 2,000 trade creditors.
- **Population Value:** ₹1,50,00,000

Step 2 - Determine Sample Size

- The sample size depends on three key factors:
 1. **Tolerable Misstatement:** The maximum misstatement in the population that the auditor is willing to accept. We will set this at **₹5,00,000**. This is based on the auditor's professional judgment and the overall materiality for the financial statements
 2. **Expected Misstatement:** The misstatement rate the auditor expects to find. Based on previous audits, we expect a low misstatement rate. We'll assume **0** for this case to demonstrate a "best-case" scenario
 3. **Risk of Incorrect Acceptance (RIA):** The risk that the auditor concludes the population is fairly stated when it is materially misstated. We will set this at **5%**, which corresponds to a **Confidence Level of 95%**. This is a standard level of assurance for a substantive test

Step 2 - Determine Sample Size

Calculation of Sample Size:

- **Formula:** Sample Size = (Population Value × Confidence Factor)/ Tolerable Misstatement
- **Confidence Factor:** For a 5% RIA (95% confidence) and 0 expected misstatements, the factor is approximately **3.0** (standard number based upon Poisson distribution – used in practice as such without much ado). It represent "What's the smallest number of misstatements we could find in our sample that would still allow us to be 95% confident that the actual misstatement rate in the population isn't too high?"
- **Sample Size** = $(₹1,50,00,000 \times 3.0) / ₹5,00,000 = 90$

Step 3 - Select the Sample

- **Method:** We will use a systematic selection method with a random start
- **Sampling Interval:** ₹1,50,00,000/ 90 = ₹1,66,667
- **Process:**
 1. Generate a random number between ₹1 and ₹1,66,667. Let's say our random start is ₹55,000. This is our first sampled rupee.
 2. Select the creditor account containing the ₹55,000th rupee.
 3. Select the next creditor containing the ₹55,000 + ₹1,66,667 = ₹2,21,667th rupee.
 4. Repeat this process, adding the sampling interval each time, until 90 creditors are selected.

Step 3 - Select the Sample

Example:

- **Selection 1:** The creditor with a cumulative balance that includes the ₹55,000 mark.
- **Selection 2:** The creditor with a cumulative balance that includes the ₹2,21,667 mark.
- ...and so on, for all 90 selections.
- **Tutorial Note:** The sampling interval represents a "slice" of the population. Using our example, the population is conceptually divided into 90 slices, each worth ₹1,66,667. The systematic selection method ensures that we select one item from each of these slices. This guarantees that the sample is spread evenly throughout the entire population and is not clustered in one area (e.g., only high-value items or only low-value items).

Step 4 - Perform Audit Procedures & Evaluate Sample Results

- **Audit Procedure:** The audit team examines the 90 selected creditor accounts. For each, they vouch the balance to supporting invoices and Goods Received Notes (GRNs)
- **Sample Results:**
- **88 accounts** were found to be correctly stated.
- **2 accounts** had misstatements:
 - **Creditor A:** Balance of ₹2,50,000 was overstated. The correct balance was ₹2,00,000. **Misstatement = ₹50,000.**
 - **Creditor B:** Balance of ₹3,00,000 was understated. The correct balance was ₹3,20,000. **Misstatement = ₹20,000**

Step 5 - Project the Misstatement to the Population

- Now we project the misstatements found in the sample to the entire population.
- **Total Misstatement in Sample:** ₹50,000 (overstatement) - ₹20,000 (understatement) = ₹30,000 net misstatement.
- **Projection Method (Ratio Method):** Projected Misstatement = (Misstatement in Sample/ Sample Value) × Population Value
- **Sample Value:** The sum of the balances of the 90 selected creditors. Let's assume this is ₹12,00,000.
- **Calculation:** Projected Misstatement = (₹30,000/ ₹12,00,000) × ₹1,50,00,000 = ₹3,75,000

Step 6 - Evaluate the Results and Conclude

- **Tolerable Misstatement:** ₹5,00,000 (The maximum we were willing to accept).
- **Projected Misstatement:** ₹3,75,000 (Our best estimate).
- **Decision Rule:**
 - If Projected Misstatement < Tolerable Misstatement, we can accept the population as fairly stated.
 - If Projected Misstatement > Tolerable Misstatement, we must conclude that the population is materially misstated.
- **Conclusion:**
 - Since the projected misstatement of **₹3,75,000** is less than the tolerable misstatement of **₹5,00,000**, the auditor can, with **95% confidence**, conclude that the accounts payable balance of ₹1,50,00,000 is not materially misstated.
 - The audit team can now finalize their procedures and issue an unmodified opinion on this area, unless other audit procedures indicate otherwise.

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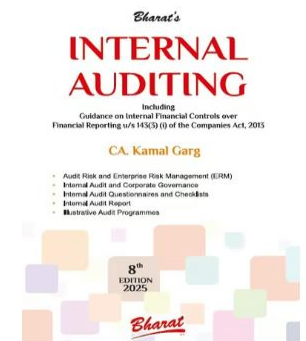
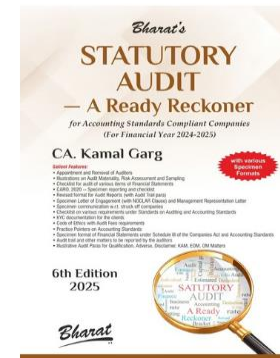
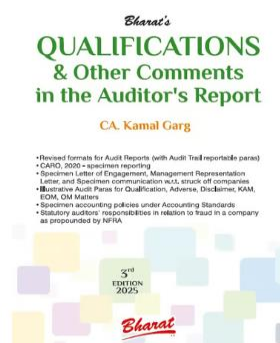
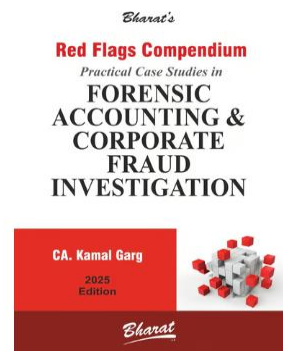
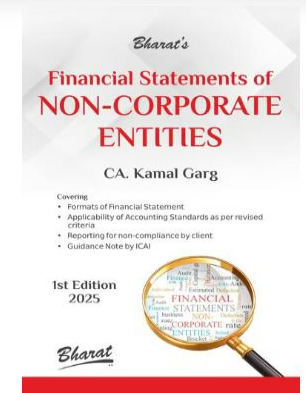
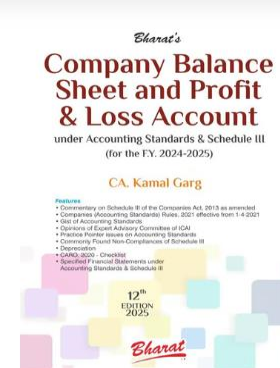
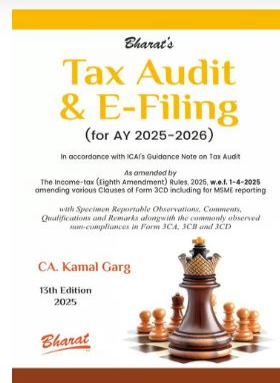
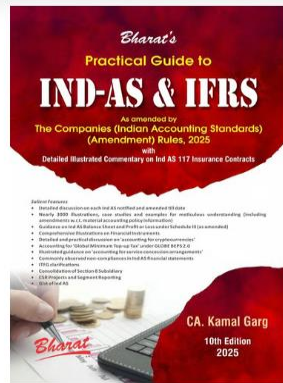
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