

4. INTERNAL CONTROL

Q.No.1. Define Internal control and also state its objectives. (B)

(M16 RTP)

1. **DEFINITION OF INTERNAL CONTROL:** Internal control is the process designed, implemented and maintained by those charged with governance and management to provide reasonable assurance about the achievement of the following objectives by the entity:
 - a) Reliability of the entity's financial reporting;
 - b) Efficiency and effectiveness of its operations;
 - c) Its compliance with applicable laws and regulations; and
 - d) Safeguarding of assets.
2. **OBJECTIVES OF INTERNAL CONTROL:** Internal controls relating to financial and accounting aspects are concerned with achieving the following objectives –
 - a) Transactions are executed in accordance with management's general or specific authorization;
 - b) All transactions and other events are
 - i) Promptly recorded in the correct amount,
 - ii) In the appropriate accounts and
 - iii) In the proper accounting period
 - iv) In accordance with the applicable accounting standards, other recognised accounting policies and practices and relevant statutory requirements.
 - c) Assets and records are safeguarded from unauthorised access, use or disposition; and
 - d) The recorded assets are compared with the existing assets at reasonable intervals and appropriate action is taken with regard to any differences.

SIMILAR QUESTIONS:

1. What are the aims of internal control so far as Financial and Accounting aspects are concerned? (PM)
 - A. Refer point no. 2 in above.
2. Explain the purpose of Internal Control.
 - A. Refer point no. 1 in above.

Q.No.2. what are the inherent limitations of Internal Control system? (A)

(PM, M 15 RTP, M 16 RTP, M 17 RTP, N 13- 8M, M15- 6M)

INHERENT LIMITATIONS OF INTERNAL CONTROL SYSTEM: Internal control can provide only reasonable but not absolute assurance that its objective relating to prevention and detection of errors/frauds, safeguarding of assets etc., are achieved.

This is because it suffers from some inherent limitations, as follows:

1. Cost of implementation of controls may be more than its benefits. So the management usually doesn't implement best controls.
2. Controls are generally made for usual or known transactions. Therefore any unusual transaction may not be controlled.
3. Human error may occur while carrying out I.C. System due to carelessness, misjudgment and misunderstanding of instructions.

4. The possibility that controls may be violated through collusion with employees or outsiders.
5. The possibility that a person responsible for exercising control may abuse that authority.
6. Manipulation by management with respect to some transactions may not be detected by control system.
7. Established procedures may become deteriorate due to changes in environment.

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." Briefly explain the inherent limitations that the system. (RTP N17, M15 RTP)
 - A. Refer above answer.
2. "Satisfactory control environment may help reduce the risk of fraud but it is not an absolute deterrent for fraud". Explain. (M 16 RTP, M 17 RTP)
 - A. Refer above answer.

Q.No.3. Write about Narrative Record? (B)

(N17 – 4M, N16 - 4M)

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.
2. **ADVANTAGES:**
 - a) It may be recommended in cases where no formal control system is in operation
 - b) It would be more suited to small business.
3. **DISADVANTAGES:**
 - a) Detailed observation is needed so it is time consuming
 - b) To understand the system in operation is quite difficult.
 - c) It doesn't readily identify weaknesses or gaps in the system
 - d) Constant updating is needed if circumstances are changed e.g. re shuffling of man power.

Q.No.4. Write about check list and Give few examples of checklist instruction. (A)

(N16 - 4M, M16 RTP)

CHECK LIST: This is a series of instructions or questions which a member of the auditing staff must follow or answer.

- a) The Instructions and Questions are framed according to the desirable elements of control.
- b) When he completes instruction, he shall mark the space against the instruction.
- c) Answers to the check list instructions are usually Yes, No or Not Applicable.

A few examples of check list instructions are given here under:

1. Are tenders called before placing orders?
2. Are the purchases made on the basis of a written order?
3. Is the purchase order form standardized and pre-numbered?
4. Are the inventory control accounts maintained by persons who have nothing to do with Receipt of inventory, Inspection of inventory and Purchase of inventory?

The complete check list is studied by the auditor to ascertain existence of internal control and evaluate its implementation and efficiency.

SIMILAR QUESTIONS:

1. What is the difference between Narrative records & Check list?

(N16 – 4M)

A. Refer 3rd and 4th Questions.

Q.No.5. write about internal control questionnaire. (B)

(PM, M13 - 4M, N10 - 4M)

1. **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. It is most widely used form for collecting information about the existence, operation and efficiency of internal control in the organization.

- a) Answers to the questions are usually Yes, No or Not Applicable along with Remarks column for an explanation or further details of 'No' answers.
- b) 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.

2. **ADVANTAGES:**

- a) Oversight or omission of any significant internal control areas is less likely to occur with this method.
- b) All internal control evaluation can be completed at one time or in sections.
- c) The review can more easily be made on an interim basis i.e. review of some areas for which ICQ is already prepared and answers are filled can be done even before completion of entire ICQ for all areas.

3. **DISADVANTAGES:**

- a) The main disadvantage is that it is highly narrative in nature.
- b) Time consuming and costly.
- c) If the questions with respect to any area are not properly framed or not framed at all, then the main purpose of ICQ to bring out the defects in internal control is defeated.

4. **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?

SIMILAR QUESTIONS:

1. Explain briefly the technique of "Internal Control Questionnaire" to facilitate the accumulation of information necessary for proper evaluation of internal control.

A. Refer above answer

(PM, N10 – 4M)

Q.No.6. Write a short note on “Use of flowcharts in evaluation of internal control”. (A)
(PM, N13 – 4M, M16 – 4M)

1. **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;

It involves the range of various symbols and signs. It discloses the document and information flow. For e.g. In the case of flowchart for purchases it shows how the various documents such as purchase orders, GRN are generated, recorded, followed up and disposed of. It shows the origin of the document and the ultimate disposal thereof.

2. **ADVANTAGES:**

- 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.

3. **DISADVANTAGES:**

- a) Everyone cannot understand it as it involves usage of symbols.
- b) It cannot be applied in the case of simple systems.
- c) Time consuming to draft flowcharts.

Q.No.7. Distinguish between the Internal Control Questionnaire and Internal Control Evaluation. (C)
(PM)

1. The internal control questionnaire show the area where weakness occur or likely to occur. They do not give any idea of the importance of those weaknesses. The Internal Control Evaluation brings to light importance of those weakness disclosed by ICQ.

2. **MAIN POINTS OF DISTINCTIONS ARE:**

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

Q.No.8. Write a short note on - Examination in Depth or Walk through test. (A)
(PM, N 12 – 4M, M 14 RTP, M 17 RTP)

1. It implies examination of a few selected transactions from the beginning to the end through the entire flow of the transaction, i.e., from initiation to the completion of the transaction by receipt of payment of cash and delivery or receipt of the goods.
2. This examination consists of studying the recording of transactions at the various stages through which they have passed.

3. At each stage, relevant records and authorities are examined to ensure that the transactions are executed with proper authorizations by the competent authorities at each stage.
4. For example in case purchases are taken for auditing in depth, the auditor will examine:
 - a) Purchase Requisition,
 - b) Invitation of quotations and analysis of the same,
 - c) Official Purchase order,
 - d) Receipt of goods, together with delivery challans
 - e) Admission of goods to stores after verification of quality, quantity etc.,
 - f) Entry in store records,
 - g) Receipt of supplier's invoice.
 - h) Entries in Purchase day book.
 - i) Postings to purchase ledger and purchase ledger control account,
 - j) Payment of Cheque in settlement of invoice & Entry for payment in Cash/Bank book,
 - k) Posting from Cash book to Ledger Account.

SIMILAR QUESTIONS:

1. "Examination in Depth" implies examination of a few selected transactions from the beginning to the end through the entire flow of the transaction. Explain. (M17 RTP)
- A. Refer above answer.

Q.No.9. Define internal check. And what are the general considerations in framing a system of internal check? (A) (PM, M15 RTP, M16 RTP, N16 RTP, M 12 - 8M)

1. **DEFINITION:** It has been defined as the checks on the day-to-day transaction which operate continuously as a part of the routine system whereby the work of one person is automatically checked by the work of another by making both jobs complementary to each other.
2. **GENERAL CONSIDERATIONS IN FRAMING A SYSTEM OF INTERNAL CHECK:**
 - a) No single person should have an independent control over an important aspect of the business. All dealings and acts of every employee should come under the review of another in the ordinary course.
 - b) The rotation of duties of employees should be done from time to time without any previous notice so that the same employee does not perform the same function for a considerable length of time without a break.
 - c) Every member of the staff should be encouraged to go on leave at least once in a year. So that the frauds committed and concealed by such employee can be detected in his absence.
 - d) Persons having physical custody of assets must not be permitted to have access to the books of account.
 - e) An accounting control should exist for important class of assets. And in addition they should be periodically inspected to establish their physical condition.
 - f) To prevent misappropriation of cash, mechanical devices, such as the automatic cash register, should be employed.
 - g) Preparing budgets and if any abnormal deviations are observed on comparing with the actuals, then they should be investigated.
 - h) During the year end stock taking, trading activities should be suspended and physical verification of stock should not be done exclusively by the stores staff.

- i) The financial and administrative powers should be distributed very judiciously among different officers and review the manners in which these are actually exercised, periodically.
- j) Procedures should be laid down for periodical verification and testing of different sections of accounting records to ensure that they are accurate and they should not become obsolete.

SIMILAR QUESTIONS:

1. Explain clearly the meaning of internal check. Also state general consideration in framing a system of internal check. (M 16 RTP)
 - A. Refer above answer.
2. GR & Co., a firm of Chartered Accountants has been called upon to audit the accounts of Dee Vee Philips Ltd. The auditors are told that Company is not performing well due to weak accounting and administration system in place. Mr. Preet handling the assignment noticed that there are gaps in internal check system of the company. You are required to explain the special steps involved in framing a system of Internal Check. (PM, M15 RTP)
 - A. Refer point no 2 in above.
3. Explain the special steps involved in framing a system of internal check. (N 16 RTP)
 - A. Refer point no 2 in above.
4. What are the elements of internal check?
 - A. Refer point no. 1 in above.

Q.No.10. What is internal audit and explain the provisions of companies act w.r.t Internal Audit? (B) (PM, M16 – 4M)

1. **MEANING:** Internal auditing is an independent, objective assurance and consulting activity designed to add value and improve an organization's operations.
2. **APPLICABILITY OF INTERNAL AUDIT:** As per section 138 of the Companies Act, 2013 the following class of companies (prescribed in Rule 13 of Companies (Accounts) Rules, 2014). Shall be required to appoint an internal auditor or a firm of internal auditors, namely:-
 - a) Every listed company.
 - b) Every unlisted Public Company having -
 - i) Paid up share capital of Rs. 50 crores or more or
 - ii) Turnover of Rs. 200 crores or more or
 - iii) Outstanding loans or borrowings from banks or public financial institutions Rs. 100 crores or more or
 - iv) Outstanding deposits of Rs. 25 crores or more
 - c) Every Private Company having-
 - i) Turnover of Rs. 200 crores or more or
 - ii) Outstanding loans or borrowings from banks or public financial institutions exceeding Rs. 100 crores or more

Relevant period to compute all the above limits: Preceding financial year

3. **ELIGIBILITY TO ACT AS INTERNAL AUDITOR:**
 - a) As per section 138, the following persons can be appointed as internal auditor which may be either an individual or a partnership firm or a body corporate:
 - i) A Chartered Accountant whether engaged in practice or not.
 - ii) A Cost Accountant whether engaged in practice or not.
 - iii) Such other professional as may be decided by the Board

b) Internal auditor may or may not be an employee of the company.

4. **OBJECTIVE AND SCOPE OF INTERNAL AUDITOR:** The functioning, periodicity and methodology for conducting the internal audit i.e. objective and scope are determined by the Audit Committee or the Board after consultation with the Internal Auditor.

(REFER PRACTICAL QUESTIONS – 1)

Q.No.11. Write a short note on - Statutory Auditor/ Audit vs. Internal Auditor/ Audit. (C)(PM)

S.No.	Statutory Auditor / Audit	Internal Auditor / Audit
1.	It is applicable for all the companies without any exception.	The applicability of internal audit is subject to the satisfaction of limits prescribed in Sec 138.
2.	It can be done only by a chartered accountant having valid Certificate of practice (COP)	It can be done by a Chartered Accountant whether engaged in practice or not or a Cost Accountant, or such other professional as may be decided by the Board
3.	The appointment and fixing of remuneration is made by the shareholders.	The appointment and fixing of remuneration is made by the management.
4.	Objective and scope are determined by the statute itself.	Objective and scope are determined by the Audit Committee or the Board after consultation with the Internal Auditor.
5.	The objective of the audit is to express opinion on true and fair view of financial position shown by the financial statements.	The objective of the audit is to satisfy that the internal control is performing efficiently and effectively.
6.	This auditor is responsible directly to the shareholder.	This auditor is responsible to management.
7.	External auditor is not the employee of the company so he has independent status.	He may or may not be an employee of the company. If internal auditor is an employee of the company, he cannot enjoy sufficient independence.

Q.No.12. Write a short note on Letter of Weakness / Letter of management. (C) (PM)

LETTER OF WEAKNESS:

- The auditor does compliance procedure to ascertain that
 - the internal control system exists in the entity;
 - it works effectively;
 - it work continuously in the entity during review period.
- The auditor should adopt techniques like flow chart, questionnaire etc. in order to arrive at weakness in the control points and issue Letter of weakness.
- Letter of weakness is a report issued by auditor stating the weakness in internal control mechanism along with the suggestions for improvement.

THE CONTENTS OF THIS LETTER ARE AS FOLLOWS:

- A statement saying that the client is responsible for the designing and implementation of IC system in the entity.
- A statement that auditor's observations are not based on exhaustive checking but on test check.
- The list of weakness observed along with Suggestions and recommendations to overcome the above weaknesses.

4. The communication of weakness to management is limited to such weaknesses that have come to notice of auditor during his auditing and it is not the auditor's objective to express opinion on internal controls for management purpose.
5. The auditor is considering internal controls only to determine the nature, timing and extent of audit procedures to be performed.

Q.No.13. Write a short note on - Independence of Internal Auditor. (B)

(PM)

1. Internal auditing is an independent, objective assurance and consulting activity designed to add value and improve an organization's operations.
2. Therefore, to be efficient and effective, the internal auditor must have adequate independence.
3. As per section 138, the following persons can be appointed as internal auditor:
 - a) A Chartered Accountant whether engaged in practice or not or
 - b) A Cost Accountant, or
 - c) Such other professional as may be decided by the Board
4. Internal auditor may or may not be an employee of the company. An outsider, like a firm of chartered accountants, if acting as internal auditor, is likely to be more independent than an employee of the organization.
5. The objective and scope are determined by the Audit Committee or the Board after consultation with the Internal Auditor.
6. As mentioned above, the internal auditor may be part of the management, but he evaluates the functioning of the management at different levels.
7. It may be noted that by its very nature, the internal audit function cannot be expected to have the same degree of independence as is essential when the external auditor expresses his opinion on the financial information.
8. To ensure his independence he is made responsible directly to the Board of Directors through audit committee.
9. Such a channel of communication provides an independent mode whereby an internal auditor can communicate and share his views on the scope of internal audit, findings, etc.
10. If internal auditor is made subordinate to lower level, his independence will be effected which will affect his functioning and effectiveness.

Q .No. 14. Distinguish between Internal Check and Internal Audit. (C)

Distinction	Internal Check	Internal Audit
Nature of work	The work of recording and checking of entries is carried on simultaneously by proper allocation of duties among staff.	Only checking of the entries recorded is carried out ensuring at the same time effective operation of internal check.
Scope of work	Limited	Unlimited
Purpose	To prevent fraud and errors.	To detect fraud and errors.
Starting & ending	It starts the moment a transaction is carried on and run till it is recorded in the books.	It starts when internal check ends after all the transactions are recorded in the books.
Appointment of staff	No special staff is provided and every staff is involved in and forming part of internal check.	It is carried out by specially assigned staff.

Reporting	There is no separate reporting by staff.	The internal auditor has to submit a report to management.
Discovery	The frauds or errors are discovered while they take place.	The frauds/errors are discovered after they have taken place.

Q.No.15. Write a short note on the internal control in small business. (C)

(FOR STUDENTS SELF STUDY) (PM, M11 – 4M)

INTERNAL CONTROL IN SMALL BUSINESS:

1. The auditor needs to obtain the Reasonable assurance in order to give an unqualified opinion on the financial statements of both small and large entities.
2. However, many controls which would be relevant to large entities are not practical in the small business e.g. in small business accounting work may be performed by only a few persons.
3. These persons may have both operating and custodial responsibilities, and segregation of functions may be missing or severally limited.
4. Inadequate segregation of duties may be offset by owner/manager supervisory controls which may exist because of direct personal knowledge of the business and involvement in the business transactions.
5. In circumstances where segregation of duties is limited or evidence of supervisory controls is lacking, the evidence necessary to support the auditors' opinion on the financial information may have to be obtained largely through the performance of substantive procedure.

Q.No.16. Explain in brief the Relationship between Statutory Auditor and Internal Auditor. (C)

(FOR STUDENTS SELF STUDY)

RELATIONSHIP BETWEEN STATUTORY AUDITOR AND INTERNAL AUDITOR:

1. The function of an internal auditor is an integral part of the system of internal control.
2. It is statutory requirement too as per section 138 of the Companies Act, 2013 and where objective and scope are determined by the Audit Committee or the Board after consultation with the Internal Auditor.
3. However, it is obligatory for a statutory auditor to examine the scope and effectiveness of the work carried out by the internal auditor.
4. Though the roles and primary objectives of internal and statutory audit differ, some of their means of achieving their respective objectives are similar.
Thus, much of the work of the internal auditor may be useful to the statutory auditor in determining the nature, timing and extent of his audit procedures.
5. If the statutory auditor is satisfied that the internal audit has been efficient and effective, he may accept the checking/evaluation carried out by the internal auditor in the area of internal control, verification of assets and liabilities etc.
6. Just because there is a co-operation of work among statutory auditor and internal auditor with respect to an area of internal control, their individual responsibilities are not decreased with respect to such area.
7. i.e. statutory auditor's responsibility towards shareholders and the internal auditor's responsibility towards management.

SIMILAR QUESTIONS:

1. How far is the internal audit useful to the statutory auditor?

A. Same as above answer.

PRACTICAL QUESTIONS

Q.No.1. MWF (P) Ltd. is a private company having Rs. 50 lacs paid up capital during the preceding financial year. The company had turnover of last three consecutive financial years, immediately preceding the financial year under audit, being Rs. 210 crores, Rs. 205 crores and Rs. 200 crores, but does not have any internal audit system. In view of the management, internal audit system is not mandatory. You are required to state the provisions related to applicability of internal audit as per the Companies Act, 2013 and comment upon the contention of the management of the company. (PM)

Provision: Refer: Theory Question No.10

Analysis & Conclusion: In the instant case, MWF (P) Ltd. is a private company having turnover of Rs. 200 crores during the preceding financial year which is under the limit prescribed for the applicability of provisions on internal audit. Hence, the company has the statutory liability to appoint an Internal Auditor and mandatorily conduct internal audit. Consequently, the contention of the management of the company is not tenable.

SA 610 (Revised) USING THE WORK OF INTERNAL AUDITORS (on or after April 1, 2016)**A. DEFINITIONS:**

1. **Internal audit function (IAF):** A function of an entity that performs assurance and consulting activities designed to evaluate and improve the effectiveness of the entity's governance, risk management and internal control processes.
2. **Direct assistance:** The use of internal auditors to perform audit procedures under the direction, supervision and review of the external auditor.

B. SCOPE OF THIS SA:

1. **Applicability:** This SA deals with the external auditor's responsibilities when,
 - a) Using the work of the internal audit function in obtaining audit evidence and
 - b) Using internal auditors to provide direct assistance under the direction, supervision and review of the external auditor.
2. **Non – applicability of the standard:**
 - a) **W.r.t using the work of the internal audit function:**
 - i) If the entity does not have an internal audit function.
 - ii) Even if the entity has an internal audit function, the requirements in this SA relating to using the work of that function do not apply if:
 - The activities of the function are not relevant to the audit; or
 - Based on the auditor's preliminary understanding of the function obtained as a result of procedures performed under SA 315, the external auditor decides not to use the work of the function.
 - iii) When there is a statutory prohibition or restriction on the external auditor.
 - b) **W.r.t using internal auditors to provide direct assistance:**
 - i) If the external auditor does not plan to use internal auditors to provide direct assistance.
 - ii) When there is a statutory prohibition or restriction on the external auditor.

C. **OBJECTIVES OF THE AUDITOR:** The objectives of the external auditor are:

1. To determine whether the work of the internal audit function can be used, if so,
 - a) in which areas and to what extent such work can be used, and
 - b) whether such work is adequate for the purpose of audit.
2. To determine whether direct assistance of internal auditor can be used, if so
 - a) in which areas and to what extent such assistance can be used and
 - b) to appropriately direct, supervise and review internal auditor's work.

D. **THE EXTERNAL AUDITOR'S RESPONSIBILITY FOR THE AUDIT:**

1. The external auditor has sole responsibility for the audit opinion expressed.
2. Responsibility is not reduced by the external auditor's use of the work of the IAF or internal auditors to provide direct assistance on the engagement.

E. **USING THE WORK OF IAF:**

1. **Determine whether the work of the IAF can be used:**

- a) **Evaluation:** External auditor shall determine whether the work of the IAF can be used for purposes of the audit by evaluating the following,
 - i) Extent to which the IA function's organizational status and relevant policies and procedures support the objectivity of the internal Auditors,
 - ii) Level of competence of the IA function, and
 - iii) Whether the IA function applies a systematic & disciplined approach.
- b) **Circumstances when IAF's work cannot be used:** The external auditor shall not use work of the IAF if,
 - i) The IAF's status and its policies and procedures do not support the objectivity of the internal auditors
 - ii) No competence of IAF.
 - iii) The function does not apply a systematic and disciplined approach.
 - iv) When there is a statutory prohibition or restriction on the external auditor from using the work of IAF.

2. **Determining the nature and extent of work of the IAF that can be used:**

- a) **Evaluation:** To determine the areas and the extent to which the work of the IAF can be used, the external auditor shall consider
 - i) the nature and scope of the work that has been performed by the IAF and
 - ii) its relevance to the external auditor's overall audit strategy and audit plan.
- b) **Using less extent of IAF:** The external auditor shall plan to use less of the work of the function and perform more of the work directly so as to prevent undue use of the work of the IAF in the following situations:
 - i) High degree of judgment involved.
 - ii) The higher the assessed risk of material misstatement.
 - iii) The IAF's organizational status and relevant policies and procedures are not adequately supporting the objectivity of the internal auditors.
 - iv) The lower the levels of competence of the IAF.

3. **Using the work of the IAF and determining its adequacy:**

- a) **Discussion for Co-ordination:** the external auditor shall discuss the planned use of its work with the function for proper coordination in their respective activities.
- b) **Read the IAF reports:** To obtain an understanding of the nature and extent of audit procedures it performed and the related findings.

- c) **Evaluation to determine adequacy:** The external auditor shall perform sufficient audit procedures to determine its adequacy for purposes of the audit by evaluating whether
- i) The work of the function had been properly planned, performed, supervised, reviewed and documented.
 - ii) Sufficient appropriate evidence had been obtained to enable the function to draw reasonable conclusions and
 - iii) Conclusions reached are appropriate in the circumstances and the reports prepared by the function are consistent with the results of the work performed.
- d) **Factors influencing the nature and extent of audit procedures to be performed to determine the adequacy of the function:**
- i) The amount of judgment involved.
 - ii) The assess risk of material misstatement.
 - iii) The extent to which the IAF's organizational status and relevant policies and procedures support the objectivity of the internal auditors; and
 - iv) The level of competence of the function.
- e) **Methods of audit procedures:** For this purpose, the external auditor shall
- i) Make inquiries of appropriate individuals within the IAF.
 - ii) Observe procedures performed by the IAF.
 - iii) Review the IAF's work program and working papers

F. USING THE INTERNAL AUDITOR TO PROVIDE DIRECT ASSISTANCE

1. **Determining whether internal auditors can be used to provide direct assistance:**

- a) **Evaluation:** When External auditor plans to use internal auditors to provide direct assistance on the audit, he shall evaluate the [Para 29]
- existence and significance of threats to objectivity and
 - the level of competence of the internal auditor who will be providing such assistance.
- b) **Circumstances when internal auditors cannot be used to provide direct assistance:**
- i) There are significant threats to the objectivity of the internal auditor; or
 - ii) The internal auditor lacks sufficient competence to perform the proposed work
 - iii) The using of internal auditors to provide direct assistance is prohibited by law of regulation

2. **Determining the extent of using direct assistance from internal auditors:**

- a) **Evaluation:** The external auditor shall evaluate:
- i) The amount of judgment involved.
 - ii) The assessed risk of material misstatement; and
 - iii) The external auditor's evaluation of the
 - Existence and significance of threats to the objectivity and
 - Level of competence of the internal auditor.
- b) **Areas in which Direct assistance of Internal auditor cannot be used:** The external auditor shall not use internal auditors to provide direct assistance to perform some audit procedures, if:
- i) It involves making significant judgments in the audit.
 - ii) It there is higher assessed risks of material misstatement in some area
 - iii) It relates to an area of work where the internal auditors have already been involved.
 - iv) The external auditor decides not to use in some areas in accordance with this SA.

3. Using internal auditors to provide direct assistance

- a) **Obtain written agreement:** Prior to using internal auditors to provide direct assistance for purposes of the audit, the external auditor shall obtain written agreement,
- i) **From management:** that they will allow internal auditors to follow the external auditor's instructions so as to perform work for the external auditor without any interruption or intervention.
 - ii) **From internal auditors:** that they will keep confidential specific matters as instructed by the external auditor and inform the external auditor of any threat to their objectivity.
- b) **Direction, supervision and review:**
- i) The external auditor shall direct, supervise and review, the work performed by internal auditors on the engagement,
 - in accordance with SA 220 and
 - to get satisfied that that the internal auditors have obtained sufficient appropriate audit evidence to support the conclusions based on that work.
 - ii) The nature, timing and extent of direction, supervision and review, shall
 - consider that the internal auditor are not independent of the organization.
 - be responsive to the outcome of evaluation of the factors in Para 29 of this SA (Refer A (1) above).

EXAMINATION QUESTIONS:

1. **What is the Scope of "SA 610 – Using the work of internal auditor"**
 - A. Refer point no. B in above.
2. **What are the factors to be considered while using the direct assistance of auditor and circumstances in which it cannot be used?**
 - A. Refer point no. F (1) in above.
3. **Write a short note on: "Using the direct assistance of internal auditor" with reference to SA 610.**
 - A. Refer point no. F in above.
4. **Can external auditor rely on the work of internal audit function?**
 - A. Refer point no. E (1) in above.
5. **Write a short note on: "Using the work of internal audit function" as per SA 610.**
 - A. Refer point no. E (1) in above.
6. **What are the circumstances in which Internal audit function's work cannot be used?**
 - A. Refer point no. E (1) (b) in above.
7. **An auditor of MM Ltd wants to determine whether the work of IAF is adequate. Advise him with reference to SA 610.**
 - A. Refer point no. E (3) in above.

SA 265 COMMUNICATING DEFICIENCIES IN INTERNAL CONTROL TO THOSE CHARGED WITH GOVERNANCE AND MANAGEMENT (on or after April 1, 2010)
A. DEFINITIONS:

1. **Deficiency in internal control:** This exists when:
 - a) 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
 - b) A control necessary to prevent, or detect and correct, misstatements in the financial statements on a timely basis is missing.

2. **Significant deficiency in internal control:** A deficiency or combination of deficiencies in internal control that is of sufficient importance, in the auditor's professional judgment, to merit the attention of those charged with governance.

B. INDICATORS OF SIGNIFICANT DEFICIENCIES IN INTERNAL CONTROL:

1. Evidence of ineffective aspects of the control environment.
2. Absence or ineffectiveness of entity's risk assessment process such as management's failure to identify a risk of material misstatement.
3. Evidence of an ineffective response to identified significant risks.
4. Misstatements detected by the Auditor that were not prevented, or detected and corrected, by the internal controls.
5. Disclosure of a material misstatement due to error or fraud as prior period items in the current year.
6. Evidence of management's inability to oversee the preparation of the financial statements.

C. WRITTEN COMMUNICATION OF SIGNIFICANT DEFICIENCIES IN INTERNAL CONTROL:

1. The auditor shall determine whether, he has identified the deficiencies in internal control
2. If the auditor has identified one or more deficiencies in internal control, the auditor shall determine, they constitute significant deficiencies.
3. The auditor shall communicate in writing significant deficiencies in internal control identified during the audit to those charged with governance on a timely basis.
4. The auditor shall also communicate in writing to management on a timely basis:
 - i) Significant deficiencies in internal control that the auditor has communicated or intends to communicate to those charged with governance, unless it is inappropriate to communicate directly to management in the circumstances and
 - ii) Other deficiencies in internal control identified during the audit that are of sufficient importance to merit management's attention as per auditor's professional judgment.
5. **Contents in the written communication:**
 - 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
 - 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.

EXAMINATION QUESTIONS:

1. **What do you mean by deficiencies in internal control and explain various indicators of significant deficiencies.**
 - A. Refer point no. A (1) and B in above.
2. **Write a short note on: Written communication in respect of significant deficiencies in internal controls.** (N16 – 4M)
 - A. Refer point no. C in above.
3. **What are the parameters for significant deficiencies in internal controls as per SA 265.**
 - A. Refer point no. B in above.

THE END