

# Risk Assessment and Internal Control

---

## Question 1

*Briefly discuss the compliance procedures and their use in evaluation of internal controls.*

## Answer

**Compliance Procedures and Evaluation of Internal Controls:** The auditor should obtain sufficient appropriate audit evidence through the performance of compliance and substantive procedures to enable him to draw reasonable conclusions therefrom on which to base his opinion on the financial information. According to it, compliance procedures are tests designed to obtain reasonable assurance that those internal controls on which audit reliance is to be placed are in effect. Obtaining audit evidence from compliance procedures is intended to reasonably assure the auditor in respect of the following assertions :

- Existence - that the internal control exists.
- Effectiveness - that the internal control is operating effectively.
- Continuity - that the internal control has so operated throughout the period of intended reliance.

The auditor formulating his opinion on financial information needs reasonable assurance that transactions are properly authorised and recorded in the accounting records and that the transactions have not been omitted. Internal controls, even if fairly simple, may contribute to the reasonable assurance the auditor seeks. The auditors' objective in studying and evaluating internal controls is to establish the reliance he can place thereon in determining the nature, timing and extent of his substantive auditing procedures.

Compliance procedures are tests designed to obtain reasonable assurance that those internal controls on which audit reliance is to be placed are in place and are also effective. Compliance procedures enable the auditor to determine the existence, effectiveness and continuous operation of the internal control system. These procedures include tests requiring inspection of documents supporting transactions to gain evidence that controls have operated properly. For example, the auditor may see that the documents have been properly authorised. The auditor may also make enquiries about the observation of controls, for example, determining who actually performs each function not merely who is supposed to perform it. Compliance procedures are conducted by the auditor to gain evidence that those internal controls on which he intends to rely operates generally as identified by him and they function effectively throughout the period of intended reliance. The concept of effective operation recognises that some deviations from prescribed controls may have occurred.

### 3.2 Advanced Auditing and Professional Ethics

---

Based on the results of his compliance procedures, the auditor evaluates whether the internal controls are adequate for his purpose. If based on the results of the compliance procedures, the auditor concludes that it is not appropriate to rely on a particular internal control to the degree previously contemplated, he should ascertain whether there is another control which would satisfy his purpose and on which he might rely (after applying appropriate compliance procedures). Alternatively, he may modify the nature, timing or the extent of his substantive audit procedures.

#### Question 2

*"Corporate accountability and civil and criminal penalties for white collar crimes." Comment on the major provisions of Sarbanes Oxley Act.*

#### Answer

**Major provisions of Sarbanes Oxley Act :** The Sarbanes Oxley Act of 2002 established corporate accountability and civil and criminal penalties for white – collar crimes. This Act also known as the Public Company Accounting Reform and Investor Protection Act of 2002 and commonly called SOX or Sarbox; is a United States federal law passed in response to a number of major corporate and accounting scandals including those affecting Enron, Tyco International, and WorldCom. These scandals resulted in a decline of public trust in accounting and reporting practices.

This Act provides regulatory bodies and courts to take various actions-civil and criminal proceedings in connection of misstatements amounting to accounting scandals and fraudulent financial reports, other frauds on securities matters, obstruction of justice and retaliating against corporate whistleblowers. The Act also enforce tougher civil and criminal penalties for fraud and accounting scandals, securities fraud and certain other forms of obstruction of justice. As per SOX protect employer against corporate whistle blowers (person who provide evidence of fraud in the company).

Some of the major provisions of Sarbanes-Oxley Act of 2002 are:

- Creation of the Public Company Accounting Oversight Board (PCAOB);
- A requirement that public companies evaluate and disclose the effectiveness of their internal controls as they relate to financial reporting, and that independent auditors for such companies "attest" (i.e., agree, or qualify) to such disclosure;
- Certification of financial reports by chief executive officers and chief financial officers;
- Auditor independence, including outright bans on certain types of work for audit clients and pre-certification by the company's Audit Committee of all other non-audit work;
- Ban on most personal loans to any executive officer or director;
- Accelerated reporting of insider trading;
- Prohibition on insider trades during pension fund blackout periods;

- Enhanced criminal and civil penalties for violations of securities law;
- A requirement that companies listed on stock exchanges have fully independent audit committees that oversee the relationship between the company and its auditor;
- Additional disclosure;
- Significantly longer maximum jail sentences and larger fines for corporate executives who knowingly and willfully misstate financial statements, although maximum sentences are largely irrelevant because judges generally follow the Federal Sentencing Guidelines in setting actual sentences;
- Employee protections allowing those corporate fraud whistleblowers who file complaints with OSHA within 90 days to win reinstatement, back pay and benefits, compensatory damages, and congressional page abatement orders, and reasonable attorney fees and costs.

### Question 3

*Explain briefly the Flow Chart technique for evaluation of the Internal Control system.*

### Answer

**Flow-Chart Technique for evaluation of Internal Control:** This technique can be resorted to for evaluation of the Internal Control System. It is a graphic presentation of internal controls in the organisation and is normally drawn up to show the controls in each section or sub-section.

As distinct from a narrative form, it provides the most concise and comprehensive way for reviewing the internal controls and the evaluator's findings. In a flow chart narratives are reduced to the minimum and by that process, it can successfully bring the whole control structure, specially the essential parts thereof, in a condensed but wholly meaningful manner. Every details relevant from the control point of view and the details about how an operation is performed can be included in the flow-chart.

Essentially, a flow chart is a diagram full with lines and symbols and if judicious use of them can be made, it is probably an effective way of presenting the state of internal controls in the client's organisation. A properly drawn up flow chart can provide a neat visual picture of the whole activities of the section or department involving flow of documents and activities. More specifically it can show –

- (i) at what point a document is raised internally or received from external sources;
- (ii) the number of copies in which a document is raised or received;
- (iii) the intermediate stages set sequentially through which the document and the activity pass;
- (iv) distribution of the documents to various sections, department or operations;
- (v) checking authorisation and matching at relevant stages;
- (vi) filing of the documents; and
- (vii) final disposal by sending out or destruction.

### 3.4 Advanced Auditing and Professional Ethics

---

A flow chart is normally a horizontal one in which documents and activities are shown to flow horizontally from section to section and concerned sections are shown as the vertical column needs. These can be sales, purchase, wages, production etc.

Purchases can be linked with sundry creditors and payments, sales with sundry debtors and collections. By this process, a flow chart will become self contained, complete and meaningful for evaluation of internal controls. Generally, a questionnaire is also enclosed with a flow chart, incorporating questions, the answers to which are to be looked into from the flow chart.

#### Question 4

- (a) *As auditor of Z Ltd., you would like to limit your examination of account balance tests. What are the control objectives you would like the accounting control system to achieve to suit your purpose?*
- (b) *In the audit planning process of X Ltd., you would like to consider audit risk at the financial statement level. What are the factors can influence your decision?*

#### Answer

- (a) **Basic Accounting Control Objectives:** The basic accounting control objectives which are sought to be achieved by any accounting control system are:
- (i) Whether all transactions are recorded;
  - (ii) Whether recorded transactions are real;
  - (iii) Whether all recorded transactions are properly valued;
  - (iv) Whether all transactions are recorded timely;
  - (v) Whether all transactions are properly posted;
  - (vi) Whether all transactions are properly classified and disclosed;
  - (vii) Whether all transactions are properly summarized.
- (b) **Audit risk at financial statement level:** The following factors will be considered for determination of audit risk at financial statement level.
- (i) Integrity of Management.
  - (ii) Management experience, knowledge and changes during the period.
  - (iii) Unusual pressures on the Management.
  - (iv) Nature of entity's business.
  - (v) Factors affecting the Industry in which the entity operates.

#### Question 5

*Corporate responsibility as envisaged under Sarbanes and Oxley Act-2002. Briefly explain.*

**Answer**

*Corporate Responsibility under Sarbanes Oxley Act of 2002 : The Sarbanes–Oxley Act of 2002, also known as the Public Company Accounting Reform and Investor Protection Act of 2002 is a United States federal law passed in response to a number of major corporate and accounting scandals including those affecting Enron, Tyco International, and WorldCom. The act contains eleven titles and establishes corporate accountability and civil and criminal penalties for white – collar crimes. The title three deals with the Corporate Responsibility which is as follows:*

- (1) The audit committee to be more independent through enhancement of their oversight responsibilities and one of the Audit committee members to be financial expert.*
- (2) Requires CEO& CFO to issue certification of the quarterly financial results and annual reports to SEC as part of compliance with Form 10K*
- (3) Provides rules of conduct for companies managerial and their officers regarding Pension matters.*
- (4) To Comply with SEC rules requiring attorneys to report violation of securities to the company's CEO or Chief Legal Counsel and to Audit Committee if no action is taken.*