



# RISK ASSESSMENT AND INTERNAL CONTROL

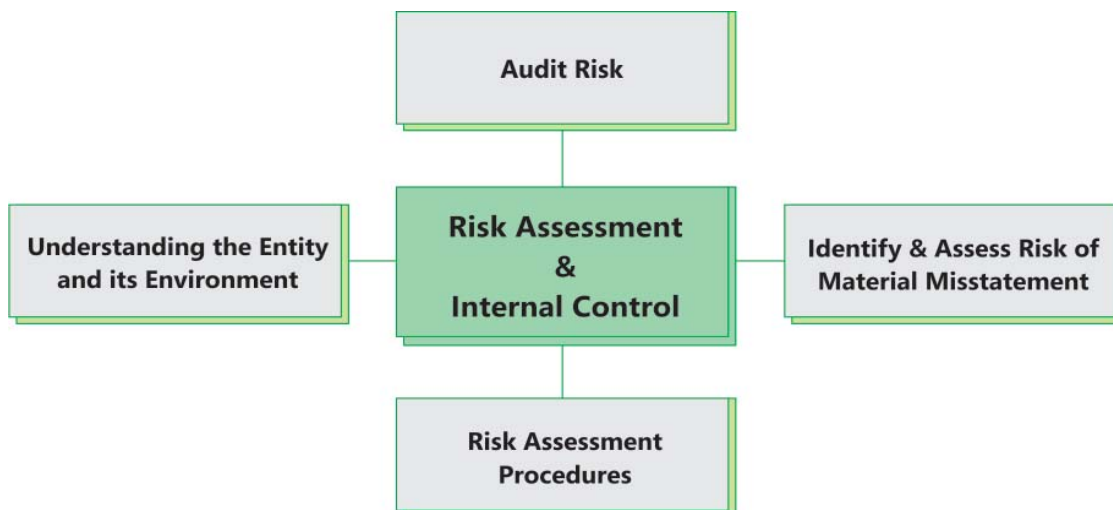


## LEARNING OUTCOMES

After studying this chapter, you will be able to understand:

- ❑ Audit Risk, Risk of Material Misstatement and its Components.
- ❑ Risk Assessment Procedures.
- ❑ The Entity and Its Environment, Including the Entity's Internal Control.
- ❑ Concept of Internal Control, Components of Internal Control and Controls relevant to Audit.
- ❑ Identify Significant Risks.

## CHAPTER OVERVIEW





## 1. AUDIT RISK

Audit risk means the risk that the auditor gives an inappropriate audit opinion when the financial statements are materially misstated. Thus, it is the risk that the auditor may fail to express an appropriate opinion in an audit assignment.

Audit risk is a function of the risks of material misstatement and detection risk.

From the above, it is clear that –

**Audit Risk = Risk of Material Misstatement x Detection Risk-----(1)**

**Note 1: Risk of material misstatement may be defined as** the risk that the financial statements are materially misstated prior to audit. This consists of two components, described as follows at the assertion level:

- (a) **Inherent risk**—The susceptibility of an assertion about a class of transaction, account balance or disclosure to a misstatement that could be material, either individually or when aggregated with other misstatements, before consideration of any related controls.
- (b) **Control risk**—The risk that a misstatement that could occur in an assertion about a class of transaction, account balance or disclosure and that could be material, either individually or when aggregated with other misstatements, will not be prevented, or detected and corrected, on a timely basis by the entity's internal control.

**Note 2: Misstatement refers to a** difference between the amount, classification, presentation, or disclosure of a reported financial statement item and the amount, classification, presentation, or disclosure that is required for the item to be in accordance with the applicable financial reporting framework. Misstatements can arise from error or fraud.

### 1.1 Assessment of Risks - Matter of Professional Judgement

The assessment of risks is based on audit procedures to obtain information necessary for that purpose and evidence obtained throughout the audit. The assessment of risks is a matter of professional judgment, rather than a matter capable of precise measurement.

### 1.2 What is not included in Audit Risk ?

- (i) Audit risk does not include the risk that the auditor might express an opinion that the financial statements are materially misstated when they are not. This risk is ordinarily insignificant.
- (ii) Further, audit risk is a technical term related to the process of auditing; it does not refer to the auditor's business risks such as loss from litigation, adverse publicity, or other events arising in connection with the audit of financial statements.

### 1.3 Risks of Material Misstatement at Two levels

The risks of material misstatement may exist at two levels:

- (i) **The overall financial statement level-** Risks of material misstatement at the overall financial statement level refer to risks of material misstatement that relate pervasively to the financial statements as a whole and potentially affect many assertions.
- (ii) **The assertion level for classes of transactions, account balances, and disclosures-** Risks of material misstatement at the assertion level are assessed in order to determine the nature, timing, and extent of further audit procedures necessary to obtain sufficient appropriate audit evidence. This evidence enables the auditor to express an opinion on the financial statements at an acceptably low level of audit risk.

### 1.4 Components of Risk of Material Misstatement

**The risks of material misstatement at the assertion level consist of two components:**

- (i) Inherent risk and
- (ii) control risk.

Inherent risk and control risk are the entity's risks; they exist independently of the audit of the financial statements.

**Inherent risk** is higher for some assertions and related classes of transactions, account balances, and disclosures than for others. For example, it may be higher for complex calculations. External circumstances giving rise to business risks may also influence inherent risk. For example, technological developments might make a particular product obsolete. Factors in the entity and its environment may also influence the inherent risk related to a specific assertion.

Inherent risk factors are considered while designing tests of controls and substantive procedures. Category of auditor's assessment lower or higher, each category covers a range of degrees of inherent risk. Auditor may assess the inherent risk of two different assertions as lower while recognizing that one assertion has less inherent risk than the other, although both have been assessed as lower. It is important to consider the reason for each identified inherent risk even if the risk is lower, when auditor designs tests of controls and substantive procedures.

#### **E** *example*

A lack of sufficient working capital to continue operations or a declining industry characterised by a large number of business failures.

**Control risk** is a function of the effectiveness of the design, implementation and maintenance of internal control by management. However, internal control can only

reduce but not eliminate risks of material misstatement in the financial statements. This is because of the inherent limitations of internal control.

### **E**example

The possibility of human errors or mistakes, or of controls being circumvented by collusion. Accordingly, some control risk will always exist.

The SAs provide the conditions under which the auditor is required to test the operating effectiveness of controls in determining the nature, timing and extent of substantive procedures to be performed.

**Auditor assesses control risk as Rely or Not rely on Controls.** When making control risk assessments, consider:

- The control environment's influence over internal control. A control environment that supports the prevention, and detection and correction, of material misstatements allows greater confidence in the reliability of internal control and audit evidence generated within the entity. However it does not guarantee the effectiveness of specific controls. We therefore, test the operating effectiveness of controls over significant class of transactions (SCOTs) when we plan to take a controls reliance strategy. Conversely, the control environment may undermine the effectiveness of specific controls and is a key factor in our control risk assessments.
- Evaluations of the related IT processes that support application and IT-dependent manual controls.
- Our testing approach over SCOTs and disclosure processes (i.e., controls reliance or substantive only strategy).
- The expectation of the operating effectiveness of controls based on the understanding of entity's processes.

### **E**example

Identify a control that a shipping report is prepared only for goods that have been shipped. To determine that only sales that have occurred are recorded, identify a further control that sales cannot be recorded unless a shipping report is produced. In this example, several controls operate collectively in order to address the occurrence assertion for sales.

In another example, a regular reconciliation of quantities shipped to quantities billed is a specific control that may be effective enough by itself to address the **WCGW (What Could Go Wrong)** regarding the completeness assertion in a sales process.

Whether several controls are required to operate collectively (i.e., a suite of controls) to achieve a financial reporting objective. If so, the auditor should assess whether all controls operate effectively in order to rely on controls.

**Control risk assessment when control deficiencies are identified :** When auditor identifies deficiencies and report on internal controls, he determines the significant financial statement assertions that are affected by the ineffective controls in order to evaluate the effect on control risk assessments and strategy for the audit of the financial statements.

When control deficiencies are identified and auditor identifies and tests more than one control for each relevant assertion, he evaluates control risk considering all of the controls he has tested. If auditor determines that they support a 'rely on controls' risk assessment, or if compensating controls are identified, tested and evaluated to be effective, he may conclude that the 'rely on controls' is still appropriate. Otherwise we change our control risk assessment to 'not rely on controls.'

When a deficiency relates to an ineffective control that is the only control identified for an assertion, he revises risk assessment to 'not rely on controls' for associated assertions, as no other controls have been identified that mitigate the risk related to the assertion. If the deficiency relates to one WCGW (what can go wrong) out of several WCGW's, he can 'rely on controls' but performs additional substantive procedures to adequately address the risks related to the deficiency.

### 1.5 Combined Assessment of the Risk of Material Misstatement

The SAs do not ordinarily refer to inherent risk and control risk separately, but rather to a combined assessment of the "risks of material misstatement". However, the auditor may make separate or combined assessments of inherent and control risk depending on preferred audit techniques or methodologies and practical considerations. The assessment of the risks of material misstatement may be expressed in quantitative terms, such as in percentages, or in non-quantitative terms. In any case, the need for the auditor to make appropriate risk assessments is more important than the different approaches by which they may be made.

It can be concluded from the above that-

**Risk of Material Misstatement= Inherent Risk x Control Risk-----(2)**

From (1) and (2), we arrive at-

**Audit Risk = Inherent Risk x Control Risk x Detection Risk**

SA 315 establishes requirements and provides guidance on identifying and assessing the risks of material misstatement at the financial statement and assertion levels.

## 1.6 Detection Risk

**Detection risk:** The risk that the procedures performed by the auditor to reduce audit risk to an acceptably low level will not detect a misstatement that exists and that could be material, either individually or when aggregated with other misstatements.

### ILLUSTRATION

XYZ Ltd is engaged in the business and running several stores dealing in variety of items such as ready made 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.

### SOLUTION

**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.



## 2. IDENTIFYING AND ASSESSING THE RISKS OF MATERIAL MISSTATEMENT

**Objective of Auditor as per SA 315:** As per SA 315 - "Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and its Environment", the objective of the auditor is to identify and assess the risks of material misstatement, whether due to fraud or error, at the financial statement and assertion levels, through understanding the entity and its environment, including the entity's internal control, thereby providing a basis for designing and implementing responses to the assessed risks of material misstatement. This will help the auditor to reduce the risk of material misstatement to an acceptably low level.

Let us understand the objective of the auditor as stated in SA 315 in detail.

### 2.1 Identify and assess the risks of material misstatement

- (i) The auditor shall **identify and assess** the risks of material misstatement at:
  - (a) the financial statement level

**(b) the assertion level for classes of transactions, account balances, and disclosures**

to provide a basis for designing and performing further audit procedures

- (ii) For the purpose of Identifying and assessing the risks of material misstatement, the auditor shall:
- (a) Identify risks throughout the process of obtaining an understanding of the entity and its environment, including relevant controls that relate to the risks, and by considering the classes of transactions, account balances, and disclosures in the financial statements;
  - (b) Assess the identified risks, and evaluate whether they relate more pervasively to the financial statements as a whole and potentially affect many assertions;
  - (c) Relate the identified risks to what can go wrong at the assertion level, taking account of relevant controls that the auditor intends to test; and
  - (d) Consider the likelihood of misstatement, including the possibility of multiple misstatements, and whether the potential misstatement is of a magnitude that could result in a material misstatement.

### 2.1.1 Risk Assessment Procedures

**Definition:** The audit procedures performed to obtain an understanding of the entity and its environment, including the entity's internal control, to identify and assess the risks of material misstatement, whether due to fraud or error, at the financial statement and assertion levels.

#### **Risk assessment procedure - a basis for the identification and assessment of risks of material misstatement at the financial statement and assertion levels**

The auditor shall perform risk assessment procedures to provide a basis for the identification and assessment of risks of material misstatement at the financial statement and assertion levels. Risk assessment procedures by themselves, however, do not provide sufficient appropriate audit evidence on which to base the audit opinion.

#### **Information obtained by performing risk assessment procedures - Used as audit evidence**

Information obtained by performing risk assessment procedures and related activities may be used by the auditor as audit evidence to support assessments of the risks of material misstatement. In addition, the auditor may obtain audit evidence about classes of transactions, account balances, or disclosures and related assertions and about the operating effectiveness of controls, even though such procedures were not specifically planned as substantive procedures or as tests of controls. The auditor also may choose to perform substantive procedures or tests of controls concurrently with risk assessment procedures because it is efficient to do so.

### The risks to be assessed include both those due to error and those due to fraud

The risks to be assessed include both those due to error and those due to fraud, and both are covered by this SA. However, the significance of fraud is such that further requirements and guidance are included in SA 240, "The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements", in relation to risk assessment procedures and related activities to obtain information that is used to identify the risks of material misstatement due to fraud. (Fraud risk is discussed in detail in Chapter 5 Fraud and Responsibilities of an Auditor in this regard).

### What is included in Risk Assessment Procedures ?

The risk assessment procedures shall include the following:

- (a) Inquiries of management and of others within the entity who in the auditor's judgment may have information that is likely to assist in identifying risks of material misstatement due to fraud or error.
- (b) Analytical procedures.
- (c) Observation and inspection.

**(a) Inquiries of Management and Others Within the Entity:** 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.

### **E**xample

- Inquiries directed towards those charged with governance may help the auditor understand the environment in which the financial statements are prepared.
- Inquiries directed toward internal audit personnel may provide information about internal audit procedures performed during the year relating to the design and effectiveness of the entity's internal control and whether management has satisfactorily responded to findings from those procedures.
- Inquiries of employees involved in initiating, processing or recording complex or unusual transactions may help the auditor to evaluate the appropriateness of the selection and application of certain accounting policies.
- Inquiries directed toward in-house legal counsel may provide information about such matters as litigation, compliance with laws and regulations, knowledge of fraud or suspected fraud affecting the entity, warranties, post-sales obligations, arrangements (such as joint ventures) with business partners and the meaning of contract terms.



- Inquiries directed towards marketing or sales personnel may provide information about changes in the entity's marketing strategies, sales trends, or contractual arrangements with its customers.
- Inquiries directed to the risk management function (or those performing such roles) may provide information about operational and regulatory risks that may affect financial reporting.
- Inquiries directed to information systems personnel may provide information about system changes, system or control failures, or other information system-related risks.

- (b) **Analytical Procedures** : 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. Analytical procedures performed as risk assessment procedures may include both financial and non-financial information, for example, the relationship between sales and square footage of selling space or volume of goods sold.

Analytical procedures may help identify the existence of unusual transactions or events, and amounts, ratios, and trends that might indicate matters that have audit implications. Unusual or unexpected relationships that are identified may assist the auditor in identifying risks of material misstatement, especially risks of material misstatement due to fraud.

However, when such analytical procedures use data aggregated at a high level (which may be the situation with analytical procedures performed as risk assessment procedures), the results of those analytical procedures only provide a broad initial indication about whether a material misstatement may exist. Accordingly, in such cases, consideration of other information that has been gathered when identifying the risks of material misstatement together with the results of such analytical procedures may assist the auditor in understanding and evaluating the results of the analytical procedures.

- (c) **Observation and Inspection** : Observation and inspection may support inquiries of management and others, and may also provide information about the entity and its environment.

### **Example**

**Examples of such audit procedures include observation or inspection of the following:**

The entity's operations.

Documents (such as business plans and strategies), records, and internal control manuals.

Reports prepared by management (such as quarterly management reports and interim financial statements) and those charged with governance (such as minutes of board of directors' meetings).

The entity's premises and plant facilities.

## 2.2 UNDERSTANDING OF THE ENTITY- A CONTINUOUS PROCESS

Obtaining an understanding of the entity and its environment, including the entity's internal control (referred to hereafter as an "understanding of the entity"), is a continuous, dynamic process of gathering, updating and analysing information throughout the audit. The understanding establishes a frame of reference within which the auditor plans the audit and exercises professional judgment throughout the audit, for example, when:

- Assessing risks of material misstatement of the financial statements;
- Determining materiality in accordance with SA 320;
- Considering the appropriateness of the selection and application of accounting policies;
- 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, or considering the business purpose of transactions;
- Developing expectations for use when performing analytical procedures;
- Evaluating the sufficiency and appropriateness of audit evidence obtained, such as the appropriateness of assumptions and of management's oral and written representations.

### ILLUSTRATION

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.

### SOLUTION

Obtaining an understanding of the entity and its environment, including the entity's internal control (referred to hereafter as an "understanding of the entity"), is a continuous, dynamic process of gathering, updating and analysing information throughout the audit. The auditor should proceed accordingly.

## 2.3 The Required Understanding of the Entity and Its Environment, Including the Entity's Internal Control

**The auditor shall obtain an understanding of the following:**

- (a) Relevant industry, regulatory, and other external factors including the applicable financial reporting framework.

- (b) The nature of the entity, including:
  - (i) its operations;
  - (ii) its ownership and governance structures;
  - (iii) the types of investments that the entity is making and plans to make, including investments in special-purpose entities; and
  - (iv) the way that the entity is structured and how it is financed;to enable the auditor to understand the classes of transactions, account balances, and disclosures to be expected in the financial statements.
- (c) The entity's selection and application of accounting policies, including the reasons for changes thereto. The auditor shall evaluate whether the entity's accounting policies are appropriate for its business and consistent with the applicable financial reporting framework and accounting policies used in the relevant industry.
- (d) The entity's objectives and strategies, and those related business risks that may result in risks of material misstatement.
- (e) The measurement and review of the entity's financial performance.

### ILLUSTRATION

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.

### SOLUTION

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.



## 3. INTERNAL CONTROL

### Meaning of Internal Control

As per SA-315, "Identifying and Assessing the Risk of Material Misstatement Through Understanding the Entity and its Environment", the internal control may be defined 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. The term "controls" refers to any aspects of one or more of the components of internal control."

### Objectives of Internal Control

- (i) transactions are executed in accordance with managements general or specific authorization;
- (ii) all transactions are promptly recorded in the correct amount in the appropriate accounts and in the accounting period in which executed so as to permit preparation of financial information within a framework of recognized accounting policies and practices and relevant statutory requirements, if any, and to maintain accountability for assets;
- (iii) assets are safeguarded from unauthorised access, use or disposition; and
- (iv) the recorded assets are compared with the existing assets at reasonable intervals and appropriate action is taken with regard to any differences.

### The Entity's Internal Control

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.

### Benefits of Understanding of Internal Control

**An understanding of internal control assists the auditor in :**

- (i) identifying types of potential misstatements ;
- (ii) identifying factors that affect the risks of material misstatement, and
- (iii) designing the nature, timing, and extent of further audit procedures.

### ILLUSTRATION

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.

### SOLUTION

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.

Study of various aspects of internal control is divided into four sections, as follows:



### ***(I) General Nature and Characteristics of Internal Control***

**Purpose of Internal Control :** Internal control is designed, implemented and maintained to address identified business risks that threaten the achievement of any of the entity's objectives that concern:

- The reliability of the entity's financial reporting;
- The effectiveness and efficiency of its operations;
- Its compliance with applicable laws and regulations; and
- Safeguarding of assets.

The way in which internal control is designed, implemented and maintained varies with an entity's size and complexity.

### **Limitations of Internal Control**

#### **(i) Internal control can provide only reasonable assurance:**

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.

#### **(ii) Human judgment in decision-making:**

Realities that human judgment in decision-making can be faulty and that breakdowns in internal control can occur because of human error.

#### ***Example***

There may be an error in the design of, or in the change to, a control.

#### **(iii) Lack of understanding the purpose:**

Equally, the operation of a control may not be effective, such as where information produced for the purposes of internal control (for example, an exception report)

is not effectively used because the individual responsible for reviewing the information does not understand its purpose or fails to take appropriate action.

**(iv) Collusion among People:**

Additionally, controls can be circumvented by the collusion of two or more people or inappropriate management override of internal control. **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. Also, edit checks in a software program that are designed to identify and report transactions that exceed specified credit limits may be overridden or disabled.

**(v) Judgements by Management:**

Further, in designing and implementing controls, management may make judgments on the nature and extent of the controls it chooses to implement, and the nature and extent of the risks it chooses to assume.

**(vi) Limitations in case of Small Entities:**

Smaller entities often have fewer employees due to which segregation of duties is not practicable. However, in a small owner-managed entity, the owner-manager may be able to exercise more effective oversight than in a larger entity. This oversight may compensate for the generally more limited opportunities for segregation of duties.

On the other hand, the owner-manager may be more able to override controls because the system of internal control is less structured. This is taken into account by the auditor when identifying the risks of material misstatement due to fraud.

**(II) Controls Relevant to the Audit**

There is a direct relationship between an entity's objectives and the controls it implements to provide reasonable assurance about their achievement. The entity's objectives, and therefore controls, relate to financial reporting, operations and compliance; however, not all of these objectives and controls are relevant to the auditor's risk assessment.

**Factors relevant to the auditor's judgment about whether a control, individually or in combination with others, is relevant to the audit may include such matters as the following:**

- Materiality.
- The significance of the related risk.
- The size of the entity.
- The nature of the entity's business, including its organisation and ownership characteristics.

- The diversity and complexity of the entity's operations.
- Applicable legal and regulatory requirements.
- The circumstances and the applicable component of internal control.
- The nature and complexity of the systems that are part of the entity's internal control, including the use of service organisations.
- Whether, and how, a specific control, individually or in combination with others, prevents, or detects and corrects, material misstatement.

### **Controls over the completeness and accuracy of information**

Controls over the completeness and accuracy of information produced by the entity may be relevant to the audit if the auditor intends to make use of the information in designing and performing further procedures. For example, in auditing revenue by applying standard prices to records of sales volume, the auditor considers the accuracy of the price information and the completeness and accuracy of the sales volume data. Controls relating to operations and compliance objectives may also be relevant to an audit if they relate to data the auditor evaluates or uses in applying audit procedures.

### **Internal control over safeguarding of assets**

Internal control over safeguarding of assets against unauthorised acquisition, use, or disposition may include controls relating to both financial reporting and operations objectives. The auditor's consideration of such controls is generally limited to those relevant to the reliability of financial reporting. For example, use of access controls, such as passwords, that limit access to the data and programs that process cash disbursements may be relevant to a financial statement audit. Conversely, safeguarding controls relating to operations objectives, such as controls to prevent the excessive use of materials in production, generally are not relevant to a financial statement audit.

### **Controls relating to objectives that are not relevant to an audit**

An entity generally has controls relating to objectives that are not relevant to an audit and therefore need not be considered. For example, an entity may rely on a sophisticated system of automated controls to provide efficient and effective operations (such as an airline's system of automated controls to maintain flight schedules), but these controls ordinarily would not be relevant to the audit. Further, although internal control applies to the entire entity or to any of its operating units or business processes, an understanding of internal control relating to each of the entity's operating units and business processes may not be relevant to the audit.

### **The statute may require the auditor to report on compliance with certain internal controls**

In certain circumstances, the statute or the regulation governing the entity may require

the auditor to report on compliance with certain specific aspects of internal controls as a result, the auditor's review of internal control may be broader and more detailed.

**(III) Nature and Extent of the Understanding of Relevant Controls.**

- (i) 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 significant deficiency in internal control.

- (ii) Risk assessment procedures to obtain audit evidence about the design and implementation of relevant controls may include-

- Inquiring of entity personnel.
- Observing the application of specific controls.
- Inspecting documents and reports.
- Tracing transactions through the information system relevant to financial reporting.

Inquiry alone, however, is not sufficient for such purposes.

- (iii) Obtaining an understanding of an entity's controls is not sufficient to test their operating effectiveness, unless there is some automation that provides for the consistent operation of the controls.

**Example**

Obtaining audit evidence about the implementation of a manual control at a point in time does not provide audit evidence about the operating effectiveness of the control at other times during the period under audit. However, because of the inherent consistency of IT processing, performing audit procedures to determine whether an automated control has been implemented may serve as a test of that control's operating effectiveness, depending on the auditor's assessment and testing of controls such as those over program changes.

**(IV) Components of Internal Control**

The division of internal control into the following five components provides a useful framework for auditors to consider how different aspects of an entity's internal control may affect the audit:



- (A) The control environment;
- (B) The entity's risk assessment process
- (C) The information system, including the related business processes, relevant to financial reporting, and communication
- (D) Control activities
- (E) Monitoring of controls.

- (A) Control Environment– Component of Internal Control–** The auditor shall obtain an understanding of the control environment. As part of obtaining this understanding, the auditor shall evaluate whether:
- (i) Management has created and maintained a culture of honesty and ethical behavior; and
  - (ii) The strengths in the control environment elements collectively provide an appropriate foundation for the other components of internal control.

### **What is included in Control Environment ?**

The control environment includes:

- (i) the governance and management functions and
- (ii) the attitudes, awareness, and actions of those charged with governance and management .
- (iii) the control environment sets the tone of an organization, influencing the control consciousness of its people.

**Elements of the Control Environment–** Elements of the control environment that may be relevant when obtaining an understanding of the control environment include the following:

- (a) Communication and enforcement of integrity and ethical values–** These are essential elements that influence the effectiveness of the design, administration and monitoring of controls.
- (b) Commitment to competence–** Matters such as management's consideration of the competence levels for particular jobs and how those levels translate into requisite skills and knowledge.
- (c) Participation by those charged with governance–** Attributes of those charged with governance such as:
  - Their independence from management.
  - Their experience and stature.

- The extent of their involvement and the information they receive, and the scrutiny of activities.
  - The appropriateness of their actions, including the degree to which difficult questions are raised and pursued with management, and their interaction with internal and external auditors.
- (d) **Management's philosophy and operating style**– Characteristics such as management's:
- Approach to taking and managing business risks.
  - Attitudes and actions toward financial reporting.
  - Attitudes toward information processing and accounting functions and personnel.
- (e) **Organisational structure**– The framework within which an entity's activities for achieving its objectives are planned, executed, controlled, and reviewed.
- (f) **Assignment of authority and responsibility**– Matters such as how authority and responsibility for operating activities are assigned and how reporting relationships and authorisation hierarchies are established.
- (g) **Human resource policies and practices**– Policies and practices that relate to, for example, recruitment, orientation, training, evaluation, counselling, promotion, compensation, and remedial actions.

**(B) The Entity's Risk Assessment Process– Component of Control Environment**

The auditor shall obtain an understanding of whether the entity has a process for:

- (a) Identifying business risks relevant to financial reporting objectives;
- (b) Estimating the significance of the risks;
- (c) Assessing the likelihood of their occurrence; and
- (d) Deciding about actions to address those risks.

The entity's risk assessment process forms the basis for the risks to be managed. If that process is appropriate, it would assist the auditor in identifying risks of material misstatement. Whether the entity's risk assessment process is appropriate to the circumstances is a matter of judgment.

**(C) The information system, including the related business processes, relevant to financial reporting and communication– Component of Control Environment**

The auditor shall obtain an understanding of the information system, including

the related business processes, relevant to financial reporting, including the following are as:

- (a) The classes of transactions in the entity's operations that are significant to the financial statements;
- (b) The procedures by which those transactions are initiated, recorded, processed, corrected as necessary, transferred to the general ledger and reported in the financial statements;
- (c) The related accounting records, supporting information and specific accounts in the financial statements that are used to initiate, record, process and report transactions;
- (d) How the information system captures events and conditions that are significant to the financial statements;
- (e) The financial reporting process used to prepare the entity's financial statements;
- (f) Controls surrounding journal entries.

**Communicating Financial Roles and Responsibilities– Obtaining an Understanding by the Auditor:** The auditor shall obtain an understanding of how the entity communicates financial reporting roles and responsibilities including:

- |  |   |
|--|---|
| (a) Communications between management and those charged with governance; and | (b) External communications, such as those with regulatory authorities. |
|--|---|

**The following points need consideration in this regard:**

- (i) **Understanding of Roles and Responsibilities:** Communication by the entity of the financial reporting roles and responsibilities would involve providing an understanding of individual roles and responsibilities pertaining to internal control over financial reporting.
- (ii) **Understanding regarding Relation of Activities:** It includes understanding by employees as to how their activities relate to the work of others and the means of reporting exceptions to higher level within the entity.
- (iii) **Policy Manuals and Financial Reporting Manuals:** Communication may take such forms as policy manuals and financial reporting manuals.
- (iv) **Open Communication Channels:** Open communication channels help ensure that exceptions are reported and acted on.
- (v) **Less structured and easier for Small Entities:** Communication may be less structured and easier to achieve in a small entity than in a larger entity due to fewer levels of responsibility and management's greater visibility and availability.

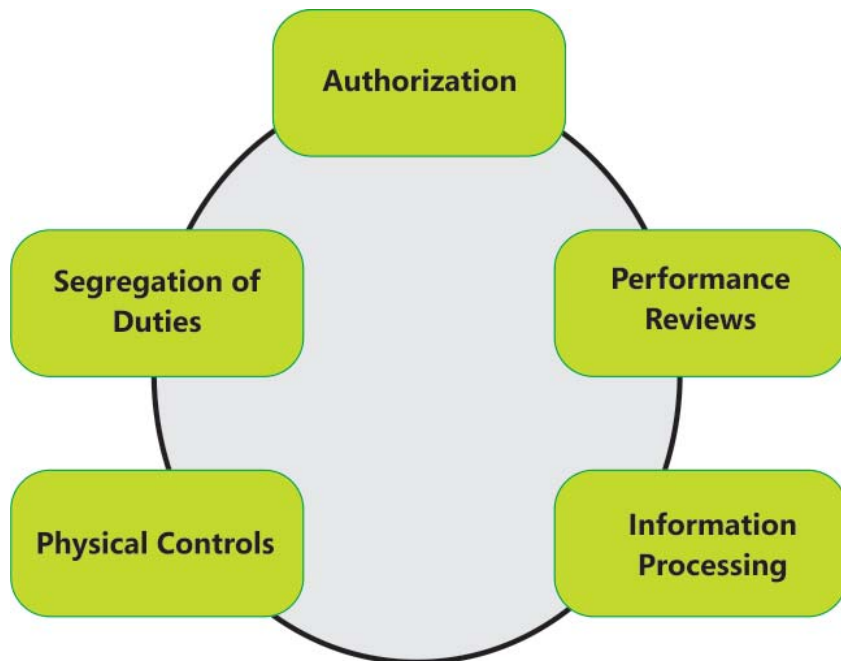
**(D) Control Activities– Component of Internal Control**

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. An audit 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.

**Control activities are the policies and procedures that help ensure that management directives are carried out.**

Control activities, whether within IT or manual systems, have various objectives and are applied at various organisational and functional levels.

**Examples of specific control activities include those relating to the following:**



**Control activities that are relevant to the audit are:**

- Control activities that relate to **significant risks** and those that relate to risks for **which substantive procedures alone do not provide sufficient appropriate audit evidence**; or
- Those that are considered to be relevant in the judgment of the auditor;
- 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.

**In exercising judgment as to which risks are significant risks, the auditor shall consider at least the following:**

- (a) Whether the risk is a risk of fraud;
- (b) Whether the risk is related to recent significant economic, accounting, or other developments like changes in regulatory environment, etc., and, therefore, requires specific attention;
- (c) The complexity of transactions;
- (d) Whether the risk involves significant transactions with related parties;
- (e) The degree of subjectivity in the measurement of financial information related to the risk, especially those measurements involving a wide range of measurement uncertainty; and
- (f) Whether the risk involves significant transactions that are outside the normal course of business for the entity, or that otherwise appear to be unusual.

**(Note :** Student may refer Chapter 5 on for detailed understanding of Fraud Risk)

**Identifying Significant Risks:** Significant risks often relate to significant non-routine transactions or judgmental matters. Non-routine transactions are transactions that are unusual, due to either size or nature, and that therefore occur infrequently. Judgmental matters may include the development of accounting estimates for which there is significant measurement uncertainty.

Significant risks are inherent risks with both a higher likelihood of occurrence and a higher magnitude of potential misstatement. The auditor assess assertions affected by a significant risk as higher inherent risk. The following are always significant risks :

- Risks of material misstatement due to fraud
- Significant transactions with related parties that are outside the normal course of business for the entity

**Risks of Material Misstatement– Greater for Significant Non-Routine Transactions**

Risks of material misstatement may be greater for significant non-routine transactions arising from matters such as the following:

- Greater management intervention to specify the accounting treatment.
- Greater manual intervention for data collection and processing.
- Complex calculations or accounting principles.

- The nature of non-routine transactions, which may make it difficult for the entity to implement effective controls over the risks.

### **Risks of material misstatement– Greater for Significant Judgmental Matters**

Risks of material misstatement may be greater for significant judgmental matters that require the development of accounting estimates, arising from matters such as the following:

- Accounting principles for accounting estimates or revenue recognition may be subject to differing interpretation.
- Required judgment may be subjective or complex, or require assumptions about the effects of future events, for example, judgment about fair value.

### **(E) Monitoring of Controls – Component of Internal Control**

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

- (i) **Monitoring of controls Defined:** Monitoring of controls is a process to assess the effectiveness of internal control performance over time.
- (ii) **Helps in assessing the effectiveness of controls on a timely basis:** It involves assessing the effectiveness of controls on a timely basis and taking necessary remedial actions.
- (iii) **Management accomplishes through ongoing activities, separate evaluations etc.:** 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.
- (iv) **Management's monitoring activities include:** 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.
- (v) **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. This involvement often will identify significant variances from expectations and inaccuracies in financial data leading to remedial action to the control.

**Monitoring of Controls– If the entity has an internal audit function**

If the entity has an internal audit function, the auditor shall obtain an understanding of the following :

- (a) The internal audit function's responsibilities and how the internal audit function fits in the entity's organisational structure; and
- (b) The activities performed, or to be performed, by the internal audit function.

**The following points merit consideration in this regard:**

- (i) **Internal Audit Function relevant to the Audit:** The entity's internal audit function is likely to be relevant to the audit if its activities are related to the entity's financial reporting. Also if the auditor expects to use the work of the internal auditors to modify the audit procedures to be performed. When the auditor determines that the internal audit function is likely to be relevant to the audit, SA 610 applies.
- (ii) **Size and Structure of the Entity:** The objectives of an internal audit function vary widely depending on the size and structure of the entity and the requirements of management.
- (iii) **Internal audit function may include:** The responsibilities of an internal audit function may include, for example, monitoring of internal control, risk management, and review of compliance with laws and regulations.  
  
On the other hand, the responsibilities of the internal audit function may be limited to the review of the economy, efficiency and effectiveness of operations, for example, and accordingly, may not relate to the entity's financial reporting.
- (iv) **External auditor's activities- on the basis of Internal Audit activities:** If the internal audit function's responsibilities are related to the entity's financial reporting, the external auditor's consideration of the activities performed may include review of the internal audit function's audit plan for the period.

**Satisfactory Control Environment – not an absolute deterrent to fraud:**

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. Conversely, deficiencies in the control environment may undermine the effectiveness of controls, in particular in relation to fraud. For example, management's failure to commit sufficient resources to address IT security risks may adversely affect internal control by allowing improper changes to be made to computer programs or to data, or unauthorized transactions to be processed. As explained in SA 330, the control environment also influences the nature, timing, and extent of the auditor's further procedures.

The control environment in itself does not prevent, or detect and correct, a material misstatement. It may, however, influence the auditor's evaluation of the effectiveness of other controls (for example, the monitoring of controls and the operation of specific control activities) and thereby, the auditor's assessment of the risks of material misstatement.



## 4. EVALUATION OF INTERNAL CONTROL BY THE AUDITOR

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. The auditor should gain an understanding of the accounting system and related internal controls and should study and evaluate the operations of these internal controls upon which he wishes to rely in determining the nature, timing and extent of other audit procedures.

### Benefits of Evaluation of Internal Control to the Auditor

The review of internal controls will enable the auditor to know:

- (i) whether errors and frauds are likely to be located in the ordinary course of operations of the business;
- (ii) whether an adequate internal control system is in use and operating as planned by the management;
- (iii) whether an effective internal auditing department is operating;
- (iv) whether any administrative control has a bearing on his work (for example, if the control over worker recruitment and enrolment is weak, there is a likelihood of dummy names being included in the wages sheet and this is relevant for the auditor);
- (v) whether the controls adequately safeguard the assets;
- (vi) how far and how adequately the management is discharging its function in so far as correct recording of transactions is concerned;
- (vii) how reliable the reports, records and the certificates to the management can be;
- (viii) the extent and the depth of the examination that he needs to carry out in the different areas of accounting;
- (ix) what would be appropriate audit technique and the audit procedure in the given circumstances;



- (x) what are the areas where control is weak and where it is excessive; and
- (xi) whether some worthwhile suggestions can be given to improve the control system.

### **Formulate Audit Program after understanding Internal Control**

The auditor can formulate his entire audit programme only after he has had a satisfactory understanding of the internal control systems and their actual operation. If he does not care to study this aspect, it is very likely that his audit programme may become unwieldy and unnecessarily heavy and the object of the audit may be altogether lost in the mass of entries and vouchers. It is also important for him to know whether the system is actually in operation. Often, after installation of a system, no proper follow up is there by the management to ensure compliance. The auditor, in such circumstances, may be led to believe that a system is in operation which in reality may not be altogether in operation or may at best operate only partially. This state of affairs is probably the worst that an auditor may come across and he would be in the midst of confusion, if he does not take care.

It would be better if the auditor can undertake the review of the internal control system of client. This will give him enough time to assimilate the controls and implications and will enable him to be more objective in the framing of the audit programme. He will also be in a position to bring to the notice of the management the weaknesses of the system and to suggest measures for improvement. At a further interim date or in the course of the audit, he may ascertain how far the weaknesses have been removed.

From the foregoing, it can be concluded that the extent and the nature of the audit programme is substantially influenced by the internal control system in operation. In deciding upon a plan of test checking, the existence and operation of internal control system is of great significance.

A proper understanding of the internal control system in its content and working also enables an auditor to decide upon the appropriate audit procedure to be applied in different areas to be covered in the audit programme.

In a situation where the internal controls are considered weak in some areas, the auditor might choose an auditing procedure or test that otherwise might not be required; he might extend certain tests to cover a large number of transactions or other items than he otherwise would examine and at times he may perform additional tests to bring him the necessary satisfaction.

**Example**

Normally the distribution of wages is not observed by the auditor. But if the internal control over wages is so weak that there exists a possibility of dummy workers being paid, the auditor might include observation of wages distribution in his programme in order to find out the workers who do not turn up for receipt of wages.

On the other hand, if he is satisfied with the internal control on sales and trade receivables, the auditor can get trade receivables' balances confirmed at almost any time reasonably close to the balance sheet date. But if the control is weak, he may feel that he should get the confirmation exactly on the date of the year closing so that he may eliminate the risk of errors and frauds occurring between the intervening period. Also, he may in that situation, decide to have a large coverage of trade receivables by the confirmation procedure.

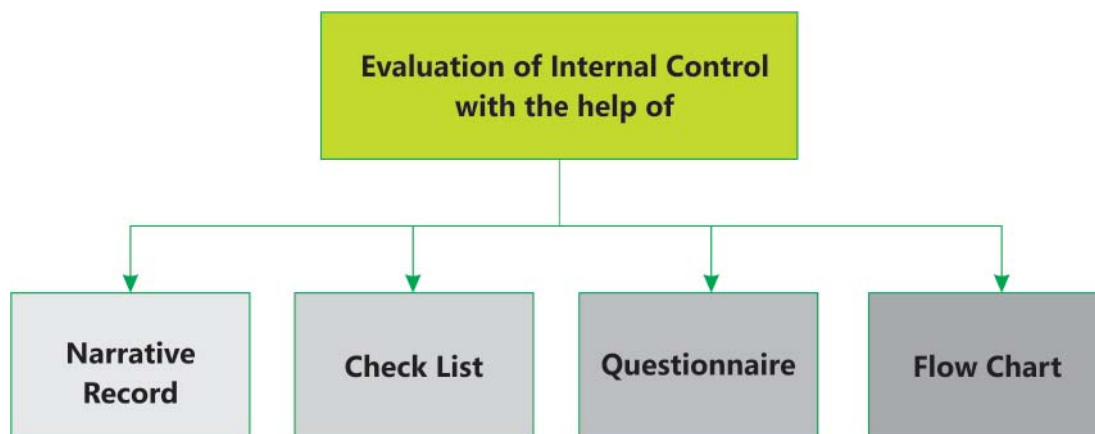
**Evaluation of Internal Control– Methods**

A review of the internal control can be done by a process of study, examination and evaluation of the control system installed by the management.

The first step involves determination of the control and procedures laid down by the management. By reading company manuals, studying organisation charts and flow charts and by making suitable enquiries from the officers and employees, the auditor may ascertain the character, scope and efficacy of the control system. To acquaint himself about how all the accounting information is collected and processed and to learn the nature of controls that makes the information reliable and protect the company's assets, calls for considerable skill and knowledge. In many cases, very little of this information is available in writing; the auditor must ask the right people the right questions if he is to get the information he wants. It would be better if he makes written notes of the relevant information and procedures contained in the manual or ascertained on enquiry.

**To facilitate the accumulation of the information necessary for the proper review and evaluation of internal controls, the auditor can use one of the following to help him to know and assimilate the system and evaluate the same:**

- (i) Narrative record;
- (ii) Check List;
- (iii) Questionnaire; and
- (iv) Flow chart.



### 4.1 The 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 and would be more suited to small business.

The basic disadvantages of narrative records are:

- (i) To comprehend the system in operation is quite difficult.
- (ii) To identify weaknesses or gaps in the system.
- (iii) To incorporate changes arising on account of reshuffling of manpower, etc.

### 4.2 A Check List

This is a series of instructions and/or questions which a member of the auditing staff must follow and/or answer. When he completes instruction, he initials the space against the instruction. Answers to the check list instructions are usually Yes, No or Not Applicable. This is again an on the job requirement and instructions are framed having regard to the desirable elements of control.

#### **E**example

**A few examples of check list instructions are given hereunder:**

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 standardised?
4. Are purchase order forms pre-numbered?
5. Are the inventory control accounts maintained by persons who have nothing to do with custody of work, receipt of inventory, inspection of inventory and purchase of inventory?

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

### 4.3 Internal Control Questionnaire

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

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

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

### 4.4 A Flow Chart

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

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



## 5. TESTING OF INTERNAL CONTROL

After assimilating the internal control system, the auditor needs to examine whether and how far the same is actually in operation. For this, he resorts to actual testing of the system in operation. This he does on a selective basis: he can plan this testing in such a manner that all the important areas are covered in a period of, say, three years. Selective testing is being done by application of procedural tests and auditing in depth.

**Test of Controls:**

Test of controls are performed to obtain audit evidence about the effectiveness of the:

**(a) design of the accounting and internal control systems, i.e., whether they are suitably designed to prevent or detect and correct material misstatements; and**

**(b) operation of the internal controls throughout the period.**

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

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

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

**Test of controls may include:**

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

**(Students may note that testing of IT System related controls are discussed in details in Chapter 6 Audit in an Automated Environment)**

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. Deviations from prescribed controls may be caused by such factors as changes in key personnel, significant seasonal fluctuations in volume of transactions and human error. When deviations are detected the auditor makes specific inquiries regarding these matters, particularly, the timing of staff changes in key internal control functions. The auditor then ensures that the tests of control appropriately cover such a period of change or fluctuation.

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

It has been suggested that actual operation of the internal control should be tested by the application of procedural tests and examination in depth. 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.

### **E**example

**For example, the procedure for sales requires the following:**

- (i) Before acceptance of any order the position of inventory of the relevant article should be known to ascertain whether the order can be executed in time.
- (ii) An advice under the authorisation of the sales manager should be sent to the party placing the order, internal reference number, and the acceptance of the order. This advice should be prepared on a standardised form and copy thereof should be forwarded to inventory section to enable it to prepare for the execution of the order in time.
- (iii) The credit period allowed to the party should be the normal credit period. For any special credit period a special authorisation of the sales manager would be necessary.

- (iv) The rate at which the order has been accepted and other terms about transport, insurance, etc., should be clearly specified.
- (v) Before deciding upon the credit period, a reference should be made to the credit section to know the creditworthiness of the party and particularly whether the party has honoured its commitments in the past.

An auditor testing the internal controls on sales should invariably test whether any of the aforesaid procedures have been omitted. If credit has actually been granted without a reference to the credit section to know the creditworthiness of the party, it is possible that the amount may prove bad because of the financial crisis or deadlock in the management of the party, a fact which could have been easily gathered from the credit section. Similarly, if an order is received without a reference to the inventory section, it is likely due to non-availability of the inventory on the stipulated date; execution of the order may be delayed and the company may have to compensate the buyer for the damages suffered by him.



## 6. INTERNAL CONTROL AND IT ENVIRONMENT

Characteristics of Manual and Automated Elements of Internal Control Relevant to the Auditor's Risk Assessment: An entity's system of internal control contains manual elements and often contains automated elements. The characteristics of manual or automated elements relevant to the auditor's risk assessment and further audit procedures are explained hereunder-

- (i) **Controls in Manual and IT System:** The use of manual or automated elements in internal control affects the manner in which transactions are initiated, recorded, processed, and reported:
  - (1) Controls in a manual system may include such procedures as approvals and reviews of transactions, and reconciliations and follow-up of reconciling items. Alternatively, an entity may use automated procedures to initiate, record, process, and report transactions, in which case records in electronic format replace paper documents.
  - (2) Controls in IT systems consist of a combination of automated controls (for example, controls embedded in computer programs) and manual controls. Further, manual controls may be independent of IT, may use information produced by IT, or may be limited to monitoring the effective functioning of IT and of automated controls, and to handling exceptions.
- (ii) **Use of IT:** An entity's mix of manual and automated elements in internal control varies with the nature and complexity of the entity's use of IT.
- (iii) **Generally, IT benefits an entity's internal control by enabling an entity to:**
  - Consistently apply predefined business rules and perform complex calculations in processing large volumes of transactions or data;



- Enhance the timeliness, availability, and accuracy of information;
- Facilitate the additional analysis of information;
- Enhance the ability to monitor the performance of the entity's activities and its policies and procedures;
- Reduce the risk that controls will be circumvented; and
- Enhance the ability to achieve effective segregation of duties by implementing security controls in applications, databases, and operating systems.

### Benefits of IT in an Entity's Internal Control

**Processing of large volumes of transactions or data becomes simple;**

**Enhance the timeliness, availability, and accuracy of information;**

**Facilitate the additional analysis of information;**

**Enhance the ability to monitor the performance of the entity's activities and its policies and procedures;**

**Reduce the risk that controls will be circumvented; and**

**Effective segregation of duties through security controls.**

**(iv) IT also poses specific risks to an entity's internal control, including, for example:**

- Reliance on systems or programs that are inaccurately processing data, processing inaccurate data, or both.
- Unauthorised 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.
- The possibility of IT personnel gaining access privileges beyond those necessary to perform their assigned duties thereby breaking down segregation of duties.
- Unauthorised changes to data in master files.
- Unauthorised changes to systems or programs.
- Failure to make necessary changes to systems or programs.



- Inappropriate manual intervention.
  - Potential loss of data or inability to access data as required.
- (v) **Suitability:** Manual elements in internal control may be more suitable where judgment and discretion are required.
- (vi) **Reliability:** Manual elements in internal control may be less reliable than automated elements because they can be more easily bypassed, ignored, or overridden and they are also more prone to simple errors and mistakes. Consistency of application of a manual control element cannot therefore be assumed.
- (vii) **Nature of Entity's Information System:** 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.



## 7. MATERIALITY AND AUDIT RISK

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.

In conducting an audit of financial statements, the overall objectives of the auditor are to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, thereby enabling the auditor to express an opinion on whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework; and to report on the financial statements, and communicate as required by the SAs, in accordance with the auditor's findings. The auditor obtains reasonable assurance by obtaining sufficient appropriate audit evidence to reduce audit risk to an acceptably low level.

Audit risk is the risk that the auditor expresses an inappropriate audit opinion when the financial statements are materially misstated. Audit risk is a function of the risks of material misstatement and detection risk. Materiality and audit risk are considered throughout the audit, in particular, when:

- (a) Identifying and assessing the risks of material misstatement;
- (b) Determining the nature, timing and extent of further audit procedures; and



- (c) Evaluating the effect of uncorrected misstatements, if any, on the financial statements and in forming the opinion in the auditor's report.



## 8. DOCUMENTING THE RISK

The auditor shall document:

- (a) The discussion among the engagement team and the significant decisions reached;
- (b) Key elements of the understanding obtained regarding each of the aspects of the entity and its environment and of each of the internal control components, the sources of information from which the understanding was obtained; and the risk assessment procedures performed;
- (c) The identified and assessed risks of material misstatement at the financial statement level and at the assertion level ; and
- (d) The risks identified, and related controls about which the auditor has obtained an understanding.



## 9. INTERNAL AUDIT

As defined in scope of the Standards on Internal Audit, **Internal Audit** means "An independent management function, which involves a continuous and critical appraisal of the functioning of an entity with a view to suggest improvements thereto and add value to and strengthen the overall governance mechanism of the entity, including the entity's strategic risk management and internal control system".

### 9.1 Applicability of Provisions of Internal Audit

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

- (a) every listed company;
- (b) every unlisted public company having-
  - (i) paid up share capital of fifty crore rupees or more during the preceding financial year; or
  - (ii) turnover of two hundred crore rupees or more during the preceding financial year; or
  - (iii) outstanding loans or borrowings from banks or public financial institutions exceeding one hundred crore rupees or more at any point of time during the preceding financial year; or

- (iv) outstanding deposits of twenty five crore rupees or more at any point of time during the preceding financial year; and
- (c) every private company having-
  - (i) turnover of two hundred crore rupees or more during the preceding financial year; or
  - (ii) outstanding loans or borrowings from banks or public financial institutions exceeding one hundred crore rupees or more at any point of time during the preceding financial year:

It is provided that an existing company covered under any of the above criteria shall comply with the requirements within six months of commencement of such section.

## 9.2 Who can be appointed as Internal Auditor?

As per section 138, the internal auditor shall either be a chartered accountant or a cost accountant (whether engaged in practice or not), or such other professional as may be decided by the Board to conduct internal audit of the functions and activities of the companies. The internal auditor may or may not be an employee of the company.

## 9.3 Internal audit function

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.

### 9.3.1 The objectives and scope of internal audit functions

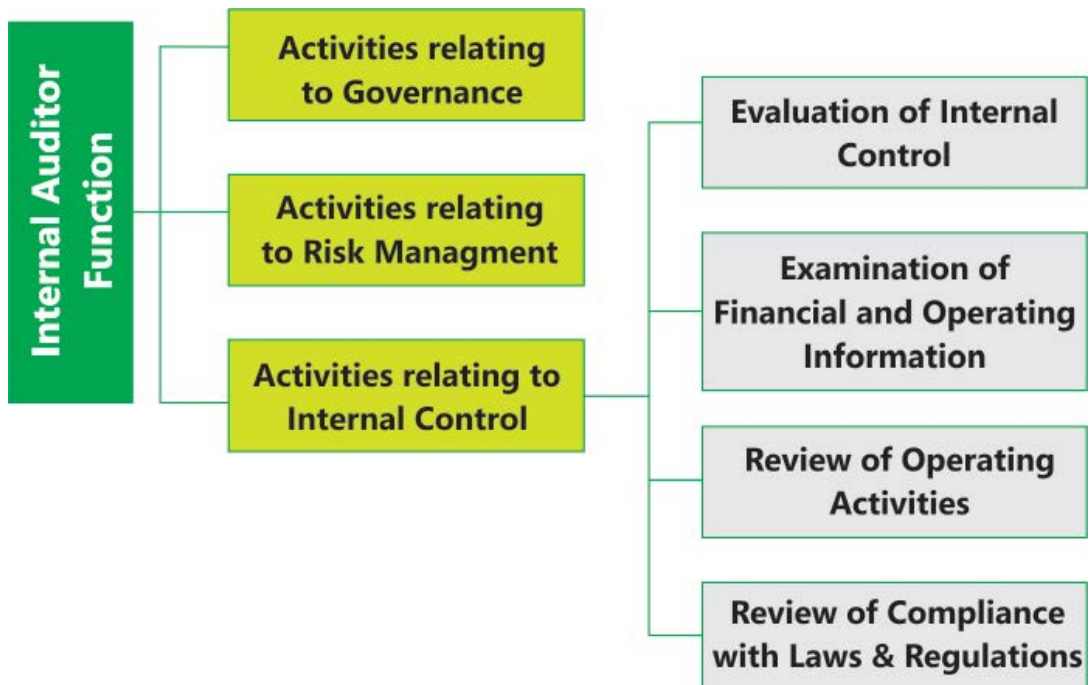
As per SA-610, "Using the Work of an Internal Auditor", the objectives of internal audit functions vary widely and depend on the size and structure of the entity and the requirements of management and, where applicable, those charged with governance.

The objectives and scope of internal audit functions typically include assurance and consulting activities designed to evaluate and improve the effectiveness of the entity's governance processes, risk management and internal control such as the following:

1. **Activities Relating to Governance:** The internal audit function may assess the governance process in its accomplishment of objectives on ethics and values, performance management and accountability, communicating risk and control information to appropriate areas of the organization and effectiveness of communication among those charged with governance, external and internal auditors, and management.
2. **Activities Relating to Risk Management:** The internal audit function may assist the entity by identifying and evaluating significant exposures to risk and contributing to the improvement of risk management and internal control (including effectiveness of the financial reporting process). The internal audit function may perform procedures to assist the entity in the detection of fraud.

### 3. Activities Relating to Internal Control:

- (i) **Evaluation of internal control:** The internal audit function may be assigned specific responsibility for reviewing controls, evaluating their operation and recommending improvements thereto. In doing so, the internal audit function provides assurance on the control. For example, the internal audit function might plan and perform tests or other procedures to provide assurance to management and those charged with governance regarding the design, implementation and operating effectiveness of internal control, including those controls that are relevant to the audit.
- (ii) **Examination of financial and operating information:** The internal audit function may be assigned to review the means used to identify, recognize, measure, classify and report financial and operating information, and to make specific inquiry into individual items, including detailed testing of transactions, balances and procedures.
- (iii) **Review of operating activities:** The internal audit function may be assigned to review the economy, efficiency and effectiveness of operating activities, including nonfinancial activities of an entity.
- (vi) **Review of compliance with laws and regulations:** The internal audit function may be assigned to review compliance with laws, regulations and other external requirements, and with management policies and directives and other internal requirements.





## 10. BASICS OF STANDARDS ON INTERNAL AUDIT ISSUED BY ICAI

Considering the increasing importance of internal auditing, the Institute of Chartered Accountants of India has constituted a Committee on Internal Audit (CIA) as a non-standing committee on February 5, 2004. The CIA was constituted with the object of formulating Standards and Guidance Notes on Internal Audit now it is known as Internal Audit Standard Board.

The Board has, till date, issued eighteen Standards on Internal Audit (SIAs) and the list is given below. The SIAs aim to codify the best practices in the area of internal audit and also serve to provide a benchmark of the performance of the internal audit services. While formulating SIAs, the Board takes into consideration the applicable laws, customs, usages and business environment and generally accepted auditing practices in India.

The following SIAs are recommendatory in nature. The Standards shall become mandatory from such date as notified by the council:

<b>SIA 1:</b> Planning an Internal Audit.	<b>SIA 2:</b> Basic Principles Governing Internal Audit
<b>SIA 3:</b> Documentation.	<b>SIA 4:</b> Reporting.
<b>SIA 5:</b> Sampling.	<b>SIA 6:</b> Analytical Procedures.
<b>SIA 7:</b> Quality Assurance in Internal Audit.	<b>SIA 8:</b> Terms of Internal Audit.
<b>SIA 9:</b> Communication with Management.	<b>SIA 10:</b> Internal Audit Evidence.
<b>SIA 11:</b> Consideration of Fraud in an Internal Audit.	<b>SIA 12:</b> Internal Control Evaluation.
<b>SIA 13:</b> Enterprise Risk Management.	<b>SIA 14:</b> Internal Audit in an Information Technology Environment.
<b>SIA 15:</b> Knowledge of the Entity and its Environment.	<b>SIA 16:</b> Using the Work of an Expert.
<b>SIA 17:</b> Consideration of Laws and Regulations in an Internal Audit.	<b>SIA 18:</b> Related Parties.



## 11. BASICS OF INTERNAL FINANCIAL CONTROL AND REPORTING REQUIREMENTS

**Clause (e) of Sub-section 5 of Section 134 explains the meaning of internal financial controls as, "the policies and procedures adopted by the company for**

ensuring the orderly and efficient conduct of its business, including adherence to company's policies, the safeguarding of its assets, the prevention and detection of frauds and errors, the accuracy and completeness of the accounting records, and the timely preparation of reliable financial information."

From the above definition, it is clear that **internal financial controls** are the policies and procedures adopted by the company for :

1. ensuring the orderly and efficient conduct of its business, including adherence to company's policies,
2. the safeguarding of its assets,
3. the prevention and detection of frauds and errors,
4. the accuracy and completeness of the accounting records, and
5. the timely preparation of reliable financial information."

### **Auditors' Responsibility for Reporting on Internal Financial Controls over Financial Reporting in India**

Clause (i) of Sub-section 3 of Section 143 of the Act requires the auditors' report to state whether the company has adequate internal financial controls system in place and the operating effectiveness of such controls.

It may be noted that 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.

Accordingly, reporting on internal financial controls will not be applicable with respect to interim financial statements, such as quarterly or half-yearly financial statements, unless such reporting is required under any other law or regulation.

**Objectives of an auditor in an audit of internal financial controls over financial reporting:** The auditor's objective in an audit of internal financial controls over financial reporting is, " **to express an opinion on the effectiveness of the company's internal financial controls over financial reporting.**" **It is carried out along with an audit of the financial statements.**

**Reporting under Section 143(3)(i)** is dependent on the underlying criteria for internal financial controls over financial reporting adopted by the management. However, any system of internal controls provides only a reasonable assurance on achievement of the objectives for which it has been established. Also, the auditor shall use the concept of materiality in determining the extent of testing such controls.

**Rule 8(5)(viii) of the Companies (Accounts) Rules, 2014** requires the board report of all companies to state the details in respect of adequacy of internal financial controls with reference to the financial statements.

The inclusion of the matters relating to internal financial controls in the directors responsibility statement is in addition to the requirement of the directors stating that they have taken proper and sufficient care for the maintenance of adequate accounting records in accordance with the provisions of the 2013 Act for safeguarding the assets of the company and for preventing and detecting fraud and other irregularities.



## 12. DIFFERENCE BETWEEN INTERNAL FINANCIAL CONTROL AND INTERNAL CONTROL OVER FINANCIAL REPORTING

**Internal Financial Control as per Section 134(5)(e)**, “the policies and procedures adopted by the company for ensuring the orderly and efficient conduct of its business, including adherence to company’s policies, the safeguarding of its assets, the prevention and detection of frauds and errors, the accuracy and completeness of the accounting records, and the timely preparation of reliable financial information.”

**On the other hand, Internal controls over financial reporting-is required** where auditors are required to express an opinion on the effectiveness of an entity’s **internal controls over financial reporting**, such opinion is in addition to and distinct from the opinion expressed by the auditor on the financial statements.



### SUMMARY

Audit risk means the risk that the auditor gives an inappropriate audit opinion when the financial statement are materially misstated. Audit risk is a function of the risks of material misstatement and detection risk. Risk of material misstatement may be defined as the risk that the financial statements are materially misstated prior to audit. This consists of two components- Inherent risk and Control risk. Inherent risk is the susceptibility of an assertion to a misstatement before consideration of any related controls. Control risk is the risk that a misstatement that could occur in an assertion will not be prevented, or detected and corrected, on a timely basis by the entity’s internal control.

Misstatement refers to a difference between the amount, classification, presentation, or disclosure of a reported financial statement item and the amount, classification, presentation, or disclosure that is required for the item to be in accordance with the applicable financial reporting framework.

The assessment of risks is a matter of professional judgment.

Detection risk refers to the risk that the procedures performed by the auditor to reduce audit risk to an acceptably low level will not detect a misstatement that exists and that could be material, either individually or when aggregated with other misstatements.

Audit Risk = Inherent Risk x Control Risk x Detection Risk



Objective of Auditor as per SA 315: As per SA 315 - "Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and its Environment", the objective of the auditor is to identify and assess the risks of material misstatement, whether due to fraud or error, at the financial statement and assertion levels, through understanding the entity and its environment, including the entity's internal control, thereby providing a basis for designing and implementing responses to the assessed risks of material misstatement. This will help the auditor to reduce the risk of material misstatement to an acceptably low level.

As per SA-315, "Identifying and Assessing the Risk of Material Misstatement Through Understanding the Entity and its Environment", the internal control may be defined 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. The term "controls" refers to any aspects of one or more of the components of internal control."

The control environment includes the governance and management functions and the attitudes, awareness, and actions of those charged with governance and management. 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.

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.

The auditor can formulate his entire audit programme only after he has had a satisfactory understanding of the internal control systems and their actual operation.

After assimilating the internal control system, the auditor needs to examine whether and how far the same is actually in operation. Selective testing is done by application of procedural tests and auditing in depth.

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

As defined in scope of the Standards on Internal Audit, Internal Audit means "An independent management function, which involves a continuous and critical appraisal of the functioning of an entity with a view to suggest improvements thereto and add



value to and strengthen the overall governance mechanism of the entity, including the entity's strategic risk management and internal control system".

Clause (i) of Sub-section 3 of Section 143 of the Act requires the auditors' report to state whether the company has adequate internal financial controls system in place and the operating effectiveness of such controls. The auditor's objective in an audit of internal financial controls over financial reporting is, "to express an opinion on the effectiveness of the company's internal financial controls over financial reporting." It is carried out along with an audit of the financial statements.

## TEST YOUR KNOWLEDGE

### MCQs

1. Audit risk is a function of the risks of material misstatement and \_\_\_\_\_
  - (a) detection risk.
  - (b) inherent risk
  - (c) control risk
  - (d) business risk
2. For a given level of audit risk, the acceptable level of detection risk bears \_\_\_\_\_ relationship to the assessed risks of material misstatement at the assertion level.
  - (a) direct.
  - (b) Inverse
  - (c) no
  - (d) none of the above
3. Risk of material misstatement has \_\_\_\_\_ components
  - (a) one
  - (b) two
  - (d) three
  - (d) four
4. Controls can be \_\_\_\_\_ related to an assertion.
  - (a) directly
  - (b) indirectly
  - (c) directly or indirectly
  - (d) none of the above

5. Control activities, whether within IT or manual systems, have various objectives and are applied at various organisational and functional levels. Which of the following is an example of control activities:
- (a) Authorization.
  - (b) Performance reviews.
  - (c) Information processing.
  - (d) All of the above

### Correct/Incorrect

**State with reasons (in short) whether the following statements are correct or incorrect:**

- (i) As per section 138 of the Companies Act, 2013 private companies are not required to appoint internal auditor.
- (ii) There is direct relationship between materiality and the degree of audit risk.
- (iii) Control risk is the susceptibility of an account balance or class of transactions to misstatement that could be material either individually or, when aggregated with misstatements in other balances or classes, assuming that there were no related internal controls.
- (iv) Tests of control are performed to obtain audit evidence about the effectiveness of Internal Controls Systems.
- (v) Maintenance of Internal Control System is the responsibility of the Statutory Auditor.

### Theoretical Questions

- 1. "The auditor shall obtain an understanding of the major activities that the entity uses to monitor internal control over financial reporting" Explain
- 2. "**Risk of material misstatement** consists of two components" Explain clearly defining risk of material misstatement
- 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
- 4. "The auditor shall obtain an understanding of the control environment" Explain stating what is included in control environment.

### ANSWERS/SOLUTIONS

#### Answers to MCQs

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

### Answers to Correct/Incorrect

- (i) **Incorrect:** Section 138 of the Companies Act, 2013 requires every private company to appoint an internal auditor having turnover of ₹ 200 crore or more during the preceding financial year; or outstanding loans or borrowings from banks or public financial institutions exceeding ₹ 100 crore or more at any point of time during the preceding financial year.
- (ii) **Incorrect:** There is an inverse relationship between materiality and the degree of audit risk. The higher the materiality level, the lower the audit risk and vice versa. For example, the risk that a particular account balance or class of transactions could be misstated by an extremely large amount might be very low but the risk that it could be misstated by an extremely small amount might be very high.
- (iii) **Incorrect:** Inherent risk is the susceptibility of an account balance or class of transactions to misstatement that could be material either individually or, when aggregated with misstatements in other balances or classes, assuming that there were no related internal controls.
- (iv) **Correct:** Tests of Control are performed to obtain audit evidence about the effectiveness of :
- (a) the design of the accounting and internal control systems that is whether, they are suitably designed to prevent or detect or correct material misstatements and
  - (b) the operation of the internal controls throughout the period.
- (v) **Incorrect:** 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. Maintenance of Internal Control System is responsibility of management because the internal control is the process designed, implemented and maintained by those charged with governance/management to provide reasonable assurance about the achievement of entity's objectives.

### Answers to Theoretical Questions

1. Refer Para 3.
2. Refer Para 1.
3. Refer Para 1.5
4. Refer Para 3.