



RISK ASSESSMENT AND INTERNAL CONTROL



LEARNING OUTCOMES

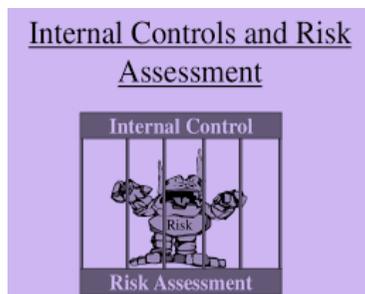
After studying this chapter, you will be able to:

- Know the Internal Control System-Nature, Scope, Objective and Structure.
- Identify the components of Internal Control.
- Learn to review of the systems of Internal Control.
- Understand the concept of Risk Based Audit, Internal Control and Risk Assessment.
- Gain knowledge of reporting to clients on Internal Control weaknesses.
- Know the framework of Reporting of Internal Control

CHAPTER OVERVIEW



1. INTRODUCTION



It is the risk that the auditor may fail to express an appropriate opinion in an audit assignment. An auditor may consider audit risk both at overall level as well as at the level of individual account balances or classes of transactions. This means that at overall level the auditor applies their professional judgement to determine the extent of risk which he considers to be an acceptable level. At account balance level, audit risk refers to the risk that error in monetary terms exists beyond a tolerable error limit in the account balances or class of transaction which

the auditor fails to detect. **Fig.: Internal Control and Risk Assessment***

* Source : SlideShare

	<p>AUDIT RISK means the risk that the auditor gives an inappropriate audit opinion when the financial statement are materially misstated. SA 315 establishes requirements and provides guidance on identifying and assessing the risks of material misstatement at the financial statement and assertion levels.</p>
<p><u>Audit risk is a function of the risks of material misstatement and detection risk</u></p>	<p>Risk of material misstatement may be defined as the risk that the financial statements are materially misstated prior to audit. This consists of two components, described as follows at the assertion level:</p>
<p>Audit Risk = Risk of Material Misstatement x Detection Risk-----(1)</p>	<p>(A) Inherent risk—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.</p>
<p>Risk of Material Misstatement= Inherent Risk x Control Risk-----(2)</p>	<p>(B) Control risk—The risk that a misstatement that could occur in an assertion about a class of transaction, account balance or disclosure and that could be material, either individually or when aggregated with other misstatements, will not be prevented, or detected and corrected, on a timely basis by the entity's internal control.</p>
<p>From (1) and (2), we arrive at-</p>	<p>(C) Detection Risk: The risk that the procedures performed by the auditor to reduce audit risk to an acceptably low level will not detect a misstatement that exists and that could be material, either individually or when aggregated with other misstatements.</p>
<p><u>Audit Risk = Inherent Risk x Control Risk x Detection Risk</u></p>	
<p>Assessment of Risks - Matter of Professional Judgement</p>	

The Internal Control structure in an organization is referred to as the policies and procedures established by the entity to provide reasonable assurance that the objectives are achieved. The control structure in an organization basically has the following components:

1. **Control Environment** - Control environment covers the effect of various factors like management attitude, awareness and actions for establishing, enhancing or mitigating the effectiveness of specific policies and procedures.
2. **Accounting System** - Accounting system means the series of task and records of an entity by



which transactions are processed for maintaining financial records. Such system identifies, assemble, analyze, calculate, classify, record, summarize and report transactions and other events.

- 3. Control Procedure** - Policies and procedures means those policies and procedures in addition to the control environment and accounting systems which the management has established to achieve the entity's specific objectives.

In this regard, the management is responsible for maintaining an adequate accounting system incorporating various internal controls to the extent that they are appropriate to the size and nature of the business. There should be reasonable assurance for the auditor that the accounting system is adequate and that all the accounting information required to be recorded has in fact been recorded.

Internal controls normally contribute to such assurance. The auditor should gain an understanding of the accounting system and related internal controls and should study and evaluate the operation of those internal controls upon which he wishes to rely in determining the nature, timing and extent of other audit procedures. Where the auditor concludes that he can rely on certain internal controls, he could reduce his substantive procedures which otherwise may be required and may also differ as to the nature and timing.

Specific Requirement under **SA 315 - "Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and its Environment"** deals with the auditor's responsibility to identify and assess the risks of material misstatement in the financial statements, through understanding the entity and its environment, including the entity's internal control.

SA 315 defines the system of internal control as the process designed, implemented and maintained by those charged with governance, management and other personnel to provide reasonable assurance about the achievement of an entity's objectives with regard to reliability of financial reporting, effectiveness and efficiency of operations, safeguarding of assets, and compliance with applicable laws and regulations.

SA 315 further states that the auditor should identify and assess the risks of material misstatement, whether due to fraud or error, at the financial statement and assertion levels, through understanding the entity and its environment, including the entity's internal control, thereby providing a basis for designing and implementing responses to the assessed risks of material misstatement. This will help the auditor to reduce the risk of material misstatement to an acceptably low level.



2. INTERNAL CONTROL SYSTEM - NATURE, SCOPE, OBJECTIVES AND STRUCTURE

Internal controls are a system consisting of specific policies and procedures designed to provide management with reasonable assurance that the goals and objectives it believes important to the entity will be met.



"Internal Control System" means all the policies and procedures (internal controls) adopted by the management of an entity to assist in achieving management's objective of ensuring, as far as practicable, the orderly and efficient conduct of its business, including adherence

to management policies, the safeguarding of assets, the prevention and detection of fraud and error, the accuracy and completeness of the accounting records, and the timely preparation of reliable financial information.

To state whether a set of financial statements presents a true and fair view, it is essential to benchmark and check the financial statements for compliance with the framework. The Accounting Standards specified under the Companies Act, 1956 (which are deemed to be applicable as per Section 133 of the 2013 Act, read with Rule 7 of Companies (Accounts) Rules, 2014) is one of the criteria constituting the financial reporting framework on which companies prepare and present their financial statements under the Act and against which the auditors evaluate if the financial statements present a true and fair view of the state of affairs and the results of operations of the company in an audit of the financial statements carried out under the Act.

The following are the Nature, Scope, Objectives and Structure of an Internal Control Audit:

2.1 Nature of Internal Control

A set of internally generated policies and procedures adopted by the management of an enterprise is a prerequisite for an organisations efficient and effective performance. It is thus, a primary responsibility of every management to create and maintain an adequate system of internal control appropriate to the size and nature of the business entity.

SA 315 defines the system of internal control as the process designed, implemented and maintained by those charged with governance, management and other personnel to provide reasonable assurance about the achievement of an entity's objectives with regard to reliability of financial reporting, effectiveness and efficiency of operations, safeguarding of assets, and compliance with applicable laws and regulations.

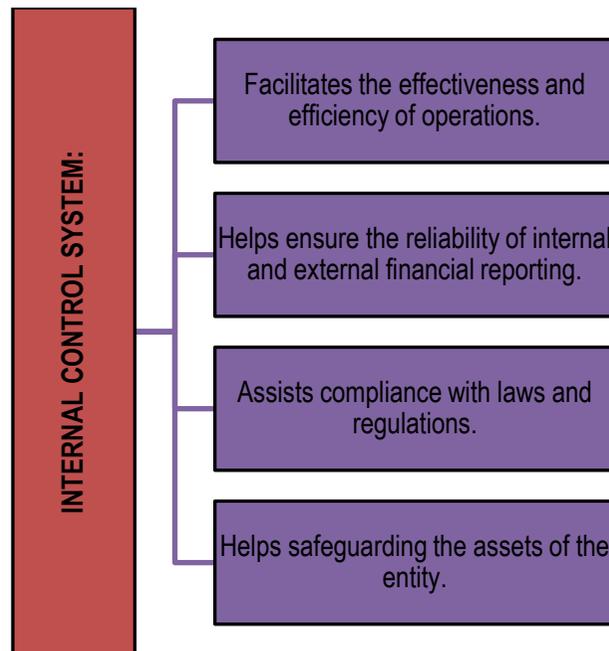
Internal control is a process/set of processes designed to facilitate and support the achievement of business objectives. Any system of internal control is based on a consideration of significant risks in operations, compliance and financial reporting. Objectives such as improving business effectiveness are included, as are compliance and reporting objectives.

2.2 Scope of Internal Controls

The scope of internal controls extends beyond mere accounting controls and includes all administrative controls concerned with the decision - making process leading to managements authorization of transaction, such controls include, production method, time and motion study, pricing policies, quality control, work standard, budgetary control, policy appraisal, quantitative controls etc. In an independent financial audit, the auditor is primarily concerned with those policies and procedures having a bearing on the assertions underlying the financial statements. These comprise primarily controls relating to safeguarding of assets, prevention and detection of fraud and error, accuracy and completeness of accounting records and timely preparation of reliable financial information. Administrative controls, on the other hand, have only a remote relationship with financial records and the auditor may evaluate only those administrative controls which have a bearing on the reliability of the financial records.

The fundamental therefore is that effective internal control is a process effected by people that supports the organization in several ways, enabling it to provide reasonable assurance regarding risk and to assist in the achievement of objectives.

Fundamental to a system of internal control is that it is integral to the activities of the company, and not something practiced in isolation.

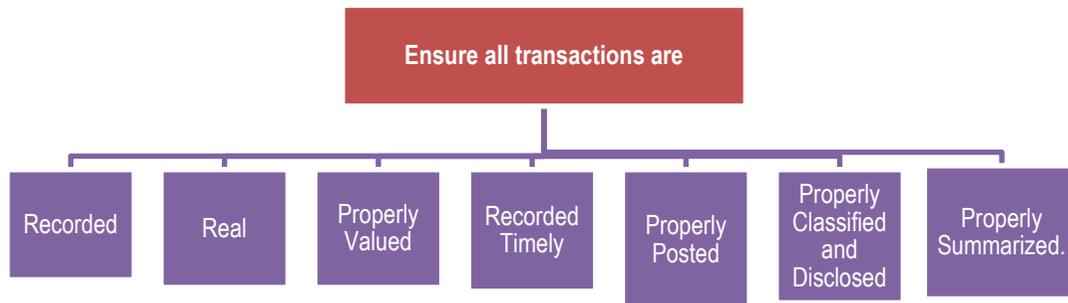


2.3 Objectives of Internal Control System

The objectives of internal control systems are determined by the management, after considering the nature of business, scale operations, the extent of professionalism of the management etc.

The objectives of internal controls relating to the accounting system are:	
(i)	Transactions are executed through general or specific management authorization .
(ii)	All transactions are promptly recorded in an appropriate manner to permit the preparation of financial information and to maintain accountability of assets.
(iii)	Assets and records are safeguarded from unauthorized access, use or disposition .
(iv)	Assets are verified at reasonable intervals and appropriate action is taken with regard to the discrepancies .

Precisely, the control objectives ensure that the transactions processed are complete, valid and accurate. The basic accounting control objectives which are sought to be achieved by any accounting control system are:



If the response to all the above answer is positive, the auditor would be justified in limiting his account balance tests considerably.

In case of excellent companies it may also be possible to rely on account balance with minimum of external tests, such as direct confirmation, management representation etc. Where in a system a particular control is found to be deficient, audit attention can be focused on the areas where basic accounting control objectives are not being adhered to.



In case, if it found that sales transactions are not being properly valued in accordance with the price list determined by the management, the auditor would have to perform extensive searching tests on sales invoices to assure himself that the recoverable amounts are correctly posted. He may also want to expand his confirmation request at the year end to cover a large majority of trade receivables.

2.3.1 Limitations of Internal Control - Internal control, no matter how effective, can provide an entity with only reasonable assurance and not absolute assurance about achieving the entity's operational, financial reporting and compliance objectives.

Internal control systems are subject to certain inherent limitations, such as:

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| <p>❏ Management's consideration that the cost of an internal control does not exceed the expected benefits to be derived.</p> |
| <p>❏ The fact that most internal controls do not tend to be directed at transactions of unusual nature. The potential for human error, such as, due to carelessness, distraction, mistakes of judgement and misunderstanding of instructions.</p> |
| <p>❏ The possibility of circumvention of internal controls through collusion with employees or with parties outside the entity.</p> |
| <p>❏ The possibility that a person responsible for exercising an internal control could abuse that responsibility, for example, a member of management overriding an internal control.</p> |
| <p>❏ Manipulations by management with respect to transactions or estimates and judgements required in the preparation of financial statements.</p> |

2.4 Structure of Internal Control

In order to achieve the objectives of internal controls, it is necessary to establish adequate control policies and procedures. Most of these policies and procedures cover:

2.4.1 Segregation of duties - Transaction processing are allocated to different persons in such a manner that no one person can carry through the completion of a transaction from start to finish or the work of one person is made complimentary to the work of another person. The purpose is to minimize the occurrence of fraud and errors and to detect them on a timely basis, when they take place. The following functions are segregated -

- (a) authorization of transactions;
- (b) execution of transactions;
- (c) physical custody of related assets; and
- (d) maintenance of records and documents, while allocating duties, the considerations of cost and efficacy should be kept in mind as there is a tendency to stretch the allocation of tasks involved in a job to more persons than what is required resulting in cumbersome procedures, over elaboration of records and unduly high cost of administration.

Apart from segregation of duties, periodic rotation of duties of personnel is also desirable. The rotation of duties seeks to ensure that if a fraud and error is committed by a person, it does not remain undetected for long. It also ensures that a person cannot develop vested interest by holding a position for too long. Rotation of duties also ensures that each employee keeps his work up to date. This also makes an employee be careful because he is aware that his performed tasks will be reviewed by others when duties are rotated.

2.4.2 Authorization of Transaction - Delegation of authority to different levels and to particular persons are required to establish by the management for controlling the execution of transaction

in accordance with prescribed conditions. Authorization may be general or it may be specific with reference to a single transaction. It is necessary to establish procedures which provide assurance that authorizations are issued by persons acting within the scope of their authority, and that the transactions conform to the terms of the authorizations. This objective can be achieved by making independent comparison of transaction document with general or specific authorizations, as the case may be.

2.4.3 Adequacy of Records and Documents - Accounting controls should ensure that -

(i)	Transactions are executed in accordance with management's general or specific authorization.
(ii)	Transactions and other events are promptly recorded at correct amounts.
(iii)	Transactions should be classified in appropriate accounts and in the appropriate period to which it relates.
(iv)	Transaction should be recorded in a manner so as to facilitate preparation of financial statements in accordance with applicable accounting standards, other accounting policies and practices and relevant statutory requirements.
(v)	Recording of transaction should facilitate maintaining accountability for assets.
(vi)	Assets and records are required to be protected from unauthorized access, use or disposition.
(vii)	Records of assets such as sufficient description of the assets (to facilitate identification) its location should also be maintained so that the assets could be physically verified periodically.

For prompt, accurate, complete and appropriate recording of accounting transaction, several procedures are often established by the management. The assurance that transactions have been properly recorded can also be obtained through a comparison of records with an independent source of information which provides an indication of the execution of the relevant transactions.

2.4.4 Accountability and Safeguarding of Assets - The process of accountability of assets commences from acquisitions of assets its use and final disposal. Safeguarding of assets requires appropriate maintenance of records, their periodic reconciliation with the related assets. Assets like cash, inventories, investment scrips require frequent physical verification with book records. The frequency of reconciliation would differ for different assets depending upon their nature and amount. Assets which are considered sensitive or susceptible to error need to be reconcile more frequently than others. For proper safeguarding of assets, only authorized personnel should be given access to such asset. This not only means physical access but also exercising control over processing of documents relating to authorization for use and disposal of assets. It is essential to have effective controls over physical custody of cash, inventories, investments and other fixed assets. In some cases, as per requirement, special procedures regarding physical custody of assets may have to be designed by the management.

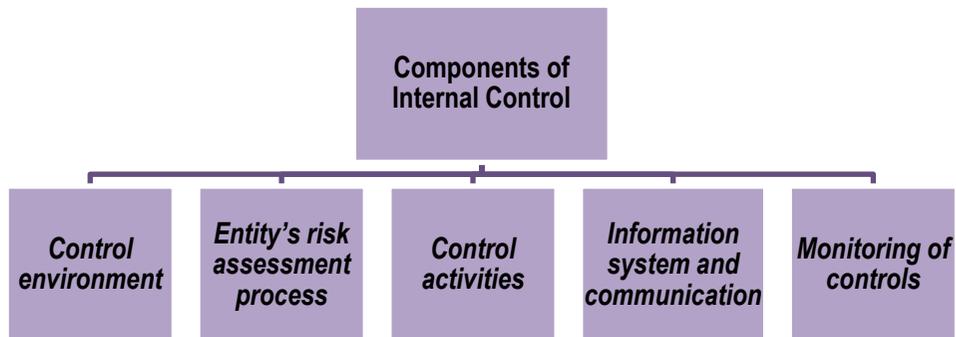
2.4.5 Independent Checks - Independent verification of the control systems, designed and implemented by the management, involves periodic or regular review by independent persons to ascertain whether the control procedures are operating effectively or not. Such process may be carried out by specially assigned staff under the banner of external audit.



3. COMPONENTS OF INTERNAL CONTROLS

In general, a system of internal control to be considered adequate should include the following five components:

- (i) Control environment;
- (ii) Entity's Risk assessment Process;
- (iii) Control activities;
- (iv) Information system and communication;
- (v) Monitoring of Controls



3.1 Control Environment

The control environment encompasses the following elements:

- (a) **Communication and enforcement of integrity and ethical values:** The effectiveness of controls cannot rise above the integrity and ethical values of the people who create, administer, and monitor them. Integrity and ethical behavior are the product of the entity's ethical and behavioral standards, how they are communicated, and how they are reinforced in practice. The enforcement of integrity and ethical values includes, for example, management actions to eliminate or mitigate incentives or temptations that might prompt personnel to engage in dishonest, illegal, or unethical acts. The communication of entity policies on integrity and ethical values may include the communication of behavioral standards to personnel through policy statements and codes of conduct and by example.
- (b) **Commitment to competence:** Competence is the knowledge and skills necessary to accomplish tasks that define the individual's job.

- (c) **Participation by those charged with governance:** An entity's control consciousness is influenced significantly by those charged with governance. The importance of the responsibilities of those charged with governance is recognised in codes of practice and other laws and regulations or guidance produced for the benefit of those charged with governance. Other responsibilities of those charged with governance include oversight of the design and effective operation of whistle blower procedures and the process for reviewing the effectiveness of the entity's internal control.
- (d) **Management's philosophy and operating style:** Management's philosophy and operating style encompass a broad range of characteristics. For example, management's attitudes and actions toward financial reporting may manifest themselves through conservative or aggressive selection from available alternative accounting principles, or conscientiousness and conservatism with which accounting estimates are developed.
- (e) **Organisational structure:** Establishing a relevant organizational structure includes considering key areas of authority and responsibility and appropriate lines of reporting. The appropriateness of an entity's organisational structure depends, in part, on its size and the nature of its activities.
- (f) **Assignment of authority and responsibility:** The assignment of authority and responsibility may include policies relating to appropriate business practices, knowledge and experience of key personnel, and resources provided for carrying out duties. In addition, it may include policies and communications directed at ensuring that all personnel understand the entity's objectives, know how their individual actions interrelate and contribute to those objectives, and recognize how and for what they will be held accountable.
- (g) **Human resource policies and practices:** Human resource policies and practices often demonstrate important matters in relation to the control consciousness of an entity. For example, standards for recruiting the most qualified individuals – with emphasis on educational background, prior work experience, past accomplishments, and evidence of integrity and ethical behaviour – demonstrate an entity's commitment to competent and trustworthy people. Training policies that communicate prospective roles and responsibilities and include practices such as training schools and seminars illustrate expected levels of performance and behaviour. Promotions driven by periodic performance appraisals demonstrate the entity's commitment to the advancement of qualified personnel to higher levels of responsibility.

3.2 Entity's Risk Assessment Process

For financial reporting purposes, the entity's risk assessment process includes how management identifies business risks relevant to the preparation of financial statements in accordance with the entity's applicable financial reporting framework, estimates their significance, assesses the likelihood of their occurrence, and decides upon actions to respond to and manage them and the

results thereof. For example, the entity's risk assessment process may address how the entity considers the possibility of unrecorded transactions or identifies and analyses significant estimates recorded in the financial statements.

Risks relevant to reliable financial reporting include external and internal events, transactions or circumstances that may occur and adversely affect an entity's ability to initiate, record, process, and report financial data consistent with the assertions of management in the financial statements. Management may initiate plans, programs, or actions to address specific risks or it may decide to accept a risk because of cost or other considerations.

Risks can arise or change due to circumstances such as the following:

- (a) Changes in operating environment. Changes in the regulatory or operating environment can result in changes in competitive pressures and significantly different risks.
- (b) New personnel. New personnel may have a different focus on or understanding of internal control.
- (c) New or revamped information systems. Significant and rapid changes in information systems can change the risk relating to internal control.
- (d) Rapid growth. Significant and rapid expansion of operations can strain controls and increase the risk of a breakdown in controls.
- (e) New technology. Incorporating new technologies into production processes or information systems may change the risk associated with internal control.
- (f) New business models, products, or activities. Entering into business areas or transactions with which an entity has little experience may introduce new risks associated with internal control.
- (g) Corporate restructurings. Restructurings may be accompanied by staff reductions and changes in supervision and segregation of duties that may change the risk associated with internal control.
- (h) Expanded foreign operations. The expansion or acquisition of foreign operations carries new and often unique risks that may affect internal control, for example, additional or changed risks from foreign currency transactions.
- (i) New accounting pronouncements. Adoption of new accounting principles or changing accounting principles may affect risks in preparing financial statements.

3.3 Control Activities

Generally, control activities that may be relevant to an audit may be categorised as policies and procedures that pertain to the following:

- (a) **Performance reviews:** These control activities include reviews and analyses of actual performance versus budgets, forecasts, and prior period performance; relating different sets of data – operating or financial – to one another, together with analyses of the relationships and investigative and corrective actions; comparing internal data with external sources of information; and review of functional or activity performance.
- (b) **Information processing:** The two broad groupings of information systems control activities are application controls, which apply to the processing of individual applications, and general IT-controls, which are policies and procedures that relate to many applications and support the effective functioning of application controls by helping to ensure the continued proper operation of information systems. Examples of application controls include checking the arithmetical accuracy of records, maintaining and reviewing accounts and trial balances, automated controls such as edit checks of input data and numerical sequence checks, and manual follow-up of exception reports. Examples of general IT-controls are program change controls, controls that restrict access to programs or data, controls over the implementation of new releases of packaged software applications, and controls over system software that restrict access to or monitor the use of system utilities that could change financial data or records without leaving an audit trail.
- (c) **Physical controls:** Controls that encompass:
 - The physical security of assets, including adequate safeguards such as secured facilities over access to assets and records.
 - The authorisation for access to computer programs and data files.
 - The periodic counting and comparison with amounts shown on control records (for example, comparing the results of cash, security and inventory counts with accounting records). The extent to which physical controls intended to prevent theft of assets are relevant to the reliability of financial statement preparation, and therefore the audit, depends on circumstances such as when assets are highly susceptible to misappropriation.
- (d) **Segregation of duties:** Assigning different people the responsibilities of authorising transactions, recording transactions, and maintaining custody of assets. Segregation of duties is intended to reduce the opportunities to allow any person to be in a position to both perpetrate and conceal errors or fraud in the normal course of the person's duties.

Certain control activities may depend on the existence of appropriate higher level policies established by management or those charged with governance. For example, authorisation controls may be delegated under established guidelines, such as, investment criteria set by

those charged with governance; alternatively, non-routine transactions such as, major acquisitions or divestments may require specific high level approval, including in some cases that of shareholders.

3.4 Information System, Including the Related Business Processes, Relevant to Financial Reporting, and Communication

An information system consists of infrastructure (physical and hardware components), software, people, procedures, and data. Many information systems make extensive use of information technology (IT).

The information system relevant to financial reporting objectives, which includes the financial reporting system, encompasses methods and records that:

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| (a) | Identify and record all valid transactions. |
| (b) | Describe on a timely basis the transactions in sufficient detail to permit proper classification of transactions for financial reporting. |
| (c) | Measure the value of transactions in a manner that permits recording their proper monetary value in the financial statements. |
| (d) | Determine the time period in which transactions occurred to permit recording of transactions in the proper accounting period. |
| (e) | Present properly the transactions and related disclosures in the financial statements. |

The quality of system-generated information affects management's ability to make appropriate decisions in managing and controlling the entity's activities and to prepare reliable financial reports.

Communication, which involves providing an understanding of individual roles and responsibilities pertaining to internal control over financial reporting, may take such forms as policy manuals, accounting and financial reporting manuals, and memoranda. Communication also can be made electronically, orally, and through the actions of management.

3.5 Monitoring of Controls

An important management responsibility is to establish and maintain internal control on an ongoing basis. Management's monitoring of controls includes considering whether they are operating as intended and that they are modified as appropriate for changes in conditions. Monitoring of controls may include activities such as, management's review of whether bank reconciliations are being prepared on a timely basis, internal auditors' evaluation of sales personnel's compliance with the entity's policies on terms of sales contracts, and a legal department's oversight of compliance with the entity's ethical or business practice policies. Monitoring is done also to ensure

that controls continue to operate effectively over time. For example, if the timeliness and accuracy of bank reconciliations are not monitored, personnel are likely to stop preparing them.

Internal auditors or personnel performing similar functions may contribute to the monitoring of an entity's controls through separate evaluations. Ordinarily, they regularly provide information about the functioning of internal control, focusing considerable attention on evaluating the effectiveness of internal control, and communicate information about strengths and deficiencies in internal control and recommendations for improving internal control.

Monitoring activities may include using information from communications from external parties that may indicate problems or highlight areas in need of improvement. Customers implicitly corroborate billing data by paying their invoices or complaining about their charges. In addition, regulators may communicate with the entity concerning matters that affect the functioning of internal control, for example, communications concerning examinations by bank regulatory agencies. Also, management may consider communications relating to internal control from external auditors in performing monitoring activities.

The overall systems of internal control comprises of Administrative Control and Accounting Controls, Internal Checks and Internal Audit are important constituents of Accounting Controls.

1. Internal Check System - Internal check system implies organization of the overall system of book-keeping and arrangement of Staff duties in such a way that no one person can carry through a transaction and record every aspect thereof. It is a part of overall control system and operates basically as a built-in-device as far as organization and job-allocation aspects of the controls are concerned.

The system provides existence of checks on the day to day transactions which operate continuously as part of the routine system whereby the work of each person is either proved independently or is made complimentary to the work of another.

The 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.

The effectiveness of an efficient system of internal check depends on the following considerations-

- (i) **Clarity of Responsibility** - The responsibility of different persons engaged in various operations of business transactions should be properly identified. A well integrated organizational chart depicting the names of responsible persons associated with specific functions may help to fix up responsibility.
- (ii) **Division of Work** - The segregation of work should be made in such a manner that the free flow of work is not interrupted and also helps to determine that the work of one person is complementary to the other. Then, it is suggested that rotation of different employees through various components of job should be effectively implemented.
- (iii) **Standardization** - The entire process of accounting should be standardized by creating suitable policies commensurate with the nature of the business, so as to strengthen the system of internal check.
- (iv) **Appraisal** - Periodic review should be made of the chain of operations and work flow. Such process may be carried out by preparing an audit flow chart.

The general condition pertaining to the internal check system may be summarized as under:

- (i) no single person should have complete control over any important aspect of the business operation. Every employee's action should come under the review of another person.
- (ii) Staff duties should be rotated from time to time so that members do not 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 a year.
- (iv) Persons having physical custody of assets must not be permitted to have access to the books of accounts.
- (v) There should exist an accounting control in respect of each class of assets, in addition, there should be periodical inspection so as to establish their physical condition.
- (vi) Mechanical devices should be used, where ever practicable to prevent loss or misappropriation of cash.
- (vii) Budgetary control should be exercised and wide deviations observed should be reconciled.
- (viii) For inventory taking, at the close of the year, trading activities should, if possible be suspended, and it should be done by staff belonging to several sections of the organization.
- (ix) The financial and administrative powers should be distributed very judiciously among different officers and the manner in which those are actually exercised should be reviewed periodically.
- (x) Procedures should be laid down for periodical verification and testing of different sections of accounting records to ensure that they are accurate.

The scope of statutory audit is limited by both time and cost. Therefore, it is increasingly being recognized that for an audit to be effective especially in case of large organization, the existence of a system of internal check is essential.

2. Internal Audit - Internal audit may be defined as, an independent appraisal function established within an organization to examine and evaluate its activities as a service to the organization. The scope of the internal audit is determined by the management. Internal auditing includes a series of processes and techniques through which an organizations own employees ascertain for the management, by means of on-the-job observation, whether established management controls are adequate, and are effectively maintained; records and reports financial, accounting and otherwise reflect actual operation and results accurately and properly; each division, department or other units are carrying out the plans, policies and procedures for which they are responsible.

Note: For a detailed discussion on internal audit refer to Chapter 15.



4. REVIEW OF THE SYSTEM OF INTERNAL CONTROLS

The control environment sets the tone of an organization, influencing the control consciousness of its people. The control environment includes the governance and management functions and the attitudes, awareness, and actions of those charged with governance and management concerning the entity's internal control and its importance in the entity.

Evaluating the design of a control involves considering whether the control, individually or in combination with other controls, is capable of effectively preventing, or detecting and correcting, material misstatements. Implementation of a control means that the control exists and that the entity is using it. There is little point in assessing the implementation of a control that is not effective, and so the design of a control is considered first. An improperly designed control may represent a material weakness or significant deficiency in the entity's internal control.

An entity's system of internal control contains manual elements and often contains automated elements. The use of manual or automated elements in internal control also affects the manner in which transactions are initiated, recorded, processed, and reported. An entity's mix of manual and automated elements in internal control varies with the nature and complexity of the entity's use of information technology.

Manual elements in internal control may be more suitable where judgment and discretion are required such as for the following circumstances:

-  Large, unusual or non-recurring transactions.
-  Circumstances where errors are difficult to define, anticipate or predict.
-  In changing circumstances that require a control response outside the scope of an existing automated control.

☛ In monitoring the effectiveness of automated controls.

The extent and nature of the risks to internal control vary depending on the nature and characteristics of the entity's information system. The entity responds to the risks arising from the use of IT or from use of manual elements in internal control by establishing effective controls in light of the characteristics of the entity's information system.

The review of the internal control system enables the auditor -

- (i) to formulate his opinion as to the reliance he may place on the system itself i.e. whether the system is such as would enable the management to produce a true and fair set of financial statements; and
- (ii) to locate the areas of weakness in the system so that the audit programme and the nature, timing and extent of substantive and compliance audit procedures can be adjusted to meet the situation. For example, if the auditor is not satisfied with the control system as regards trade receivable, he may decide to have a wider coverage for confirmation of trade receivables' balances. Normally, investments and cash are physically verified at the end of the period and this routine is known to the client and his employees. In case the auditor comes across a weakness in the control either he may provide in the programme for a surprise cash count or investment verification on a day preceding or succeeding the routine verification. In such a case, a surprise check will be more useful if it is undertaken after the routine verification is over. Similarly, if he is of the view that because of weak controls the possibility of wrong billing to customers exists, he may extend the programme for comparison of the invoices with the forwarding notes and for checking of the extensions and castings of the invoices.

Deciding the point of time appropriate for undertaking the review of the internal controls is a matter for individual judgement of the auditor. This decision can be taken on a consideration of the size and complexity of the client's operations. If the auditor, because of his continuing relationship with his client, is already aware of the features and efficacy of internal controls, he may just review the changes that have taken place in the intervening period because of changes in the operations of the client. However, a comprehensive review in such cases must be made at an interval of, say, 3 years. Ordinarily, the review of internal controls should be undertaken as a distinct phase of audit before finalisation of the audit programme. However, if the size of operations is rather small, the review can be undertaken in conjunction with other audit procedures and the programmes can be adjusted for any extension or elimination of checking.

When the auditor finds inadequacies or weaknesses in the internal control system, he should advise his client about such inadequacies and weaknesses and the consequences that may follow. It should be the duty of the auditor to see, in the course of his audit, how far the inadequacies and weaknesses have been removed. He will take this into account in preparing his audit report. It is a useful practice to note the following after each function, set out in the audit programme -

- (a) Any change in the system of internal control from that record in the appropriate section of the internal control questionnaire.
- (b) Any further weakness noted in the internal control.
- (c) Any instance where the prescribed system or procedure has not been followed.

These should be considered in deciding whether any further modification in the audit programme is called for. Also, these should be communicated to the client and confirmation should be sought as regards changes in the system.

The review of internal control consists mainly of enquiries of personnel at various organisational levels within the enterprise together with reference to documentation such as procedures, manuals, job description and flow-charts, to gain knowledge about the controls which the auditor has identified as significant to his audit. The auditor may trace a few transactions through the accounting system to assist in understanding that system and it is related to internal controls. The auditor's preliminary evaluation of internal controls should be made on the assumption that the controls operate generally as described and that they function effectively throughout the period of intended reliance. The purpose of the preliminary evaluation is to identify the particular controls on which the auditor still intends to rely and to test through compliance procedures. Different techniques are used to record information relating to an internal control system. Selection of a particular technique is a matter for the auditor's judgement.

5. METHODS OF RECORDING

The following are the methods of recording:

5.1 Questionnaire

Because of the widespread experience that auditors possess about the business operations in general and the knowledge about the appropriate control, most of the auditing firms have developed their own standardised internal control questionnaire on a generally applicable basis. In developing the standard questionnaire, endeavour is made to make it as wide as possible so that all situations, generally found, are included therein but all of these may not be applicable in a particular case. A questionnaire is a set of questions framed in an organised manner, about each functional area, which has as purpose the evaluation of the effectiveness of control and detection of its weakness if any. A questionnaire usually consists of several separate sections devoted to areas such as purchases, sales, trade receivables, trade payables, wages, etc. The questionnaire is intended to be filled by the company executives who are in charge of the various areas. However, this poses some practical difficulties. The questionnaire is to travel from executives and, therefore, it may take a pretty long time to be filled; also the questions may not be readily intelligible to busy executives and there is a possibility of the questionnaire being misplaced while travelling from one table to another. Having regard to these difficulties, it is now almost an accepted practice that the auditor (or his representative) arranges meetings with the executives

concerned and gets the answers filled by each executive. Sometimes, the auditor himself may be required to fill the answers. In such a case, he should ensure that the concerned executive has initiated the answers as a token of his agreement therewith.

Questions are so framed as generally to dispense with the requirement of a detailed answer to each question. For this purpose, often one general question is broken down into a number of questions and sub-questions to enable the executive to provide a just 'Yes', 'No' or 'Not applicable' form of reply. Questions are also framed in such a manner that generally a "No" answer will effect weakness in the control system. This requires giving a positive power to the question, keeping in view what the proper control should be. Consider the question 'Are all receipts recorded promptly and deposited in bank daily? If the answer to this is 'Yes', it fits with the plan of good internal control. But if it is 'No' it indicates weakness in the system in as much as the moneys received may not be recorded and may be defalcated because the cashier has continued control over the amount for an uncertain period. However, this should not be taken as an unbreakable rule. Questions may be framed also when a 'Yes' answer would indicate weakness. The only thing that should be borne in mind is that the scheme of questions should be consistent, sequential, logical, and if possible corroborative. Wherever it is necessary, slightly detailed answers also may be asked for to bring clarity to the matter.

In the use of standardized internal control questionnaire, certain basic assumptions about elements of good control are taken into account. These are -

- | | |
|-------|--|
| (i) | Certain procedures in general used by most business concerns are essential in achieving reliable internal control. This is a time-tested assumption. Deposit into bank of the entire receipts of a day or daily balancing of the cash book and ledgers or periodic reconciliation with the control accounts are examples of widely used practices which are considered good internal control practices. Besides, basic operations giving rise to these practices exist in all businesses irrespective of their nature. |
| (ii) | Organisations are such that permit an extensive division of duties and responsibilities. The larger the organisation, the greater is the scope of such division. |
| (iii) | Employees concerned with accounting function are not assigned any custodial function. |
| (iv) | No single person is thrust with the responsibility of completing a transaction all by himself. |
| (v) | There should always be evidence to identify the person who has done the work whether involving authorisation, implementation or checking. |
| (vi) | The work performed by each one is expected to come under review of another in the usual course of routine. |
| (vii) | There is proper documentation and recording of the transactions. |

The questionnaire serves the purpose of a record so far as the auditor is concerned about the state of internal control as given to him officially. A question naturally arises as to whether it is necessary to issue questionnaire for every year of the auditor's engagement.

For the first year of engagements issue of questionnaire is necessary.

For subsequent years, the auditor, instead of issuing a questionnaire again, may request the client to confirm whether any change in the nature and scope of business has taken place that necessitated a corresponding change in the control system, or whether, even without a change in the nature and scope of business, the control system has undergone a change.

If there has been a change, the auditor should take note of its and enter appropriate comments on the relevant part of the questionnaire. However, it would be a good practice in the case of continuing engagements to issue a questionnaire irrespective of any change, say, every third year. This will obviate unnecessary trouble of filling the answers every time and to that extent the client's and the auditor's own time will be saved. The rationale for issuance of a questionnaire every three years, in the case of even no change, lies in altering the client as regards unnoticed and unspectacular changes that might have taken place during the intervening period; also this will make the client more control-conscious. Questionnaires can be prepared for various aspects of the internal control system.

5.2 Check List

It is a series of instructions or questions on internal control which the auditor must follow or answer. When a particular instruction is carried out, the auditor initials the space opposite the instruction. If it is in the form of a question, the answer generally 'Yes', 'No' or 'Not Applicable' is entered opposite the question. A check list is more in the nature of a reminder to the auditor about the matters to be checked for testing the internal control system. While a questionnaire is basically a set of questions put to the client, a check list which may be in a form of instructions, questions or just points to be checked may be meant for the auditor's own staff it is a set of instructions or points; it may be meant for the client if it is in the form of questions. The question form of check list may even be meant for the auditor's own staff.



Questions in the check list may be formed in the following manner (this is an illustrative set of questions to be answered by the audit staff).

Have you checked that the cashier -

- (i) is not responsible for opening the incoming mails;
- (ii) does not authorise any of the ledgers;
- (iii) does not authorise any expenditure or receipt;
- (iv) does not sign cheques;
- (v) takes his annual leave regularly;
- (vi) inks and balances the cash book everyday;
- (vii) verifies physical cash balance with the book figure daily at the end of the day;
- (viii) prepares monthly bank reconciliation statement;

- (ix) holds no other funds or investment;
- (x) holds no unnecessary balance in hand;
- (xi) does not pay money without looking into compliance with proper procedure and due authorisation; and
- (xii) has tendered proper security or has executed a fidelity bond?

When the check list is in question form, it is hardly different from a questionnaire. However, generally questionnaire is a popular medium for the evaluation of the internal control system.

The basic distinction between internal control questionnaire and check list are as under:

1. The ICQ incorporates a large number of detailed questions but the check list generally contains questions relating to the main control objective with the area under review.
2. ICQ, the weaknesses are highlighted by the 'Yes' while in the check list, it is indicated by 'No'.
3. The significance of 'No' in an ICQ does indicate a weakness but the significance of that weakness is not revealed automatically. However, in the check list, a specific statement is required where an apparent weakness may prove to be material in relation to the accounts as a whole.

5.3 Flow chart

The flow charting technique can also 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, though cannot perhaps be totally banished 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. It gives a bird's eye view of the system and is drawn up as a result of the auditor's review thereof. It should, however, not be understood that details are not reflected in a flow chart. Every detail 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 the most 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;

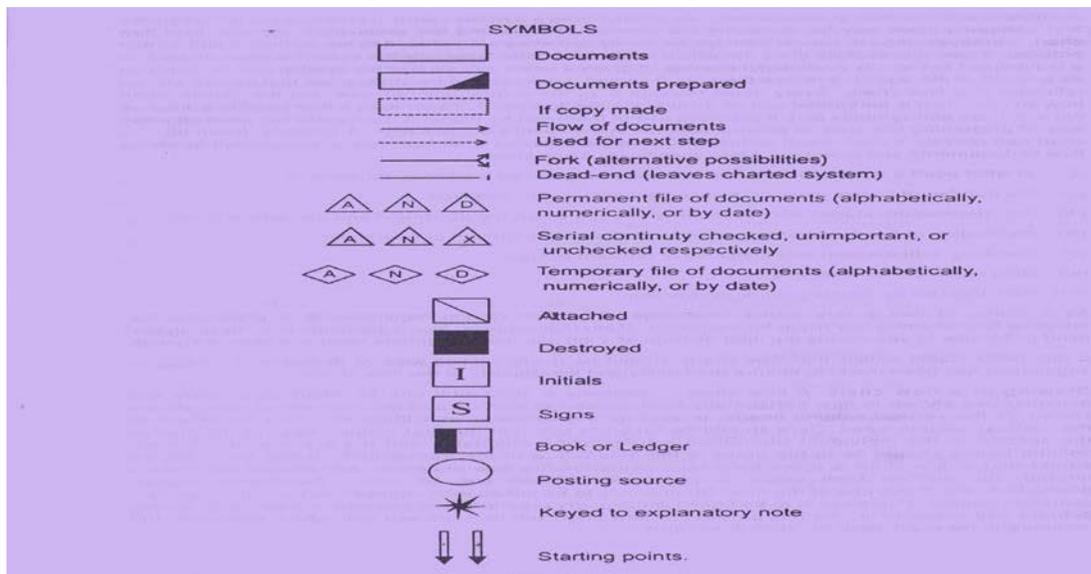
- (iv) distribution of the documents to various sections, department or operations;
- (v) checking authorisation and matching at relevant stages;
- (vi) filing of the documents; and
- (vii) final disposal by sending out or destruction.

As a matter of fact a very sound knowledge of internal control requirements is imperative for, adopting flow-charting technique for evaluation of internal controls; also it demands a highly analytical mind to be able to see clearly the inter division of a job and the appropriate control at relevant points.

It has been stated earlier that flow charts should be made section-wise or department-wise. The suggestion has been made to ensure readability and intelligibility of the flow charts.

Drawing of a flow chart - A flow chart is normally a horizontal one in which documents and activities are shown to flow horizontally from section to section and the concerned sections are shown as the vertical column heads; in appropriate cases an individual also may be shown as the vertical column head. Care should be taken to see that the first column head is devoted to the section or the individual wherefrom a transaction originates and the placements of other column heads should be in the order of the actual flow of the transaction.

It has been stated earlier that a flow chart is a symbolic representation the flow of activity and related documents through the section from origin to conclusion. These can be sales, purchases, wages, production, etc. Each one of the main functions is to be linked with related functions for making a complete course. Purchase is to be linked with trade payables and payments; sales with trade receivables 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. This is an evaluation of the control system through the process of flow charting. The internal control questionnaire contains questions; answers are available in the flow chart and they will reveal weakness, if any, in the system. In fact, the questionnaire is a guide for the study of a control system through flow charts.

We may examine the flow charting techniques for evaluation of internal controls on the sales and trade receivables function. Let us assume that these are -

1. Order receiving function.
2. Dispatch function.
3. Billing function.
4. Accounting in the trade receivables' ledger.
5. Main accounting functions.
6. Inventory recording function.

All these functions are carried out in distinct sections. As regards the Order Receiving Section, let us further assume that the section receives orders:

- (i) through mail;
- (ii) by telephone; and
- (iii) through the company's salesmen.

Basing the receipts of orders of customers, the section raises internal "Sales advices". These sales advices are consecutively numbered (by reference to the last number on the order book) and entered in the order book with the consecutive number, date, the party and other relevant details. The orders received from customers are temporarily filed in the alphabetical order. The sales advices are prepared in sets of four with a noting for the customer's sales-tax status. All the four copies are sent to the dispatch section. The dispatch section, after dispatch of the goods, sends back to the Order receiving Section the last copy of the sales advice after entering thereon the date of dispatch and the quantity despatched. Upon receipt of the last copy, the Order receiving Section enters the date of dispatch and the quantity despatched in the order book. If the quantity despatched is fulfillment of the quantity ordered, the last copy of the sales invoices is annexed to customer's order and filed in the customer's file. If, however, the order is only partly executed, the copy of the sales advice is kept in a temporary file in numerical order. Periodically this file is checked to determine the unfulfilled orders and, if inventory is then available, the Section again initiates fresh sales advices in respect of the unfulfilled part and all the processes, as in the case of original, are repeated. The last copy of the original set is annexed to the customer's order and kept in the customer's file.

The salesmen use the same advice form as is being used by the order receiving section.

For the purpose of drawing a flow chart to incorporate the above narration it is useful to know -

1. the point for originating the flow of transaction.
2. the documents, internal and external, and the flow of the transaction, number of copies, distribution flow and the details.
3. the books, if any, maintained and the details recorded there in and the source or sources for the details.
4. that there exists an alternative possibility.

The flow chart for the above may be as under -

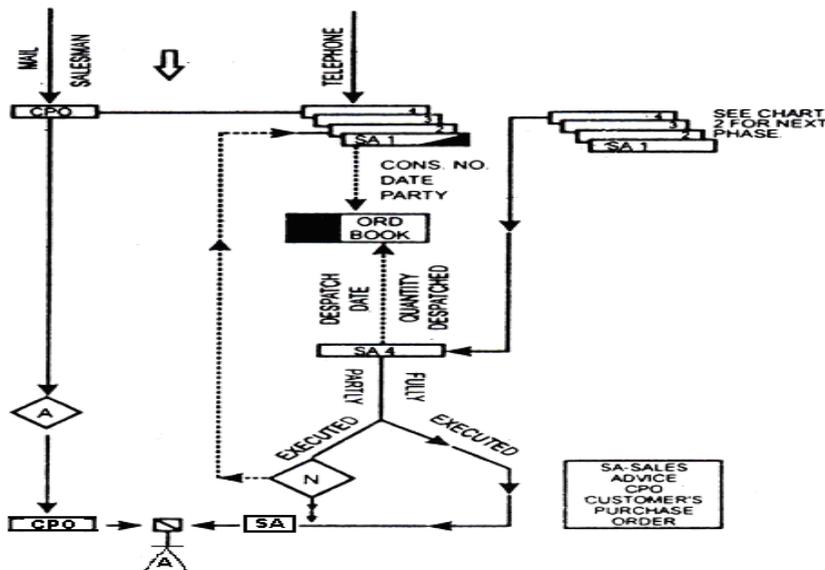


CHART 1

We can extend the activity flow now to the dispatch section which is the logical second stage of operation. The work and procedure content of the dispatch section is assumed to be as follows:

After the receipt of the sales advices in sets of four, the dispatch section arranges dispatch of materials and put the date of dispatch and the quantities despatched; the head of the Section initials the advices. The last copy of the advice is sent back to the Order Receiving Section. The first copy is sent as a packing slip with the goods, the second copy goes to the Billing Department and the third copy accompanies the goods when delivered to the buyer and, obtaining the buyer's acknowledgement of the receipt of the goods therein, is received back and filed date-wise. In case of goods not directly delivered to the buyers, i.e., when the goods are sent either by rail, road or water transport, the copy constitutes the basis for raising the relevant forwarding note on the basis of which R.R. etc., can be prepared.

The flow chart for the dispatch section may be as follows -

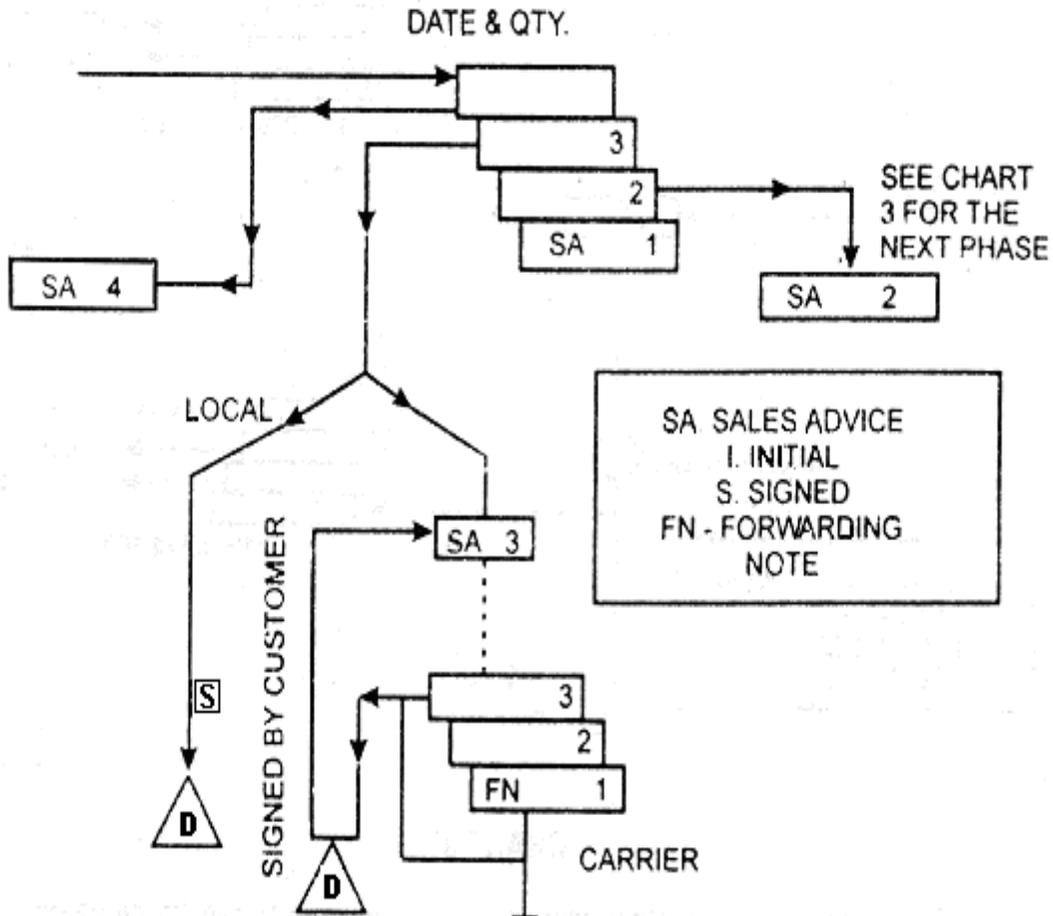
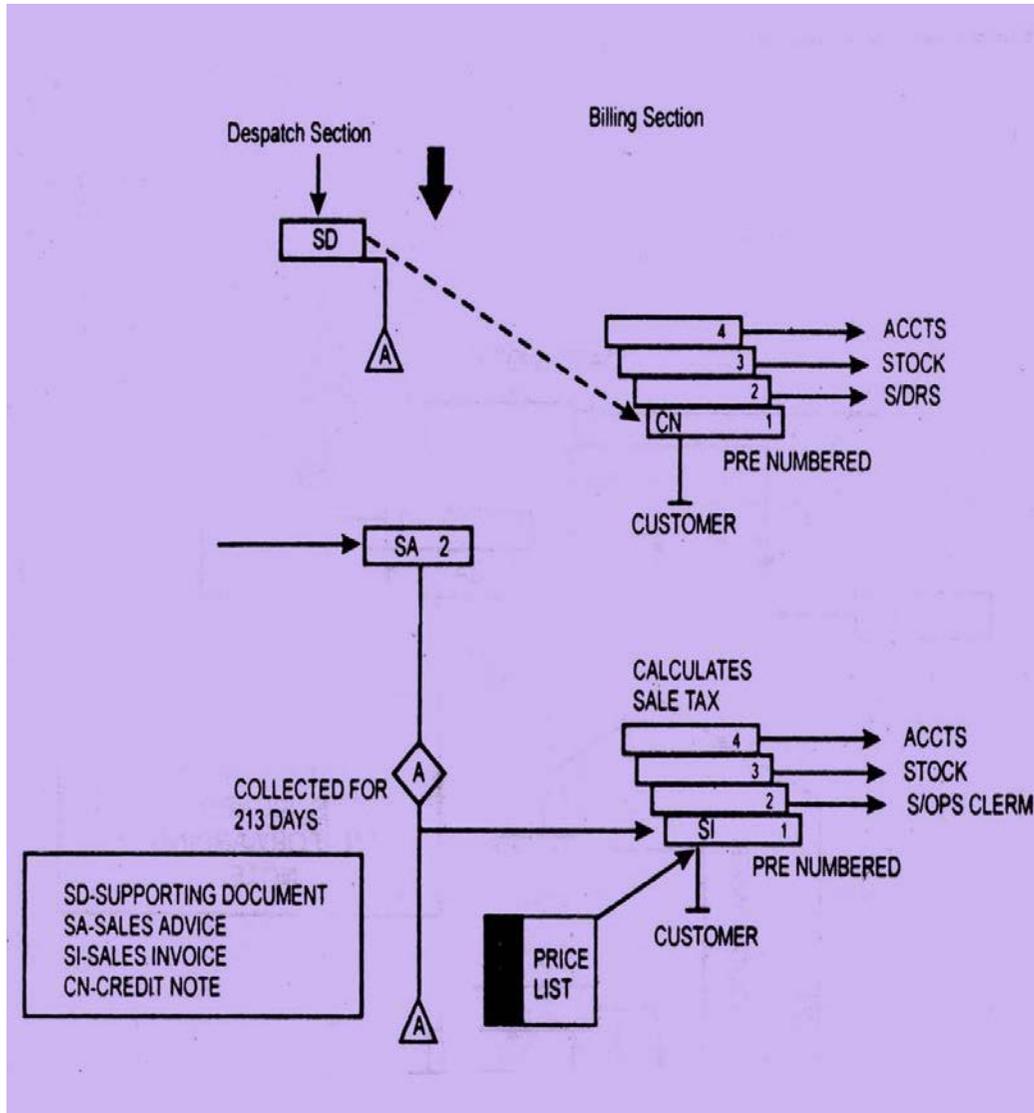


CHART 2

This flow is taken to the Billing Section. The Section generally accumulates the second copy of the Sales Advice for two or three days and prepares sales invoices in sets of four. The pricing of the sales invoice is done by reference to the company's current price list or the catalogue. The number of the sales advice is entered on the corresponding invoice which is pre-numbered, also, the number of the invoice is recorded on the copy of the sales advice which is then filed alphabetically. The first copy of the invoice is sent to the customer while the second, third and fourth copies are respectively sent to the trade receivables ledger clerk, the Inventory Section and the Accounts Section. The Billing Section also is responsible for raising credit notes on the basis of documents received. Credit notes are also prepared in sets of four and are distributed in exactly the same way as invoices. The inventories of invoice and the credit note forms remain in the Billing Section.

The Flow Chart for this Section is given below -

CHART 3



Now, in the order of the flow of activities, more sectional flow charts can be prepared to cover the activities in the Accounts Section and the Inventory Section and they together, when sequentially assembled, will constitute the complete flow chart for the sales transactions and trade receivables recordings.

(These flow charts have been prepared on the basis of the approach and the symbols used in the book "Analytical Auditing" by Skinner and Anderson. Students who desire to study the subject of preparation of flow charts further may refer to Chapter 4 of that book.)

It is now left for us to see how these flow charts reveal the state of internal control. A close look into flow charts will show the following:

- (i) The advices are sent by salesmen; though prepared on the same sales advice form as is prepared in the section, there is no check that all the advices sent by salesmen have been received. This may entail loss of business because of non-receipt of sales advice. (Refer to the flow chart for the Order Receiving Section).
- (ii) The raising of sales advices on the basis of telephonic orders, irrespective of the party's standing and record of performance is risky from the business point of view. (Refer to the flow chart for the Order Receiving Section).
- (iii) There is no system of prior credit sanction to the parties; in consequence, there may be dispatch of goods to bad credit risks. (Refer to the flow chart for the Dispatch Section).
- (iv) There is no check that all the second copies of the sales advices sent by the Dispatch Section have been received by the Billing Section. The possibility of dispatch not being billed exists, (Refer to the flow chart for the Dispatch as well as the Billing Section).
- (v) There is no check in respect of pricing, extension and addition on the invoice or the credit notes. This may result in loss of revenue for wrong pricing or wrong calculation. (Refer to the flow chart for Billing Section).
- (vi) It is not clear whether the supporting documents are adequate for authorising the issue of credit notes where there is a need for a greater caution. (Refer to the flow chart for Billing Section).

So far we have seen the points of weaknesses that are evident from these flow charts. For a clearer understanding of the flow chart as a medium for evaluating internal controls, the following further points may be useful:

- (a) There exists proper numerical control over orders booked (except the case for the salesmen's orders).
- (b) There is a permanent and continuous record of the orders booked in the form of order book.
- (c) There is a definite basis for raising sales advices.
- (d) The order book record is always kept complete by entering the information about the execution of the order and this keeps the information about the pending orders ready at any moment.
- (e) Partly executed orders are reviewed from time to time so that as soon as goods are available, the same may be despatched to customers.
- (f) The customer's purchase order and the related sales advice are matched and kept together in the customer's file.

- (g) The sales advices are initialed by the Dispatch Section head as token of his having satisfied himself about the correctness of the entries as regards the quantity despatched and the date of dispatch.
- (h) Record of actual direct delivery is maintained through the copy of the sales advice bearing the customer's, acknowledgement of his having received the goods. Similarly, the record of out station deliveries is kept in the copy of the forwarding note annexed to the sales advice copy.
- (i) Documents have as many copies as are necessary for ensuring proper flow and proper control. There is neither wastage through unnecessary copies nor any hold up because of inadequacy of copies.
- (j) There are supporting documents for raising invoices and credit notes.
- (k) The distribution of invoices and credit notes is such as would enable the recording of billing at the relevant centres independent of each other.
- (l) There is control over the number of invoices and credit notes by pre-numbering.

Thus, by flow charting, an auditor can very clearly see the inter-relationships of the activities and flows and how they are integrated from stage to stage. However, the auditor has to be careful about the readability and intelligibility of the chart. Identification of all individual functions in a section is also highly relevant for preparation of the flow chart. The smaller the segment, the better is the possibility of quick comprehension. Naturally, the auditor should try to see each section as the natural assembly of distinct and identified components.



6. INTERNAL CONTROL AND RISK ASSESSMENT

The auditor should obtain an understanding of the control environment sufficient to assess management's attitudes, awareness and actions regarding internal controls and their importance in the entity. Such an understanding would also help the auditor to make a preliminary assessment of the adequacy of the accounting and internal control systems as a basis for the preparation of the financial statements, and of the likely nature, timing and extent of audit procedures.

The auditor should obtain an understanding of the control procedures sufficient to develop the audit plan. In obtaining this understanding, the auditor would consider knowledge about the presence or absence of control procedures obtained from the understanding of the control environment and accounting system in determining whether any additional understanding of control procedures is necessary. Because control procedures are integrated with the control environment and the accounting system, as the auditor obtains an understanding of the control environment and the accounting system, some knowledge about control procedures is also likely to be obtained, for example, in obtaining an understanding of the accounting system pertaining to cash, the auditor ordinarily becomes aware of whether bank accounts are reconciled regularly.

Ordinarily, development of the overall audit plan does not require an understanding of control procedures for every financial statement assertion in each account balance and transaction class.

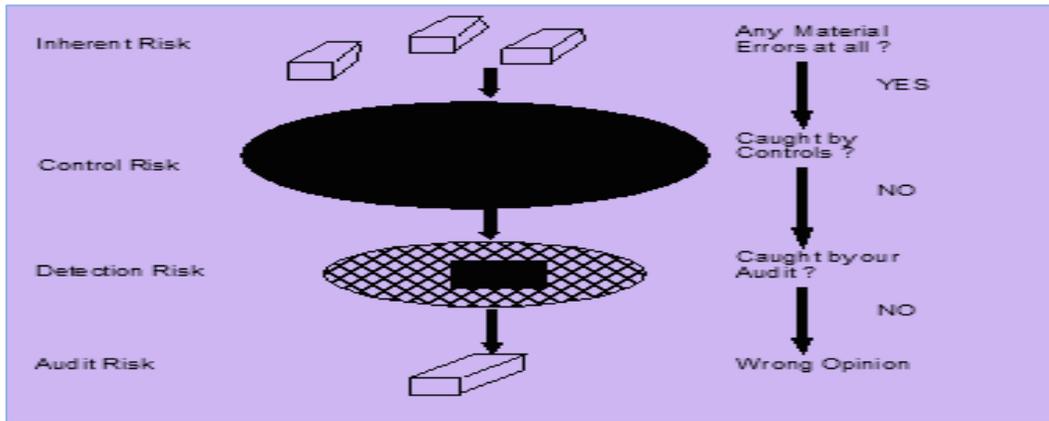


Fig.: Risks of Material Mis-statement*

An auditor's judgement as to what is sufficient and appropriate audit evidence is affected by the degree of risk of mis-statement. Audit risk is the risk that an auditor may give an inappropriate opinion on financial information which is materially misstated.

As per SA 200 "Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Standards on Auditing", the risks of material misstatement at the assertion level consist of two components: inherent risk and control risk. Inherent risk and control risk are the entity's risks; they exist independently of the audit of the financial statements. The nature of each of these types of risk and their interrelationship is discussed below:

- (i) **Inherent risk:** It is the susceptibility of an account balance or class of transactions to misstatement that could be material either individually or, when aggregated with misstatements in other balances or classes, assuming that there were no related internal controls. 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.
- (ii) **Control Risk:** It is the risk that a misstatement that could occur in an assertion about a class of transaction, account balance or disclosure and that could be material, either individually or when aggregated with other misstatements, will not be prevented, or detected and corrected, on a timely basis by the entity's internal control. It is a function of the effectiveness of the design, implementation and maintenance of internal control by management to address identified risks that threaten the achievement of the entity's objectives relevant to preparation of the entity's financial statements.

* Source : Source : [cjess1 audit class pln - WordPress.com](http://cjess1.auditclass.pln.wordpress.com)

The SAs do not ordinarily refer to inherent risk and control risk separately, but rather to a combined assessment of the “risks of material misstatement”. However, the auditor may make separate or combined assessments of inherent and control risk depending on preferred audit techniques or methodologies and practical considerations.

- (iii) **Detection Risk:** It is the risk that the procedures performed by the auditor to reduce audit risk to an acceptably low level will not detect a misstatement that exists and that could be material, either individually or when aggregated with other misstatements. Detection risk relates to the nature, timing, and extent of the auditor’s procedures that are determined by the auditor to reduce audit risk to an acceptably low level. It is therefore a function of the effectiveness of an audit procedure and of its application by the auditor.

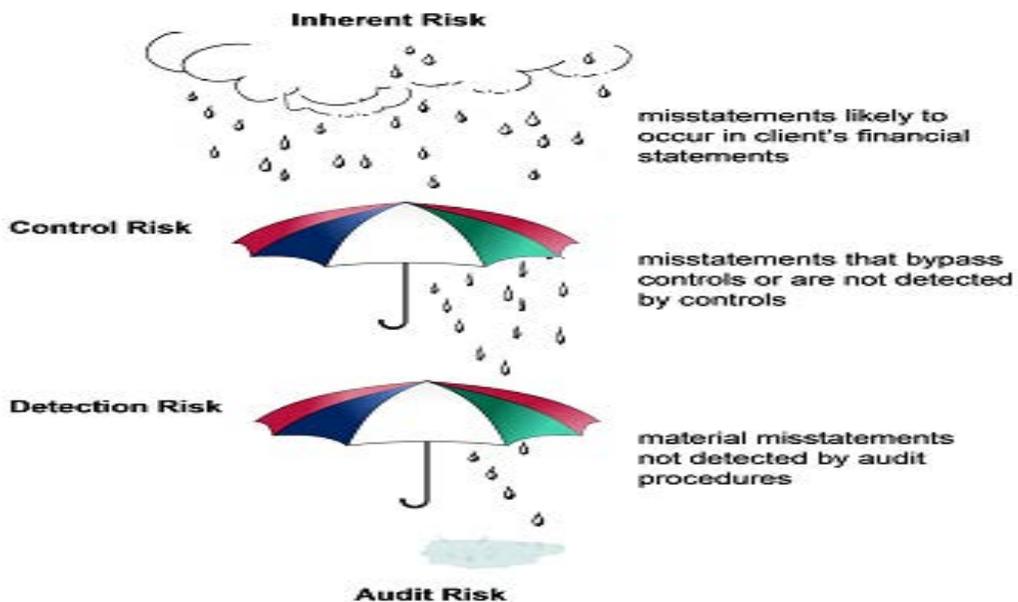


Fig.: Audit Risk*

The inherent and control risks are functions of the entity’s business and its environment and the nature of the account balances or classes of transactions, regardless of whether an audit is conducted. Even though inherent and control risks cannot be controlled by the auditor, the auditor can assess them and design his substantive procedures to produce on acceptable level of detection risk, thereby reducing audit risk to an acceptably low level.

6.1 Preliminary Assessment of Control Risk

After obtaining an understanding of the accounting system and internal control system, the auditor should make a preliminary assessment of control risk, at the assertion level, for each material account balance or class of transactions.

* Source: *cplusglobal* - WordPress.com

The preliminary assessment of control risk is the process of evaluating the likely effectiveness of an entity's accounting and internal control systems in preventing or detecting and correcting material misstatements. The preliminary assessment of control risk is based on the assumption that the controls operate generally as described and that they operate effectively throughout the period of intended reliance. There will always be some control risk because of the inherent limitations of any accounting and internal control system.

The auditor ordinarily assesses control risk at a high level for some or all assertions when:

- (a) the entity's accounting and internal control systems are not effective; or
- (b) evaluating the effectiveness of the entity's accounting and internal control systems would not be efficient.

In the above circumstances, the auditor would obtain sufficient appropriate audit evidence from substantive procedures and from any audit work carried out in the preparation of financial statements.

The preliminary assessment of control risk for a financial statement assertion should be high unless the auditor:

- (a) is able to identify internal controls relevant to the assertion which are likely to prevent or detect and correct a material misstatement; and
- (b) plans to perform tests of control to support the assessment.

Documentation of Understanding and Assessment of Control Risk - The auditor should document in the audit working papers:

- (a) the understanding obtained of the entity's accounting and internal control systems; and
- (b) the assessment of control risk.

When control risk is assessed at less than high, the auditor would also document the basis for the conclusions.

Different techniques may be used to document information relating to accounting and internal control systems. Selection of a particular technique is a matter for the auditor's judgement.

Tests of Control - Tests of control are performed to obtain audit evidence about the effectiveness of the:

- (a) design of the accounting and internal control systems, that is, whether they are suitably designed to prevent or detect and correct material misstatements; and
- (b) operation of the internal controls throughout the period.

Tests of control include tests of elements of the control environment where strengths in the control environment are used by auditors to reduce control risk.

Some of the procedures performed to obtain the understanding of the accounting and internal control systems may not have been specifically planned as tests of control but may provide audit evidence about the effectiveness of the design and operation of internal controls relevant to certain assertions and, consequently, serve as tests of control. For example, in obtaining the understanding of the accounting and internal control systems pertaining to cash, the auditor may have obtained audit evidence about the effectiveness of the bank reconciliation process through inquiry and observation.

When the auditor concludes that procedures performed to obtain the understanding of the accounting and internal control systems also provide audit evidence about the suitability of design and operating effectiveness of policies and procedures relevant to a particular financial statement assertion, the auditor may use that audit evidence, provided it is sufficient to support a control risk assessment at less than a high level.

Tests of control may include:	
◆	Inspection of documents supporting transactions and other events to gain audit evidence that internal controls have operated properly, for example, verifying that a transaction has been authorised.
◆	Inquiries about, and observation of, internal controls which leave no audit trail, for example, determining who actually performs each function and not merely who is supposed to perform it.
◆	Re-performance of internal controls, for example, reconciliation of bank accounts, to ensure they were correctly performed by the entity.
◆	Testing of internal control operating on specific computerised applications or over the overall information technology function, for example, access or program change controls.

The auditor should obtain audit evidence through tests of control to support any assessment of control risk which is less than high. The lower the assessment of control risk, the more evidence the auditor should obtain that accounting and internal control systems are suitably designed and operating effectively.

When obtaining audit evidence about the effective operation of internal controls, the auditor considers :

✍️ how they were applied,	✍️ the consistency with which they were applied during the period and	✍️ by whom they were applied.
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The concept of effective operation recognises that some deviations may have occurred. Deviations from prescribed controls may be caused by such factors as changes in key personnel, significant seasonal fluctuations in volume of transactions and human error. When deviations are detected the auditor makes specific inquiries regarding these matters, particularly, the timing of staff changes in key internal control functions. The auditor then ensures that the tests of control appropriately cover such a period of change or fluctuation.

Based on the results of the tests of control, the auditor should evaluate whether the internal controls are designed and operating as contemplated in the preliminary assessment of control risk. The evaluation of deviations may result in the auditor concluding that the assessed level of control risk needs to be revised. In such cases, the auditor would modify the nature, timing and extent of planned substantive procedures.

Quality and Timeliness of Audit Evidence

Certain types of audit evidence obtained by the auditor are more reliable than others. Ordinarily, the auditor's observation provides more reliable audit evidence than merely making inquiries, for example, the auditor might obtain audit evidence about the proper segregation of duties by observing the individual who applies a control procedure or by making inquiries of appropriate personnel. However, audit evidence obtained by some tests of control, such as observation, pertains only to the point in time at which the procedure was applied. The auditor may decide, therefore, to supplement these procedures with other tests of control capable of providing audit evidence about other periods of time.

In determining the appropriate audit evidence to support a conclusion about control risk, the auditor may consider the audit evidence obtained in prior audits. In a continuing engagement, the auditor will be aware of the accounting and internal control systems through work carried out previously but will need to update the knowledge gained and consider the need to obtain further audit evidence of any changes in control. Before relying on procedures performed in prior audits, the auditor should obtain audit evidence which supports this reliance. The auditor would obtain audit evidence as to the nature, timing and extent of any changes in the entity's accounting and internal control systems since such procedures were performed and assess their impact on the auditor's intended reliance. The longer the time elapsed since the performance of such procedures the less assurance that may result.

The auditor should consider whether the internal controls were in use throughout the period. If substantially different controls were used at different times during the period, the auditor would consider each separately. A breakdown in internal controls for a specific portion of the period requires separate consideration of the nature, timing and extent of the audit procedures to be applied to the transactions and other events of that period.

The auditor may decide to perform some tests of control during an interim visit in advance of the period end. However, the auditor cannot rely on the results of such tests without considering the need to obtain further audit evidence relating to the remainder of the period.

Factors to be considered include:
◆ The results of the interim tests.
◆ The length of the remaining period.
◆ Whether any changes have occurred in the accounting and internal control systems during the remaining period.
◆ The nature and amount of the transactions and other events and the balances involved.
◆ The control environment, especially supervisory controls.
◆ The nature, timing and extent of substantive procedures which the auditor plans to carry out.

Final Assessment of Control Risk

Before the conclusion of the audit, based on the results of substantive procedures and other audit evidence obtained by the auditor, the auditor should consider whether the assessment of control risk is confirmed. In case of deviations from the prescribed accounting and internal control systems, the auditor would make specific inquiries to consider their implications. Where, on the basis of such inquiries, the auditor concludes that the deviations are such that the preliminary assessment of control risk is not supported, he would amend the same unless the audit evidence obtained from other tests of control supports that assessment. Where the auditor concludes that the assessed level of control risk needs to be revised, he would modify the nature, timing and extent of his planned substantive procedures.

6.2 Relationship between the Assessments of Inherent and Control Risk

Management often reacts to inherent risk situations by designing accounting and internal control systems to prevent or detect and correct misstatements and therefore, in many cases, inherent risk and control risk are highly interrelated. In such situations, if the auditor attempts to assess inherent and control risks separately, there is a possibility of inappropriate risk assessment. As a result, audit risk may be more appropriately determined in such situations by making a combined assessment.

6.3 Detection Risk

The level of detection risk relates directly to the auditor's substantive procedures. The auditor's control risk assessment, together with the inherent risk assessment, influences the nature, timing and extent of substantive procedures to be performed to reduce detection risk, and therefore audit risk, to an acceptably low level.

Some detection risk would always be present even if an auditor was to examine 100 percent of the account balances or class of transactions because, for example, most audit evidence is persuasive rather than conclusive.

The auditor should consider the assessed levels of inherent and control risks in determining the nature, timing and extent of substantive procedures required to reduce audit risk to an acceptably low level. In this regard the auditor would consider:

- | | |
|-----|--|
| (a) | the nature of substantive procedures, for example, using tests directed toward independent parties outside the entity rather than tests directed toward parties or documentation within the entity, or using tests of details for a particular audit objective in addition to analytical procedures; |
| (b) | the timing of substantive procedures, for example, performing them at period end rather than at an earlier date; and |
| (c) | the extent of substantive procedures, for example, using a larger sample size. |

<p>There is an inverse relationship between detection risk and the combined level of inherent and control risks. For example, when inherent and control risks are high, acceptable detection risk needs to be low to reduce audit risk to an acceptably low level. On the other hand, when inherent and control risks are low, an auditor can accept a higher detection risk and still reduce audit risk to an acceptably low level.</p>
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While tests of control and substantive procedures are distinguishable as to their purpose, the results of either type of procedure may contribute to the purpose of the other. Misstatements discovered in conducting substantive procedures may cause the auditor to modify the previous assessment of control risk.

The assessed levels of inherent and control risks cannot be sufficiently low to eliminate the need for the auditor to perform any substantive procedures. Regardless of the assessed levels of inherent and control risks, the auditor should perform some substantive procedures for material account balances and classes of transactions.

The auditor's assessment of the components of audit risk may change during the course of an audit, for example, information may come to the auditor's attention when performing substantive procedures that differs significantly from the information on which the auditor originally assessed inherent and control risks. In such cases, the auditor would modify the planned substantive procedures based on a revision of the assessed levels of inherent and control risks.

The higher the assessment of inherent and control risks, the more audit evidence the auditor should obtain from the performance of substantive procedures. When both inherent and control risks are assessed as high, the auditor needs to consider whether substantive procedures can provide sufficient appropriate audit evidence to reduce detection risk, and therefore audit risk, to an acceptably low level. When the auditor determines that detection risk regarding a financial statement assertion for a material account balance or class of transactions cannot be reduced to

an acceptable level, the auditor should express a qualified opinion or a disclaimer of opinion as may be appropriate.

Mathematically Audit Risk (AR) can be expressed as a product of Inherent Risk (IR), Control Risk (CR) and Detection Risk (DR), i.e. $AR = IR \times CR \times DR$

It should be noted that:

1. The combined level of Inherent Risk and Control Risk is inversely related with Detection Risk, and
2. Audit Materiality is also inversely related with audit risk.

The relationship between different components of audit risks is given in the following table:

		Auditors' assessment of control risk		
		High	Medium	Low
Auditors' assessment of inherent risk	High	Lowest	Lower	Medium
	Medium	Lower	Medium	Higher
	Low	Medium	Higher	Highest

The shaded areas in this table relate to detection risk.



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.

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 -

- 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.
- 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.
- 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.



7. INTERNAL CONTROL ASSESSMENT & EVALUATION

The quality & effectiveness of internal controls is directly dependent on the Organisational environment. The tone at the top (the Board & Executive Management) & the credibility of the



message on internal controls from top plays an important role in establishing strong control environment. Following are some of the key components to assess & evaluate the controls environment:

Standard Operating Procedures (SOPs): A well defined set of SOPs helps define role, responsibilities, process & controls & thus helps clearly communicate the operating controls to all

touch points of a process. The controls are likely to be clearly understood & consistently applied even during employee turnover

1. **Enterprise Risk Management:** An organization which has robust process to identify & mitigate risks across the enterprise & its periodical review will assist in early identification of gaps & taking effective control measures. In such organizations, surprises of failures in controls is likely to be few.
2. **Segregation of Job Responsibilities:** A key element of control is that multiple activities in a transaction/decision should not be concentrated with one individual. Segregation of duties is an important element of control such that no two commercial activities should be conducted by the same person.



a buyer should not be involved in receiving of materials or passing of bills. Similarly bank reconciliation should be prepared by a person other than the one who maintains bank book.

3. **Job Rotation in Sensitive Areas:** Any job carried out by the same person over a long period of time is likely to lead to complacency & possible misuse in sensitive areas. It is therefore important that in key commercial functions, the job rotation is regularly followed to avoid degeneration of controls. For example if the same buyer continues to conduct purchase function for long period, it is likely that he gets into comfort zone with existing vendors & hence does not exercise adequate controls in terms of vendor development, competitive quotes etc.
4. **Delegation of Financial Powers Document:** As the organization grows, it needs to delegate the financial & other powers to their employees. A clearly defined document on delegation of powers allows controls to be clearly operated without being dependent on individuals.
5. **Information Technology based Controls:** With the advent of computers & enterprise resource planning (ERP) systems, it is much easier to embed controls through the system instead of being human dependent. The failure rate for IT embedded controls is likely to be low, is likely to have better audit trail & is thus easier to monitor. For example at the stage of customer invoicing, application of correct rates in invoices or credit control can all be exercised directly through IT system improving control environment.



8. REPORTING TO CLIENTS ON INTERNAL CONTROL WEAKNESSES

During the course of audit work, the audit may notice material weaknesses in the internal control system. Material weaknesses are defined as absence of adequate controls on flow of transactions that increases the possibility of errors and frauds in the financial statements of the entity.



In case, if monthly age-wise analysis of trade receivables is not performed then it may result in inadequate provisioning of bad debts for the fiscal year under audit.

The auditor should communicate such material weaknesses to the management or the audit committee, if any, on a timely basis. This communication should be, preferably, in writing through a letter of weakness or management letter. **Important points with regard to such a letter are as follows:**

- (a) The letter lists down the area of weaknesses in the system and offers suggestions for improvement.
- (b) It should clearly indicate that it discusses only weaknesses which have come to the attention of the auditor as a result of his audit and that his examination has not been designed to determine the adequacy of internal control for management.

- (c) This letter serves as a valuable reference document for management for the purpose of revising the system and insisting on its strict implementation.
- (d) The letter may also serve to minimize legal liability in the event of a major defalcation or other loss resulting from a weakness in internal control.

It should be appreciated that by writing a letter to the management about the weaknesses in the system, the auditor is not absolved from his duty to report the shortcomings in the accounts by way of qualification where the defects have not been corrected to the auditor's satisfaction weighing the materiality of weaknesses and their impact, if considered necessary.

The practice of the issue of letter of weaknesses has a great merit in relieving the auditor from liability in case serious frauds or losses have occurred, which probably would not have taken place had the client taken due note of the auditor's points in the letter of weakness. In the case *Re S.P. Catterson & Ltd.* (1937, 81, Act L.R. 62), the auditor was acquitted of the charge of negligence for employee's fraud in view of the fact that he had already informed the client about the unsatisfactory state in the specific areas of accounts and had suggested improvements which were not acted upon by the management.

The Council of ICAI has issued SA 265 on "Communicating Deficiencies in Internal Control to Those Charged with Governance and Management" in this regard. This Standard on Auditing (SA) deals with the auditor's responsibility to communicate appropriately to those charged with governance and management deficiencies in internal control that the auditor has identified in an audit of financial statements. This SA does not impose additional responsibilities on the auditor regarding obtaining an understanding of internal control and designing and performing tests of controls over and above the requirements of SA 315 and SA 330.

The objective of the auditor is to communicate appropriately to those charged with governance and management deficiencies in internal control that the auditor has identified during the audit and that, in the auditor's professional judgment, are of sufficient importance to merit their respective attentions.

The auditor shall determine whether, on the basis of the audit work performed, the auditor has identified one or more deficiencies in internal control.

If the auditor has identified one or more deficiencies in internal control, the auditor shall determine, on the basis of the audit work performed, whether, individually or in combination, they constitute significant deficiencies.

The auditor shall communicate in writing significant deficiencies in internal control identified during the audit to those charged with governance on a timely basis.

The auditor shall also communicate to management at an appropriate level of responsibility on a timely basis:

- (a) In writing, significant deficiencies in internal control that the auditor has communicated or intends to communicate to those charged with governance, unless it would be inappropriate to communicate directly to management in the circumstances; and
- (b) Other deficiencies in internal control identified during the audit that have not been communicated to management by other parties and that, in the auditor's professional judgment, are of sufficient importance to merit management's attention.

The auditor shall include in the written communication of significant deficiencies in internal control:

- | | |
|-----|--|
| (a) | A description of the deficiencies and an explanation of their potential effects; and |
| (b) | Sufficient information to enable those charged with governance and management to understand the context of the communication. In particular, the auditor shall explain that: <ol style="list-style-type: none"> (i) The purpose of the audit was for the auditor to express an opinion on the financial statements; (ii) The audit included consideration of internal control relevant to the preparation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of internal control; and (iii) The matters being reported are limited to those deficiencies that the auditor has identified during the audit and that the auditor has concluded are of sufficient importance to merit being reported to those charged with governance. |

9. RISK-BASED AUDIT

Audit should be risk-based or focused on areas of greatest risk to the achievement of the audited entity's objectives. Risk-based audit (RBA) is an approach to audit that analyzes audit risks, sets materiality thresholds based on audit risk analysis and develops audit programmes that allocate a larger portion of audit resources to high-risk areas.

The auditor does not normally need to perform specific audit procedures on all areas of audit. He only needs to design audit programmes and procedures on areas earlier identified as major risks that could result in the financial statements being materially misstated. RBA is an essential element of financial audit- both in the attest audit of the financial statements and in the audit of financial systems and transactions including evaluation of internal controls. It focuses primarily on the identification and assessment of the financial statement misstatement risks and provides a framework to reduce the impact to the financial statement of these identified risks to an acceptable level before rendering an opinion on the financial statements. It also provides indicators of risks as a basis of opportunity for improvement of auditee risk management and control processes. This affords an opportunity to the auditee to improve its operations from recommendations on risks that do not have a current impact on the financial statements but impact the audited entity's operational strategies and performance over the longer term.

In the context of performance audit, it is the risk to delivery of an activity or scheme or programme of the entity with economy, efficiency and effectiveness. Awareness of areas that puts the programme or resources at risk from the point of view of economy, efficiency and effectiveness helps focus audit attention on them. The risk analysis provides a framework for assurance in performance auditing.

9.1 Audit Risk Analysis

The auditor should perform an analysis of the audit risks that impact on the auditee before undertaking specific audit procedures. Risk assessment is a subjective process. It is part of the professional judgment of the auditor and of the particular circumstances. It is the risk that the auditor may unknowingly fail to appropriately modify his opinion on financial statements that are materially misstated.

Audit risks are brought about by error and fraud:

- ◆ Error is an unintentional mistake resulting from omission, as when legitimate transactions and/or balances are excluded from the financial statements; or by commission, as when erroneous transactions and/or balances are included in the financial statements.
- ◆ Fraud is an intentional misstatement in the accounting records or supporting documents from which the financial statements are prepared. It is intended to deceive financial statement users or to conceal misappropriations.

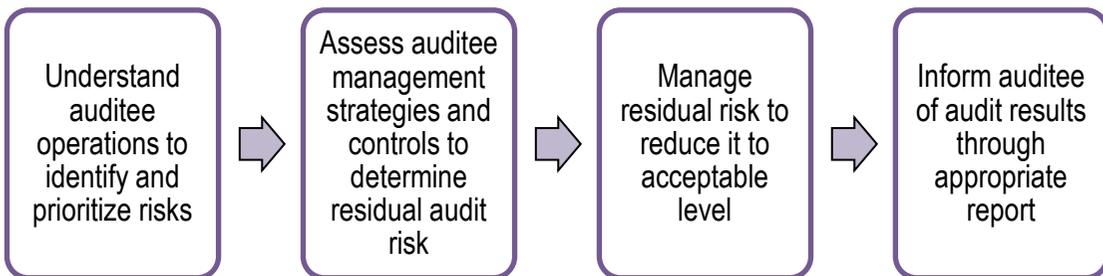
The auditor has the responsibility to plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatements, whether caused by error or fraud.

An error risk may arise from an error in principle, estimate, critical information processing, financial reporting process or disclosure.

Fraud risk involves manipulation, falsification of accounting records, or misrepresentation in the financial statements of events, transactions or other significant information, or misapplication of accounting principles or misappropriation of funds.

9.2 General Steps in the Conduct of RBA

RBA consists of four main phases starting with the identification and prioritization of risks, to the determination of residual risk, reduction of residual risk to acceptable level and the reporting to auditee of audit results. These are achieved through the following:



Step 1 Understand auditee operations to identify and prioritize risks: Understanding auditee operations involves processes for reviewing and understanding the audited organization's risk management processes for its strategies, framework of operations, operational performance and information process framework, in order to identify and prioritize the error and fraud risks that impact the audit of financial statements. The environment in which the auditee operates, the information required to monitor changes in the environment, and the process or activities integral to the audited entity's success in meeting its objectives are the key factors to an understanding of agency risks. Likewise, a performance review of the audited entity's delivery of service by comparing expectations against actual results may also aid in understanding agency operations.

Step 2 Assess auditee management strategies and controls to determine residual audit risk: Assessment of management risk strategies and controls is the determination as to how controls within the auditee are designed. The role of internal audit in promoting a sound accounting system and internal control is recognized, thus the SAI should evaluate the effectiveness of internal audit to determine the extent to which reliance can be placed upon it in the conduct of substantive tests.

Step 3 Manage residual risk to reduce it to acceptable level: Management of residual risk requires the design and execution of a risk reduction approach that is efficient and effective to bring down residual audit risk to an acceptable level. This includes the design and execution of necessary audit procedures and substantive testing to obtain evidence in support of transactions and balances. More resources should be allocated to areas of high audit risks, which were earlier known through the analytical procedures undertaken.

Step 4 Inform auditee of audit results through appropriate report: The results of audit shall be communicated by the auditor to the audited entity. The auditor must immediately communicate to

the auditee reportable conditions that have been observed even before completion of the audit, such as weaknesses in the internal control system, deficiencies in the design and operation of internal controls that affect the organization's ability to record, process, summarize and report financial data.



10. FRAMEWORKS OF INTERNAL CONTROL

Corporate internal controls are part of governance mechanisms of every organisation and, whether a company adopts a global internal control framework or develops its own, management should always be guided by the need to safeguard business value. There are a number of global internal control frameworks that provide guidance to entities for developing and establishing their internal control systems.

Control should be built and established within the processes through which the company pursues its objectives. It follows that, rather than developing separate risk reporting systems, it would be more appropriate to build early warning mechanisms into existing management information systems. The board of directors or those charged with governance need to consider whether they have enough timely, relevant and reliable reports on progress against business objectives and significant risks.

Objective: Internal control is fundamental to the successful operation and day-to-day running of a business and it assists the company in achieving its business objectives. It is wider in scope and encompasses all controls incorporated into the strategic, governance and management process, covering the company's entire range of activities and operations, and not limited to those directly related to financial operations and reporting. There are many internal control frameworks. The objective of this chapter is to give an overview of the common international frameworks.

Guidance Note on Audit of Internal Financial Controls Over Financial Reporting: ICAI has issued a Guidance Note on Audit of Internal Financial Controls Over Financial Reporting which covers aspects such as Scope of reporting on internal financial controls under Companies Act 2013, essential components of internal controls, Technical guidance on audit of Internal Financial Controls, Implementation guidance on audit of Internal Financial Controls. The Guidance Note states as below:

"To state whether a set of financial statements presents a true and fair view, it is essential to benchmark and check the financial statements for compliance with the financial reporting framework.

The Accounting Standards specified under the Companies Act, 1956 (which are deemed to be applicable as per Section 133 of the 2013 Act, read with Rule 7 of Companies (Accounts) Rules, 2014) is one of the criteria constituting the financial reporting framework based on which companies prepare and present their financial statements and against which the auditors evaluate if the financial statements present a true and fair view of the state of affairs and operations of the company in an audit of the financial statements carried out under the Companies Act, 2013.

Similarly, a benchmark internal control system, based on suitable criteria, is essential to enable the management and auditors to assess and state adequacy of and compliance with the system of internal control. In the Indian context, students are advised to refer Appendix 1 “Internal Control Components” of SA 315, “Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and its Environment” provides the necessary criteria for internal financial controls over financial reporting for companies.

10.1 International Internal Control Frameworks

An overview of different internal control frameworks followed internationally are given below:

A. Internal Control - Integrated Framework issued by Committee of the Sponsoring Organisations of the Treadway Commission (COSO Framework).

COSO’s Internal Control – Integrated Framework was introduced in 1992 as guidance on how to establish better controls so companies can achieve their objectives. COSO categorizes entity-level objectives into operations, financial reporting, and compliance. The framework includes more than 20 basic principles representing the fundamental concepts associated with its five components: control environment, risk assessment, control activities, information and communication, and monitoring. Some of the principles include key elements for compliance, such as integrity and ethical values, authorities and responsibilities, policies and procedures, and reporting deficiencies.

However, the Framework clarifies the requirements for effective internal control. This was largely done through the articulation of the 17 principles, which are relevant to every entity and must be present and functioning in order to have an effective system of internal control. Here are the tiles of the 17 internal control principles by internal control component as presented in COSO’s framework:

Control Environment	Risk Assessment	Control Activities	Information and Communication	Monitoring
<ul style="list-style-type: none"> ☛ Demonstrates commitment to integrity and ethical values ☛ Exercises oversight responsibility ☛ Establishes structure, authority, and responsibility ☛ Demonstrates commitment to competence ☛ Enforces accountability 	<ul style="list-style-type: none"> ☛ Specifies suitable objectives ☛ Identifies and analyses risk ☛ Assesses fraud risk ☛ Identifies and analyses significant change 	<ul style="list-style-type: none"> ☛ Selects and develops control activities ☛ Selects and develops general controls over technology ☛ Deploys through policies and procedures 	<ul style="list-style-type: none"> ☛ Uses relevant information ☛ Communicates internally ☛ Communicates externally 	<ul style="list-style-type: none"> ☛ Conducts ongoing and/or separate evaluations ☛ Evaluates and communicate deficiencies

The COSO Framework is designed to be used by organizations to assess the effectiveness of the system of internal control to achieve objectives as determined by management. The Framework lists three categories of objectives as below:

- **Operations Objectives** – related to the effectiveness and efficiency of the entity's operations, including operational and financial performance goals, and safeguarding assets against loss.
- **Reporting Objectives** – related to internal and external financial and non-financial reporting to stakeholders, which would encompass reliability, timeliness, transparency, or other terms as established by regulators, standard setters, or the entity's policies.
- **Compliance objectives** – In the Framework, the compliance objective was described as "relating to the entity's compliance with applicable laws and regulations." The Framework considers the increased demands and complexities in laws, regulations, and accounting standards.

Limitations of Internal Control: The Framework acknowledges that there are limitations related to a system of internal control. For example, certain events or conditions are beyond an organization's control, and no system of internal control will always do what it was designed to do. Controls are performed by people and are subject to human error, uncertainties inherent in judgment, management override, and their circumvention due to collusion. An effective system of internal control recognizes their inherent limitations and addresses ways to minimize these risks by the design, implementation, and conduct of the system of internal control. However, an effective system will not eliminate these risks. An effective system of internal control provides reasonable assurance, not absolute assurance, that the entity will achieve its defined operating, reporting, and compliance objectives.

B. Guidance on Assessing Control published by the Canadian Institute of Chartered Accountants (CoCo)

CoCo was introduced in 1992 with the objective of improving organizational performance and decision-making with better controls, risk management, and corporate governance.

The **Criteria of Control (CoCo)** framework was developed by the Canadian Institute of Chartered Accountants with the objective of improving organisational performance and decision making with better controls, risk management, and corporate governance. In 1995, Guidance on Control was produced and described the CoCo framework and defining controls. The framework includes 20 criteria for effective control in four areas of an organization: purpose (direction), commitment (identity and values), capability (competence), and monitoring and learning (evolution).

The framework emphasizes that control involves the entire organization but begins on an individual level, with the employee.

The CoCo framework outlines criteria for effective control in the following four areas:

- Purpose
- Commitment

- Capability
- Monitoring and Learning

In order to assess whether controls exist and are operating effectively, each criterion would be examined to identify the controls that are in place to address them.

C. Control Objectives for Information and Related Technology (COBIT)

COBIT stands for Control Objectives for Information and Related Technology. It is a framework created by the ISACA (Information Systems Audit and Control Association) for IT governance and management. COBIT has 34 high-level processes that cover 210 control objectives categorized in four domains: planning and organization, acquisition and implementation, delivery and support, and monitoring and evaluation. It is designed as a supportive tool for managers and allows bridging the crucial gap between technical issues, business risks and control requirements.

Business managers are equipped with a model to deliver value to the organization and practice better risk management practices associated with the IT processes. It is a control model that guarantees the integrity of the information system. Today, COBIT is used globally by all managers who are responsible for the IT business processes. It is a thoroughly recognized guideline that can be applied to any organization across industries. Overall, COBIT ensures quality, control and reliability of information systems in organization, which is also the most important aspect of every modern business.

This framework guides an organization on how to use IT resources (i.e., applications, information, infrastructure, and people) to manage IT domains, processes, and activities to respond to business requirements, which include compliance, effectiveness, efficiency, confidentiality, integrity, availability, and reliability. Well-governed IT practices can assist businesses in complying with laws, regulations, and contractual arrangements.

D. Internal Control: Guidance for Directors on the Combined Code, published by the Institute of Chartered Accountants in England & Wales (known as the Turnbull Report)

When the Combined Code of the Committee on Corporate Governance (the Code) was published, the Institute of Chartered Accountants in England & Wales agreed with the London Stock Exchange that it would provide guidance to assist listed companies to implement the requirements in the Code relating to internal control. The key principles of the Code are enunciated as below:

- The board should maintain a sound system of internal control to safeguard shareholders' investment and the company's assets.
- The directors should, at least annually, conduct a review of the effectiveness of the group's system of internal control and should report to shareholders that they have done so. The review should cover all controls, including financial, operational and compliance controls and risk management.
- Companies which do not have an internal audit function should from time to time review the need for one.

The guidance requires directors to exercise judgement in reviewing how the company has implemented the requirements of the Code relating to internal control and reporting to shareholders thereon. The guidance is based on the adoption by a company's board of a risk-based approach to establishing a sound system of internal control and reviewing its effectiveness. This should be incorporated by the company within its normal management and governance processes. It should not be treated as a separate exercise undertaken to meet regulatory requirements

E. Sarbanes-Oxley Section 404

SOX Section 404 (Sarbanes-Oxley Act Section 404) mandates that all publicly-traded companies must establish internal controls and procedures for financial reporting and must document, test and maintain those controls and procedures to ensure their effectiveness. The purpose of SOX is to reduce the possibilities of corporate fraud by increasing the stringency of procedures and requirements for financial reporting. The Sarbanes Oxley Act, signed into law in 2002, has revamped federal regulations pertaining to publicly traded companies' corporate governance and reporting obligations. The PCAOB followed with AS 2, which was approved by the SEC in June 2004. AS 2 was replaced in May 2007 by AS 5.

The SEC rules and PCAOB standard require that:

- Management perform a formal assessment of its controls over financial reporting including tests that confirm the design and operating effectiveness of the controls.
- Management include in its annual report an assessment of ICFR.
- The external auditors provide two opinions as part of a single integrated audit of the company:
 - An independent opinion on the effectiveness of the system of ICFR.
 - The traditional opinion on the financial statements.

There are a number of different definitions of the term *internal control*. For the purposes of Section 404, the great majority of companies and all the CPA firms use the definition in COSO's *Internal Control — Integrated Framework*. The COSO framework has made it easier for management to see what's covered and here gaps may exist in their SOX 404 compliance program.

Management needs to determine whether the system of internal control in effect as of the date of the assessment provides reasonable assurance that material errors, in either interim or annual financial statements, will be prevented or detected.

The rules issued by Securities and Exchange Commission require a company's annual report to include an internal control report of management that contains:

- A statement of management's responsibility for establishing and maintaining adequate internal control over financial reporting for the company.

- A statement identifying the framework used by management to conduct the required evaluation of the effectiveness of the company's internal control over financial reporting.
- Management's assessment of the effectiveness of the company's internal control over financial reporting as of the end of the company's most recent fiscal year, including a statement as to whether or not the company's internal control over financial reporting is effective. The assessment must include disclosure of any "material weaknesses" in the company's internal control over financial reporting identified by management. Management is not permitted to conclude that the company's internal control over financial reporting is effective if there are one or more material weaknesses in the company's internal control over financial reporting. A statement that the registered public accounting firm that audited the financial statements included in the annual report has issued an attestation report on management's assessment of the registrant's internal control over financial reporting.

The final rules also require a company to file, as part of the company's annual report, the attestation report of the registered public accounting firm that audited the company's financial statements.

TEST YOUR KNOWLEDGE

Theoretical Questions

1. Briefly describe the various stages of a Risk Assessment process.
2. What are the components of an internal control framework?
3. During the course of his audit, the auditor noticed material weaknesses in the internal control system and he wishes to communicate the same to the management. You are required to elucidate the important points the auditor should keep in the mind while drafting the letter of weaknesses in internal control system.
4. Explain briefly the Flow Chart technique for evaluation of the Internal Control system.
5. What are the General Steps in the conduct of Risk based audit?

Multiple Choice Questions:

1. Raj Private Limited is engaged in the business of retail and has its retail outlets concentrated towards Northern India. Currently, the company has 59 outlets and the plan of the management is to take this to at least 100 over the next 2 years.

The company is audited by Raj & Associates, a firm of Chartered Accountants, who have been operating for over 20 years, however, they don't have much experience in the retail sector. Because of this fact the audit team decided to plan efficiently for the audit of the financial statements of the company for the year ended 31 March 2019, being their first year of audit.

During the course of risk assessment by the auditors, it was discussed that the company is operating in an industry where the operations are not very complicated and mostly the processes are known to all. Considering the same they decided that assessment of inherent risk should not be done for this company as that would be inefficient. However, the auditors will take due care of the control risks. The same assessment was deliberated upon and after lot of discussions it was finalized like this.

In the given situation, please advise which one of the following would be correct.

- (a) The assessment of audit team is correct.
- (b) The assessment of audit team is wrong considering the fact that this is a private company wherein such assessment is not possible.
- (c) The assessment of audit team is wrong for this company.
- (d) The assessment of audit team is correct considering the fact that this has been thoroughly discussed.

2. Kshitij Private Ltd is a company based out of Noida having operations in India and Dubai. The company's operations in Dubai have increase over the last 2 years and the management is earning very good profits.

Because of the profits, the management also planned that they should now focus on strengthening of internal controls of the company and for that purpose they have discussed with the statutory auditors to carry out the audit for the financial year ended 31 March 2019 very rigorously.

The report on internal financial controls is also applicable to the company and hence the auditors during the course of their work asked for Risk-control matrices from the company. During the year ended 31 March 2018, Risk-control matrix was not available with the company and was prepared in a draft manner and the same was shared with the audit team during that year and the auditors completed their work on the basis of that.

However, for the year ended 31 March 2019, the auditors would like to have robust documentation and are not ready to accept the same Risk-control matrices.

In the given situation, please suggest what should be the course of action.

- (a) The request of audit team is correct and the management should provide that.
- (b) The requirement of audit team is not justified considering the fact that last year same documentation was used by them.
- (c) The requirement of audit team is not justified considering the fact that it's a private company and auditor anyways is required to perform rigorous audit procedures.

(d) In case of a private company on which internal financial controls report is required, the auditor is not allowed to take any Risk-control matrix from the management. Seems to be an ethical issue.

3. SK Private Limited is a medium-sized company having operations in Jharkhand. The company manufactures some parts and sells that to various dealers on ex-works basis. The financial statements of the company are prepared as per Ind AS and internal financial controls report is also applicable on the same.

During the course of audit of the financial statements for the year ended 31 March 2019, the management of the company had a detailed discussion with the auditors for audit planning.

Further it was also decided that any observations of the auditors should also be discussed with the management before conclusion by the audit team which was not done in the past years.

Considering this, the auditors started the risk assessment and requested the management to share their documentation for the same on which the management said that they don't have any risks and if the auditors come across any such thing they can discuss that with the management.

But the auditors were not convinced with the view of the management and the same thing has happened in the past years as well.

You are required to provide your inputs to resolve this matter.

- (a) The requirement of the audit team is not correct.
- (b) The view of the management is correct because of the applicability of Ind AS.
- (c) The view of the management is correct because of the applicability of internal financial controls reporting.
- (d) The view of the management is not correct.
4. AJ Private Ltd is in the business of telecom and have significant operations across India predominantly in Northern India.

The statutory auditors of the company have been continuing for the last 3 years and have been issuing clean report.

For the financial year ended 31 March 2019, the statutory auditors commenced their work in March 2019 as per discussions with the management and with a plan to complete the audit by first week of May 2019.

The audit team concluded the work as per the agreed timelines and the financial statements and audit report were signed on 5 May 2019 along with the engagement letter for the financial year ended 31 March 2019.

In the given situation, please advise which of the following would be correct.

- (a) The engagement letter should have been signed before commencing the audit work.
 - (b) The engagement letter should have been signed at least a day before signing the audit report.
 - (c) The engagement letter should have been signed at least a day before signing the financial statements.
 - (d) The engagement letter is optional in case of a private company and hence can be signed anytime.
5. RIM Private Ltd is engaged in the business of manufacturing of water bottles and is experiencing significant increase in turnover year on year. It is a subsidiary of RIM Gmbh, based out of Germany.

During the financial year ended 31 March 2019, the company carried out a detailed physical verification of its inventory and property, plant and equipment.

During the year, various other activities were carried out to increase efficiency in operations and reductions of costs.

The statutory auditors of the company started their audit work from April 2019 and requested for a documentation on changes in processes and activities during the year as well as any resultant impact of the same on management controls.

The management of the company told the auditors that all such documentation is maintained by the parent company as this is a closely held private company and even though internal financial controls reporting is applicable on this company, the parent company is taking due care of each and every process.

The auditors did not agree with the views of the management. Please advise both the management and the auditors.

- (a) The auditors should look for documentation as per Sarbanes Oxley in this case.
- (b) The auditors are correct in this case and the management should provide the required documentation.
- (c) The auditors are correct in this case and the management should provide the required documentation. However, in case the parent company is covered by Sarbanes Oxley then it can be ignored by the auditors.
- (d) The management is correct.

Answers to Theoretical Questions

1. Risk Assessment is one of the most critical components of Enterprise Risk Management. The risk assessment process involves considerations for qualitative and quantitative factors, definition of key performance and risk indicators, risk appetite, risk scores, scales and maps, use of data & metrics and benchmarking. **The various stages in a Risk Assessment process are as follows:**

- Define Business Objectives and Goals;
- Identify events that affect achievement of business objectives;
- Assess likelihood and impact;
- Respond and mitigate risks;
- Assess residual risk.

2. There are **five components** of an internal control framework. They are as follows:

- Control Environment;
- Risk Assessment;
- Information & Communication;
- Monitoring;
- Control Activities.

3. **Important Points to be kept in Mind While Drafting Letter of Weakness:** As per SA 265, "Communicating Deficiencies in Internal Control to Those who Charged with Governance and Management", the auditor shall include in the written communication of significant deficiencies in internal control -

- (i) A description of the deficiencies and an explanation of their potential effects; and
- (ii) Sufficient information to enable those charged with governance and management to understand the context of the communication.

In other words, the auditor should communicate material weaknesses to the management or the audit committee, if any, on a timely basis. This communication should be, preferably, in writing through a letter of weakness or management letter. Important points with regard to such a letter are as follows-

- (1) The letter lists down the area of weaknesses in the system and offers suggestions for improvement.

- (2) It should clearly indicate that it discusses only weaknesses which have come to the attention of the auditor as a result of his audit and that his examination has not been designed to determine the adequacy of internal control for management.
 - (3) This letter serves as a valuable reference document for management for the purpose of revising the system and insisting on its strict implementation.
 - (4) The letter may also serve to minimize legal liability in the event of a major defalcation or other loss resulting from a weakness in internal control.
4. Refer Para 5.3
 5. Refer Para 9.2.

Answers to Multiple Choice Questions

1. (c)
2. (a)
3. (d)
4. (a)
5. (b)

