

4

Internal Control

Question 1

State with reasons (in short) whether the following statement is correct or incorrect:

Maintenance of internal control system is responsibility of Auditor. (2 Marks, May, 2014)

Answer

Incorrect: It is the responsibility of the management for the maintenance of internal control system rather than of the Auditor. Because, Internal control is the process designed, implemented and maintained by those charged with governance, management to provide reasonable assurance about the achievement of entity's objectives.

Question 2

Write a short note on Auditing through the computer. (4 Marks, May, 2014)

Or

What do you understand by 'Auditing through the computer'? (4 Marks, May, 2005)

Answer

Auditing through the Computer Approach: The sophistication of computers has finally reached the point where auditors can no longer audit around the system. They are forced to treat the computers as the target of the audit and audit through it. Auditing through the computer requires that the auditor submits data to the computer for processing. The results are then analysed for the processing reliability and accuracy of the computer programme. Technical and other developments that necessitated this approach include the following-

- On-line data entry.
- Elimination or reduction of print-outs.
- Real time files updating.

The auditor can use the computer to test the logic and controls existing within the system; and the records produced by the system.

Depending upon the complexity of the application system being audited, the approach may be fairly simple or require extensive technical competence on the part of the auditor.

There are several circumstances where auditing through the computer approach must be used-

- (i) The application system processes large volumes of input and produces large volumes of output that make extensive direct examination of the validity of input and output difficult.
- (ii) Significant parts of the internal control system are embodied in the computer system. For example, in an online banking system a computer program may batch transactions for individual tellers to provide control totals for reconciliation at the end of the day's processing.
- (iii) The logic of the system is complex and there are large portions that facilitate use of the system for efficient processing.
- (iv) Because of cost-benefit considerations, there are substantial gaps in the visible audit trail.

The primary advantage is that the auditor has increased power to effectively test a computer system. The range and capability of tests that can be performed increases and the auditor acquires greater confidence that data processing is correct. By examining the system's processing the auditor also can assess the system's ability to cope with environment change.

The primary disadvantages of the approach are the high costs sometimes involved and the need for extensive technical expertise when systems are complex. However, these disadvantages are really spurious if auditing through computer is the only viable method of carrying out the audit.

Question 3

State with reason (in short) whether the following statement is correct or incorrect:

"Examination in depth" implies that the auditor vouches almost all transactions in a manner that the chances of not checking any transaction are left at minimum.

(2 Marks, November, 2013)

Answer

Incorrect. Examination in depth implies examination of a few selected transactions from the beginning to the end through the entire flow of the transaction. This examination consists of studying the recording of transactions at the various stages through which they have passed. At each stage, relevant records and authorities are examined; it is also judged whether the person who has exercised the authority in relation to the transactions is fit to do so in terms of the prescribed procedure.

Question 4

Explain inherent limitations of internal control systems. *(8 Marks, November, 2013)*

Or

What are the inherent limitations of Internal control? *(7 Marks, November, 2007)*

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Answer

Inherent Limitations of Internal Control Systems: Internal control can provide only reasonable but not absolute assurance that its objective relating to prevention and detection of errors/frauds, safeguarding of assets etc., are achieved. This is because it suffers from some inherent limitations, such as-

- (i) Management's consideration that cost of an internal control does not exceed the expected benefits.
- (ii) Most controls do not tend to be directed at unusual transactions.
- (iii) The potential of human error due to carelessness, misjudgment and misunderstanding of instructions.
- (iv) The possibility that control may be circumvented through collusion with employees or outsiders.
- (v) The possibility that a person responsible for exercising control may abuse that authority.
- (vi) Compliance with procedures may deteriorate because the procedures becoming inadequate due to change in condition.
- (vii) Manipulation by management with respect to transactions or estimates and judgements required in the preparation of financial statements.
- (viii) Inherent limitations of Audit.

Question 5

Write short notes on the following:

- (a) *Use of flow charts in evaluation of internal control.* (4 Marks, November, 2013)
- (b) *Letter of Weakness.* (4 Marks, May, 2013) (5 Marks, June, 2009)

Answer

- (a) **Use of Flow Charts in Evaluation of Internal Control:** It is a graphic presentation of each part of the company's system of internal control. A flow chart is considered to be the most concise way of recording the auditor's review of the system. It minimises the amount of narrative explanation and thereby achieves a consideration or presentation not possible in any other form. It gives bird's eye view of the system and the flow of transactions and integration and in documentation, can be easily spotted and improvements can be suggested.

It is also necessary for the auditor to study the significant features of the business carried on by the concern; the nature of its activities and various channels of goods and materials as well as cash, both inward and outward; and also a comprehensive study of the entire process of manufacturing, trading and administration. This will help him to understand and evaluate the internal controls in the correct perspective.

(b) Letter of Weakness

- (i) The auditor does compliance procedure to ascertain that the internal control system exist in the entity, it works effectively; it work continuously in the entity during review period.
- (ii) When he comes across any weakness in the control points, he issues letter of weakness.
- (iii) Letter of weakness is a report issued by auditor stating the weakness in internal control mechanism. It also suggests measures by which the weakness in the system be corrected and the control system be made better protected.
- (iv) Lapses in operation of internal control too are reported in the communication of weakness.
- (v) The communication of weakness is reporting to management of such weakness in design and operation of internal control as have come to notice of auditor during his auditing and it should not be taken to be a review and comment on adequacy of the control mechanism for management purpose.

Question 6

Write a short note on Internal Control Questionnaire.

(4 Marks, May, 2013)

Or

Explain briefly the technique of "Internal Control Questionnaire" to facilitate the accumulation of information necessary for proper evaluation of internal control. (4 Marks, November, 2010)

Answer

Internal Control Questionnaire: This is a comprehensive series of questions concerning internal control. This is the most widely used form for collecting information about the existence, operation and efficiency of internal control in an organisation.

An important advantage of the questionnaire approach is that oversight or omission of significant internal control review procedures is less likely to occur with this method. With a proper questionnaire, all internal control evaluation can be completed at one time or in sections. The review can more easily be made on an interim basis. The questionnaire form also provides an orderly means of disclosing control defects. It is the general practice to review the internal control system annually and record the review in detail. In the questionnaire, generally questions are so framed that a 'Yes' answer denotes satisfactory position and a 'No' answer suggests weakness. Provision is made for an explanation or further details of 'No' answers. In respect of questions not relevant to the business, 'Not Applicable' reply is given.

The questionnaire is usually issued to the client and the client is requested to get it filled by the concerned executives and employees. If on a perusal of the answers, inconsistencies or apparent incongruities are noticed, the matter is further discussed by auditor's staff with the

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client's employees for a clear picture. The concerned auditor then prepares a report of deficiencies and recommendations for improvement.

Question 7

"Internal check is part of internal control system". Comment. (2 Marks, May, 2013)

Answer

Internal Check being part of Internal Control System: Internal check has been defined as "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". Internal check is a part of the overall internal control system and operates as a built-in device as far as the staff organisation and job allocation aspects of the control system are concerned. Therefore, the statement given in the question is not correct.

Question 8

To prepare an audit plan in CIS environment an auditor should gather information. Mention any four such important information which he has to collect. (4 Marks, May, 2013)

Answer

Information to be gathered to prepare an Audit Plan in CIS Environment: The auditor should gather information about the CIS environment that is relevant to the audit plan, including information as to-

- (i) How the CIS function is organized and the extent of concentration or distribution of computer processing throughout the entity.
- (ii) The computer hardware and software used by the entity.
- (iii) Each significant application processed by the computer, the nature of the processing (e.g. batch, on-line), and data retention policies.
- (iv) Planned implementation of new applications or revisions to existing applications.
- (v) When considering his overall plan the auditor should consider matters, such as:
 - (a) Determining the degree of reliance, if any, he expects to be able to place on the CIS controls in his overall evaluation of internal control.
 - (b) Planning how, where and when the CIS function will be reviewed including scheduling the works of CIS experts, as applicable.
 - (c) Planning auditing procedures using computer-assisted audit techniques.

Question 9

Write a short note on Inherent risk. (4 Marks, November, 2012)

Answer

Inherent Risk (risk that material errors will occur): The susceptibility of an assertion about a class of transaction, account balance or disclosure to a misstatement that could be material, either individually or when aggregated with other misstatements, before consideration of any related controls. It is higher for some assertions and related classes of transactions, account balances, and disclosures than for others. For example, it may be higher for complex calculations or for accounts consisting of amounts derived from accounting estimates that are subject to significant estimation uncertainty. External circumstances giving rise to business risks may also influence inherent risk. For example, technological developments might make a particular product obsolete, thereby causing inventory to be more susceptible to overstatement. Factors in the entity and its environment that relate to several or all of the classes of transactions, account balances, or disclosures may also influence the inherent risk related to a specific assertion. Such factors may include, for example, a lack of sufficient working capital to continue operations or a declining industry characterised by a large number of business failures.

Question 10

What are the general considerations in framing a system of internal check? (8 Marks, May, 2012)

Or

What are the special steps involved in framing a system of Internal Check?

(8 Marks, May, 2006)

Answer

General Considerations in framing 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.

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- (vi) The system of Budgetary Control should be introduced.
- (vii) For inventory-taking, at the close of the year, trading activities should, if possible, be suspended. The task of inventory-taking, and evaluation should be done by staff belonging to other than inventory 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 11

Explain the objectives of internal audit.

(8 Marks, November, 2011)

Answer

Objectives of Internal Audit: Internal Audit is an independent management function, which involves a continuous and critical appraisal of the functioning of an entity with a view to suggest improvements thereto and add value to and strengthen the overall governance mechanism of the entity, including the entity's risk management and internal control system. Now it is statutory requirement as per the provisions of section 138 of the Companies Act, 2013.

The objective of internal audit can be stated as follows:

- (i) To verify the accuracy and authenticity of the financial accounting and statistical records presented by the management.
- (ii) To ascertain that the standard accounting practices, as have been decided to be followed by the organisation, are being adhered to.
- (iii) To establish that there is a proper authority for every acquisition, retirement and disposal of assets.
- (iv) To confirm that liabilities have been incurred only for the legitimate activities of the organisation.
- (v) To analyse and improve the system of internal check in particular to see that it is (1) working; (2) sound; and (3) economical.
- (vi) To facilitate the prevention and detection of frauds.
- (vii) To examine the protection afforded to assets and the uses to which they are put.
- (viii) To make special investigations for management.
- (ix) To provide a channel whereby new ideas can be brought to the attention of management.
- (x) To review the operation of the overall internal control system and to bring material departures and non-compliances to the notice of the appropriate level of management; the review also generally aims at locating unnecessary and weak controls for making the entire control system effective and economical.

Question 12

What are CAATS? Why are CAAT required in computerized information system (CIS) environment? (8 Marks, November, 2011)

Or

Why are Computer Aided Audit Techniques (CAAT) required in EDP audit? What are the advantages of CAATs? (10 Marks, May, 2006)

Answer

Computer Aided Audit Techniques (CAATs): The use of computers may result in the design of systems that provide less visible evidence than those using manual procedures. Computer Aided Audit Techniques (CAATs) are such techniques applied through the computer which are used in the verifying the data being processed by it.

System characteristics resulting from the Computerised Information System (CIS) Environment that demand the use of Computer Aided Audit Techniques (CAAT) are-

- (i) **Absence of input documents:** Data may be entered directly into the computer systems without supporting documents. In on-line transaction systems, written evidence of individual data entry authorization, e.g., credit limit approval may not be available.
- (ii) **Lack of visible transaction trail:** Certain data may be maintained on computer files only. In a manual system, it is normally possible to follow a transaction through the system by examining source documents, books of account, records, files and reports. In CIS environment, however, the transaction trail may be partly in machine-readable form, and it may exist only for a limited period of time.
- (iii) **Lack of visible output:** In a manual system, it is normally possible to examine visually the results of processing. In CIS environment, the results of processing may not be printed or only a summary data may be printed. Thus, lack of visible output may result in the need to access data retained on machine readable files.
- (iv) **Ease of Access to data and computer programmes:** Data and computer programmes may be altered at the computer or through the use of computer equipment at remote locations. Therefore, in the absence of appropriate controls, there is an increased potential for unauthorized access to, and allocation of, data and programmes by persons inside or outside the entity.

Advantages of CAAT-

- (i) **Audit effectiveness:** The effectiveness and efficiency of auditing procedures will be improved through the use of CAAT in obtaining and evaluating audit evidence, for example –
 - (1) Some transactions may be tested more effectively for a similar level of cost by using the computer.
 - (2) In applying analytical review procedures, transactions or balance details of unusual items may be reviewed and reports got printed more efficiently by using the computer.

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- (ii) **Savings in time:** The auditor can save time by reviewing the CIS controls using CAAT than through other audit procedures.
- (iii) **Effective test checking and examination in depth:** CAAT permits effective examination in depth of selected transactions since the auditor constructs the lost audit trail.

Question 13

Write a short note on Internal control in small business.

(4 Marks, May, 2011)

Answer

Internal Control in Small Business: The auditor needs to obtain the same degree of assurance in order to give an unqualified opinion on the financial statements of both small and large entities. However, many controls which would be relevant to large entities are not practical in the small business e.g. in small business accounting work may be performed by only a few persons. These persons may have both operating and custodial responsibilities, and segregation of functions may be missing or severally limited.

Inadequate segregation of duties may, in some cases, be offset by owner/manager supervisory controls which may exist because of direct personal knowledge of the business and involvement in the business transactions. In circumstances where segregation of duties is limited or evidence of supervisory controls is lacking, the evidence necessary to support the auditors' opinion on the financial information may have to be obtained largely through the performance of substantive procedure.

Question 14

State clearly the circumstances where "Auditing through the computer" approach must be used.

(6 Marks, November, 2010)

Or

State the circumstances where the auditing through the computer must be used.

(5 Marks, May, 2007)

Answer

Auditing Through the Computer Approach: The auditor can use the computer to test-

- (a) The logic and controls existing within the system.
- (b) The records produced by the system.

Depending upon the complexity of the application system being audited, the approach may be fairly simple or require extensive technical competence on the part of the auditor.

Following are several circumstances where auditing through the computer approach must be used:

- (i) The application system processes large volumes of input and produces large volumes of output that make extensive direct examination of the validity of input and output difficult.

- (ii) Significant parts of the internal control system are embodied in the computer system. For example, in an online banking system a computer program may batch transactions for individual tellers to provide control totals for reconciliation at the end of the day's processing.
- (iii) The logic of the system is complex and there are large portions that facilitate use of the system for efficient processing.
- (iv) Because of cost-benefit considerations, there are substantial gaps in the visible audit trail.

Question 15

'Doing the audit in EDP environment is simpler since Trial Balance always tallies.' Analyse the statement critically. (5 Marks, May, 2010)

Answer

Audit in a Computerised Information System (CIS) Environment: Though it is true that in CIS environment the trial balance always tallies, the same can not imply that the job of an auditor becomes simpler. There can still be some accounting errors like omission of certain entries, compensating errors, duplication of entries, errors of commission in the form of wrong head of accounts etc. Possibility of "Window Dressing" and/or "Creation of Secret Reserves" can be possible in CIS environment also in spite of tallied trial balance. At present, due to complex business environment the importance of trial balance cannot be judged only upto the arithmetical accuracy but the nature of transactions recorded and its classification in the books should be focused.

The emergence of new forms of financial instruments like options and futures, derivatives, off balance sheet financing etc have given rise to further complexities in recording and disclosure of transactions. In an audit, besides the tallying of a trial balance, there are other issue also like estimation of provision for depreciation, estimation of tax liability, valuation of inventories, obtaining audit evidence, ensuring compliance with various laws, regulations and standards, verification of existence and valuation of assets and liabilities, reporting requirement as per statute etc. which still requires judgement to be exercised by the auditor.

The CIS environment has its own complexities and requires lot of controls, safeguards and application which requires specialised knowledge and skill for proper implementation.

Responsibility of expressing an audit opinion and objectives of an audit are not changed in the audit in CIS environment. Compliance with various laws and standards are still to be verified, ensured and reported.

Therefore, it can be said that simply because of CIS environment and tallying of the trial balance, the audit can't be said to have become simpler.

Question 16

Discuss Internal Controls in a CIS Environment.

(5 Marks, May, 2010)

Answer

Internal Controls in CIS Environment: The internal controls over computer processing, which help to achieve the overall objectives of internal control, include both manual procedures and procedures designed into computer programmes. Such manual and computer controls affect the CIS environment (general CIS controls) and the specific controls over the accounting applications (CIS application controls).

General CIS Controls: The purpose of general CIS controls is to establish a framework of overall control over the CIS activities and to provide a reasonable level of assurance that the overall objectives of internal control are achieved. These controls may include-

- (1) Organisation and management controls are designed to establish an organizational framework over CIS activities, including:
 - (i) Policies and procedures relating to control functions.
 - (ii) Appropriate segregation of incompatible functions.
- (2) Application systems development and maintenance controls are designed to establish control over:
 - (i) Testing, conversion, implementation and documentation of new or revised systems.
 - (ii) Changes to application systems.
 - (iii) Access to systems documentation.
 - (iv) Acquisition of application systems from third parties.
- (3) Computer operation controls are designed to control the operation of the systems and to provide reasonable assurance that:
 - (i) The systems are used for authorised purposes only.
 - (ii) Access to computer operations is restricted to authorised personnel.
 - (iii) Only authorised programs are used.
 - (iv) Processing errors are detected and corrected.
- (4) Systems software controls include:
 - (i) Authorisation, approval, testing, implementation and documentation of new systems software and systems software modifications.
 - (ii) Restriction of access to systems software and documentation to authorised personnel.
- (5) Data entry and program controls are designed to provide reasonable assurance that:
 - (i) An authorisation structure is established over transactions being entered into the system.
 - (ii) Access to data and programs is restricted to authorised personnel.
 - (iii) Offsite back-up of data and computer programmes.
 - (iv) Recovery procedures for use in the event of theft, loss or intentional or accidental destruction.

- (v) Provision for offsite processing in the event of disaster.

CIS Application Controls: The purpose of CIS application controls is to establish specific control procedures over the accounting applications to provide reasonable assurance that all transactions are authorised and recorded, and are processed completely, accurately and on a timely basis. These include-

- (1) Controls over input are designed to provide reasonable assurance that:
 - (i) Transactions are properly authorised before being processed by the computer.
 - (ii) Transactions are accurately converted into machine readable form and recorded in the computer data files.
 - (iii) Transactions are not lost, added, duplicated or improperly changed.
 - (iv) Incorrect transactions are rejected, corrected and if necessary, resubmitted on a timely basis.
- (2) Controls over processing and computer data files are designed to provide reasonable assurance that:
 - (i) Transactions, including system generated transactions, are properly processed by the computer.
 - (ii) Transactions are not lost, added, duplicated or improperly changed.
 - (iii) Processing errors are identified and corrected on a timely basis.
- (3) Controls over output are designed to provide reasonable assurance that:
 - (i) Results of processing are accurate.
 - (ii) Access to output is restricted to authorised personnel.
 - (iii) Output is provided to appropriate authorised personnel on a timely basis.

Question 17

State with reasons (in short) whether the following statement is True or False:

The overall objective of audit changes in Computer Information System (CIS) environment.

(2 Marks, November, 2009)

Answer

False: Overall objective of audit does not change in Computer Information System (CIS) environment. But the use of computer changes the processing and storage, retrieval and communication of financial information.

Question 18

State with reason (in short) whether the following statement is correct or incorrect:

"Auditing in-depth implies that the auditor vouches almost all transactions in a manner that the chances of not checking any transaction are left at minimum".

(2 Marks, June, 2009)

Answer

False: Auditing in depth does not mean cent percent or near cent percent vouching. It is checking selected transactions from beginning to end to understand and vet the system within which the transaction passes through.

Question 19

Mention any six points to be considered for good internal control for collection of tuition fees from students of college. (6 Marks, June, 2009)

Answer

Internal Control points for Collection of Tuition Fees

- (i) There must be a clear cut tuition fee structure approved by the college council.
- (ii) The challan or paying in slip should contain necessary fields for identifying the roll number of the student, class, and period for which fees is paid etc. The slips should have such number of counterfoils to cross check the remittance.
- (iii) The paying in slip when filled by the students should be checked for its correctness as to applicable amount etc. by one clerk and the amount should be entered in a scroll. He must initial the slip which authorises the cashier to accept the fees as per slip.
- (iv) The cashier scroll and the authorising officer/s scroll should be checked by an officer daily.
- (v) All remittance should be banked each day. No amount should be allowed to be spared for meeting any type of expense.
- (vi) Alternatively, the fees may be directly remitted into bank and banker's daily remittance slip should be scrutinised by college officers.
- (vii) Arrears list should be periodically prepared from the students rolls. Any concession, remission of tuition fees should have approval of competent authority.
- (viii) Delayed remittance should carry fines or compensating charges for delay.
- (ix) When students are readmitted after removal for non-payment of fees, the admission should carry the permission of competent authority.

Question 20

State with reasons (in short) whether the following statement is True or False:

"The environment in which internal control operates has no relationship with the effectiveness of the Specific control procedure". (2 Marks, November, 2008)

Answer

False: The environment in which internal control operates has an impact on the effectiveness of the specific control procedure. For example, strong control environment in association with effective internal audit system strengthen the internal control system.

Question 21

A company has ₹ 60 lakh of paid up Capital and ₹ 3 crore of average Annual Turnover of past three years preceding the Financial year under Audit. The company does not have any Internal Audit system because the Management does not think it necessary. As an Auditor how would you react? (6 Marks, November, 2008)

Answer

Applicability of Provisions of Internal Audit: As per section 138 of the Companies Act, 2013 the following class of companies (prescribed in rule 13 of Companies (Accounts) Rules, 2014) shall be required to appoint an internal auditor or a firm of internal auditors, namely-

- (a) every listed company;
- (b) every unlisted public company having-
 - (i) paid up share capital of ₹ 50 crore or more during the preceding financial year; or
 - (ii) turnover of ₹ 200 crore or more during the preceding financial year; or
 - (iii) outstanding loans or borrowings from banks or public financial institutions exceeding ₹ 100 crore or more at any point of time during the preceding financial year; or
 - (iv) outstanding deposits of ₹ 25 crore or more at any point of time during the preceding financial year; and
- (c) every private company having-
 - (i) turnover of ₹ 200 crore or more during the preceding financial year; or
 - (ii) outstanding loans or borrowings from banks or public financial institutions exceeding ₹ 100 crore or more at any point of time during the preceding financial year.

Thus, any of the condition is required to be satisfied for the applicability of the provision. The internal auditor to be appointed shall either be a chartered accountant whether engaged in practice or not or a cost accountant, or such other professional as may be decided by the Board to conduct internal audit of the functions and activities of the companies auditor may or may not be an employee of the company.

In the instant case, the company is having paid up capital less than ₹ 50 crore and turnover less than ₹ 200 hundred crore. It is not clear in the question whether the company is a listed company or an unlisted public company or a private company.

Further, maximum outstanding loan or borrowing from public financial institution and maximum outstanding deposits have also not been given. Therefore, it is assumed that outstanding loans or borrowings from banks or public financial institutions and outstanding deposits are also not exceeding the prescribed limits for applicability of the provisions of internal audit.

Thus, being it is either an unlisted public company or a private company; the company is not liable for internal audit as per section 138 of the Companies Act, 2013.

[Note: Alternate answer is possible assuming it's a listed company.]

Question 22

In a CIS environment, what are the different Design and Procedural aspects, which are different from those found in Manual systems? (4 Marks, November, 2008)

Answer

Different Design and Procedural Aspects of a Computerised Information System (CIS):

The development of Computerised Information Systems (CIS) will generally result in design and procedural characteristics that are different from those found in manual systems. These different design and procedural aspects of systems include –

- (i) **Consistency of performance:** CIS system performed functions are more reliable provided that all transactions types and conditions that could occur are anticipated and incorporated into the system.
- (ii) **Programme control procedures:** These procedures can be designed to provide controls with limited visibility.
- (iii) **Single transaction update of multiple or data base computer file:** A single input into the accounting system may automatically update all records associated with the transaction.
- (iv) **Systems generated transactions:** Certain transactions may be initiated by the CIS system itself without the need for an input document e.g., interest may be calculated and changed automatically to customer's account balances.
- (v) **Vulnerability of data and programme storage media:** Large volume of data may be stored on portable or fixed storage media, such as magnetic disks and tapes.

Question 23

How would you assess the reliability of Internal control system in computerized information system? (6 Marks, May, 2008)

Answer

Reliability of Internal Control System in CIS: For evaluating the reliability of internal control system in CIS, the auditor would consider the followings-

- (i) That authorised, correct and complete data is made available for processing.
- (ii) That it provides for timely detection and corrections of errors.
- (iii) That in case of interruption due to mechanical, power or processing failures, the system restarts without distorting the completion of entries and records.
- (iv) That it ensures the accuracy and completeness of output.
- (v) That it provides security to application softwares & data files against fraud etc.
- (vi) That it prevents unauthorised amendments to programs.

Question 24

Why are computer assisted audit techniques (CAAT) needed in a Computer Information Systems (CIS) environment and how it helps the auditor in obtaining and evaluating audit evidences?
(6 Marks, November, 2007)

Answer

Need of CAATs in a CIS Environment: Computer Assisted Audit Techniques (CAAT) may be required in a CIS environment in the following circumstances-

- The absence of input documents (e.g. order entry in on-line systems) or the generation of accounting transactions by computer programs (e.g. automatic calculation of discounts) may preclude the auditor from examining documentary evidence.
- The lack of a visible audit trail will preclude the auditor from visually following transactions through the computerized accounting system.
- The lack of visible output may necessitate access to data retained on files readable only by the computer.

The effectiveness and efficiency of auditing procedures may be improved through the use of computer-assisted audit techniques in obtaining and evaluating audit evidence, for example:

- (i) Some transactions may be tested more effectively for a similar level of cost by using the computer to examine all or a greater number of transactions than would otherwise be selected.
- (ii) In applying analytical review procedures, transactions or balance details may be reviewed and reports printed of unusual items more efficiently by using the computer than by manual methods.

Question 25

Write a short note on "Examination in depth".
(5 Marks, November, 2007)

Answer

Examination in Depth: It implies examination of a few selected transactions from the beginning to the end through the entire flow of the transaction, i.e., from initiation to the completion of the transaction by receipt or payment of cash and delivery or receipt of the goods. This examination consists of studying the recording of transactions at the various stages through which they have passed. At each stage, relevant records and authorities are examined; it is also judged whether the person who has exercised the authority in relation to the transactions is fit to do so in terms of the prescribed procedure. For example, a purchase of goods may commence when a predetermined re-order level has been reached. The ensuing stages may be summarised thus-

- (i) Requisitions are pre-printed, pre-numbered and authorised;
- (ii) official company order, also sequentially pre-numbered, authorised and placed with approved suppliers only;

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- (iii) receipt of supplier's invoice;
- (iv) receipt of supplier's statement;
- (v) entries in purchases day book;
- (vi) postings to purchase ledger and purchase ledger control account;
- (vii) cheque in settlement;
- (viii) entry on bank statement and returned "paid" cheque (if requested);
- (ix) cash book entry;
- (x) posting from cash book to ledger and control account, taking into account any discounts;
- (xi) receipt of goods, together with delivery/advice note;
- (xii) admission of goods to stores;
- (xiii) indication, by initials or rubber stamp on internal goods inwards note, of compliance with order regarding specification, quantity and quality;
- (xiv) entries in stores records.

It should be noted that the above list is not necessarily comprehensive, nor does its constituent stages inevitably take place in the sequence suggested. The important point to note is that from the moment it was realised that once a re-order level had reached, a chain of events was put in motion, together leaving what may be termed as "audit trail". Each item selected for testing must be traced meticulously, and although sample sizes need not be large, they must, of course, be representative.

It is an acceptable practice to check a slightly smaller number of transactions at each successive stage within a depth test, on the statistical grounds (based on probability theory) that the optimum sample size decreases as the auditor's "level of confidence" concerning the functioning of the system increases. Examination in depth has been found indispensable in modern auditing practice and, if intelligently conducted, its reconstruction of the audit trail reveals more about the functioning (or malfunctioning) of the client's system in practice than the haphazard and mechanical approach to testing.

Question 26

Explain "Relationship between Statutory Auditor and internal Auditor". (5 Marks, May, 2007)

Answer

Relationship between Statutory Auditor and Internal Auditor: The function of an internal auditor is an integral part of the system of internal control. It is statutory requirement too as per section 138 of the Companies Act, 2013 where the Audit Committee of the company or the Board shall, in consultation with the Internal Auditor, formulate the scope, functioning, periodicity and methodology for conducting the internal audit. However, it is obligatory for a statutory auditor to examine the scope and effectiveness of the work carried out by the internal auditor.

CARO, 2015 also requires the statutory auditor to comment on the adequacy of internal control system commensurate with the size of the company and the nature of its business, for the

purchase of inventory and fixed assets and for the sale of goods and services. The order further requires to comment whether there is a continuing failure to correct major weaknesses in internal control system.

Though the roles and primary objectives of internal and statutory audit differs, some of their means of achieving their respective objectives are similar. Thus, much of the work of the internal auditor may be useful to the statutory auditor in determining the nature, timing and extent of his audit procedures. Depending upon such evaluation, the statutory auditor may be able to adopt less extensive procedures.

If the statutory auditor is satisfied on an examination of the work of the internal auditor, that the internal audit has been efficient and effective, he may accept the checking/evaluation carried out by the internal auditor in the area of internal control, verification of assets and liabilities etc.

It must however be mentioned that the area of co-operation between the statutory and internal auditor is limited by the fact that both owe their allegiance to separate authorities, the shareholders in the case of statutory auditor and the management in the case of internal auditor.

Question 27

Distinguish between Internal Control Questionnaire and Internal Control Evaluation.

(5 Marks, May, 2007)

Answer

Internal Control Questionnaire (ICQ) and Internal Control Evaluation (ICE): The internal control questionnaires show the area where weakness occur or likely to occur. They do not give any idea of the importance of those weaknesses. The Internal Control Evaluation brings to light importance of those weakness disclosed by ICQ.

Main points of distinctions are:

- (i) ICQ incorporates a large number of detailed questions but does not attempt to distinguish their relation in materiality. ICE isolates the main control objectives within the area of review.
- (ii) Weaknesses are highlighted by answer "Yes" on ICE compared with 'No' on ICQ.
- (iii) Answer 'no' in ICQ indicates a weakness real or potential, but its significance is not revealed. Whereas ICE requires audit personnel to state whether, an apparent weakness may prove to be material in relation to the accounts as a whole.
- (iv) The 'Control Checklist' in ICE is more than a summary of key control factors, and is no substitute for ICQ.

Question 28

JKT Ltd. having ₹ 40 lacs paid up capital, ₹ 9.50 lacs reserves and turnover of last three consecutive financial years, immediately preceding the financial year under audit, being ₹ 4.90

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crores, ₹ 4.50 crores and ₹ 6 crores, but does not have any internal audit system. In view of the management, internal audit system is not mandatory. Comment as an Auditor.

(4 Marks, November, 2006)

Answer

Applicability of Provisions of Internal Audit: As per section 138 of the Companies Act, 2013, the following class of companies (prescribed in rule 13 of Companies (Accounts) Rules, 2014) shall be required to appoint an internal auditor or a firm of internal auditors, namely-

- (a) every listed company;
- (b) every unlisted public company having-
 - (i) paid up share capital of ₹ 50 crore or more during the preceding financial year; or
 - (ii) turnover of ₹ 200 crore or more during the preceding financial year; or
 - (iii) outstanding loans or borrowings from banks or public financial institutions exceeding ₹ 100 crore or more at any point of time during the preceding financial year; or
 - (iv) outstanding deposits of ₹ 25 crore or more at any point of time during the preceding financial year; and
- (c) every private company having-
 - (i) turnover of ₹ 200 crore or more during the preceding financial year; or
 - (ii) outstanding loans or borrowings from banks or public financial institutions exceeding ₹ 100 crore or more at any point of time during the preceding financial year.

Thus, any of the condition is required to be satisfied for the applicability of the provision. The internal auditor to be appointed shall either be a chartered accountant whether engaged in practice or not or a cost accountant, or such other professional as may be decided by the Board to conduct internal audit of the functions and activities of the companies auditor may or may not be an employee of the company.

In the instant case, JKT Ltd. is having paid up capital less than ₹ 50 crore and turnover less than ₹ 200 hundred crore. Further, maximum outstanding loan or borrowings from public financial institution and maximum outstanding deposits have not been given. Therefore, it is assumed that outstanding loans or borrowings from banks or public financial institutions and outstanding deposits are also not exceeding the prescribed limits for applicability of the provisions of internal audit.

Thus, any of the condition in respect of paid up capital, turnover, outstanding loans or outstanding deposits is not satisfied. So, the company is not liable for internal audit as per section 138 of the Companies Act, 2013.

Question 29

What do you understand by Internal checks?

(6 Marks, November, 2006)

Answer

Internal Check: It means checks on day to day transaction which operate continuously as part of the routine system whereby the work of one person is proved independently or is complimentary to the work of another. The object of internal check is mainly prevention or early detection of fraud or error-intentional or unintentional. By employing a good system, the chances of occurrence of errors or fraud or their remaining undetected are greatly reduced. Internal check is a part of the overall internal control system and operates as a built-in-devices as far as the staff organisation and job allocation aspects of the control system are concerned. The system in accounting implies organization of system of bookkeeping and arrangement of staff in such a manner that no one person can completely carry through a transaction and record every aspect thereof.

Therefore it is increasingly being recognised that for an audit to be effective, especially when the size of a concern is large, the existence of a system of internal check is essential. The auditor can rely on sound system of internal check and on that consideration, reduce the extent of detailed checking to be carried out by him. Scope of audit can be reduced by both the time and cost factors.

Question 30

Is there any change in audit approach in the audit of computerised accounts as compared to audit of manual accounts?
(8 Marks, November, 2005)

Answer

Audit Approach in respect of Computerised Accounts: The principal objective of an audit of financial statements, prepared within a framework of recognised accounting policies and practices and relevant statutory requirements, if any, is to ensure that the financial statements reflect a true and fair view. The scope of an audit of financial statements is determined by the auditor having regard to the terms of the engagement, the requirements of relevant legislation and the pronouncements of the Institute. This would involve assessment of reliability and sufficiency of the information contained in the accounting records and other source data by study and evaluation of accounting system and internal controls in operation.

The overall objective and scope of an audit does not change in Computerised Information System (CIS) environment but the use of a computer changes the processing and storage of financial information and may affect the organisation and procedures employed by the entity to achieve adequate internal control. Accordingly, the procedures followed by the auditor in his study and evaluation of the accounting system and related internal controls and nature, timing and extent of his other audit procedures may be affected by CIS environment. The computerisation of accounts would also have an impact on the increase in fraud and errors. Unless there is well laid down control with regard to use of programme, access, processing and other operations, the auditor runs the risk of material misstatement appearing in the financial statement. Thus, when auditing in CIS environment, the auditor should have sufficient understanding of computer hardware, software and processing systems to plan the engagement and to understand how CIS affects the study and evaluation of internal control and application of auditing procedures including computer-assisted audit techniques. The

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auditor should also have sufficient knowledge of CIS to implement the auditing procedures, depending on the particular audit approach adopted. Again, there is lack of audit trail (in a one to one fashion) in a highly computerised environment (e.g. on-line system). In such a case, the auditor has to ensure that data fed are correctly, and reliably processed; no unauthorised data are fed; the output produced to him had not been manipulated. In such a case, the auditor has to audit through the computer.

Thus, it is clear from the above that overall objective and scope of audit does not change irrespective of fact that whether the accounting information is generated manually or through CIS.

Question 31

What do you understand by 'Auditing around the computer'? (4 Marks, May, 2005)

Answer

'Audit around the Computer': Audit around the computer involves forming of an audit opinion wherein the existence of computer is not taken into account. Rather the principle of conventional audit like examination of internal controls and substantive testing is done. The auditor views the computer as a black box, as the application system processing is not examined directly. The main advantage of auditing around the computer is its simplicity. Audit around the computer is applicable in the following situations-

- (a) The system is simple and uses generalised software that is well tested and widely used.
- (b) Processing mainly consists of sorting the input data and updating the master file in sequence.
- (c) Audit trail is clear. Detailed reports are prepared at key processing points within the system.
- (d) Control over input transactions can be maintained through normal methods, i.e. separation of duties, and management supervision.

Generalised software packages, like payroll and provident fund package, accounts receivable and payable package, etc. are available, developed by software vendors. Though the auditor may decide not to go in details of the processing aspects, if there are well tested widely used packages provided by a reputed vendor. However, he has to ensure that there are adequate controls to prevent unauthorised modifications of the package. However, it may be noted that all such generalised packages do not make the system amenable to audit. Some software packages provide generalized functions, that still must be selected and combined to achieve the required application system. In such a case, instead of simply examining the systems input and output, the auditor must check the system in depth to satisfy himself about such system. The main disadvantages of the system of auditing around the computer are:

- (a) It is not beneficial for complex systems of large scale in very large multi unit, multi locational companies, having various inter unit transactions. It can be used only in case of small organisations having simple operations.
- (b) It is difficult for the auditor to assess the degradation in the system in case of change in environment, and whether the system can cope with a changed environment.

Question 32

Write a short note on "Independence of Internal Auditor".

(4 Marks, May, 2005)

Answer

Independence of Internal Auditor: As per section 138 of the Companies Act, 2013, the internal auditor, who shall either be a chartered accountant whether engaged in practice or not or a cost accountant, or such other professional as may be decided by the Board to conduct internal audit of the functions and activities of the companies auditor may or may not be an employee of the company. Further, the Audit Committee of the company or the Board shall, in consultation with the Internal Auditor, formulate the scope, functioning, periodicity and methodology for conducting the internal audit. It may also be noted that the Central Government may, by rules, prescribe the manner and the intervals in which the internal audit shall be conducted and reported to the Board.

So, the concept of independence is equally relevant for internal auditor also. Internal auditing is an independent, objective assurance and consulting activity designed to add value and improve an organisation's operations. As mentioned above, the internal auditor may be part of the management but he evaluates the functioning of the management at different levels.

Therefore, to be efficient and effective, the internal auditor must have adequate independence. It may be noted that by its very nature, the internal audit function cannot be expected to have the same degree of independence as is essential when the external auditor expresses his opinion on the financial information. To ensure his independence he is made responsible directly to the Board of Directors through audit committee. Such a channel of communication provides an independent mode whereby an internal auditor can communicate and share his views on the scope of internal audit, findings, etc. If internal auditor is made subordinate to lower level, his independence will be effected which will affect his functioning and effectiveness. An outsider, like a firm of chartered accountants, if acting as internal auditor, is likely to be more independent than an employee of the organization.

Question 33

Write a short note on "Audit trail in a computerized accounting environment".

(4 Marks, November, 2004)

Answer

Audit Trail in a Computerised Accounting Environment: An audit trail refers to a situation where it is possible to relate 'one-to-one' basis, the original input along with the final output. The work of an auditor would be hardly affected if "Audit Trail" is maintained i.e. if it were still possible to relate, on a 'one-to-one' basis, the original input with the final output. A simplified representation of the documentation in a manually created audit trail.

The particular credit notes may be located by the auditor at any time he may wish to examine them, even months after the balance sheet date. He also has the means, should he so wish, of directly verifying the accuracy of the totals and sub-totals that feature in the control listing,

by reference to individual credit notes. He can, of course, check all detailed calculations, casts and postings in the accounting records, at any time.

In first and early second-generation computer systems, such a complete and trail was generally available, no doubt, to management's own healthy skepticism of what the new machine could be relied upon to achieve – an attitude obviously shared by the auditor.

In such a system-

- (i) The output itself is as complete and as detailed as in any manual system.
- (ii) The trail, from beginning to end, is complete, so that all documents may be identified by located for purposes of vouching, totalling and cross-referencing.

Any form of audit checking is possible, including depth testing in either direction. In case audit trail is missing, the auditor employs Computer Assisted Techniques (CAATs) to ensure the validity of accounting data.

Question 34

What is an Audit Trail? Briefly state the special audit techniques using the computer as an audit tool. (8 Marks, May, 2004)

Answer

Audit Trail: 'Audit trail' refers to a situation where it is possible to relate, on a "one-to-one" basis, the original input with the final output. In a manual accounting system, it is possible to relate the recording of a transaction of each successive stage enabling an auditor to locate and identify all documents from beginning to end for the purposes of examining documents, totalling and cross – referencing. In first and early second generation computer systems, a complete audit trail was generally available. However, with the advent of modern machines, the CIS environment has become more complex. This led to use of exception reporting by the management which effectively eliminated the audit trail between input and output. The lack of visible evidence may occur at different stages in the accounting process, for example:

- (i) Input documents may be non-existent where sales orders are entered online. In addition, accounting transactions such as discounts and interest calculations may be generated by computer programmes with no visible authorization of individual transactions.
- (ii) The system may not produce a visible audit trail of transactions processed through the computer. Delivery notes and suppliers invoices may be matched by a computer programme. In addition, programmed control procedures such as checking customer credit limits, may provide visible evidence only on an exception basis. In such cases, there may be no visible evidence that all transactions have been processed.
- (iii) Output reports may not be produced by system or a printed report may only contain summary totals while supporting details are retained in computer files.

Special Audit Techniques: In the absence of audit trail, the auditor needs the assurance that the programmes are functioning correctly in respect of specific items by using special audit techniques. The absence of input documents or the lack of visible audit trail may require the

use of Computer Assisted Audit Techniques (CAATs) i.e. using the computer as an audit tool. The auditor can use the computer to test-

- ❖ the logic and controls existing within the system, and
- ❖ the records produced by the system.

Depending upon the complexity of the application system being audited, the approach may be fairly simple or require extensive technical competence on the part of the auditor. The effectiveness and efficiency of auditing procedure may be enhanced through the use of CAATs. Properly, two common types of CAATs are in vogue, viz., test pack or test data and audit software or computer audit programmes.

Question 35

Explain the important requirements which should be kept in mind to establish or evaluate a system of internal control for application process at Service Bureau? (10 Marks, May, 2004)

Answer

Requirements of Internal Control System at a Service Bureau: Various requirements to establish or evaluate a system of internal control for applications processed at a service bureau are stated below-

- (i) Liaison between bureau and user should be clearly defined. Senior member of the user's staff is appointed as liaison officer.
- (ii) Need for a system testing including all clerical procedures at the user company.
- (iii) Control over physical movement of data and in this respect whether a copy or microfilm of documents sent to the service bureau is kept.
- (iv) Planning procedure so that error is identified by documents provided by the bureau. The user must ensure that prompt correction and resubmission of rejection to meet the bureau processing schedule.
- (v) Establishing a system in the user company to ensure that all exceptional reports are received from bureau.
- (vi) Establish clerical control to verify the accuracy of computer processing.
- (vii) Normally, user has no physical control over the files; therefore, high control over the maintenance of data on master files should be established.

Question 36

"Installation of Computer Operating System have created both benefits and problems for auditors". Explain the Statement? (6 Marks, May, 2004)

Answer

Computer Operating Systems and the Auditor: The installation of computer operating system is an integral and absolutely essential part of a computer even in a standalone PC-based environment. In fact it is difficult to visualize a computer to be operational without installation of the operating system. With the advancement of technology, the operating

systems are part of the server or hard disc and provide lot of options and flexibility to the user. The provision of all these built-in-features is quite beneficial to user and the auditor alike. The data stored in the system can be extracted depending upon the requirement, e.g., records relating to students can be region-wise, city-wise, examination centre-wise, etc to compare the performance. At the same time, these advanced features of operating systems have given rise to several general hazards associated with it. In these circumstances, it becomes essential to restrict the access to data by ensuring proper security system such as passwords and other access controls, etc. However, such system at time can be hacked and then the entire database is vulnerable to manipulation. Thus, from the auditor's point of view installation of operating system have created both benefits and problems. The major benefits flow from the fact of examination of execution of transactions, taking samples, etc. while problems might arise to potential manipulation of the data. It May however, be noted that benefits from the operating system for outweigh the problems associated with it.