CHAPTER 4

MATERIALITY, RISK ASSESSMENT AND INTERNAL CONTROL



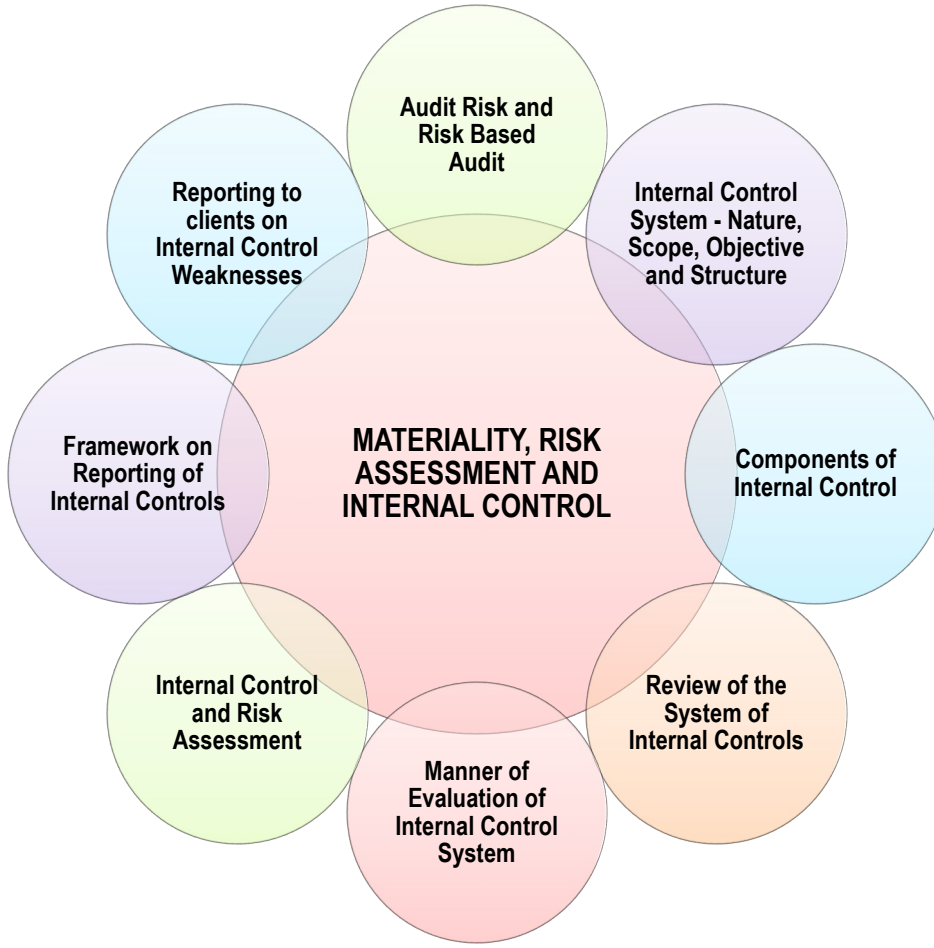
LEARNING OUTCOMES

After studying this chapter, you will be able to:

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

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CHAPTER OVERVIEW



CA Y, auditor of a company for the last three years, is set to assess audit risk for the engagement. Before he proceeded, a question struck his mind. Is such an exercise useful for him practically? How assessing audit risk is useful for an auditor every year? He seemed to be caught in SALY approach (Same as last year). Turning to a webinar on the topic helped him illuminate his insight. Not only assessing audit risk is mandatory under Standards on Auditing, but it also leads to audit effectiveness and audit quality. Besides, it helps auditors to plan audits in a better way.

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By understanding the company and its internal control, auditor can identify those areas which are prone to misstatements whether due to errors or frauds. The risk assessment need not be same as of last year due to new developments like change in laws, change in business model of the company or due to changes in industry in which the client company operates or due to other factors.

He also learnt how understanding business risks of the company and strategy formulated by the company to deal with business risks influences audit risk. Where the company has an established plan to deal with business risks peculiar to it, the auditor gains comfort regarding management's ability to deal with such business risks by evaluating such plans.

Evaluation of controls of a company helps auditor in zeroing in those areas where controls are deficient. It also aids in discovering those areas where controls may be missing and non-existent. If controls are not effective or are missing, risk of material misstatement also increases due to increase in control risk. By using needed risk assessment procedures like inquiries, inspection and observation, auditors can understand areas of risks of material misstatement. It would ultimately lead to performing an effective and qualitative audit.

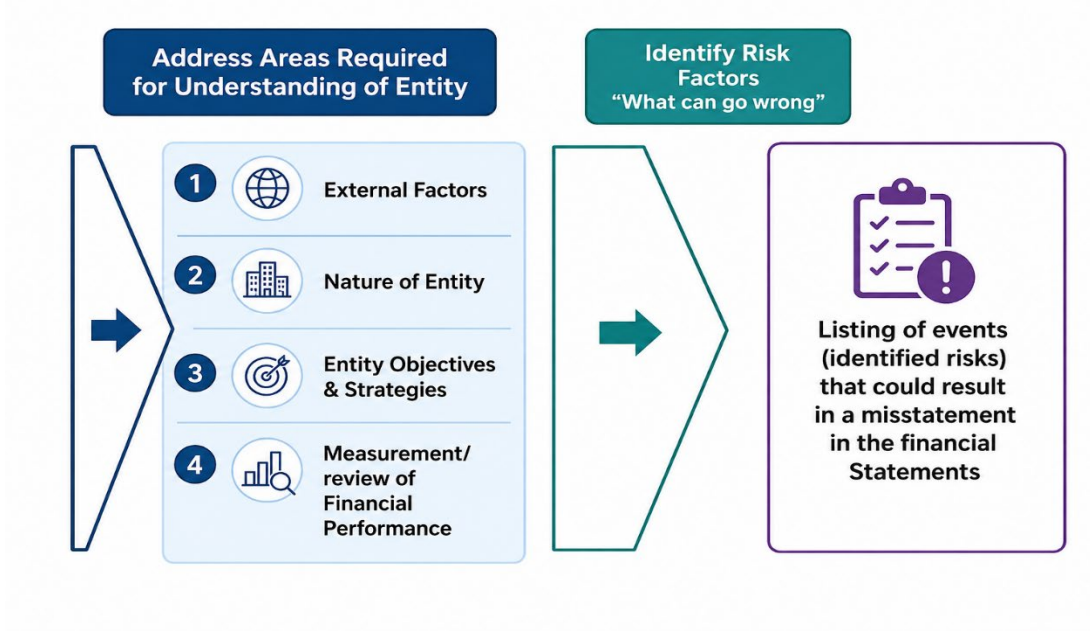
What happens when an auditor identifies significant deficiencies in the internal control system of the company? Besides having an impact on audit risk, auditor has also a responsibility to communicate such deficiencies to the management, to those responsible for governing the company. It may induce those sitting in board rooms to take note of the same and initiate corrective actions. Besides, such communications also end up saving auditor's skin. It is due to the reason that he has already taken pre-emptive steps in this regard. Significant deficiencies have already been communicated to management and this could come to defence of the auditor later.

1. MATERIALITY & RISK ASSESSMENT

As per SA 320, the concept of materiality is applied by the auditor both in planning and performing the audit, and in evaluating the effect of identified misstatements on the audit and of uncorrected misstatements, if any, on the financial statements and in forming the opinion in the auditor's report. Materiality and audit risk are considered throughout the audit, in particular, when identifying and assessing the risks of material misstatement, determining the nature, timing and extent of further audit procedures; and evaluating the effect of uncorrected misstatements, if any, on the financial statements and in forming the opinion in the auditor's report.

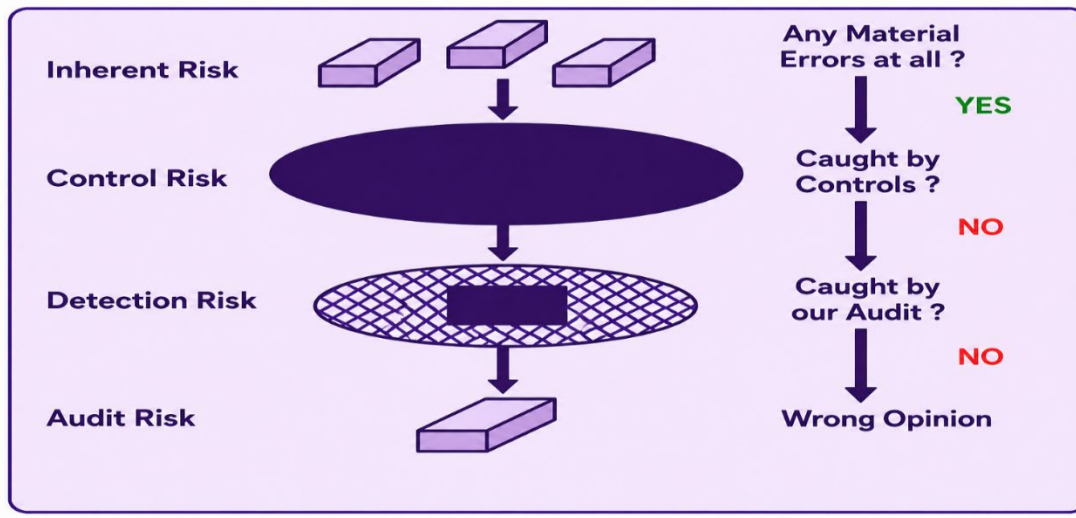
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Risk assessment assesses the level of risk in the various business processes. Risk assessment focuses on the business environment, regulatory environment, organisation structure, organizational and business environmental changes and specific concerns of management and the audit committee to determine the areas of greatest risk.



1.1 Identification of Risks

Audit risk is the risk of expressing an inappropriate audit opinion on financial statements that are materially misstated.



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1.2 Audit Risk Components

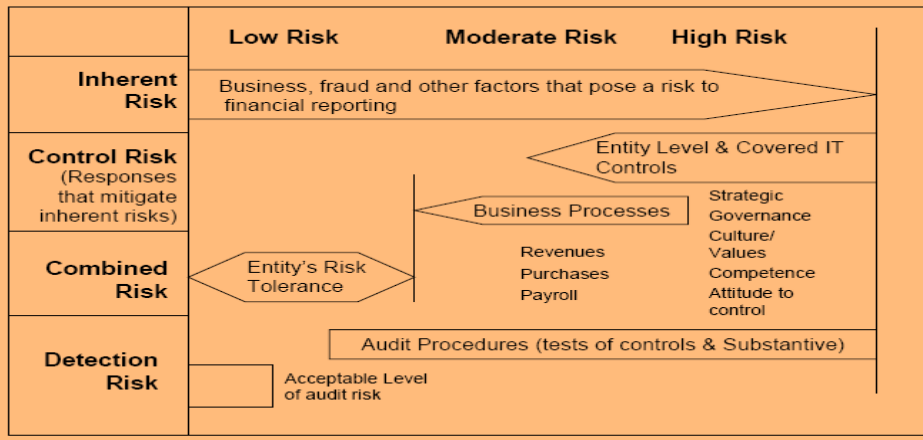
The major components of audit risk are described in the Table below

Nature	Description	Commentary
Inherent Risk	Susceptibility of an assertion to a misstatement that could be material, individually or when aggregated with other misstatements, assuming that there are no related controls. Inherent risk is addressed at both the financial statement level and at the assertion level. For example, technological developments might make a particular product obsolete, thereby causing inventory to be more susceptible to overstatement.	These are the business and other risks that arise from the entity's objectives, nature of operations and industry, the regulatory environment in which it operates and its size and complexity. The risks of material misstatement will vary based on the nature of the account balance or class of transaction. Risks of particular concern to the auditor might include: • Complex calculations which could be misstated; • High value inventory; • Accounting estimates that are subject to significant measurement uncertainty; • Lack of sufficient working capital to continue operations; • A declining or volatile industry with many business failures; and • Technological developments that might make a particular product obsolete.
Control Risk (Do internal controls in place mitigate the inherent risks?)	Risk that the entity's internal control system will not prevent, or detect and correct on a timely basis, a misstatement that could be material, individually or when aggregated with other misstatements.	The entity should identify and assess its business and other risks (such as fraud) and respond by designing and implementing a system of internal control. Entity level controls such as board oversight, IT general controls, and HR policies are pervasive to all assertions whereas activity level controls generally, relate to specific assertions.

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		Some control risk will always exist because of the inherent limitations of any internal control system. The auditor is required to understand the entity's internal control and perform procedures to assess the risks of material misstatement at the assertion level.
Detection Risk	This is the risk that the auditor will not detect a misstatement that exists in an assertion that could be material, either individually or when aggregated with other misstatements. The acceptable level of detection risk for a given level of audit risk bears an inverse relationship to the risks of material misstatement at the assertion level	The auditor identifies assertions where there are risks of material misstatement and concentrates audit procedures on those areas. In designing and evaluating the results of performing procedures, the auditor should consider the possibility of: • Selecting an inappropriate audit procedure; • Misapplying an appropriate audit procedure; or • Misinterpreting the results from an audit procedure.

Interrelationship of Audit Risk Components



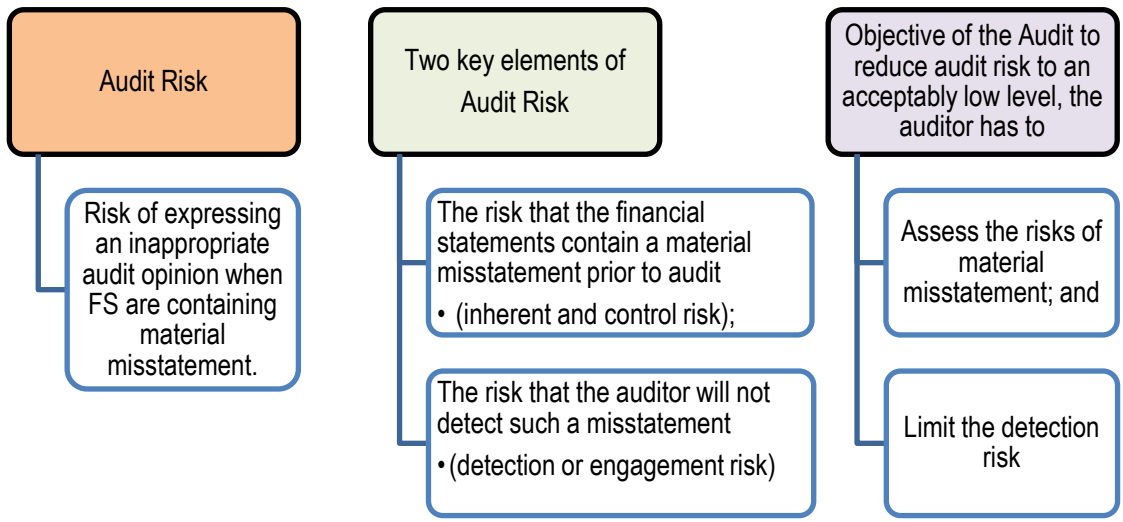
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Mathematically Audit Risk (AR) can be expressed as a product of Inherent Risk (IR), Control Risk (CR) and Detection Risk (DR), i.e. AR = IR x CR x DR

Audit Risk has two components: Risk of material misstatement (the risk that the financial statements contain a material misstatement Prior to Audit) and detection risk (the risk that the auditor will not be able to detect such misstatement).

The relationship can be defined as follows.

Audit Risk = Risk of Material Misstatement X Detection Risk
Risk of material Misstatement: - Risk of material misstatement is anticipated risk that a material misstatement may exist in financial statement before start of the audit. It has two components inherent risk and control risk. The relationship can be defined as **Risk of Material Misstatement = Inherent risk X Control risk**
Detection risk: It is a risk that a material misstatement remained undetected even if all audit procedures applied.
It should be noted that the combined level of Inherent Risk and Control Risk is inversely related with Detection Risk, and Audit Materiality is also inversely related with Audit Risk.



The objective of the audit is to reduce this audit risk to an acceptably low level. This may be achieved by performing procedures that respond to the assessed risks at the financial statement, class of transactions, account balance and assertion levels. Number of embedded assertions are included in management's representations about the financial statements. These relate to the recognition,

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measurement, presentation and disclosure of the various elements (amounts and disclosures) in the financial statements.



1. Management of ABC Ltd. may assert to the auditor that the sales balance in the accounting records contains all the sales transactions (completeness assertion), the transactions took place and are valid (occurrence assertion), and transactions have been properly recorded in the accounting records and in the appropriate accounting period (accuracy and cut-off assertion).

SA 315, "Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and Its Environment", categorises the types of assertions used by the auditor to consider the different types of potential misstatements that may occur, as follows:

Assertions about classes of transactions and events for the period under audit	**(i) Occurrence—**	**transactions and events that have been recorded have occurred and pertain to the entity.**
	(ii) Completeness—	**all transactions and events that should have been recorded have been recorded.**
	(iii) Accuracy—	**amounts and other data relating to recorded transactions and events have been recorded appropriately.**
	(iv) Cut-off—	**transactions and events have been recorded in the correct accounting period.**
	(v) Classification—	**transactions and events have been recorded in the proper accounts.**
Assertions about account balances at the period end	**(i) Existence—**	**assets, liabilities, and equity interests exist.**
	(ii) Rights and obligations—	**the entity holds or controls the rights to assets, and liabilities are the obligations of the entity.**
	(iii) Completeness—	**all assets, liabilities and equity interests that should have been.**
	(iv) Valuation and allocation—	**assets, liabilities, and equity interests are included in the FS at appropriate amounts and any resulting valuation or allocation adjustments are appropriately recorded.**

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Assertions about presentation and disclosure	**(i) Occurrence and rights and obligations —**	**disclosed events, transactions, and other matters have occurred and pertain to the entity.**
	(ii) Completeness—	**all disclosures that should have been included in the financial statements have been included.**
	(iii) Classification and understandability—	**financial information is appropriately presented and described, and disclosures are clearly expressed.**
	(iv) Accuracy and valuation—	**financial and other information are disclosed fairly and at appropriate amounts."**

Auditors are required to assess the risks of material misstatement at two levels. The first is at the overall financial statement level, which refers to risks of material misstatement that relate pervasively to the financial statements as a whole and potentially affect many assertions.



2. If the top accountant is not competent enough for the assigned tasks, it is quite possible that errors could occur in the financial statements. However, the nature of such errors will not often be confined to a single account balance, transaction stream or disclosure. In addition, the error is not likely be confined to a single assertion such as the completeness of sales. It could easily relate to other assertions such as accuracy, existence and valuation.

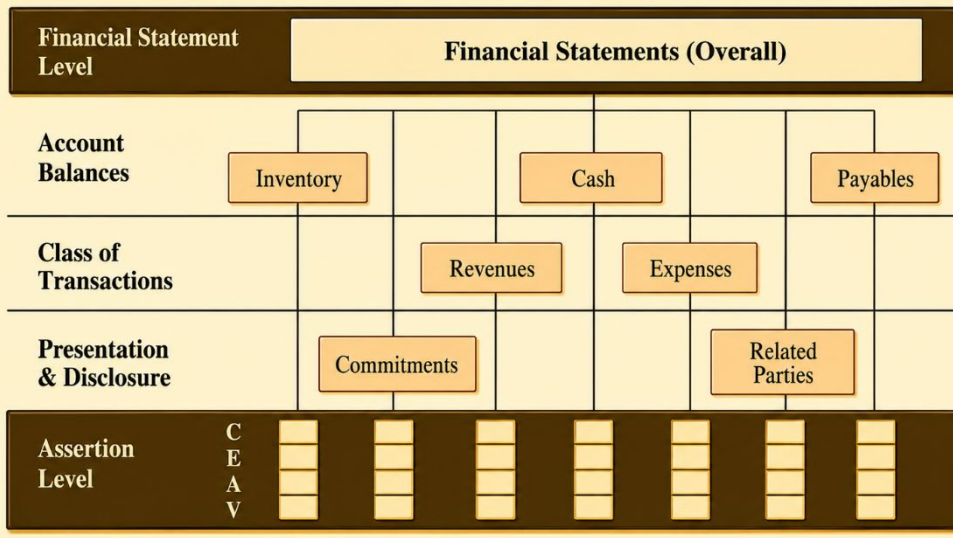
The second relates to risks identifiable with specific assertions at the class of transactions, account balance, or disclosure level. This means that for each account balance, class of transactions and disclosure, an assessment of risk (such as high, moderate, or low) should be made for each individual assertion (C, E, A, and V in the diagram below) being addressed.



3. While considering the valuation assertion, the auditor could assess the risk of error in payables as low; however, for inventory where obsolescence is a factor, the auditor would assess the valuation risk as high. Another example would be where the risks of material misstatement due to completeness (missing items) in the inventory balance are low, but high in relation to the sales balance.

The difference between assessing risk at the overall financial statement level and the assertion level is illustrated (in partial form only) below.

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Note: The assertions used in this diagram are C = Completeness, E = Existence, A = Accuracy and cut-off, V = Valuation.

ILLUSTRATION 1

Background: *During the process of extracting the exception reports, the auditors noted numerous purchase entries without valid purchase orders.*

Analysis: *In terms of percentage, about 40% of purchases were made without valid purchase orders and also few purchase orders were validated after the actual purchase. Also, there was no reconciliation between the goods received and the goods ordered.*

Assertions: *Validity of purchases*

Pervasive/Account Balance Level: *Account Balance level*

Account Balance(s) affected: *(i) Purchases, (ii) Account Payable*

Audit Procedures: *The following procedures may address the validity of the account balance:*

- *Make a selection of the purchases, review correspondence with the vendors, purchase requisitions (internal document) and reconciliations of their accounts.*
- *Review Vendor listing along with the ageing details. Follow up the material amounts paid before the normal credit period and analyse the reasons for exceptions.*
- *Meet with the company's purchase officer and obtain responses to our inquiries regarding the purchases made without purchase orders.*
- *Discuss the summary of such issues with the client.*

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2. RISK-BASED AUDIT APPROACH

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.

Risk Based Audit 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 on the financial statements 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.

2.1 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

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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.

2.2 General Steps in the Conduct of Risk Based Audit

The auditor's objective in a risk-based audit is to obtain reasonable assurance that no material misstatements whether caused by fraud or errors exist in the financial statements.

This involves the following three key steps:

- Assessing the risks of material misstatement in the financial statements;
- Designing and performing further audit procedures that respond to assessed risks and reduce the risks of material misstatements in the financial statements to an acceptably low level; and
- Issuing an appropriate audit report based on the audit findings.

The risk-based audit process is presented in three distinct phases:

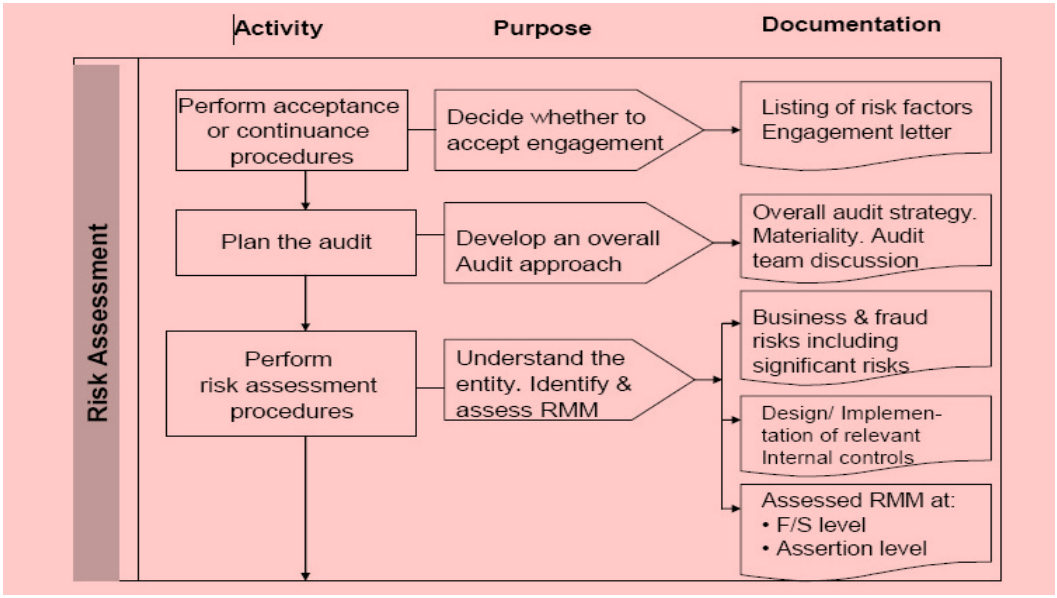
- Risk assessment.
- Risk response; and
- Reporting.

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2.2.1. Risk Assessment

The risk assessment phase of the audit involves the following steps:

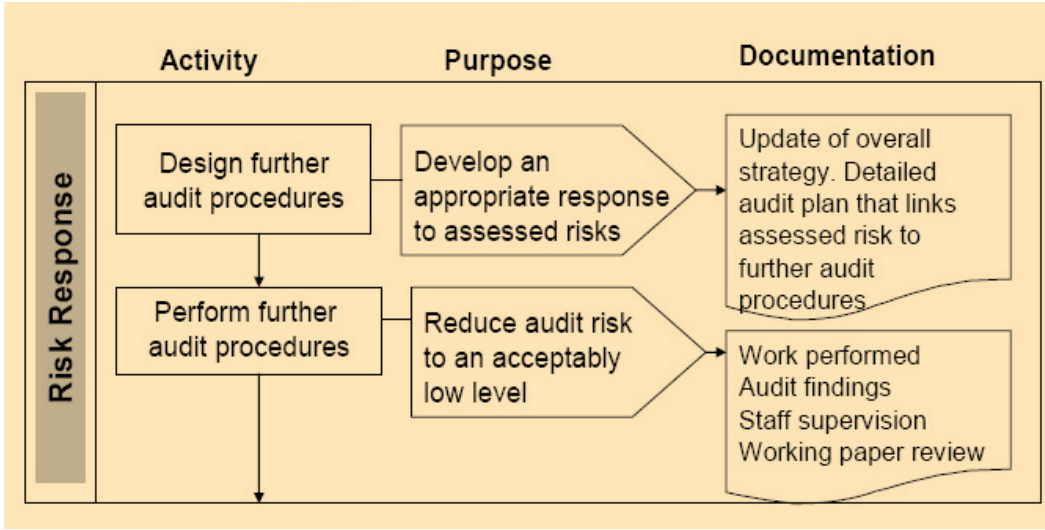
- Performing client acceptance or continuance procedures;
- Planning the overall engagement;
- Performing risk assessment procedures to understand the business and identify inherent and control risks;
- Identifying relevant internal control procedures and assessing their design and implementation (those controls that would prevent material misstatements from occurring or detect and correct misstatements after they have occurred);
- Assessing the risks of material misstatement in the financial statements;
- Identifying the significant risks that require special audit consideration and those risks for which substantive procedures alone are not sufficient;
- Communicating any material weaknesses in the design and implementation of internal control to management and those charged with governance; and
- Making an informed assessment of the risks of material misstatement at the financial statement level and at the assertion level.



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2.2.2. Risk response

This phase of the audit is to design and perform further audit procedures that respond to the assessed risks of material misstatement and will provide the evidence necessary to support the audit opinion.



Some of the matters the auditor should consider when planning the audit procedures include:

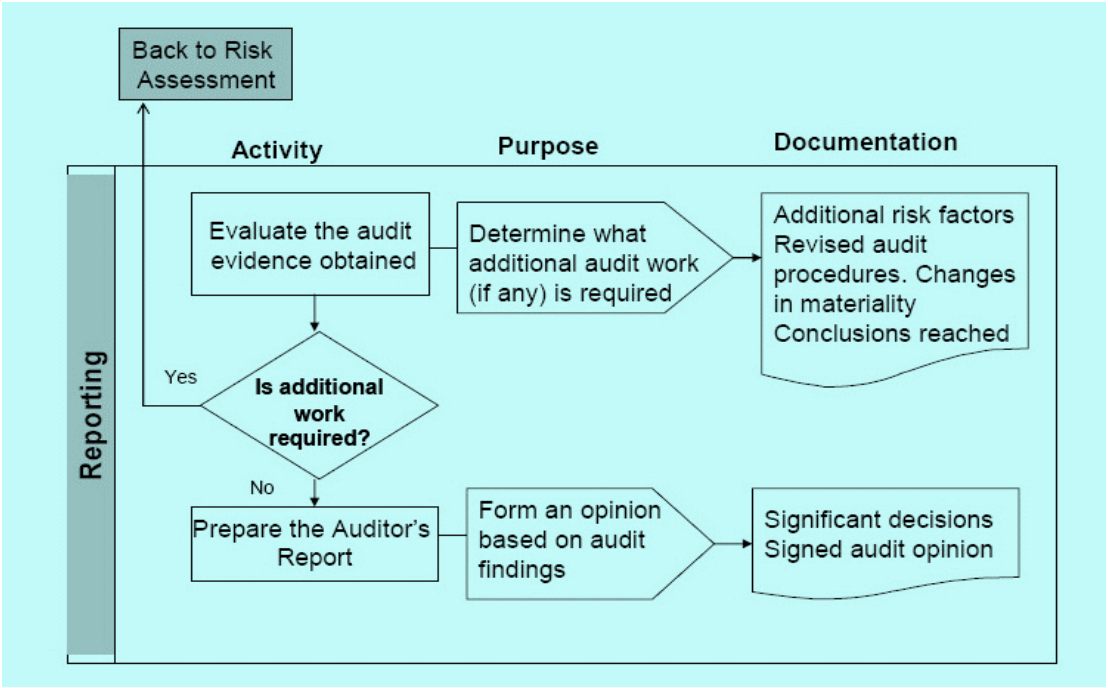
- Assertions that cannot be addressed by substantive procedures alone. This can occur where there is highly automated processing of transactions with little or no manual intervention.
- Existence of internal control that, if tested, could reduce the need/scope for other substantive procedures.
- The potential for substantive analytical procedures that would reduce the need/scope for other types of procedures.
- The need to incorporate an element of unpredictability in procedures performed.
- The need to perform further audit procedures to address the potential for management override of controls or other fraud scenarios.
- The need to perform specific procedures to address "significant risks" that have been identified.

Audit procedures designed to address the assessed risks could include a mixture of:
• Tests of the operational effectiveness of internal control; and
• Substantive procedures such as tests of details and analytical procedures.

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4. 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.

2.2.3. Reporting



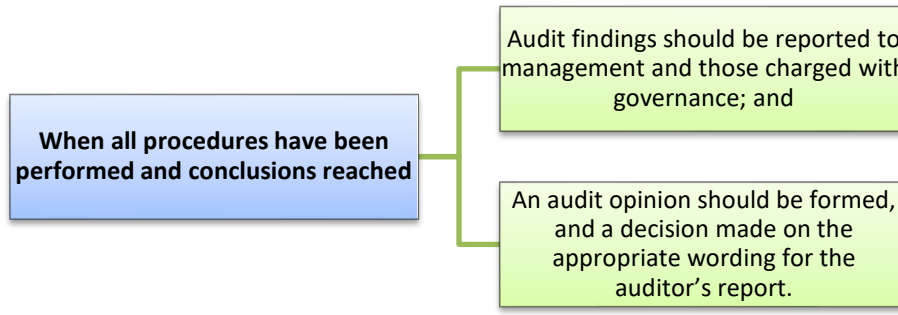
The final phase of the audit is to assess the audit evidence obtained and determine whether it is sufficient and appropriate to reduce the overall Audit Risk to an acceptably low level.

It is important at this stage to determine:

- If there had been a change in the assessed level of risk;
- Whether conclusions drawn from work performed are appropriate; and
- If any suspicious circumstances have been encountered.

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Any additional risks should be appropriately assessed, and further audit procedures performed as required.



TEST YOUR UNDERSTANDING 1

CA R is conducting statutory audit of a Divisional office (DO) of a public sector insurance company. On going through delegation of powers laid down by company's head office, it is noticed that surveyors in claims under property insurance policies beyond estimated amounts of ₹30 lac are to be appointed by Divisional Claims Committee (DCC). However, ongoing through surveyor appointment details of 10 such claims during the year, 5 instances have come to his notice where above delegation of powers has not been followed and appointments were made by Divisional manager in place of DCC.

In the beginning, the auditor had assessed risks of material misstatement to be low. Describe why the above finding would change auditor's assessment in relation to above.

TEST YOUR UNDERSTANDING 2

You have recently been appointed as an auditor of NGO working in the field of "upholding democracy" for the first time. The last year accounts of NGO were unaudited and its activities were limited at a small scale. However, it is only in the current year that NGO has received substantial donations including foreign funds. The said NGO is also crowdfunding its donations. The government has now legislative power to cancel FCRA certificate of NGO. Since it is working in a field which encompasses political and social fields, accusations and counter-accusations are flying thick and fast.

What factors you may consider for assessing audit risk?

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3. 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.

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.

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, 2013 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 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.

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. An auditor's judgement as to what is sufficient and appropriate audit evidence is affected by the degree of risk of misstatement. The auditor should obtain audit evidence through tests of control to

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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.**

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 errors. 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.



5. 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.

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.

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

3.1 Nature of Internal Control

A set of internally generated policies and procedures adopted by the management of an enterprise is a prerequisite for an organisation's 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.

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.

3.2 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.

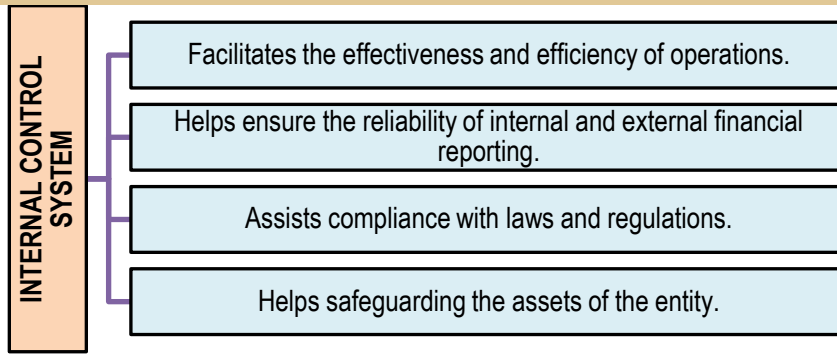
The fundamental, therefore, is that effective internal control is a process effected by people that supports the organization in several ways, enabling it to provide reasonable assurance regarding risk and to assist in the achievement of objectives.

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

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6. If production statistics were used as a basis for an analytical procedure, the controls to ensure the accuracy of such data would be relevant.

If non-compliance with certain laws and regulations has a direct and material effect on the financial statements, the controls for detecting and reporting on such non-compliance would be relevant.



3.3 Objectives of Internal Control System

The objectives of internal control system 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.:

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

In the case of excellent companies, 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.

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7. 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.

3.3.1 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:
Management's consideration that the cost of an internal control does not exceed the expected benefits to be derived.
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.
The possibility of circumvention of internal controls through collusion with employees or with parties outside the entity.
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.
Manipulations by management with respect to transactions or estimates and judgements required in the preparation of financial statements.

3.4 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:

3.4.1 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;

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(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 to be careful because he is aware that his performed tasks will be reviewed by others when duties are rotated.

3.4.2 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.

3.4.3 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.

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(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.

3.4.4 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 reconciled 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.

3.4.5 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 a process may be carried out by specially assigned staff under the banner of external audit.

4. COMPONENTS OF INTERNAL CONTROLS

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

(i) Control Environment;

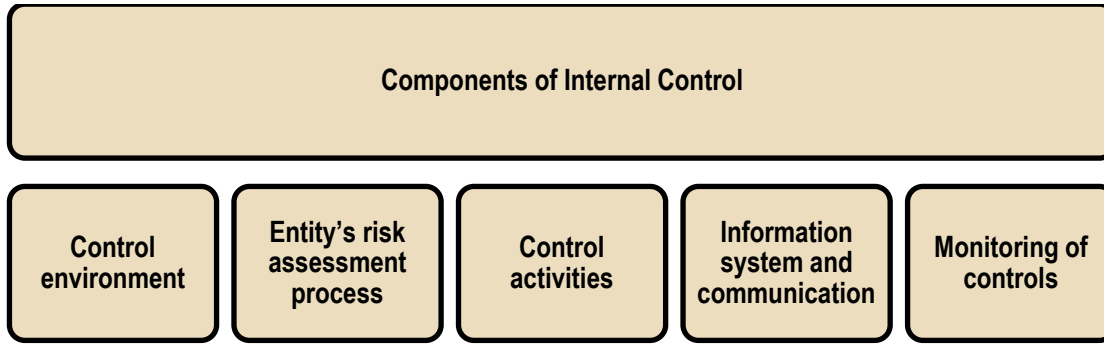
(ii) Entity's Risk Assessment Process;

(iii) Control Activities;

(iv) Information System and Communication;

(v) Monitoring of Controls

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4.1 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.

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(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.

4.2 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.



8. 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.

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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.

4.3 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

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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.

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4.4 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:	
(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.

4.5 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.

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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 system 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 the 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.

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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 the 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 workflow. 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, wherever practicable to prevent loss or misappropriation of cash.
(vii)	Budgetary control should be exercised and wide deviations observed should be reconciled.

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(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 Chapter 16 on Internal Audit in Module 3.

TEST YOUR UNDERSTANDING 3

RK Living Limited is engaged in manufacturing and processing of textile fabrics. It purchases its raw material from a company based in Silvassa taxable @ 12%. It takes about 3-4 days for raw materials to reach the company's plant. Recently, the company has revamped its internal control system for recording its transactions. You have also assumed charge as head of the internal audit department of the company a few days before.

It is noticed that the information system requires booking of purchases in purchase ledger and stock records from date of purchase invoice only. How would you deal with the above matter as internal auditor of the company?

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TEST YOUR UNDERSTANDING 4

A company as part of its internal control set up has a system under which quarterly budgeted targets in respect of sales are analysed with respect to actual performance achieved. It also involves fixing responsibilities of different product departmental heads and taking timely correction. In case of product departmental heads not achieving quarterly budgeted targets, they have to give a detailed justification for the same and also lay down how shortfalls would be compensated in ensuing quarters.

Identify and explain component of internal control alluded to in above scenario.

5. 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.

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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.



9. 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, be 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.

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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.

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6. 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 a vital role in establishing a strong control environment. Some of the key components to assess & evaluate the controls environment are as under:

1. **Standard Operating Procedures (SOPs):** A well-defined set of SOPs helps outline role, responsibilities, process and controls. This ensures that operating controls are clearly communicated to all touch points of a process. SOPs promote consistent application of controls even during employee turnover, reducing the risk of disruptions.

2. **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 are likely to be few.

3. **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.



10. 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.

4. **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.



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.

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5. **Delegation of Financial Powers Document**: As the organization grows, it needs to delegate the financial & other powers to employees. A clearly defined document on delegation of powers allows controls to be clearly operated without being dependent on individuals.

6. **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 a 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.

6.1 Techniques of Evaluation of Internal Control

The following are the techniques of evaluation of internal control:

6.1.1 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 reflect weakness

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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.

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If there has been a change, the auditor should take note of it 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.

6.1.2 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 the check list may even be meant for the auditor's own staff.



11. 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;

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(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 questionnaires are 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.	In ICQ, questions are usually answered by company executives. However, in a check list, the same are required to be answered by auditor/auditor staff.
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.

6.1.3 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, especially 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;

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(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. This suggestion has been made to ensure the readability and intelligibility of the flow charts.

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.

7. 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.



12. 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:**

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(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,

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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

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: (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

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(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.

Based upon risks of material misstatements identified and assessed by the auditor, auditor develops responses to assessed risks.

SA 330, "The Auditor's Responses to Assessed Risks", deals with the auditor's responsibility to design and implement responses to the risks of material misstatement identified and assessed by the auditor in accordance with SA 315.

The objective of the auditor in accordance with SA 330 is to obtain sufficient appropriate audit evidence about the assessed risks of material misstatement, through designing and implementing appropriate responses to those risks.

SA 330 states that:



In designing the further audit procedures to be performed, the auditor shall:
(a) Consider the reasons for the assessment given to the risk of material misstatement at the assertion level for each class of transactions, account balance, and disclosure, including: (i) The likelihood of material misstatement due to the particular characteristics of the relevant class of transactions, account balance, or disclosure (i.e., the inherent risk); and (ii) Whether the risk assessment takes into account the relevant controls (i.e., the control risk), thereby requiring the auditor to obtain audit evidence to determine whether the controls are operating effectively (i.e., the auditor intends to rely on the operating effectiveness of controls in determining the nature, timing and extent of substantive procedures); and
(b) Obtain more persuasive audit evidence the higher the auditor's assessment of risk.

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The auditor shall design and perform tests of controls to obtain sufficient appropriate audit evidence as to the operating effectiveness of relevant controls when:

(a) The auditor's assessment of risks of material misstatement at the assertion level includes an expectation that the controls are operating effectively (i.e., the auditor intends to rely on the operating effectiveness of controls in determining the nature, timing and extent of substantive procedures); or

(b) Substantive procedures alone cannot provide sufficient appropriate audit evidence at the assertion level.

In designing and performing tests of controls, the auditor shall obtain more persuasive audit evidence the greater the reliance the auditor places on the effectiveness of a control. Irrespective of the assessed risks of material misstatement, the auditor shall design and perform substantive procedures for each material class of transactions, account balance, and disclosure.

TEST YOUR UNDERSTANDING 5

CA S is statutory auditor of a listed company. On reviewing internal controls of the company, he is of the view that there can be possible situations where insurance premiums for keeping insurance policies current in respect of various assets of company may have become due and payable but internal control systems established by the company may not be able to capture it.

Elaborate how he should proceed to deal with the above matter.

8. FRAMEWORKS OF INTERNAL CONTROL

Corporate internal controls are part of the 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.

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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 the 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 the 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", as it provides the necessary criteria for internal financial controls over financial reporting for companies.

8.1 International Internal Control Frameworks

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

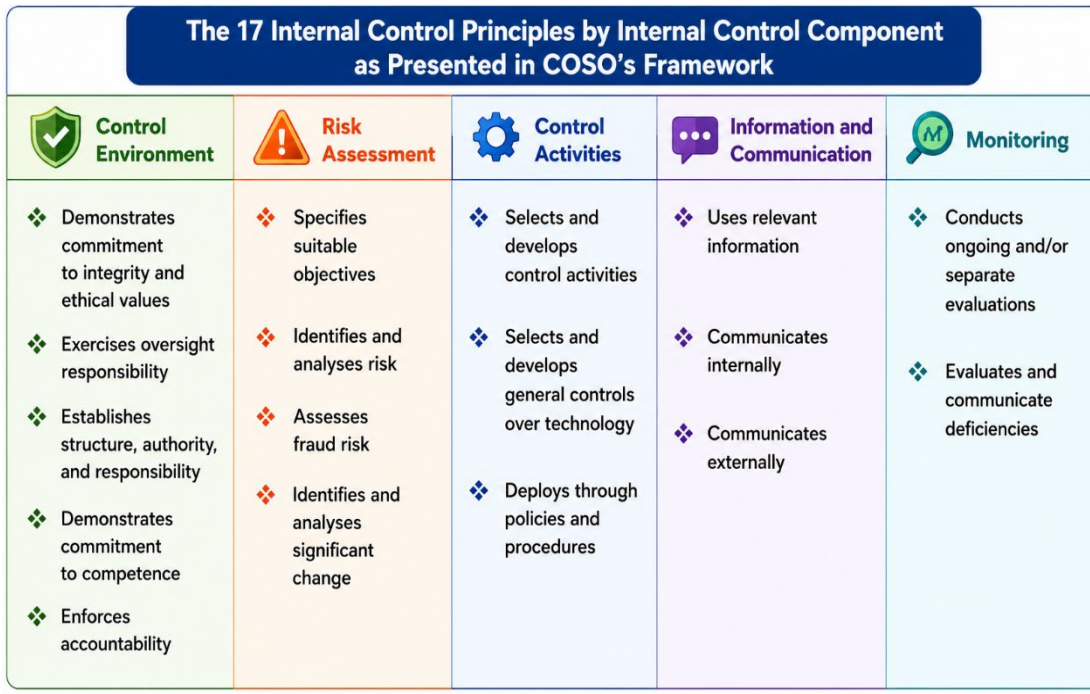
A. Internal Control - Integrated Framework issued by Committee of the Sponsoring Organisations of the Treadway Commission (COSO Framework)

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

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objectives into operations, financial reporting, and compliance. The framework includes 17 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 titles of the 17 internal control principles by internal control component as presented in COSO's framework:



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.

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- ***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 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. 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

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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.

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- 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

Section 404 of Sarbanes-Oxley Act (Sarbanes-Oxley Act Section 404) of United States of America 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, has revamped federal regulations pertaining to publicly traded companies' corporate governance and reporting obligations. It was followed up with constitution of PCAOB (Public Company Accounting Oversight Board). It regulates the audits of public companies and SEC-registered brokers and dealers in order to protect investors and further the public interest in the preparation of informative, accurate, and independent audit reports.

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.

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Key Takeaways

- Audit risk is the risk of expressing an inappropriate audit opinion on financial statements that are materially misstated. The components of audit risk include inherent risk, control risk and detection risk. Audit Risk (AR) can be expressed as a product of Inherent Risk (IR), Control Risk (CR) and Detection Risk (DR), i.e. AR = IR x CR x DR
- Auditors are required to assess the risks of material misstatement at two levels. The first is at the overall financial statement level, which refers to risks of material misstatement that relate pervasively to the financial statements as a whole and potentially affect many assertions and second one relates to risks identifiable with specific assertions at the class of transactions, account balance, or disclosure level.
- 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.
- Internal control is 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, 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.
- Components of internal control include control environment, entity's risk assessment process, the information system, including the related business processes, relevant to financial reporting, and communication, control activities and monitoring of controls.
- Review of internal control system enables auditor 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 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.
- In accordance with SA 265, it is auditor's responsibility to communicate appropriately to those charged with governance and management deficiencies in internal control that the

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auditor has identified during the audit and that, in the auditor's professional judgment, are of sufficient importance to merit their respective attentions.

- Based upon risks of material misstatements identified and assessed by the auditor, auditor develops responses to assessed risks.SA 330 deals with the auditor's responsibility to design and implement responses to the risks of material misstatement identified and assessed by the auditor in accordance with SA 315.
- Corporate internal controls are part of the 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.

Note:

Content of SA 315 "Identifying and Assessing the Risk of Material Misstatement through Understanding the Entity and its Environment" and SA 320 "Materiality in Planning and Performing an Audit" is covered in depth at Intermediate level. Thus, application part of above SAs may be discussed in the form of Case Study at Final level.

Student may note that SA 315 and SA 320 are covered in chapter 3: Risk Assessment and Internal control at Intermediate level, available at: https://resource.cdn.icai.org/93334bos-aps5884-ch3.pdf

For a concise revision of the key concepts covered in this chapter, students may refer to the Saransh Booklet for Paper 3: Advanced Auditing, Assurance and Professional Ethics, which serves as a useful last-mile revision resource for examination preparation. Saransh Booklet can be accessed at https://boslive.icai.org/AAAPE_SARANSH.pdf

TEST YOUR KNOWLEDGE

Theoretical Questions

1. *CA B was appointed as the auditor of ABC Limited for the financial year 2025-26. During the course of planning for the audit, CA B intends to apply the concept of materiality for the financial statements as a whole. Please guide him with respect to the factors that may affect the identification of an appropriate benchmark for this purpose.*

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What benchmark should be adopted by CA B, if ABC Limited is engaged in:

(i) the manufacture and sale of air conditioners and is having regular profits.

(ii) the construction of large infrastructure projects and incurred losses in the previous two financial years, due to pandemic.

2. *What are the components of an internal control framework?*

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

4. *Compute the overall Audit Risk if looking to the nature of business there are chances that 40% bills of services provided would be defalcated, inquiring on the same matter management has assured that internal control can prevent such defalcation to 75%. At his part the Auditor assesses that the procedure he could apply in the remaining time to complete Audit gives him satisfaction level of detection of frauds & error to an extent of 60%. Analyse the Risk of Material Misstatement and find out the overall Audit Risk.*

5. *ST Ltd is a growing company and currently engaged in the business of manufacturing of tiles. The company is planning to expand and diversify its operations. The management has increased the focus on the internal controls to ensure better governance. The management had a discussion with the statutory auditors to ensure the steps required to be taken so that the statutory audit is risk based and focused on areas of greatest risk to the achievement of the company's objectives. Please advise the management and the auditor on the steps that should be taken for the same.*

6. *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.*

7. *While assessing the impact of uncorrected misstatements in the audit of MINI Builders Private Limited, Mr. Gautam encountered a significant issue related to the calculation of materiality on revenue. The initial materiality calculation was based on estimated figures provided by the management. Management, to estimate full-year revenue, extrapolated the sales for 11 months to arrive at a figure for 12 months. However, given the nature of MINI Builders as a company in the construction sector, where monthly sales exhibit substantial variations, a unique challenge emerged.*

   The actual sales for the last month deviated significantly from the estimated sales due to an unexpected slowdown in project completions. As a result, the last month's actual sales represented only 30% of the estimated sales. Now, Mr. Gautam is confronted with a dilemma

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regarding the appropriate approach to evaluate uncorrected misstatements using the previously calculated materiality. Kindly Guide Mr. Gautam in the light of relevant Standards on Auditing.

8. *Deepti & Co., Chartered Accountants, during the audit of Magma Ltd. found that certain machinery had been imported for the production of a new product. Although the auditors have applied the concept of materiality to the financial statements as a whole, they now want to re-evaluate the materiality concept for the said transaction involving foreign exchange. Give your views in this regard?*

9. *AMRO Ltd. is a manufacturing and trading Company of leather goods since last 10 years. You are the internal auditor of the company for the year 2025-26. In order to review internal controls of the company, you visited the departments and noticed:*

   (1) The head of procurement, Mr. Amit, has complete control over purchasing, receiving goods, and approving payments to suppliers. His actions are not reviewed by any other person in the company.

   (2) The company's staff has been working in the same roles for over five years without any rotation. The finance manager, Mr. Sachin, in particular, has never had his duties rotated since joining the company.

   (3) The store manager, Mr. Gupta, who is responsible for maintaining the inventory, also keeps the inventory records.

   Required:

   (a) Briefly discuss the general conditions pertaining to the internal check system to be ensured by you as an auditor.

   (b) Do you think that general conditions pertaining to the internal check system are violated in the given situation?

10. ***CA Q is the engagement partner for the statutory audit of LAL Ltd. While conducting the audit he has identified some deficiencies in the internal controls. On further verification of the internal controls of the company, he has some indications that significant transactions in which management is financially interested are not being appropriately scrutinised by those charged with the governance and also in few cases he observed the susceptibility to loss of an asset. He determines, on the basis of the audit work performed, that identified deficiencies constitute significant deficiencies. How and to whom CA Q shall communicate identified significant deficiencies in the internal control? Which matters shall be included by CA Q in such communication?***

11. ***You have been appointed as internal auditor of a Company manufacturing and trading in Chemicals. You have asked your team to review the internal controls and get the***

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first hand information of each department and their heads and note their respective roles in the company's procurement and inventory processes.

Your team has observed that-

(i) The Head of Purchase department, a relative of the promoter, has for several years been in-charge of purchasing and sanctioning payments, without allowing anybody to question him.

(ii) There has been no rotation of duties for several years of most of the employees, in particular, the Chief Accountant who has a good rapport with majority customers.

(iii) The Storekeeper also has not kept adequate stock records since he joined the company without carrying out physical verification of the assets.

Analyse the specific violations of the principles of an adequate internal check system. Evaluate how these control deficiencies, individually and collectively, increase the inherent and control risk for the entity.

12. ROPE Ltd. is a manufacturing and trading Company of leather goods since last 12 years. You are the internal auditor of the company for the year 2025-26. In order to review internal controls of the company, you visited the departments and noticed:

(i) The store manager, Mr. Abhishek, who is responsible for maintaining the inventory, also keeps the inventory records.

(ii) The company's staff has been working in the same roles for over seven years without any rotation. The finance manager, Mr. Krishna, in particular, has never had his duties rotated since joining the company.

(iii) The head of procurement, Mr. Sumit, has complete control over purchasing, receiving goods, and approving payments to suppliers. His actions are not reviewed by any other person in the company.

Do you think that general conditions pertaining to the internal check system are violated in the given situation? Comment.

13. Evan & Co, a firm of Chartered Accountants, conducting the audit of a listed company PARI Ltd. for the year ended 31-03-2026 are concerned with the presentation and disclosure of segment information included in Company's Annual Report.

The audit team wants to ensure that methods used by management for determining segment information have resulted in disclosure in accordance with the applicable financial reporting framework.

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With reference to the relevant Standards on Auditing, explain the 'examples of matters' that the auditors should consider while obtaining an understanding of the methods used by management in determining and presenting segment information in the financial statements.

14. During the audit of Rishabh Ltd., a company engaged in manufacturing home appliances, the auditor noted several significant developments in the current financial year. The company implemented a new integrated information system to replace its old accounting software. It also entered into two new foreign markets to expand its sales and hired several new employees in the finance and IT departments to manage the increased operations.

Further, the company introduced innovative smart appliances incorporating advanced technology and experienced substantial growth in its production and sales volumes. In addition, the management changed some of the accounting policies to comply with updated requirements of the applicable financial reporting framework.

While performing the audit, the auditor is evaluating whether these developments could affect the reliability of financial reporting and the effectiveness of internal control within the company.

As an auditor, identify the circumstances in the above situation that may give rise to risks affecting the preparation of financial statements and briefly discuss how such changes may impact the entity's internal control and financial reporting process.

15. While conducting the statutory audit of Super Ltd. for the financial year 2025–26, the auditor, CA Chintan, identified several weaknesses in the internal control system in areas such as cash handling, inventory management, and authorization procedures. These deficiencies indicated potential risks of errors and fraud. Chintan decided to communicate these weaknesses to the company's management and those charged with governance through a Letter of Weakness. However, he wants to ensure that the communication reflects the scope and limitations of the audit properly. You are required to elucidate the important points CA Chintan should keep in mind while drafting the letter of weaknesses in internal control system.

Answers to Test your Understanding Question

1. Evaluation of internal controls influences auditor's assessment of risks of material misstatement. Risks of material misstatement also consists of control risk.

In the given situation of statutory audit of a Divisional office of a public sector insurance company, it is noticed that procedure relating to delegation of powers has not been followed

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and surveyor appointments have been made in violation of laid down procedures. It is a serious violation and shows that controls are not operating effectively as laid down by company management.

Such deviations from established controls may lead auditor to conclude that control risk needs to be revised. Revision of control risk assessment is likely to lead to revision in risks of material misstatement. It may also result in modification of nature, timing and extent of planned substantive procedures.

2. For assessing audit risk, auditor shall consider all components of audit risk. The said NGO is working in a political-cum-social field which can make its activities inherently risky. Crowd funding donations may have to be seen in relation to the constitution of NGO which may make these risky. Since the NGO is in receipt of foreign funds, it may make transactions inherently risky. The credibility and integrity of persons behind NGO is important. Shady NGOs can be involved in money laundering activities and may be involved in mis utilizing funds from donors. Since last year's accounts were unaudited, it also increases the inherent risk due to the probable effect of misstatements, if any, of last year. Non-compliance with strict laws has the potential to make activities of NGO inherently risky.

Since NGO has received substantial donations in the current year and its activities were on a relatively small scale during last year, formal controls may not be in place. Lack of formal controls may lead to non-compliance with laws. Non-compliance with FCRA can have serious consequences including cancelling such certificate of NGO. Therefore, control risk could be high.

Further, audit for NGO has been accepted for the first time. There may be a lack of understanding of activities of NGO. It may lead to higher detection risk due to inappropriate sampling procedures or faulty application of audit procedures.

3. Internal audit involves continuous and critical appraisal of functioning of an entity with a view to suggest improvements thereto and add value to and strengthen the overall governance mechanism of the entity including its strategic risk management and internal control system. Internal audit also involves evaluation of internal control to provide assurance to management regarding design, implementation and operating effectiveness of control.

In the given situation, the information system requires booking of purchases in purchase ledger and stock records from date of invoice. Such a control system is likely to present a distorted picture of stocks of the company. It would show stocks of raw material as received whereas these goods could be in transit. Therefore, the design of the control itself is faulty, which allows booking from date of purchase invoice only. Further, such a system can have implications with respect to GST laws.

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The internal auditor should report on the above matter asking management for corrective action.

4. The above referred component of internal control is "Control activities". Control activities that may be relevant to an audit include policies and procedures that pertain to "performance reviews".

Such 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.

The control activities pertaining to analysis of budgeted target of sales with respect to actual performance, fixing of responsibilities and taking timely corrective action falls in nature of performance reviews. Such performance reviews are part of control activities which is a component of internal control.

5. A deficiency in internal control exists when:

(i) A control is designed, implemented or operated in such a way that it is unable to prevent, or detect and correct, misstatements in the financial statements on a timely basis or

(ii) A control necessary to prevent, or detect and correct, misstatements in the financial statements on a timely basis is missing.

In the above situation, there is a possibility that internal control systems established by the company may not be able to capture insurance premiums which may have become due and payable. It is a significant deficiency as failure to keep insurance policies current would render assets of the company uninsured. It may lead to losses for the company in case of any eventuality.

Further, in accordance with SA 265, the significance of a deficiency or a combination of deficiencies in internal control depends not only on whether a misstatement has actually occurred, but also on the likelihood that a misstatement could occur and the potential magnitude of the misstatement. Significant deficiencies may, therefore, exist even though the auditor has not identified misstatements during the audit.

The susceptibility to loss of an asset is a factor in determining whether a deficiency constitutes significant deficiency in internal control.

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The auditor shall communicate in writing significant deficiency in internal control to those charged with governance and 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.

Answers to Theoretical Questions

1. **Use of Benchmarks in Determining Materiality for the Financial Statements as a Whole:** As per SA 320, determining materiality involves the exercise of professional judgment. A percentage is often applied to a chosen benchmark as a starting point in determining materiality for the financial statements as a whole.

Factors that may affect the identification of an appropriate benchmark include the following:

- The elements of the financial statements (for example, assets, liabilities, equity, revenue, expenses);
- Whether there are items on which the attention of the users of the particular entity's financial statements tends to be focused (for example, for the purpose of evaluating financial performance users may tend to focus on profit, revenue or net assets);
- The nature of the entity, where the entity is at in its life cycle, and the industry and economic environment in which the entity operates;
- The entity's ownership structure and the way it is financed (for example, if an entity is financed solely by debt rather than equity, users may put more emphasis on assets, and claims on them, than on the entity's earnings); and
- The relative volatility of the benchmark.

Determining a percentage to be applied to a chosen benchmark involves the exercise of professional judgment. There is a relationship between the percentage and the chosen benchmark, such that a percentage applied to profit before tax from continuing operations will normally be higher than a percentage applied to total revenue.

In case if ABC Limited is engaged in manufacture and sale of air conditioner, and is having regular profits: CA B, the auditor may consider profit before tax /Earnings.

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In case ABC Limited is engaged in the construction of large infrastructure projects and incurred losses in the previous two financial years, due to pandemic: CA B, the auditor may consider Revenue or Gross Profit as benchmarking.

Alternatively, CA B, the auditor may consider the criteria relevant for audit of the entities doing public utility programs/ projects, Total cost or net cost (expenses less revenues or expenditure less receipts) may be appropriate benchmarks for that particular program/project activity. Where an entity has custody of the assets, assets may be an appropriate benchmark.

2. Refer Para 4

3. Refer Para 6.1.3

4. According to SA-200, "Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Standards on Auditing", the Audit Risk is a risk that Auditor will issue an inappropriate opinion while Financial Statements are materially misstated.

Audit Risk has two components: Risk of material Misstatement and Detection Risk. The relationship can be defined as follows.

Audit Risk = Risk of Material Misstatement X Detection Risk

Risk of Material Misstatement: - Risk of Material Misstatement is anticipated risk that a material Misstatement may exist in Financial Statement before start of the Audit. It has two components Inherent risk and Control risk. The relationship can be defined as

Risk of Material Misstatement = Inherent risk X control risk

Inherent risk: It is a susceptibility of an assertion about account balance; class of transaction, disclosure towards misstatements which may be either individually or collectively with other Misstatement becomes material before considering any related internal control which is 40% in the given case.

Control risk: It is a risk that there may be chances of material Misstatement even if there is a control applied by the management and it has prevented defalcation to 75%.

Hence, control risk is 25% (100%-75%)

Risk of Material Misstatement: Inherent risk X Control risk i.e., 40% X 25 % = 10%

Chances of Material Misstatement are reduced to 10% by the internal control applied by management.

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Detection risk: It is a risk that a material misstatement remained undetected even if all audit procedures applied, Detection Risk is 100-60=40%

In the given case, overall Audit Risk can be reduced up to 4% as follows:

Audit Risk: Risk of Material Misstatement X Detection Risk = 10X 40% = 4%

5. Refer Para 2.2

6. **Control System over Selling and Collection of Tickets:** In order to achieve proper internal control over the sale of tickets and its collection by the Y Co. Ltd., following system should be adopted -

(i) **Printing of tickets:** Serially numbered pre-printed tickets should be used and designed in such a way that any type of ticket used cannot be duplicated by others in order to avoid forgery. Serial numbers should not be repeated during a reasonable period, say a month or year depending on the turnover. The separate series of the serial should be used for such denomination.

(ii) **Ticket sales:** The sale of tickets should take place from the Central ticket office at each of the 5 centres, preferably through machines. There should be proper control over the keys of the machines.

(iii) **Daily cash reconciliation:** Cash collection at each office and machine should be reconciled with the number of tickets sold. Serial number of tickets for each entertainment activity/denomination will facilitate the reconciliation.

(iv) **Daily banking:** Each day's collection should be deposited in the bank on the 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 the 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.

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(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. As per SA 450, "Evaluation of Misstatements Identified during the Audit", the auditor is required to reassess materiality, in accordance with SA 320, "Materiality in Planning and Performing an Audit", before evaluating the impact of uncorrected misstatements. This reassessment is crucial to confirm the ongoing appropriateness of materiality in light of the entity's actual financial results.

The determination of materiality under SA 320 often relies on estimates of the entity's financial results, given that the actual results may not be known during the early stages of the audit. Therefore, before the auditor proceeds to assess the effect of uncorrected misstatements, it becomes necessary to adjust the materiality calculated under SA 320 based on the now available actual financial results.

SA 320 outlines that, as the audit progresses, materiality may be revised for the financial statements as a whole or for specific classes of transactions, account balances, or disclosures. This revision is prompted by the auditor's awareness of information that would have led to a different initial determination. Typically, significant revisions occur before the evaluation of uncorrected misstatements. However, if the reassessment of materiality under SA 320 results in a lower amount, the auditor must reconsider performance materiality and the appropriateness of the audit procedures' nature, timing, and extent. This is crucial for obtaining sufficient and appropriate audit evidence on which to base the audit opinion.

In the present case involving MINI Builders Private Limited, it has been identified that the materiality calculated at the beginning of the audit for revenue was based on estimates provided by the management. The management extrapolated sales for the full year using the actual amount of 11 months, but since the company experiences significant monthly variations in sales, the actual sales for the last month were only 30% of the estimated figure. This discrepancy arose due to an unexpected slowdown in project completion.

In this audit scenario, Mr. Gautam, the auditor, must review and reassess the materiality initially determined under SA 320 to ensure its continued validity in light of the actual financial results. If the re-assessed materiality is lower than the previously calculated amount, Mr. Gautam must reconsider performance materiality and the appropriateness of the nature, timing, and extent of further audit procedures. This meticulous approach is essential to gather sufficient and appropriate audit evidence, enabling Mr. Gautam to form an independent and objective opinion on the financial statements of MINI Builders Private Limited.

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8. As per SA 320, "Materiality in Planning and Performing an Audit", when establishing the overall audit strategy, the auditor shall determine materiality for the financial statement as a whole. If, in the specific circumstances of the entity, there is one or more particular classes of transactions, account balances or disclosures for which misstatements of lesser amounts than the materiality for the financial statements as a whole could reasonably be expected to influence the economic decisions of users taken on the basis of the financial statements, the auditor shall also determine the materiality level or levels to be applied to those particular classes of transactions, account balances or disclosures.

The auditor shall revise materiality for the financial statements as a whole (and, if applicable, the materiality level or levels for particular classes of transactions, account balances or disclosures) in the event of becoming aware of information during the audit that would have caused the auditor to have determined a different amount (or amounts) initially.

If the auditor concludes a lower materiality for the same, he shall determine whether it is necessary to revise performance materiality and whether the nature, timing and extent of the further audit procedures remain appropriate.

In the given case, Deepti & Co., as an auditor has applied the concept of materiality for the financial statements as a whole. But they want to re-evaluate the materiality concept on the basis of additional information of import of machinery for production of new product which draws attention to a particular aspect of the company's business.

Thus, Deepti & Co. can re-evaluate the materiality concepts after considering the necessity of such revision.

9. (a) Refer Para 4.5 Sub-heading 1

(b) Yes, in the given situation general conditions pertaining to the internal check system are violated as follows:

(1) The head of procurement, Mr. Amit, having complete control over the procurement process without oversight violates the principle that no single person should control any important aspect of the business operation.

(2) The lack of staff rotation for over five years violates the principle that staff duties should be rotated periodically to prevent any single person from performing the same function for too long.

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(3) Allowing Mr. Gupta, the store manager, to maintain inventory records while also having custody of the inventory violates the principle that those with physical custody of assets should not have access to accounting records.

10. Communicating Deficiencies in Internal Control: SA 265 on "Communicating Deficiencies in Internal Control to Those Charged with Governance and Management", 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.

The auditor, CA Q shall communicate significant deficiencies in internal control identified during the audit to those charged with governance on a timely basis in writing. CA Q shall also communicate to management at an appropriate level of responsibility on a timely basis.

Refer "the auditor shall include in the written communication of significant deficiencies in internal control" described under Para 7.

11. Based on the observations made by the internal audit team, the following violations of the principles of an adequate internal check system are identified:

(i) The Head of the Purchase Department, being a relative of the promoter, has been entrusted with both purchasing and sanctioning of payments for several years without allowing anybody to question him. This violates the fundamental principle that no single person should have complete control over any important aspect of business operations and that every employee's actions should come under the review of another person. It also breaches the principle relating to distribution of financial and administrative powers and their periodic review.

(ii) There has been no rotation of duties for several years of most of the employees, in particular, the Chief Accountant, who has a good rapport with major customers. This violates the principle that staff duties should be rotated from time to time so that employees do not perform the same function for a considerable length of time.

(iii) The Storekeeper has failed to maintain proper stock records and no physical verification of assets has been carried out since his appointment. This violates the principle that those with physical custody of assets should not have access to accounting records. It also violates the principle that there should exist an

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accounting control in respect of each class of assets, in addition there should be periodical inspection so as to establish their physical condition.

Impact of Control Deficiencies on Inherent and Control Risk:

Increased Inherent Risk: The nature of the procurement and inventory functions makes them inherently susceptible to fraud such as fictitious purchases, overbilling, or theft of stock. The lack of proper controls means that these inherent risks are not mitigated.

Increased Control Risk: Non-rotation of accounting staff increases the risk of collusion and manipulation of receivables, while absence of stock records and physical verification exposes the company to theft, pilferage, and incorrect inventory valuation. The identified deficiencies demonstrate that the company's internal control system is not operating effectively. This leads to a high control risk in the procurement and inventory cycles.

12. *Yes, in the given situation general conditions pertaining to the internal check system are violated as follows:*

    (i) *Allowing Mr. Abhishek, the store manager, to maintain inventory records while also having custody of the inventory violates the principle that those with physical custody of assets should not have access to accounting records.*

    (ii) *The lack of staff rotation for over seven years violates the principle that staff duties should be rotated periodically to prevent any single person from performing the same function for too long.*

    (iii) *The head of procurement, Mr. Sumit, having complete control over the procurement process without oversight violates the principle that no single person should control any important aspect of the business operation.*

13. *The auditors, Evan & Co. wanted to ensure and obtain sufficient appropriate audit evidence regarding the presentation and disclosure of segment information in accordance with the applicable financial reporting framework by obtaining an understanding of the methods used by management in determining segment information. SA 501 guides in this regard. As per SA 501- "Audit Evidence—Specific Considerations for Selected Items", example of matters that may be relevant when obtaining an understanding of the methods used by management in determining segment information and whether such methods are likely to result in disclosure in accordance with the applicable financial reporting framework include:*

    (i) *Sales, transfers and charges between segments, and elimination of inter-segment amounts.*

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(ii) Comparisons with budgets and other expected results, for example, operating profits as a percentage of sales.

(iii) The allocation of assets and costs among segments.

(iv) Consistency with prior periods, and the adequacy of the disclosures with respect to inconsistencies.

14. In the given case of Rishabh Ltd., several developments during the year may give rise to risks affecting the preparation and reliability of financial statements. As part of the entity's risk assessment process, management identifies and evaluates such risks that may affect financial reporting.

The circumstances and their impact are as follows:

Refer "Risks can arise or change due to circumstances such as the following" described under Para 4.2

15. As per SA 265, "Communicating Deficiencies in Internal Control to Those Charged with Governance and Management", the auditor CA Chintan 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 CA Chintan 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.

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