Chapter 4 INTERNAL CONTROLS AND RISK ASSESSMENT
Compilation of Important ICAI Question Answers

Question: In exercising judgment as to which risks are significant risks, the auditor shall consider the factors as per SA 315. Comment.

Answer: 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.

Identifying Significant Risks: Significant risks often relate to significant nonroutine 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.

Question : Briefly discuss the limitations of Internal Control. (6 **Marks) (May 2018)**

Answer: 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.

(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.

Question : XYZ & Associates, Chartered Accountants, while evaluating the operating effectiveness of internal controls, detects deviation from controls. In such a situation, state the specific inquiries to be made by an auditor to understand these matters and their potential consequences. (5 **Marks) (May 2018)**

Answer: Evaluating the Operating Effectiveness of Controls: When evaluating the operating effectiveness of relevant controls, the auditor shall evaluate whether misstatements that have been detected by substantive procedures indicate that controls are not operating effectively. The absence of misstatements detected by substantive procedures, however, does not provide audit evidence that controls related to the assertion being tested are effective.

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

(a) The tests of controls that have been performed provide an appropriate basis for reliance on the controls;

(b) Additional tests of controls are necessary; or

(c) The potential risks of misstatement need to be addressed using substantive procedures.

A material misstatement detected by the auditor's procedures is a strong indicator of the existence of a significant deficiency in internal control.

Question : "A multinational co. wants to appoint you to carry the statutory audit." Discuss with reference to SA 330 the substantive procedures to be performed to assess the risk of material misstatement. **(Nov. 2018)** (6 Marks)

Answer: Substantive procedures to be performed to assess the risk of material misstatement:

Irrespective of the assessed risks of material misstatement, the auditor shall design and perform substantive procedures for each material class of transactions, account balance, and disclosure.

1. This requirement reflects the facts that:
   (i) the auditor's assessment of risk is judgmental and so may not identify all risks of material misstatement; and
   (ii) there are inherent limitations to internal control, including management override.
2. Depending on the circumstances, the auditor may determine that:
   Performing only substantive analytical procedures will be sufficient to reduce audit risk to an acceptably low level. For example, where the auditor's assessment of risk is supported by audit evidence from tests of controls.
   Only tests of details are appropriate.
   A combination of substantive analytical procedures and tests of details are most responsive to the assessed risks.
3. Substantive analytical procedures are generally more applicable to large volumes of transactions that tend to be predictable over time. SA 520, "Analytical Procedures" establishes requirements and provides guidance on the application of analytical procedures during an audit.
4. The nature of the risk and assertion is relevant to the design of tests of details. For example, tests of details related to the existence or occurrence assertion may involve selecting from items contained in a financial statement amount and obtaining the relevant audit evidence. On the other hand, tests of details related to the completeness assertion may involve selecting from items that are expected to be included in the relevant financial statement amount and investigating whether they are included.
5. Because the assessment of the risk of material misstatement takes account of internal control, the extent of substantive procedures may need to be increased when the results from tests of controls are unsatisfactory.
6. In designing tests of details, the extent of testing is ordinarily thought of in terms of the sample size. However, other matters are also relevant, including whether it is more effective to use other selective means of testing.

Question : "MMJ Ltd., an unlisted public company, did not appoint any internal auditor for the financial year ending on 31st March, 2019. The company had paid up capital of ` 20 crores and reserves of ` 25 crores. Its turnover for the preceding 3 years were ` 75 crores for the year ended 31st March, 2018, ` 150 crores for March, 2017 and ` 190 crores for March, 2016. The company had availed term loan from the bank of `130 crores. The outstanding balance of the term loan as on 31st March, 2018 is ` 90 crores."

As an auditor of the company, how would you deal with the abov? **(Nov. 2018)** (5 Marks)

Answer: As per section 138, 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;

In view of above provisions, MMJ Ltd would have to appoint internal auditor for the financial year 31-03-2019 because it had availed a term loan from the bank of ` 130 Crores. The outstanding balance of term loan as on 31-03-2018 ` 90 crores would not make any difference because section is contemplating outstanding at any point of time during the preceding financial year.

Question : Discuss the various points which auditor needs to consider in determining whether it is appropriate to use audit evidence about operating effectiveness of controls obtained in previous audit, and if so, the length of the time period that may elapse before retesting. **(Nov., 2019) (4 Marks)**

Answer: In determining whether it is appropriate to use audit evidence about the operating effectiveness of controls obtained in previous audits, and, if so, the length of the time period that may elapse before retesting a control, the auditor shall consider the following:

i. The effectiveness of other elements of internal control, including the control environment, the entity's monitoring of controls, and the entity's risk assessment process;
ii. The risks arising from the characteristics of the control, including whether it is manual or automated;
iii. The effectiveness of general IT-controls;
iv. The effectiveness of the control and its application by the entity, including the nature and extent of deviations in the application of the control noted in previous audits, and whether there have been personnel changes that significantly affects the application of the control;
v. Whether the lack of a change in a particular control poses a risk due to changing circumstances; and
vi. The risks of material misstatement and the extent of reliance on the control.

Question : Board of Directors of MN Ltd. wants to appoint CA B, a practicing Chartered Accountant, as an internal auditor of the company as they believe that they could not appoint any other person as an internal auditor other than practicing chartered accountant. **(Nov., 2019) (3 Marks)**

Examine the correctness of the statement of Board of Directors of MN Ltd. with respect to provisions of Companies Act, 2013.

Answer:

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

Question : "Inadequate internal control over assets may increase the susceptibility of misappropriation of those assets." State any three examples of such occurrence of misappropriation of such assets. **(Nov., 2019) (4 Marks)**

Answer: Inadequate internal control over assets may increase the susceptibility of misappropriation of those assets. For example, misappropriation of assets may occur because there is the following:

(i) Inadequate segregation of duties or independent checks.
(ii) Inadequate oversight of senior management expenditures, such as travel and other reimbursements
(iii) Inadequate record keeping with respect to assets.
(iv) Inadequate system of authorization and approval of transactions (for example, in purchasing).

(v) Inadequate physical safeguards over cash, investments, inventory, or fixed assets. (vi) Lack of complete and timely reconciliations of assets.
(vii) Lack of timely and appropriate documentation of transactions, for example, credits for merchandise returns.
(viii) Lack of mandatory vacations for employees performing key control functions.
(ix) Inadequate management understanding of information technology, which enables information technology employees to perpetrate a misappropriation.
(x) Inadequate access controls over automated records, including controls over and review of computer systems event logs.

Question: The auditor shall obtain an understanding of major activities that the entity uses to monitor internal control over financial reporting. Discuss "Monitoring of control" as a component of Internal control. **(Nov. 2020) (4 Marks)**

Answer: 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.

Monitoring of controls Defined: ***Monitoring of controls is a process to assess the effectiveness of internal control performance over time.***

(i) 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.
(ii) 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.
(iii) 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.
(iv) 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.

Question : What factors are to be considered by an auditor while making control risk assessments? **(Nov. 2020) (3 Marks)**

Answer: Auditor assesses control risk as Rely or Not rely on Controls.

When making control risk assessments, the factors an auditor would consider are:

The control environment's influence over internal control. A control environment that supports the prevention, detection and correction of material misstatements allows greater confidence in the reliability of internal control and audit evidence generated within the entity.

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.

Question: Explain how Internal Financial Control and Internal controls over financial reporting differ?
(Jan. 2021) (4 Marks)

Answer: 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.

Question : Discuss the objectives and scope of internal audit functions with respect to activities relating to internal control. **(Jan. 2021)** (3 Marks)

Answer: The objectives and scope of internal audit functions relating to Internal Control are:

(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.

(iv) **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.

Question : In case of certain subject matters, ***limitations on the auditor's ability to detect material misstatements are particularly significant.*** Explain such assertions or subject matters. **(July 2021) (3 Marks)**

Answer: In case of certain subject matters, limitations on the auditor's ability to detect material misstatements are particularly significant. Such assertions or subject matters include:

- **Fraud**, particularly fraud involving senior management or collusion
- The existence and completeness of **related party relationships** and transactions.
- The occurrence of **non-compliance** with laws and regulations.
- **Future events** or conditions that may cause an entity to cease to continue as a **going concern**.

Question : CA L is in the process of finalizing his Risk Assessment Procedures of Effluent Limited which include observation and inspection that may support inquiries of management and others. Discuss few examples of audit procedures which include observation or inspection of the entity's operations. **(July 2021) (3 Marks)**

Answer: Observation and inspection may support inquiries of management and others, and may also provide information about the entity and its environment.

Examples of audit procedures which include observation or inspection of the entity's operations are:

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

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

(3) The entity's premises and plant facilities.

Question : Care Ltd. is an unlisted public limited company, During the financial year 2019 -20, the paid-up share capital of Care Ltd. was INR 50 crore and the turnover was INR 80 crore. During the financial year 2020-21, the Board of Directors of the company appointed an internal auditor. Whether Care Ltd. is required to appoint an internal auditor according to the provisions of the Companies act, 2013? **(July 2021) (3 Marks)**

Answer: As per section 138 of the Companies Act, 2013: 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.

Conclusion: Applying the above to the given problem, since Care Ltd is an unlisted public company and having paid up share capital of ` 50 crores during the preceding F.Y. 2019-20, therefore, Care Ltd is required to appoint an Internal Auditor.

Question : Auditor or Sunshine Ltd. is of the view that due to greater management intervention to specify accounting treatment, the risk of material misstatement is greater for non-routine transactions. Is the view of the auditor correct? Specify the other matters due to which the risk of material misstatement is greater for significant non-routine transactions.**(Dec.2021) (3 Marks)**

Answer: **Risk of Material Misstatement – Greater for Significant Non-Routine Transactions**:

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.

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:

(a) Greater management intervention to specify the accounting treatment.
(b) Greater manual intervention for data collection and processing.
(c) Complex calculations or accounting principles.
(d) The nature of non-routine transactions, which may make it difficult for the entity to implement effective controls over the risks.

Keeping in view above, view of Auditor of Sunshine Ltd is correct.

Question : Define Audit risk. "Risk of material misstatement consists of two components" Explain clearly defining risk of material misstatement.

Answer:

Audit risk means the risk that the auditor gives an inappropriate audit opinion when the financial statement 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.
- There is always a risk that before considering any existence of internal control in an entity, a particular transaction, balance of an account or a disclosure required to be made in the financial statements of an entity have a chance of being misstated and such misstatement can be material.
- This risk is known as Inherent Risk.

(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.
- Control Risk is a risk that internal control existing and operating in an entity would not be efficient enough to stop from happening, or find and then rectify in an appropriate time, any material misstatement relating to a transaction, balance of an account or disclosure required to be made in the financial statements of that entity.
- So in a way it can be said that there exists an inverse relation between Control Risk and Efficiency of Internal Control of an Entity.
- When efficiency of internal control of an entity is high the control risk is low and when efficiency of internal control of that entity is low the control risk is high.

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

Question: "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

Answers: 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
  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.

Question: State what is not included in Audit Risk?

Answer (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

Question: "The auditor shall obtain an understanding of the control environment" Explain stating what is included in control environment.

Answer:

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.

Question.

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. Explain

Answer:

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.

Question:

Obtaining an understanding of the entity and its environment, including the entity's internal control, is a continuous, dynamic process of gathering, updating and analysing information throughout the audit. Analyse and explain giving examples.

Answer:.

Obtaining an understanding of the entity and its environment, including the entity's internal control, 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.

Question:
Internal control over safeguarding of assets against unauthorised acquisition, use, or disposition may include controls relating to both financial reporting and operations objectives. Explain stating clearly the objectives of Internal Control.
Answer:
Objectives of Internal Control
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.
Objectives of Internal Control are:
(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.

Question:
It has been suggested that actual operation of the internal control should be tested by the application of procedural tests and examination in depth. Explain with the help of example in respect of the procedure for sales.
Answer:
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.
For example, the **procedure for sales requires** the following:

1. 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.
2. 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.
3. 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.
4. The rate at which the order has been accepted and other terms about transport, insurance, etc., should be clearly specified.
5. 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.

Question: Risks of Material Misstatement exists at Two levels. Comment

Answer: 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.

QUESTION: EXPLAIN the concept of Detection risk

ANSWER:

- 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.
- Suppose auditor of a company uses certain audit procedures for the purpose of obtaining audit evidence and reducing audit risk, but still there will remain a risk that audit procedures used by the auditor may not be able to detect a misstatement which by nature is material, then that risk is known as Detection Risk.
- **Example** While auditing the books of accounts of Grateful Limited for the financial year 2021-22, the auditor of the above mentioned company used various audit procedures, for example-observation, inspection, reperformance, recalculation etc for obtaining audit evidence regarding stock, Debtors, sales, purchases etc., and consequently reducing the audit risk. However, there will always remain a risk that various audit procedures as used by auditor of Grateful Limited will not be able to detect misstatements which are material in nature. This risk is known as Detection Risk.

QUESTION: 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.

ANSWER:

- 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.

QUESTION: 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. EXPLAIN RISK ASSESSMENT PROCEDURE.

ANSWER: Risk Assessment Procedures (SA 315)

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.

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.

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**

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 and related activities may be used by the auditor as audit evidence to support assessments of the risks of material misstatement.

Question: 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. Give Examples.

ANSWER:

♦ 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 t

♦ 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.

Question: What does test of control include. State with example?

Answer: 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 control.

Question: 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./ Auditor to obtain knowledge of clients business. E**xplain.

Answer:

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

The auditor shall, as per SA 315, 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.

Question: Name the components of Internal Control

Answer: The division of internal control into the following five components (as stated in SA 315) 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

QUESTION: what are the Factors relevant to the auditor's judgment about whether a control, individually or in combination with others, is relevant to the audit.

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.

Question: "The auditor shall obtain an **understanding of the information system**, including the related business processes, relevant to financial reporting" comment.

Answer: 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

QUESTION Satisfactory Control Environment – not an absolute deterrent to fraud. Comment.
ANSWER

- 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.

Question: Information technology generally benefits the internal control system of the entity, at the same time it poses specific risks to the system, explain.

Answer:

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.

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 require

Question: WRITE SHORT NOTE ON Narrative Record

Answer: 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.

Question: WRITE SHORT NOTE ON Check list

Answer: A Check List

1.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.

2.This is again an on the job requirement and instructions are framed having regard to the desirable elements of control.

3.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?

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

Question: WRITE SHORT NOTE ON Internal Control Questionnaire

Answer:

Internal Control Questionnaire

1.This is a comprehensive series of questions concerning internal control.

2.This is the most widely used form for collecting information about the existence, operation and efficiency of internal control in an organisation.

3.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.

4.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.

5.The questionnaire form also provides an orderly means of disclosing control defects.

6.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.

7.The questionnaire is usually issued to the client and the client is requested to get it filled by the concerned executives and employees.

8.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.

9.The concerned auditor then prepares a report of deficiencies and recommendations for improvement.

Question: WRITE SHORT NOTE ON **Flow Chart:**

Answer: 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.

Question – Make a list of Standards on Internal Audit (SIA) issued by ICAI

Ans. 100 Series: Standards on Key Concepts

→ Standard on Internal Audit (SIA) 110, Nature of Assurance

→ Standard on Internal Audit (SIA) 120, Internal Controls

- 200 Series: Standards on Internal Audit Management

→ Standard on Internal Audit (SIA) 210, Managing the Internal Audit Function

→ Standard on Internal Audit (SIA) 220, Conducting Overall Internal Audit Planning

→ Standard on Internal Audit (SIA) 230, Objectives of Internal Audit

→ Standard on Internal Audit (SIA) 240, Using the Work of an Expert

- 300–400 Series: Standards on the Conduct of Audit Assignments

→ Standard on Internal Audit (SIA) 310, Planning the Internal Audit Assignment

→ Standard on Internal Audit (SIA) 320, Internal Audit Evidence

→ Standard on Internal Audit (SIA) 330, Internal Audit Documentation

→ Standard on Internal Audit (SIA) 350, Review and Supervision of Audit Assignments

→ Standard on Internal Audit (SIA) 360, Communication with Management

→ Standard on Internal Audit (SIA) 370, Reporting Results

→ Standard on Internal Audit (SIA) 390, Monitoring and Reporting of Prior Audit Issues

- Standards issued up to July 1, 2013

→ Standard on Internal Audit (SIA) 5, Sampling

→ Standard on Internal Audit (SIA) 6, Analytical Procedures

→ Standard on Internal Audit (SIA) 7, Quality Assurance in Internal Audit

→ Standard on Internal Audit (SIA) 11, Consideration of Fraud in an Internal Audit

→ Standard on Internal Audit (SIA) 13, Enterprise Risk Management

→ Standard on Internal Audit (SIA) 14, Internal Audit in an Information Technology Environment

→ Standard on Internal Audit (SIA) 17, Consideration of Laws and Regulations in an Internal Audit

→ Standard on Internal Audit (SIA) 18, Related Parties

***Question* – Differentiate between internal audit and statutory audit.**

Internal Auditor/Audit	Statutory Auditor/Audit
(1) Examines activities / operations	(1) Examines financial statements
(2) Reporting on operational effectiveness	(2) Opinion on financial statements (true and fair)
(3) Appointment by management	(3) Appointment is generally made by members
(4) Report to management	(4) Report to members
(5) In case of companies, applicable only for prescribed classes of companies	(5) In case of companies, every company is required to get its accounts audited for every financial year.
(6) By CA or Cost Accountant or other Professional (u/s 138)	(6) By CA (u/s 141)
(7) Less independent	(7) More independent
(8) Follows Standards on Internal Auditing (SIA)	(8) Follows Standards on Auditing (SA)
(9) Part of Internal Control system	(9) Reviews Internal Control system [SA 610]

Question 1 (a) Few members of the Board of Directors oppose the appointment of Mr. N, an employee of the company, as an Internal Auditor, stating that Mr. N is not a chartered accountant and further he is an employee of the company. (2 **Marks) (May 2018)**

Answer (a) Incorrect: 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.

Question 1 (d) Inquiry alone is sufficient to test the operating effectiveness of controls. (2 **Marks) (May 2018)**

Answer (d) Incorrect: Inquiry along with other audit procedures (for example observation, inspection, external confirmation etc.) would only enable the auditor to test the operating effectiveness of controls. Inquiry alone is not sufficient to test the operating effectiveness of controls.

Question 1 (B) Satisfactory Control environment is not an absolute deterrent to fraud. **(May 2019) (2 Marks)**

Answer (B) Correct**-** The existence of a Satisfactory Control environment can be a positive factor when an auditor assesses the risk of material misstatement. However, although it may help reduce the risk of fraud, a satisfactory Control environment is not an absolute deterrent to fraud.

Question 1 (a) The auditor's reporting on internal financial control will be applicable with respect to interim financial statements. **(Nov., 2019) (2 Marks)**

Answer(a) Incorrect: 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.

Question 1 (h) For an auditor, the Risk assessment procedure provides sufficient appropriate audit evidence to base the audit opinion. **(Nov., 2019) (2 Marks)**

Answer (h) Incorrect: 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.

Question 1 (g) Risks of material misstatement may be greater for significant judgmental matter s that require the development of accounting estimates. **(Nov. 2020) (2 Marks)**

Answer (g) Correct: 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.

Question 1 (d) The objectives and scope of internal audit functions are restricted to activities relating to evaluation of internal control only. **(Jan. 2021)** (2 Marks)

Answer (d) Incorrect: 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.

From the above, it can be concluded that the objective and scope of internal audit function are not restricted to activities relating to evaluation of control only.

Question 1 (a) Internal control cannot eliminate risk of material misstatements in the financial statements **(Dec.2021)(2marks)**

Answer (a)**Correct:** 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.

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