

10. RISK ASSESSMENT AND INTERNAL CONTROL

QUESTION - WISE ANALYSIS OF PREVIOUS EXAMINATIONS

No.	N-13	M-14	N-14	M-15	N-15	M-16	N-16	M-17	N-17	M-18(O)	M-18(N)	N-18(O)	N-18(N)
6.	-	-	-	-	-	-	-	-	-	-	6	-	-
8.	-	-	-	-	-	-	-	5	-	-	-	-	-
9.	-	-	-	-	-	4	4	-	4	-	-	-	-
12.	-	-	-	-	-	-	-	-	-	4	-	-	-
13.	-	-	-	-	-	-	-	-	-	-	5	-	-
15.	-	-	-	-	-	5	-	-	-	-	-	-	-

CHAPTER OVERVIEW

SECTION	TOPIC	STARTING PAGE NO.
1.	THEORY FOR CLASSROOM DISCUSSION	10.1
2.	QUESTIONS FOR ACADEMIC INTEREST – FOR STUDENTS SELF STUDY	10.11
3.	PRACTICAL QUESTIONS FOR CLASSROOM DISCUSSION	10.15

SECTION 1: THEORY FOR CLASSROOM DISCUSSION

Q.No.1. Define Audit Risk? What are the components of audit risk? Write about inter relationship between components of audit risk? (A) (NEW SM)

1) MEANING OF AUDIT RISK:

a) Includes:

- i) The risk of expressing an inappropriate opinion when the financial statements are materially misstated is termed as audit risk.
- ii) In other words, expression of unmodified opinion in a situation where modified opinion would be suitable.
- iii) Further the assessment of risk is a matter of professional judgment.

b) Excludes: It does not include

- i) Risk of expressing a modified opinion when financial statements are not materially misstated.
- ii) Business risk faced by auditor. Example: Loss of clients or reputation is not considered as audit risk.

2) COMPONENTS OF AUDIT RISK: Audit risk is a function of the risks of material misstatement and detection risk.

$$\text{Audit Risk} = \text{Risk of Material Misstatement} \times \text{Detection Risk}$$

- a) Risk of MMS:** The risk that the financial statements are materially misstated prior to audit. This consists of two components namely inherent risk and control risk. Further the Risk of MMS is an entity's risk and will exist irrespective of audit of financial statements.

i) Inherent risk:

- i) The risk of that a transaction or balance could be materially misstated before considering the related internal control system.
- ii) Absence of related control is also termed as inherent risk.
- iii) Inherent risk is generally unavoidable and inherent in the system.

ii) Control risk:

- i) The risk that the internal control system, fails to prevent, detect or correct a misstatement on a timely basis.
- ii) This risk is also termed as control weakness or control deficiency.

b) Detection risk: The risk that the audit procedures performed will not detect a material misstatement.

3) INTERRELATIONSHIP BETWEEN COMPONENTS:

There exist an INVERSE RELATIONSHIP between Risk of MMS and Detection risk.

For Example: If the Risk of MMS is high, the auditor will conduct an in depth audit, resultantly he can detect MMS.

SIMILAR QUESTIONS:

1. Write about Interrelation between components of audit risk?

A. Write Point - A and Point - C.

2. "Risk of material misstatement consists of two components" Explain clearly defining risk of material misstatement.

A. Write Point B(1)

NEW SM - TYK

3. "The SAs do not ordinarily refer to inherent risk and control risk separately, but rather to a combined assessment of the "risks of material misstatement" Explain.

NEW SM - TYK

A. Write Point C

Q.No.2. Write about Risk Assessment Procedure in light of SA 315?

(A) (NEW SM)

SA 315 - IDENTIFYING AND ASSESSING THE RISKS OF MATERIAL MISSTATEMENT THROUGH UNDERSTANDING THE ENTITY AND ITS ENVIRONMENT:

1) RISK ASSESSMENT PROCEDURE:

a) The objective of auditor is:

i) To identify the risk of MMS at two levels-

- Financial statement level.
- Assertion level.

ii) To assess (analyse) the risk of MMS for determining its significance.

iii) To minimise the audit risk to an acceptably low level by properly planning and performing audit (audit procedures) based on risk assessment process.

b) The risk is identified and d by understanding the entity and its environment including entity's internal controls.

c) Evaluate whether the risks identified are impacting financial statements at a pervasive level and affect many assertions potentially.

d) Assess What Can Go Wrong (WCGR) by considering related controls at assertion level.

e) Remember the risk may arise either from Fraud (Intentional) or error (Unintentional).

f) Also the risk assessment procedure by own do not provide sufficient appropriate audit evidence. The auditor shall carryout substantive procedures to obtain sufficient appropriate audit evidence.

g) The assessment of risk is a matter of professional judgment rather than a matter capable of precise measurements. Further risk assessment is based on information obtained through risk audit procedures.

2) RISK ASSESSMENT PROCEDURES INCLUDES:**a) Inquiries of management and of others within the entity:**

- i) Discussions with those charged with governance may enable the auditor to understand the environment in which financial statements are prepared.
- ii) Discussions with Internal audit team may provide the auditor, whether the management has properly responded to internal auditor findings.
- iii) Discussions with employees may help the auditor to identify any unusual or complex transactions.
- iv) Discussions with entity's legal council (E.g.: audit committee or lawyers) may help the auditor identifying matters related to fraud, litigations and provisions etc.,
- v) Discussing with marketing or sales personnel regarding market strategies, sales trends etc..

b) Analytical procedures:

- i) Analytical procedures performed as risk assessment procedures may include both financial and non-financial information, for example, the relationship between profit and number of employees i.e., profit generated per employee.
- ii) Unusual or unexpected relationships identified by the auditor may help in identifying risks of material misstatement, especially risks of material misstatement due to fraud.
- iii) Analytical procedures includes:
 - Ratio Analysis
 - Trend Analysis
 - Reasonableness test
 - Structural modeling (A Statistical tool. Eg. Regression theorem)

c) Observation and inspection:

- i) Observing Entity's operations. Eg: Production, Accounting etc.,
- ii) Inspecting Documents, records, internal control manuals may provide supporting information in addition to inquiries. Eg: Reading Standard Operating Manuals (SOP).
- iii) Inspecting Reports prepared by management and those charged with governance. Eg: Minutes, MIS reports.
- iv) Observing clients premises like factory, offices etc.,

SIMILAR QUESTIONS:

1. The assessment of risk is a matter of professional judgment. Explain clearly what is not included in audit risk? MTP1 N18(N)
- A. Write - Point A (7) and Question - 1 - Point A (2).
2. The auditor shall identify and assess the risks of material misstatement at both levels to provide a basis for designing and performing further audit procedures. For the purpose of identifying and assessing the risks of material misstatement the auditor shall identify risks, assess the identified risks, relate the identified risks and consider the likelihood of misstatement. Explain the above in detail. MTP2 N18(N)
- A. Write Point - A (1, 2, 4 and 7).
3. Discuss what is included in risk assessment procedures to obtain audit evidence about the design and implementation of controls. RTP M18 (N&O), RTP M17
- A. Write Point - B (2 Points each for every heading)
4. For the purpose of identifying and assessing the risks of material misstatement, the auditor shall identify risks throughout the process of obtaining an understanding of the entity and its environment. Explain in detail along with other relevant points N20 RTP
- A. Refer A
5. Much of the information obtained by the auditor's inquiries is obtained from management and those responsible for financial reporting. However, the auditor may also obtain information, or a different perspective in identifying risks of material misstatement, through inquiries of others within the entity and other employees with different levels of authority. Explain with the help of examples N20 RTP
- A. Refer B(1)

6. Analytical procedures performed as risk assessment procedures may identify aspects of the entity of which the auditor was unaware and may assist in assessing the risks of material misstatement in order to provide a basis for designing and implementing responses to the assessed risks. Explain in detail N20 RTP
- A. Refer A (1,2) and B(2)

Q.No.3 Risk of material misstatements are assessed at financial statement level and assertion level. Describe? (OR) Write about levels of assessment of risk of MMS? (B) (NEW SM)

The risks of material misstatement may exist at TWO LEVELS:

1) FINANCIAL STATEMENTS LEVEL:

- a) Risks of material misstatement that are pervasive to financial statements as a whole and affect many assertions potentially.
- b) Risks of this nature are not specific to a particular assertion.
- c) This is also known as pervasive level risk.
- d) **Indicators:**
 - i) Concerns about the integrity of the entity's management.
 - ii) Unusual pressure on management.
 - iii) Lack of adequate competence of management to prepare financial statements.
 - iv) Going concern and liquidity issues including loss of significant customers.

Due to the above issues the auditor may conclude the financial statements as a whole are materially misrepresented by management or those charged with governance.

- 2) ASSERTION LEVEL:** Risks of material misstatement at the assertion level are assessed in order to determine the nature, timing, and extent of further audit procedures. This enables the auditor to express an opinion on the financial statements after obtaining reasonable assurance.

Indicators:

- a) Quality of accounting systems.
- b) Significant transactions with related parties.
- c) Effectiveness of Controls at warehouse.
- d) Complex transactions.
- e) Assets prone to misappropriation.
- f) Unusual transactions at year end.
- g) Pending litigation and contingent liabilities, for example, sales warranties, financial guarantees and environmental remediation.

SIMILAR QUESTIONS:

1. Write about Risk of MMS at financial statement levels?
 - A. Refer Point – A
2. Write about Risk of MMS at assertion level?
 - A. Refer Point – B

Q.No.4 Understanding an entity is a continuous and dynamic process. Comment. (A)RTP M20(N)

- 1) **CONTINUOUS PROCESS:** Obtaining an understanding of the entity and its environment including the entity's internal control, is a continuous and dynamic process of gathering, updating and analysing information throughout the audit.
- 2) **USES:** The understanding helps the auditor to plan and perform the audit and exercise professional judgment where ever necessary. Examples:
 - a) Assessing risks of material misstatement of the financial statements;

- b) Determining materiality in accordance with SA 320;
- c) Considering the appropriateness of the selection and application of accounting policies;
- d) Identifying areas where special audit consideration may be necessary, for example, related party transactions, the appropriateness of management's use of the going concern assumption;
- e) Evaluating the sufficiency and appropriateness of audit evidence obtained.

SIMILAR QUESTIONS:

1. The auditor of ABC Textiles Ltd chalks out an audit plan without understanding the entity's business. Since he has carried out many audits of textile companies, there is no need to understand the nature of business of ABC Ltd. Advise the auditor how he should proceed. NEW SM
- A. Write above answer.
2. Prince Blankets is engaged in business of blankets. Its major portion of sales is taking place through internet. Advise the auditor how he would proceed in this regard as to understanding the entity and its environment. NEW SM
- A. While understanding entity and its environment, internet sales is being perceived as risky area by the auditor and thereby would be spending substantial time and extensive audit procedures on this particular area.

Q.No.5. Write about internal controls and its objectives?

(A) RTPM20(N) (NEW SM)

DEFINITION OF INTERNAL CONTROL:

- 1) As per SA-315, the internal control means "the process designed, implemented and maintained by those charged with governance, management and other personnel"
- 2) The internal controls provide reasonable assurance about the achievement of an entity's objectives.

OBJECTIVES / PURPOSE OF INTERNAL CONTROL:

- 1) Reliability of Financial Reporting:
 - a) To ensure the transactions are executed with proper authorisations from management.
 - b) To ensure the transactions are recorded
 - i) At appropriate Amounts
 - ii) Under appropriate head
 - iii) In the Appropriate accounting period
 - iv) As per applicable financial reporting framework.
- 2) Effectiveness and Efficiency of Operations.
- 3) Safeguarding of Assets:
 - a) The assets are safeguarded from unauthorised access, use or disposition.
 - b) Recorded assets are compared with physical assets at reasonable intervals.
- 4) Compliance with Applicable Laws and Regulations.

SIMILAR QUESTIONS:

1. Explain the purpose of Internal Control. RTP M19(O)
- A. Write above answers (Ignore sub points)

Copyrights Reserved To **MASTER MINDS COMMERCE INSTITUTE PVT.LTD.**

Q.No.6. Write about Inherent Limitations of Internal controls?

(A) (NEW SM, RTP N18 (O))

Internal control, no matter how effective, can provide an entity with only reasonable assurance about achieving the entity's financial reporting objectives. Due to various inherent limitations the objectives may not be achieved fully. The limitations are as below:

1) HUMAN JUDGMENT IN DECISION-MAKING:

- a) Judgment in decision-making can be faulty and that leads to failure in the internal control because of human error.
- b) There may be an error in the design of a control.

2) LACK OF UNDERSTANDING THE PURPOSE:

- a) The person responsible to review the control may not understand the basic purpose of such control.
- b) This leads to ineffective utilisation of exception reports and taking a wrong course of action.

3) COLLUSION AMONG PEOPLE:

- a) Controls can be overridden by the collusion of two or more people or inappropriate management override of internal control.
- b) For example, management may enter into side agreements with customers that alter the terms and conditions of the entity's standard sales contracts, which may result in improper revenue recognition.

4) COST EXCEEDING BENEFITS: In Few situations the cost of designing and maintaining the controls may exceed the benefits there from. Resultantly the management may not implement such controls leading to excess cost.**5) LIMITATIONS IN CASE OF SMALL ENTITIES:**

- a) Smaller entities often have fewer employees due to which segregation of duties is not practicable.
- b) However, in a small owner-managed entity, the owner-manager may be able to exercise more effective oversight than in a larger entity.
- c) This oversight may limit opportunities for segregation of duties.
- d) Further the owner-manager may override controls because the system of internal control is less structured.
- e) The auditor shall take into account the above factors while assessing risks in case of small entities.

SIMILAR QUESTIONS:

1. Internal control can provide only reasonable but not absolute assurance that its objective relating to prevention and detection of errors/frauds, safeguarding of assets etc. are achieved. In view of above, briefly state some of the inherent limitations of Internal Control System. MTP N18 (O), MTP M18 (O)
- A. Write above answer.
2. Internal control, no matter how effective, can provide an entity with only reasonable assurance about achieving the entity's financial reporting objectives. The likelihood of their achievement is affected by inherent limitations of internal control. Explain those limitations. RTP M19 (O), RTP N17
- A. Write above answer.
3. Briefly discuss the limitations of internal controls? M18(N) - 6M, MTP2 M19 (N&O)
- A. Write above answer.

Q.No.7 Write about controls relevant to audit?**(C) (NEW SM)**

- 1) There is a direct relationship between an entity's objectives and its internal controls to provide reasonable assurance about their achievement of such objectives.
- 2) The entity's controls are generally related to financial reporting, operations and compliance;
- 3) **FACTORS TO JUDGE RELEVANCE:** The following are various factors that the auditor will consider to judge whether a control is relevant or not in audit:
 - a) Materiality.
 - b) The significance of the related risk.
 - c) The size of the entity.
 - d) The nature of the entity's business.
 - e) Ownership and management structure.
 - f) The diversity of the entity's operations.
 - g) Applicable legal and regulatory requirements.

4) INTERNAL CONTROLS NOT RELEVANT:

- a) An entity generally has controls that are not
- b) to an audit and therefore need not be considered by the auditor.
- c) For example, airline's system of automated controls to maintain flight schedules, these controls ordinarily would not be relevant to the audit but these controls play an important role for revenue generation and influence financial statements indirectly.

5) AUDIT REPORTING: For Company incorporated under companies act, 2013, the auditor has to express opinion on Internal Financial Controls with reference to financial statements u/s 143(3)(i).**SIMILAR QUESTIONS:**

1. Auditor GR and Associates, appointed for audit of PNG Ltd, a manufacturing company engaged in manufacturing of various food items. While planning an audit, the auditor does not think that it would be necessary to understand internal controls. Advise the auditor in this regard. SM
- A. The auditor shall obtain an understanding of internal control relevant to the audit. Although most controls relevant to the audit are likely to relate to financial reporting, not all controls that relate to financial reporting are relevant to the audit. It is a matter of the auditor's professional judgment whether a control, individually or in combination with others, is relevant to the audit.

Q.No.8 Write about Benefits of Internal Control Evaluation? Or Write about understanding of internal controls and its benefits? (B) (NEW SM)**1) UNDERSTANDING OF INTERNAL CONTROLS:**

- a) The auditor shall understand the internal controls and accounting system to determine the nature, timing and extent of audit procedures. The audit programme is substantially influenced by internal control system found in operation.
- b) Further the evaluation enables the auditor to prioritise the audit areas depending upon the weaknesses identified in the system.
- c) If he does not care to study this aspect, it is very likely that his audit programme may become unwieldy (Uncontrollable) and unnecessarily heavy and the object of the audit may be altogether lost in the mass of entries and vouchers.
- d) The information about the controls can be obtained from reading company manuals, studying organisation charts and by making suitable enquiries from the officers and employees.
- e) Existence of satisfactory internal control is not an absolute deterrent to fraud. Even though controls are highly effective the misstatements keeps exist.
- f) Also Existence of Misstatement strongly indicates that there is a significant deficiency in related controls.
- g) Although most controls relevant to the audit are likely to relate to financial reporting, not all controls that relate to financial reporting are relevant to the audit.
- h) In other words all the controls relevant to financial reporting may or may not be relevant to audit of financial statements.

2) BENEFITS OF EVALUATION OF INTERNAL CONTROL TO THE AUDITOR: The review of internal controls will enable the auditor to know:

- a) Whether an adequate internal control system is in use and operating as planned by the management;
- b) Whether an effective internal auditing department is operating;
- c) Whether the controls adequately safeguard the assets;
- d) How management is discharging its function for correct recording of transactions;
- e) How reliable the reports, records and the certificates to the management can be;
- f) The extent and the depth of the examination that he needs to carry out in the different areas of accounting;
- g) What would be appropriate audit technique and the audit procedure in the given circumstances;
- h) What are the areas where control is weak; and
- i) Whether any suggestions can be given to improve the control system to management by auditor.

SIMILAR QUESTIONS:

1. Auditor GR and Associates, appointed for audit of PNG Ltd, a manufacturing company engaged in manufacturing of various food items. While planning an audit, the auditor does not think that it would be necessary to understand internal controls. Advise the auditor in this regard. NEW SM

A. Write above answer.

2. The existence of a satisfactory control environment can be a positive factor when the auditor assesses the risks of material misstatement. Analyse and explain. RTP M19 (N), RTP M18 (N&O), RTP M17, M17 - 5M

(OR)

A satisfactory control environment is not an absolute deterrent to fraud although it may help to reduce the risk of fraud.

- A. "The existence of a satisfactory control environment can be a positive factor when the auditor assesses the risks of material misstatement. However, although it may help reduce the risk of fraud, a satisfactory control environment is not an absolute deterrent to fraud then write Point - A (1 and 2)".

3. So far as the auditor is concerned, the examination and evaluation of the internal control system is an indispensable part of the overall audit programme. The auditor needs reasonable assurance that the accounting system is adequate and that all the accounting information which should be recorded has in fact been recorded. Internal control normally contributes to such assurance. Explain stating clearly the benefits of evaluation of internal control to the auditor. RTP M19(N)

A. Write Point - B

4. The auditor can formulate his entire audit programme only after he had a satisfactory understanding of the internal control systems and their actual operation. Analyse and explain. (OR) Audit Programme is substantially influenced by internal control system in operation. RTP N18(N) RTP N19(N)

A. Write Point - A (1,2,3 and 5)

Q.No.9. Explain methods for evaluation of internal controls by the auditor.	(A) (NEW SM)
--	---------------------

There are four methods through which the auditor can evaluate the information about the internal control system in place.

- 1) **NARRATIVE RECORD**: This is a complete and exhaustive description of the system as found in operation by the auditor. Actual testing and observation are necessary before such a record can be developed.
- It may be recommended in cases where no formal control system is in operation
 - It would be more suited to small business.
 - Detailed observation is needed so it is time consuming
- 2) **CHECK LIST**: This is a series of instructions or questions which a member of the auditing staff must follow or answer.
- The Instructions and Questions are framed according to the desirable elements of control.
 - When he completes instruction, he shall mark the space against the instruction.
 - Answers to the check list instructions are usually Yes, No or Not Applicable.

Example: Checklist for purchases:

- Are tenders called before placing orders?
 - Are the purchases made on the basis of a written order?
 - Is the purchase order form standardized and pre-numbered?
 - Are the inventory control accounts maintained by persons who have nothing to do with Receipt of inventory, Inspection of inventory and Purchase of inventory?
- 3) **INTERNAL CONTROL QUESTIONNAIRE (ICQ)**: It refers to a complete series of questions in a logical and sequential order prepared by the auditor concerning internal control.
- Answers to the questions are usually Yes, No or Not Applicable along with Remarks column for an explanation or further details of 'No' answers.
 - In ICQ, the questions are generally so framed that a 'Yes' answer denotes satisfactory position and a 'No' answer suggests weakness. In respect of questions not relevant to the business, 'Not Applicable' reply is given.

- c) The questionnaire is usually issued to the client and the answers to the questions are filled by client's employees.
- d) After examination of answers, if any inconsistencies or weaknesses are noticed, the matter is further discussed by auditor's staff with the client's employees for a clear picture.
- e) Then the auditor prepares a report of deficiencies (i.e. Letter of weaknesses) observed by him through ICQ and sends it to management along with recommendations for improvement.
- f) With a proper questionnaire, all internal control evaluation can be completed at one time or in sections

Example: ICQ for purchases

- a) Is there any purchasing department within the organization?
 - b) Whether purchase manual is in existence or not?
 - c) Are the purchase orders determined on the basis of internal indents from the production department?
 - d) Whether there is an approved list of suppliers and it is updated periodically.
 - e) Whether Tender procedure is adopted?
- 4) **FLOWCHARTS:** It is a graphic presentation of each part of the company's system of internal control such as the nature of its activities and various channels of goods and materials as well as cash, both inward and outward; **(OLD SM)**
- a) A flowchart is considered to be the most concise i.e. briefest way of recording the auditor understanding and evaluation of the internal control system in the correct perspective.
 - b) It minimizes the amount of narrative explanation
 - c) It gives bird's eye view of the entire process of manufacturing, trading and administration.
 - d) The flow of transactions through various stages can be easily spotted and improvements can be suggested.
 - e) This will help him to understand and evaluate the internal controls in the correct perspective.

SIMILAR QUESTIONS:

1. A Flow Chart is a graphic presentation of each part of the company's system of internal control. Explain elaborating each and every aspect about flow chart. **RTP N18(N)**
- A. Write Point - D.
2. Write a short note on Narrative Records? **N17 - 4M**
- A. Write Point - A.
3. What is the difference between narrative records and checklists? **N16 - 4M**
- A. Write Point - A and Point - B
4. Write a short note on use of flowcharts in evaluation of Internal Controls? **M16 - 4M**
- A. Write Point - D

Q.No.10. Why Tests of Control are performed? Also explain what does it includes. (B) (RTP N17)

- 1) **PUROPSE:** Tests of control are performed to obtain audit evidence about the effectiveness of:
 - a) Design of the accounting and internal control systems, that is, whether they are suitably designed to prevent or detect and correct material misstatements or not; and
 - b) Operation of the internal controls throughout the period.
 - c) The testing is being carried out on selective basis and will cover all important areas that are relevant to financial statements.
- 2) **TESTS OF CONTROL MAY INCLUDE:**
 - a) **Inspection** of documents supporting transactions and other events to gain audit evidence that internal controls have operated properly. For example, verifying that a transaction has been authorized.
 - b) **Inquiries** about internal controls and observation of internal controls. For example, determining who actually performs each function and not merely who is supposed to perform it.

- c) **Re-performance** of internal controls. For example, reconciliation of bank accounts, to ensure that they were correctly performed by the entity.
- d) **Testing** of internal control operating on specific computerised applications or over the overall information technology function. For example, access or program change controls.³

Q.No.11. When the auditor shall design and perform tests of controls to obtain sufficient appropriate audit evidence as to the operating effectiveness of relevant controls? (B)

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

- 1) 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
- 2) Substantive procedures alone cannot provide sufficient appropriate audit evidence at the assertion level.
- 3) A higher level of assurance may be sought about the operating effectiveness of controls when the approach adopted consists primarily of tests of controls, in particular where it is not possible or practicable to obtain sufficient appropriate audit evidence only from substantive procedures.

SIMILAR QUESTIONS:

1. A higher level of assurance may be sought about the operating effectiveness of controls when the approach adopted consists primarily of tests of controls. Explain and also state when will the auditor design and perform tests of controls to obtain sufficient appropriate audit evidence as to the operating effectiveness of relevant controls. RTP N20(N)
- A. Refer above answer.

Q.No.12. Write about Internal Financial Controls with reference to financial statements and their Reporting requirements? (A) (NEW SM)

OBJECTIVE AND PURPOSE OF INTERNAL FINANCIAL CONTROLS: Internal financial controls are the policies and procedures adopted by the company for ensuring the orderly and efficient conduct of its business, including adherence to company's policies.

- 1) The safeguarding of its assets.
- 2) The prevention and detection of frauds and errors.
- 3) The accuracy and completeness of the accounting records.
- 4) The timely preparation of reliable financial information.
- 5) Compliance with applicable laws and regulations.

AUDITORS' RESPONSIBILITY: SEC. 143(3)(I):

- 1) The auditor shall express an opinion on effectiveness of internal financial controls with reference to Financial statements.
- 2) Further this reporting responsibility is applicable only in respect of Audit of Annual financial statements and not applicable for Interim or Quarterly financial statements.

SIMILAR QUESTIONS:

1. Auditor's reporting on internal financial controls is a requirement specified in the Act and, therefore, will apply only in case of reporting on financial statements prepared under the Act and reported under Section 143. Explain stating clearly the auditor's responsibility for reporting on internal financial controls over financial reporting. RTP N18(N)
- A. Write above answer.

Q.No.13. What are the components of internal controls? (B) (NEW SM)

1) COMPONENTS OF INTERNAL CONTROLS:

- a) The control Environment (Governance, management structure and Culture of honesty).

- b) Entity's risk assessment process (Identification of risk to design a control to mitigate it).
- c) Information system, including related business process, relevant to financial reporting.
- d) Control activities (Review of policies to be implemented).
- e) Monitoring of controls (Testing of controls to update them).

Q.No.14. Write about control environment as a component of internal control

(B) (SM)

THE AUDITOR SHALL EVALUATE WHETHER:

- 1) Management has created and maintained a culture of honesty and ethical behavior;
- 2) Control environment provides appropriate foundation for other components

ELEMENTS OF CONTROL ENVIRONMENT

- 1) **Communication and enforcement of integrity and ethical values**
- 2) **Commitment to competence**: How the management decides the competence levels for particular jobs
- 3) **Participation by those charged with governance**: Evaluate the roles of those charged with governance such as:
 - a) Their independence from management
 - b) Their experience
 - c) extent of their involvement and scrutiny of activities
 - d) appropriateness of their actions and degree to which questions are raised with management
- 4) **Management's philosophy and operating style**: Characteristics such as management's:
 - a) Approach to taking and managing business risks
 - b) Attitudes and actions toward financial reporting
 - c) Attitudes toward information processing and accounting functions and personnel
- 5) **Organisational structure**: Framework within which an entity operates
- 6) **Assignment of authority and responsibility**: How operating activities are assigned and authorisation hierarchies are established.

SIMILAR QUESTIONS:

1. The auditor of MARUT Ltd, engaged in manufacturing of Smart Motor Bikes, obtains an understanding of the control environment. As part of obtaining this understanding, the auditor evaluates whether:

MTP1 N18 (N), MTP1 M18 (N), MTP1 M19 (N) MTPN19(N)

 - a) Management has created and maintained a culture of honesty and ethical behaviour.
 - b) The strengths in the control environment elements collectively provide an appropriate foundation for the other components of internal control.
 - c) Advise what is included in control environment. Also explain the elements of control environment.
- A. Refer above answer
2. The auditor shall obtain an understanding of the control environment" Explain stating what is included in control environment
- A. Refer above answer

SECTION 2: QUESTIONS FOR ACADEMIC INTEREST – FOR STUDENTS SELF STUDY

Q.No.1. Write about various Aspects of Internal controls as per SA 315? (C)

(NEW SM)

The aspects of internal controls are divided into 4 sections:

1) GENERAL NATURE AND CHARACTERISTICS OF INTERNAL CONTROLS:

- a) Purpose of Internal controls.
- b) Limitations of internal controls.

2) CONTROLS RELEVANT TO AUDIT:

- a) All controls may not be relevant to audit.
- b) For corporate entities the auditor has to report on internal controls effectiveness.

3) NATURE AND EXTENT OF UNDERSTANDING OF INTERNAL CONTROLS:

- a) Evaluate the design of controls to ensure they can prevent, detect and correct MMS.
- b) Ensure that the implemented control works effectively.
- c) Improper control leads to control deficiency.
- d) Further obtaining a mere understanding does not test its effectiveness unless the auditor chooses to test in a formal manner.

4) COMPONENTS OF INTERNAL CONTROLS:

- a) The control Environment (Governance, management structure and Culture of honesty).
- b) Entity's risk assessment process (Identification of risk to design a control to mitigate it).
- c) Information system, including related business process, relevant to financial reporting.
- d) Control activities (Review of policies to be implemented).
- e) Monitoring of controls (Testing of controls to update them).

5) SATISFACTORY CONTROLS NOT AN ABSOLUTE DETERRENT FOR FRAUDS.

Q.No.2. Write about control activities as a component of internal control	(B)
--	------------

- 1) Control activities are the policies and procedures that help ensure that management directives are carried out.
- 2) Examples of specific control activities include those relating to the following:
 - a) Authorisation
 - b) Segregation of duties
 - c) Physical controls
 - d) Performance reviews
 - e) Information processing
- 3) The auditor shall obtain an understanding of control activities relevant to the audit, which the auditor considers necessary to assess the risks of material misstatement.
- 4) Control activities, whether within IT or manual systems, have various objectives and are applied at various organisational and functional levels.
- 5) Control activities that are relevant to the audit are:
 - a) Control activities that relate to significant risks
 - b) Those that are considered to be relevant in the judgment of the auditor
 - c) As part of the risk assessment, the auditor shall determine whether any of the risks identified are, in the auditor's judgment, a significant risk.

SIMILAR QUESTIONS:

1. The auditor of PQR Ltd, a company engaged in the manufacturing of Auto parts obtains an understanding of control activities relevant to the audit, which the auditor considers necessary to assess the risks of material misstatement. Auditor is of the view that he requires an understanding of only those control activities related to significant class of transactions, account balance, and disclosure in the financial statements and the assertions which the auditor finds relevant in his risk assessment process. Advise explaining the meaning of control activities. Also identify and explain the control activities which are relevant to the audit. MTP M18(N)

A. Refer Above answer

Q.No.3. Write about Monitoring of controls**(C) (NEW SM)**

The auditor shall obtain an understanding of the major activities that the entity uses to monitor internal control over financial reporting

- a) **MONITORING OF CONTROLS DEFINED:** Monitoring of controls is a process to assess the effectiveness of internal control performance over time.
- b) It helps in assessing the effectiveness of controls on a timely basis
- c) **ACCOMPLISHMENT OF MONITORING ACTIVITIES:** Management accomplishes monitoring of controls through ongoing activities, separate evaluations, or a combination of the two. Ongoing monitoring activities are often built into the normal recurring activities of an entity and include regular management and supervisory activities.
- d) Management's monitoring activities may include using information from communications from external parties such as customer complaints and regulator comments that may indicate problems or highlight areas in need of improvement.
- e) **IN CASE OF SMALL ENTITIES:** Management's monitoring of control is often accomplished by management's or the owner-manager's close involvement in operations.

SIMILAR QUESTIONS

1. Write a short note on Monitoring of controls? M18 (O)-4M
- A. Refer above answer.
2. "The auditor shall obtain an understanding of the major activities that the entity uses to monitor internal control over financial reporting" Explain NEW SM – TYK
- A. Write above answer.

Q.No.4. State specific inquiries by auditor when deviations from controls are detected? (B) (NEW SM)

When deviations from controls upon which the auditor intends to rely are detected, the auditor shall make specific inquiries to understand these matters and their potential consequences, and shall determine whether:

- 1) The tests of controls that have been performed provide an appropriate basis for reliance on the controls;
- 2) Additional tests of controls are necessary; or
- 3) The potential risks of misstatement need to be addressed using substantive procedures.

SIMILAR QUESTIONS:

1. The auditor R of GR and Co., a firm of Chartered Accountants is conducting audit of B Industries Ltd. State the specific inquiries by auditor when deviations from controls are detected. RTP M19 (O)
- A. Refer above answer
2. XYZ and Associates, chartered accountants, while evaluating the operating effectiveness of internal controls, detects deviation from controls. In such a situation, state the specific inquiries to be made by an auditor to understand these matters and their potential consequences. M18(N)-5M
- A. Refer above answer
3. Discuss the matters the auditor may consider in determining the extent of tests of controls. RTP M17
- A. Refer above answer

Q.No.5 When more persuasive audit evidence is needed regarding the effectiveness of a control, it may be appropriate to increase the extent of testing of the control as well as the degree of reliance on controls. Discuss the matters the auditor may consider in determining the extent of test of controls. (C)

When more persuasive audit evidence is needed regarding the effectiveness of a control, it may be appropriate to increase the extent of testing of the control as well as the degree of reliance on controls. Matters the auditor may consider in determining the extent of test of controls include the following:

- 1) The frequency of the performance of the control by the entity during the period.
- 2) The length of time during the audit period that the auditor is relying on the operating effectiveness of the control.
- 3) The expected rate of deviation from a control.
- 4) The relevance and reliability of the audit evidence to be obtained regarding the operating effectiveness of the control at the assertion level.
- 5) The extent to which audit evidence is obtained from tests of other controls related to the assertion.

Q.No.6 Write about Benefits of IT to Entity's internal control.

(C) (NEW SM)

GENERALLY, IT BENEFITS AN ENTITY'S INTERNAL CONTROL BY ENABLING AN ENTITY TO:

- 1) Consistently apply predefined business rules and perform complex calculations in processing large volumes of transactions or data;
- 2) Enhance the timeliness, availability, and accuracy of information;
- 3) Facilitate the additional analysis of information;
- 4) Enhance the ability to monitor the performance of the entity's activities and its policies and procedures;
- 5) Reduce the risk that controls will be circumvented (Override); and
- 6) Enhance the ability to achieve effective segregation of duties by implementing security controls in applications, databases, and operating systems.

SIMILAR QUESTION:

1. Explain How does IT benefit's an entity's Internal Control? RTP M19(O)
- A. Refer above answer

Q.No.7. Write about specific risks posed by IT to an entity's internal controls?

(B) (NEW SM)

IT ALSO POSES SPECIFIC RISKS TO AN ENTITY'S INTERNAL CONTROL, THEY ARE:

- 1) Reliance on systems or programs that are inaccurately processing data, processing inaccurate da, or both.
- 2) Unauthorized access to data that may result in destruction of data or improper changes to data, including the recording of unauthorised or non-existent transactions, or inaccurate recording of transactions. Particular risks may arise where multiple users access a common database.
- 3) The possibility of IT personnel gaining access privileges beyond those necessary to perform their assigned duties thereby breaking down segregation of duties.
- 4) Unauthorized changes to data in master files.
- 5) Unauthorized changes to systems or programs.
- 6) Failure to make necessary changes to systems or programs.
- 7) Inappropriate manual intervention.
- 8) Potential loss of data or inability to access data as required.

SIMILAR QUESTION:

1. IT Poses specific risks to an entity's internal control. Explain. RTP M19 (N&O), M16-5M NOV 19(N)
- A. Refer above answer

Q.No.8. While 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. Analyse and Explain.

(C) (RTP N18(N))

- 1) While 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.

- 2) The concept of effective operation recognises that some deviations may have occurred. Deviations from prescribed controls may be caused by such factors as changes in key personnel, significant seasonal fluctuations in volume of transactions and human error.
- 3) 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.
- 4) 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.
- 5) 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.
- 6) 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.
- 7) In case of deviations from the prescribed accounting and internal control systems, the auditor would make specific inquiries to consider their implications.
- 8) 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.
- 9) 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.
- 10) It has been suggested that actual operation of the internal control should be tested by the application of procedural tests and examination in depth.
- 11) Procedural tests simply mean testing of the compliance with the procedures laid down by the management in respect of initiation, authorisation, recording and documentation of transaction at each stage through which it flows.

Q.No.9. Explain the role of management with regard to internal control.

(C)(OLD PM)

- 1) The management is responsible for devising and installation of internal control.
- 2) The management is vested with the responsibility of carrying on the business, safeguarding its assets and recording the transactions in the books of account and other records.
- 3) SA-200 states that, "the management is responsible for maintaining an adequate accounting system incorporating various internal controls to the extent appropriate to the size and nature of the business".
- 4) It is also important to bear in mind that the system installed needs review by the management to ascertain:
 - a) Whether the management policies are being properly followed by the employees and are faithfully implemented
 - b) Whether the prescribed procedures need a revision because of changed circumstances and
 - c) Whether effective corrective measures are taken promptly when the system appears to break down.

SECTION 3: PRACTICAL QUESTIONS FOR CLASSROOM DISCUSSION

Q.No.1. In a medium size trading organisation the accountant was given additional responsibility of making recoveries from the trade receivables. On one occasion, when an insurance claim of Rs. 45,000 was received, he credited the same to the account of a trade receivable and misappropriated the cash which he had recovered from the said trade receivable. Pinpoint weaknesses in the internal control system which led to this situation. Comment.

(RTP N18 (O), MTP1 M19 (O))

WEAKNESS IN INTERNAL CONTROL SYSTEM: Following two essential features of internal control are here-

- 1) Breaking the chain of the work in a manner so that no single person can handle a transaction from the beginning to the end and
- 2) Segregation of accounting and custodial functions.

WEAKNESS IN INTERNAL CONTROL SYSTEM IN THE INSTANT CASE:

- 1) The accountant is receiving cash and also passing the entries in the books. The accountant should not have been allowed to effect recoveries.
- 2) It also appears that system for issuing receipts for amount received - whether cash or cheque is also lacking.
- 3) In a small and to some extent medium size organization, the supervision of the owner offsets the deficiencies in internal control system. But in this case, it appears, that supervision and personal control is also lacking.

Thus, in the given case, the main weakness of the system is that it is ignoring the basic requirements of a good internal control system.

Q.No.2. XYZ Ltd is engaged in the business and running several stores dealing in variety of items such as readymade garments for all seasons, shoes, gift items, watches etc. There are security tags on each and every item. Moreover, inventory records are physically verified on monthly basis. Discuss the types of inherent, control and detection risks as perceived by the auditor. (SM)

INHERENT RISK: Because items may have been misappropriated by employees, therefore, risk to the auditor is that inventory records would be inaccurate.

CONTROL RISK: There is a security tag on each item displayed. Moreover, inventory records are physically verified on monthly basis. Despite various controls being implemented at the stores, still collusion among employees may be there and risk to auditor would again be that inventory records would be inaccurate.

DETECTION RISK: Auditor checks the efficiency and effectiveness of various control systems in place. He would do that by making observation, inspection, enquiry, etc. In addition to these, the auditor would also employ sampling techniques to check few sales transactions from beginning to end. However, despite all these procedures, the auditor may not detect the items which have been stolen or misappropriated.

THE END

Copyrights Reserved To **MASTER MINDS COMMERCE INSTITUTE PVT.LTD.**