

Risk Assessment and Internal Control

Question 1

While commencing the statutory audit of ABC Company Limited, what should be the considerations of the auditor to assess Risk of Material Misstatement and his response to such risks?
(4 Marks, November, 2014)

Answer

Considerations of Auditor for Assessing the Risk of Material Misstatement: As per SA 315 "Identifying and Assessing the Risk of Material Misstatement through understanding the Entity and its Environment", the auditor shall identify and assess the risks of material misstatement at the financial statement level; and the assertion level for classes of transactions, account balances, and disclosures to provide a basis for designing and performing further audit procedures. For this purpose, the auditor shall-

- (i) 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;
- (ii) Assess the identified risks, and evaluate whether they relate more pervasively to the financial statements as a whole and potentially affect many assertions;
- (iii) 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
- (iv) 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.

Auditor's Responses to the Assessed Risk of Material Misstatement: According to SA 330 "The Auditor's Responses to Assessed Risks", the auditor shall design and implement overall responses to address the assessed risks of material misstatement. In designing the audit procedures to be performed, the auditor shall-

- (i) 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:
 - (1) The likelihood of material misstatement due to the particular characteristics of the relevant class of transactions, account balance, or disclosure; and
 - (2) Whether the risk assessment takes into account the relevant controls, thereby

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requiring the auditor to obtain audit evidence to determine whether the controls are operating effectively; and

- (ii) Obtain more persuasive audit evidence the higher the auditor's assessment of risk.

Question 2

Write a short note on Objectives of Internal Check System. (4 Marks, May, 2014)

Answer

Objectives of the Internal Check System: Following are the objectives of the internal check system-

- (i) To detect error and frauds with ease.
- (ii) To avoid and minimize the possibility of commission of errors and fraud by any staff.
- (iii) To increase the efficiency of the staff working within the organization.
- (iv) To locate the responsibility area or the stages where actual fraud and error occurs.
- (v) To protect the integrity of the business by ensuring that accounts are always subject to proper scrutiny and check.
- (vi) To prevent and avoid the misappropriation or embezzlement of cash and falsification of accounts.

Question 3

The Auditor of S Limited has just commenced the statutory audit. What should be considerations for the effectiveness of a system of internal check? (4 Marks, November, 2013)

Answer

Considerations for the Effectiveness of a System of Internal Check: The term "internal check" is defined as the "checks on day to day transactions which operate continuously as part of the routine system whereby the work of one person is proved independently or is complementary to the work of another, the object being the prevention or early detection of errors or fraud". The following aspects should be considered in framing a system of internal check-

- (i) No single person should have an independent control over any important aspect of the business. The work done by one person should automatically be checked by another person in routine course.
- (ii) The duties/work of members of the staff should be changed from time to time without any previous notice so that the same officer or subordinate does not, without a break, perform the same function for a considerable length of time.
- (iii) Every member of the staff should be encouraged to go on leave at least once in a year so that frauds successfully concealed by such a person can be detected in his absence.
- (iv) Persons having physical custody of assets must not be permitted to have access to the books of accounts.

- (v) There should be an accounting control in respect of each important class of assets, in addition, these should be periodically inspected so as to establish their physical condition.
- (vi) The system of Budgetary Control should be introduced.
- (vii) For stock-taking, at the close of the year, trading activities should, if possible, be suspended. The task of stock-taking, and evaluation should be done by staff belonging to other than stock section.
- (viii) The financial and administrative powers should be sub divided very judiciously and the effect of such division should be reviewed periodically.
- (ix) Finally, the system must be capable of being expanded or contracted to correspond to the size of the concern.

Question 4

As the auditor of a large multi locational company, in the planning process, you are requested to identify the inherent audit risk at the account balance and class of transaction level.

(4 Marks, May, 2013)

Or

Explain the concept of Audit risk at the level of account balance and class of transactions.

(4 Marks, May 2008)

Answer

Evaluating Risk at the Account Balance and Class of Transaction Level: As per SA 315 "Identifying and Assessing the Risk of Material Misstatement through understanding the Entity and its Environment", risk of material misstatement at the assertion level for classes of transactions, account balances, and disclosures need to be considered because such consideration directly assists in determining the nature, timing, and extent of further audit procedures at the assertion level necessary to obtain sufficient appropriate audit evidence. In representing that the financial statements are in accordance with the applicable financial reporting framework, management implicitly or explicitly makes assertions regarding the recognition, measurement, presentation and disclosure of the various elements of financial statements and related disclosures. Assertions at different levels are discussed below:

- (a) Assertions about classes of transactions and events for the period under audit-
 - (i) Occurrence—transactions and events that have been recorded have occurred and pertain to the entity.
 - (ii) Completeness—all transactions and events that should have been recorded have been recorded.
 - (iii) Accuracy—amounts and other data relating to recorded transactions and events have been recorded appropriately.
 - (iv) Cut-off—transactions and events have been recorded in the correct accounting period.

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- (v) Classification—transactions and events have been recorded in the proper accounts.
- (b) Assertions about account balances at the period end-
 - (i) Existence—assets, liabilities, and equity interests exist.
 - (ii) Rights and obligations—the entity holds or controls the rights to assets, and liabilities are the obligations of the entity.
 - (iii) Completeness—all assets, liabilities and equity interests that should have been recorded have been recorded.
 - (iv) Valuation and allocation—assets, liabilities, and equity interests are included in the financial statements at appropriate amounts and any resulting valuation or allocation adjustments are appropriately recorded.

When making assertions about the financial statements of certain entities, especially, for example, where the Government is a major stakeholder, in addition to those assertions mentioned before, management may often assert that transactions and events have been carried out in accordance with legislation or proper authority. Such assertions may fall within the scope of the financial statement audit.

Question 5

- (a) *Corporate responsibility as envisaged under Sarbanes and Oxley Act-2002. Briefly explain. (3 Marks, November, 2011)*
- (b) *Y Co. Ltd. has five entertainment centers to provide recreational facilities for public especially for children and youngsters at 5 different locations in the peripheral of 200 kilometers. Collections are made in cash. Specify the adequate system towards collection of money. (6 Marks, November, 2011)*

Answer

- (a) **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-
 - (i) The audit committee to be more independent through enhancement of their oversight responsibilities and one of the Audit committee members to be financial expert.
 - (ii) Requires CEO& CFO to issue certification of the quarterly financial results and annual reports to SEC as part of compliance with Form 10K.
 - (iii) Provides rules of conduct for companies managerial and their officers regarding Pension matters.

- (iv) 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.
- (b) Control System over Selling and Collection of Tickets: In order to achieve proper internal control over the sale of tickets and its collection by the Y Co. Ltd., following system should be adopted -
 - (i) Printing of tickets: Serially numbered pre-printed tickets should be used and designed in such a way that any type of ticket used cannot be duplicated by others in order to avoid forgery. Serial numbers should not be repeated during a reasonable period, say a month or year depending on the turnover. The separate series of the serial should be used for such denomination.
 - (ii) Ticket sales: The sale of tickets should take place from the Central ticket office at each of the 5 centres, preferably through machines. There should be proper control over the keys of the machines.
 - (iii) Daily cash reconciliation: Cash collection at each office and machine should be reconciled with the number of tickets sold. Serial number of tickets for each entertainment activity/denomination will facilitate the reconciliation.
 - (iv) Daily banking: Each day's collection should be deposited in the bank on next working day of the bank. Till that time, the cash should be in the custody of properly authorized person preferably in joint custody for which the daily cash in hand report should be signed by the authorized persons.
 - (v) Entrance ticket: Entrance tickets should be cancelled at the entrance gate when public enters the centre.
 - (vi) Advance booking: If advance booking of facility is made available, the system should ensure that all advance booked tickets are paid for.
 - (vii) Discounts and free pass: The discount policy of the Y Co. Ltd. should be such that the concessional rates, say, for group booking should be properly authorized and signed forms for such authorization should be preserved.
 - (viii) Surprise checks: Internal audit system should carry out periodic surprise checks for cash counts, daily banking, reconciliation and stock of unsold tickets etc.

Question 6

"Corporate accountability and civil and criminal penalties for white collar crimes." Comment on the major provisions of Sarbanes Oxley Act. (5 Marks, November, 2010)

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:

- (i) Creation of the Public Company Accounting Oversight Board (PCAOB);
- (ii) 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;
- (iii) Certification of financial reports by chief executive officers and chief financial officers;
- (iv) 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;
- (v) Ban on most personal loans to any executive officer or director;
- (vi) Accelerated reporting of insider trading;
- (vii) Prohibition on insider trades during pension fund blackout periods;
- (viii) Enhanced criminal and civil penalties for violations of securities law;
- (ix) A requirement that companies listed on stock exchanges have fully independent audit committees that oversee the relationship between the company and its auditor;
- (x) Additional disclosure;
- (xi) 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;
- (xii) 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 7

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?
(4 Marks, May, 2010)

Answer

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.

Question 8

State briefly eight provisions of the Sarbanes-Oxley Act of 2002, which shall, if strictly applied to Indian Corporates, get fruitful results. (8 Marks, November, 2009)

Answer

Following are some provisions of the Sarbanes-Oxley Act of 2002, which, if enacted in India may be further fruitful in respect of Indian corporate:

- (i) More independence be given to Audit Committee and auditor.
- (ii) Ban on personal loan to Directors / Executive Officers of a Company.
- (iii) Strict reporting by an auditor on insider trading.
- (iv) Additional disclosures imposed on financial reporting.
- (v) If there is any conflict between company and its auditor, the Audit Committee should be empowered to resolve the same.
- (vi) Higher penalties and criminal prosecution on financial frauds.
- (vii) To include effectiveness of Internal Control System in the financial reporting.
- (viii) More responsibilities must be imposed on managerial personal with higher penalties and prosecutions on the breach.
- (ix) Strict action against white collar crime.
- (x) Disclosures of the % of shareholdings by Directors, Executive Officers and principal shareholders.

Question 9

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

(4 Marks, November, 2009)

Or

Write short explanatory notes on Flow chart technique for evaluation of internal control.

(4 Marks, May, 2004)

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. However, in drawing the flow chart, the auditor has to take few precautions, e.g., flow-charts should not be lengthy and cumbersome, should be neat, should portray the flow completely with final disposal of papers and there should be proper use of symbols and lines. The auditor will be able to visually correlate the functions and the related controls and assess the adequacy and effectiveness thereof much quickly than a possibly in any other method. 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.

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 10

Highlight the provisions relating to corporate responsibility under Sarbanes Oxley Act of 2002.

(4 Marks, November, 2008)

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:

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

Question 11

Explain the concept of Audit risk at the level of financial statements. (4 Marks, May 2008)

Answer

Audit Risk at the Financial Statement Level: As per SA 315 "Identifying and Assessing the Risk of Material Misstatement through understanding the Entity and its Environment", risks of material misstatement at the financial statement level refer to risks that relate pervasively to the financial statements as a whole and potentially affect many assertions. Risks of this nature are not necessarily risks identifiable with specific assertions at the class of transactions, account balance, or disclosure level. Rather, they represent circumstances that may increase the risks of material misstatement at the assertion level, for example, through management override of internal control. Financial statement level risks may be especially relevant to the auditor's consideration of the risks of material misstatement arising from fraud.

Risks at the financial statement level may derive in particular from deficient control environment (although these risks may also relate to other factors, such as declining economic conditions). For example, deficiencies such as management's lack of competence may have a more pervasive effect on the financial statements and may require an overall response by the auditor.

The auditor's understanding of internal control may raise doubts about the auditability of an entity's financial statements. For example:

- (i) Concerns about the integrity of the entity's management may be so serious as to cause the auditor to conclude that the risk of management misrepresentation in the financial statements is such that an audit cannot be conducted.
- (ii) Concerns about the condition and reliability of an entity's records may cause the auditor to conclude that it is unlikely that sufficient appropriate audit evidence will be available to support an unqualified opinion on the financial statements.

Question 12

Write a short note on Sampling Risk.

(4 Marks, May, 2006)

Answer

Sampling Risk: As per SA 530 "Audit Sampling", sampling risk is the risk that arises from the possibility that the auditor's conclusion, based on a sample, may be different from the conclusion that would be reached if the entire population were subjected to the same audit procedure. Sampling risk can lead to two types of erroneous conclusions -

- (i) In the case of a test of controls, that controls are more effective than they actually are, or in the case of a test of details, that a material misstatement does not exist when in fact it does. The auditor is primarily concerned with this type of erroneous conclusion because it affects audit effectiveness and is more likely to lead to an inappropriate audit opinion.
- (ii) In the case of a test of controls, that controls are less effective than they actually are, or in the case of a test of details, that a material misstatement exists when in fact it does not. This type of erroneous conclusion affects audit efficiency as it would usually lead to additional work to establish that initial conclusions were incorrect.

Sample size is affected by the level of sampling risk the auditor is willing to accept from the results of the sample. The lower the risk the auditor is willing to accept, the greater the sample size will need to be.

Question 13

Write a short note on Factors relevant in evaluation of Inherent Risk.

(4 Marks, May, 2005)

Answer

Relevant Factors in Evaluation of Inherent Risk: While developing an overall audit plan, the auditor is required to assess inherent risk at financial statement level and is then required to relate his assessment to material account balances and the class of transactions. To assess inherent risk, the auditor would use professional judgement to evaluate numerous factors, having regard to his experience of the entity from previous audit engagements of the entity, any controls established by management to compensate for a high level of inherent risk, and his knowledge of any significant changes which might have taken place since his last assessment. Normally an auditor evaluates inherent risk by assessing factors such as integrity of the management, experience and knowledge of the management, turnover of key management personnel, circumstances which may motivate the management to misstate the financial statement when its financial performance is not satisfactory, nature of entity's business prone to rapid technological obsolescence dealing with large number of related parties, etc.