Ch. 4 Materiality, Risk Assessment and Internal Control

I - Materiality & Risk Assessment

1) As per **SA 320**, the **concept of materiality** is applied by the auditor both in **planning and performing the audit**, and in evaluating the effect of identified misstatements on the audit and of uncorrected misstatements, if any, on the financial statements and in forming the opinion in the auditor's report.
2) Materiality **and audit risk** are considered throughout the audit, in particular,
   a) When 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.
3) **Risk assessment** assesses the **level of risk** in the various business processes. Risk assessment focuses on the business environment, regulatory environment, organisation structure, organizational and business environmental changes and specific concerns of management and the audit committee to determine the areas of greatest risk.

AUDIT RISK

1) 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.
2) Audit risk is a **function of the risks of material misstatement and detection risk.**

AUDIT RISK COMPONENTS

INHERENT RISK

1) **Susceptibility of an assertion** to a misstatement that could be **material**, individually or when aggregated with other misstatements, **assuming that there are no related controls.** Inherent risk is addressed at both the financial statement level and at the assertion level.
2) **Risks** of particular concern to the auditor might **include:**
   a) Complex calculations which could be misstated;
   b) High value inventory;
   c) Accounting estimates that are subject to significant measurement uncertainty
   d) Lack of sufficient working capital to continue operations;
   e) A declining or volatile industry with many business failures; and
   f) Technological developments that might make a particular product obsolete.

CONTROL RISK

1) **Risk** that the entity's internal control system will **not prevent, or detect and correct** on a timely

basis, a **misstatement** that could be **material**, individually or when aggregated with other misstatements.

2) Some control risk will always exist because of inherent limitations of any internal control system.
3) The auditor is required to understand the entity's internal control and perform procedures to assess the risks of material misstatement at the assertion level.

DETECTION RISK

1) This is the **risk** that the auditor will **not detect a misstatement** that **exists** in an assertion that could be **material**, either individually or when aggregated with other misstatements.
2) The **acceptable level of detection risk** for a given level of audit risk bears an **inverse relationship** to the risks of material misstatement at the assertion level.
3) In **designing and evaluating** the results of performing procedures, the auditor should consider the possibility of:
   a) **Selecting** an inappropriate audit procedure;
   b) **Misapplying** an appropriate audit procedure; or
   c) **Misinterpreting** the results from an audit procedure.

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

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

It should be noted that the combined level of Inherent Risk and Control Risk is inversely related with Detection Risk, and Audit Materiality is also inversely related with Audit Risk.

ASSERTION

OBJECTIVE OF AUDIT

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

ASSERTIONS ABOUT CLASSES OF TRANSACTIONS AND EVENTS FOR THE PERIOD UNDER AUDIT

a) **Occurrence:** Transactions and events that have been recorded have occurred and pertain to the entity.
b) **Completeness:** All transactions and events that should have been recorded have been recorded.
c) **Accuracy:** Amounts and other data relating to recorded transactions and events have been recorded appropriately.

d) **Cut-off:** Transactions and events have been recorded in the correct accounting period.
e) **Classification:** Transactions and events have been recorded in the proper accounts.

ASSERTIONS ABOUT ACCOUNT BALANCES AT THE PERIOD END

a) **Existence:** Assets, liabilities, and equity interests exist.
b) **Rights and obligations:** The entity holds or controls the rights to assets, and liabilities are the obligations of the entity.
c) **Completeness:** All assets, liabilities and equity interests that should have been.
d) **Valuation and allocation:** Assets, liabilities, and equity interests are included in the FS at appropriate amounts and any resulting valuation or allocation adjustments are appropriately recorded.

ASSERTIONS ABOUT PRESENTATION AND DISCLOSURE

a) **Occurrence and rights and obligations:** Disclosed events, transactions, and other matters have occurred and pertain to the entity.
b) **Completeness:** All disclosures that should have been included in the financial statements have been included.
c) **Classification and understandability:** Financial information is appropriately presented and described, and disclosures are clearly expressed.
d) **Accuracy and valuation:** Financial and other information are disclosed fairly and at appropriate amounts."

NOTES:

1) Auditors are required to assess the risks of material misstatement at two levels. **The first is at the overall financial statement level**, which refers to risks of material misstatement that relate pervasively to the financial statements as a whole and potentially affect many assertions.
2) **The second relates to risks identifiable with specific assertions at the class of transactions, account balance, or disclosure level.** This means that for each account balance, class of transactions and disclosure, an assessment of risk (such as high, moderate, or low) should be made for each individual assertion being addressed.

STEPS FOR RISK IDENTIFICATION

1) **Assess** the **significance of the assessed risk**, impact of its occurrence .
2) **Determine** the **likelihood for assessed risk** to occur and its impact on our auditing procedures.
3) **Document** the **assertions** that are effected.
4) **Consider** the **impact of the risk** on each of the assertions relevant to the account balance, class of transactions, or disclosure.
5) **Identify the degree of Significant risks** that would require separate attention and response by the auditor.
6) **Enquire and document** the management's response.

7) Consider the **nature of the internal control system** in place and its possible effectiveness in mitigating the risks involved. **Ensure the controls :**
   a) Routine in nature (occur daily) or periodic such as monthly.
   b) Designed to prevent or detect and correct errors.
   c) Manual or automated.
8) Consider any **unique characteristics** of the risk.

POSSIBLE POTENTIAL MISSTATEMENTS - INDICATIONS

COMPLETENESS

a) Transactions not identified
b) Source documents not prepared
c) Source documents not captured
d) Rejected source documents not represented

EXISTENCE

a) Fictitious or unauthorised transactions entered on source documents
b) Source documents overstated.
c) Transactions duplicated on source documents
d) Capture of source documents duplicated
e) Invalid source documents captured on subsidiary ledgers

RECORDING

a) Source documents captured inaccurately
b) Processing of transactions is inaccurate
c) Inaccurate adjustments made in subsidiary ledgers

CUT-OFF PROCEDURES

Transactions that occur in one period are recorded in another period.

II- Risk-based Audit Approach

1) **Risk-based audit (RBA) is an approach to audit that analyzes audit risks, sets materiality thresholds based on audit risk analysis and develops audit programmes that allocate a larger portion of audit resources to high-risk areas.**
2) RBA is **an essential element** of financial audit- both in the attest audit of the financial statements and in the audit of financial systems and transactions including evaluation of internal controls.
3) It focuses primarily on the **identification and assessment of the financial statement misstatement** risks and provides a framework to reduce the impact to the financial statement of these identified risks to an acceptable level before rendering an opinion on the financial statements.

4) It also provides **indicators of risks** as a basis of opportunity for **improvement of auditee risk management and control processes**.
5) In the context of **performance audit**, it is the risk to delivery of an activity or scheme or programme of the entity with **economy, efficiency and effectiveness**.

GENERAL STEPS IN THE CONDUCT OF RBA

This involves the following three key steps:

a) **Risk assessment:** Assessing the risks of material misstatement in the financial statements
b) **Risk response:** Designing and performing further audit procedures that respond to assessed risks and reduce the risks of material misstatements in the financial statements to an acceptably low level; and
c) **Reporting:** Issuing an appropriate audit report based on the audit findings.

A) RISK ASSESSMENT

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

1) **Performing** client **acceptance or continuance** procedures;
2) **Planning** the overall engagement;
3) Performing **risk assessment procedures** to understand the business and identify inherent and control risks;
4) **Identifying relevant internal control** procedures and assessing their design and implementation
5) **Assessing** the risks of material misstatement in the financial statements;
6) **Identifying the significant risks** that require special audit consideration
7) Communicating any material weaknesses in the **design and implementation of internal control** to management and TCWG and
8) Making an **informed assessment** of the risks of material misstatement at the financial statement level.

B) RISK RESPONSE

1) This phase of the audit is to **design and perform** further audit procedures that **respond** to the **assessed risks of material misstatement**.
2) **Matters** the **auditor** should consider when **planning** the audit procedures include:
   a) **Assertions** that cannot be addressed by substantive procedures alone.
   b) **Existence of internal control** that, if tested, could reduce the need/scope for other substantive procedures.
   c) The **potential for substantive analytical procedures** .
   d) The **need to incorporate** an element of unpredictability in procedures performed.
3) **Audit procedures designed to address the assessed risks could include a mixture of:**
   a) Tests of the operational effectiveness of internal control; and
   b) Substantive procedures such as **tests of details** and **analytical procedures**.

C) REPORTING

1) The **final phase** of the audit is to assess the audit evidence obtained and determine whether it is sufficient and appropriate to reduce the risks of material misstatement in the financial statements to an acceptably low level.
2) **It is important at this stage to determine:**
   a) If there had been a **change** in the assessed level of risk;
   b) Whether **conclusions drawn** from work performed are appropriate; and
   c) If any **suspicious** circumstances have been encountered.
3) Any additional risks should be **appropriately assessed**, and further audit procedures performed as required.
4) **When all procedures have been performed and conclusions reached:**
   a) **Audit findings** should be reported to management and those charged with governance; and
   b) An **audit opinion** should be formed, and a decision made on the appropriate wording for the auditor's report.

AUDIT RISK ANALYSIS

1) The auditor should **perform an analysis** of the audit risks that impact on the auditee before undertaking specific audit procedures.
2) It is the **risk** that the auditor may **unknowingly fail** to appropriately modify his opinion on financial statements that are materially misstated.
3) Audit risks are brought about by error and fraud:
   a) Error is an unintentional mistake resulting from omission, as when legitimate transactions and/or balances are excluded from the financial statements; or by commission, as when erroneous transactions and/or balances are included in the financial statements.
   b) Fraud is an intentional misstatement in the accounting records or supporting documents from which the financial statements are prepared. It is intended to deceive financial statement users or to conceal misappropriations.
4) **Fraud risk involves:**
   a) **Manipulation, falsification** of accounting records, or
   b) **Misrepresentation** in the financial statements of events, transactions or other significant information, or
   c) **Misapplication** of accounting principles or
   d) **Misappropriation** of funds.

III- Internal Control System

WHAT IS INTERNAL CONTROL SYSTEM

1) **"Internal Control System" means** all the policies and procedures (internal controls) adopted by the management of an entity to assist in achieving management's objective of ensuring, as far as practicable,
   a) The **orderly and efficient** conduct of its business,
   b) Including **adherence** to management policies,
   c) The **safeguarding of assets,**
   d) The **prevention and detection** of fraud and error,
   e) The **accuracy and completeness** of the accounting records, and
   f) The **timely** preparation of reliable financial information.
2) **SA 315 defines the system of internal control as the process designed, implemented and maintained by those charged with governance, management and other personnel to provide reasonable assurance about the achievement of an entity's objectives with regard to**
   a) **Reliability of financial reporting,**
   b) **Effectiveness and efficiency of operations,**
   c) **Safeguarding of assets, and**
   d) **Compliance with applicable laws and regulations**

SCOPE OF INTERNAL CONTROLS

1) The **scope of internal controls** extends beyond mere accounting controls and includes all administrative controls concerned with the decision - making process leading to managements authorization of transaction.
2) In an independent financial audit, **the auditor is primarily concerned with those policies and procedures having a bearing on the assertions underlying the financial statements.**
3) These **comprise** primarily controls relating to
   a) Safeguarding of assets,
   b) Prevention and detection of fraud and error,
   c) Accuracy and
   d) Completeness of accounting records and
   e) Timely preparation of reliable financial information.
4) Fundamental to a system of internal control is that it is **integral** to the activities of the company, and not something practiced in isolation.

Internal Control System

Facilitates the effectiveness and efficiency of operations	Helps ensure the reliability of internal and external financial reporting	Assists compliance with laws and regulations	Helps safeguarding the assets of the entity

OBJECTIVES OF INTERNAL CONTROL SYSTEM

1) **The objectives of internal controls relating to the accounting system are:**
   a) Transactions are executed through general or specific management **authorization**.
   b) All transactions are **promptly recorded** in an appropriate manner.
   c) Assets and records are **safeguarded from unauthorized access, use or disposition.**
   d) Assets are **verified at reasonable intervals** and **appropriate action** is taken with regard to the **discrepancies**.
2) Precisely, the **control objectives** ensure that the transactions processed are complete, valid and accurate.
3) The basic accounting control objectives which are sought to be achieved by any accounting control system are :

Ensure all Transaction are :

Recorded	Real	Properly valued	Recorded timely	Properly posted	Properly classified & disclosed	Properly summarized

LIMITATIONS OF INTERNAL CONTROL

1) Internal control, no matter how effective, can provide an entity with only **reasonable assurance and not absolute assurance** about achieving the entity's operational, financial reporting and compliance objectives.
2) Internal control systems are subject to certain **inherent limitations**, such as:
   a) Management's consideration that the **cost** of an internal control **does not exceed** the **expected benefits** to be derived.
   b) The fact that most internal controls **do not tend** to be **directed** at transactions of unusual nature.
   c) The **potential for human error**.
   d) **Collusion with employees** or with **parties outside** the entity.
   e) The **possibility** that a person responsible for exercising an internal control could abuse that responsibility.
   f) **Manipulations by management** with respect to transactions or estimates.

STRUCTURE OF INTERNAL CONTROL

SEGREGATION OF DUTIES

1) Transaction processing is allocated to different persons in such a manner that no one person can carry through the completion of a transaction from start to finish or the work of one person is made complimentary to the work of another person.
2) The purpose is to minimize the occurrence of fraud and errors and to detect them on a timely basis, when they take place.
3) **The following functions are segregated –**
   a) **Authorization of transactions;**
   b) **Execution of transactions;**
   c) **Physical custody of related assets; and**
   d) **Maintenance of records and documents, while allocating duties.**

AUTHORIZATION OF TRANSACTION

1) Delegation of authority to different levels and to particular persons are required **to establish** by the management for controlling the execution of transaction in accordance with prescribed conditions.
2) Authorization may be **general** or it may be **specific** with reference to a single transaction.

ADEQUACY OF RECORDS AND DOCUMENTS

Accounting controls should **ensure** that –

a) Transactions are **executed** in accordance with management's **general or specific authorization.**
b) Transactions and other events are **promptly recorded** at correct amounts.
c) Transactions should be **classified in appropriate accounts** and in the appropriate period to which it relates.
d) Transaction should be **recorded** in a manner so as to facilitate preparation of financial statements in accordance with applicable accounting standards, other accounting policies and practices and relevant statutory requirements.
e) Recording of transaction should facilitate **maintaining accountability** for assets.

ACCOUNTABILITY AND SAFEGUARDING OF ASSETS

1) The process of accountability of assets **commences** from **acquisitions** of assets its **use** and **final disposal**. **Safeguarding of assets** requires appropriate maintenance of records, their periodic reconciliation with the related assets.
2) Assets like cash, inventories, investment scrips require frequent physical verification with book records.
3) The frequency of reconciliation would differ for different assets depending upon their nature and amount.
4) Assets which are considered **sensitive or susceptible to error** need to be **reconcile** more frequently than others.

5) For proper safeguarding of assets, **only authorized personnel** should be given **access** to such asset. This not only means physical access but also exercising control overprocessing of documents relating to authorization for use and disposal of assets.

INDEPENDENT CHECKS

Independent verification of the control systems, **designed and implemented** by the management, involves **periodic or regular review** by independent persons to ascertain whether the control procedures are operating effectively or not.

WHEN OBTAINING AUDIT EVIDENCE ABOUT THE EFFECTIVE OPERATION OF INTERNAL CONTROLS, THE AUDITOR CONSIDERS:

a) How they were applied,
b) The consistency with which they were applied during the period and
c) By whom they were applied.

EVALUATION OF DEVIATIONS

1) The concept of **effective operation recognises that some deviations** may have occurred. Deviations from prescribed controls may be caused by such factors as
   a) Changes in key personnel,
   b) Significant seasonal fluctuations in volume of transactions and
   c) Human error.
2) 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.**
3) **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.
4) The evaluation of deviations may result in the **auditor concluding that the assessed level of control risk needs to be revised**.
5) The **auditor** should consider whether the internal controls were in use throughout the period.

IV - Components Of Internal Controls

Internal Control System				
Control Environment	Entity's Risk Assessment Process	Control activities	Information system and communication	Monitoring of Controls

CONTROL ENVIRONMENT

The control environment encompasses the following elements:

a) **Communication and enforcement of integrity and ethical values:** The effectiveness of controls cannot rise above the integrity and ethical values of the people who create, administer, and monitor them.

b) **Commitment to competence:** Competence is the knowledge and skills necessary to accomplish tasks that define the individual's job.

c) **Participation by those charged with governance:** An entity's control consciousness is influenced significantly by TCWG. The importance of the responsibilities of TCWG is recognised in codes of practice and other laws and regulations or guidance produced for the benefit of TCWG.

d) **Management's philosophy and operating style:** Management's philosophy and operating style encompass a broad range of characteristics.

e) **Organisational structure:** Establishing a relevant organizational structure includes considering key areas of authority and responsibility and appropriate lines of reporting.

f) **Assignment of authority and responsibility:** The assignment of authority and responsibility may include policies relating to appropriate business practices, knowledge and experience of key personnel, and resources provided for carrying out duties.

g) **Human resource policies and practices:** Human resource policies and practices often demonstrate important matters in relation to the control consciousness of an entity.

ENTITY'S RISK ASSESSMENT PROCESS

1) The entity's risk assessment process includes how management **identifies business risks** relevant to the preparation of financial statements in accordance with the entity's **applicable FRF**, estimates their significance, assesses the likelihood of their occurrence, and decides upon actions to respond to and manage them and the results thereof.

2) **Risks can arise or change due to circumstances such as the following:**
   a) **Changes in operating environment.**
   b) **New personnel.**
   c) **New or revamped information systems.**
   d) **Rapid growth.**
   e) **New technology.**
   f) **New business models, products, or activities.**
   g) **Corporate restructurings.**
   h) **Expanded foreign operations.**
   i) **New accounting pronouncements.**

CONTROL ACTIVITIES

Generally, control activities that may be relevant to an audit may be categorised as policies and procedures that pertain to the following:

1) **Performance reviews:** These control activities include reviews and analyses of actual performance

versus budgets, forecasts, and prior period performance; relating different sets of data.

2) **Information processing:** The two broad groupings of information systems control activities are application controls, which apply to the processing of individual applications, and general IT-controls.
3) **Physical controls:** Controls that encompass:
   a) The physical security of assets, including adequate safeguards such as secured facilities over access to assets and records.
   b) The authorisation for access to computer programs and data files.
   c) The periodic counting and comparison with amounts shown on control records
4) **Segregation of duties:** Assigning different people the responsibilities of authorising transactions, recording transactions, and maintaining custody of assets. Segregation of duties is intended to reduce the opportunities to allow any person to be in a position to both perpetrate and conceal errors or fraud in the normal course of the person's duties.

INFORMATION SYSTEM, INCLUDING THE RELATED BUSINESS PROCESSES, RELEVANT TO FINANCIAL REPORTING, AND COMMUNICATION

1) An information system consists of infrastructure (physical and hardware components), software, people, procedures, and data. Many information systems make extensive use of information technology (IT).
2) **The information system relevant to financial reporting objectives, which includes the financial reporting system, encompasses methods and records that:**
   a) **Identify and record** all valid transactions.
   b) **Describe on a timely basis** the transactions in sufficient detail to permit proper classification of transactions for financial reporting.
   c) **Measure the value of transactions** in a manner that permits recording their proper monetary value in the financial statements.
   d) **Determine the time period** in which transactions occurred to permit recording of transactions in the proper accounting period.
   e) **Present properly** the transactions and related disclosures in the financial statements.

MONITORING OF CONTROLS

1) Management's monitoring of controls includes considering whether they are **operating as intended** and that they are modified as appropriate for changes in conditions.
2) **Monitoring of controls may include activities such as,**
   a) **Management's review** of whether bank reconciliations are being prepared on a **timely basis,**
   b) **Internal auditors' evaluation** of sales personnel's compliance with the entity's policies on terms of sales contracts, and
   c) **A legal department's oversight** of compliance with the entity's ethical or business practice policies.
3) Monitoring is done also to ensure that controls **continue to operate effectively** over time.

4) **Internal auditors or personnel performing similar functions may contribute to the monitoring** of an entity's controls through separate evaluations.
5) **Monitoring activities** may include using information from communications from external parties that may **indicate** problems or highlight areas in need of improvement.
6) In addition, regulators may communicate with the entity concerning matters that affect the functioning of internal control.

INTERNAL CHECK SYSTEM

1) Internal check system **implies** organization of the overall system of book-keeping and arrangement of Staff duties in such a way that **no one person can carry through a transaction** and **record every aspect thereof**.
2) **The following are the objectives of the internal check system:**
   a) **To detect** error and frauds with ease.
   b) **To avoid and minimize** the possibility of commission of errors and fraud by any staff.
   c) **To increase** the efficiency of the staff working within the organization.
   d) **To locate** the responsibility area or the stages where actual fraud and error occurs.
   f) **To prevent and avoid** the misappropriation or embezzlement of cash and falsification of accounts.
3) **The effectiveness of an efficient system of internal check depends on the following considerations-**
   (i) **Clarity of Responsibility** - The responsibility of different persons engaged in various operations of business transactions should be properly identified.
   (ii) **Division of Work** - The segregation of work should be made in such a manner that the free flow of work is not interrupted and also helps to determine that the work of one person is complementary to the other.
   (iii) **Standardization** - The entire process of accounting should be standardized by creating suitable policies commensurate with the nature of the business, so as to strengthen the system of internal check.
   (iv) **Appraisal** - Periodic review should be made of the chain of operations and workflow. Such process may be carried out by preparing an audit flow chart.
4) **The general condition pertaining to the internal check system may be summarized as under:**
   a) **No single person** should have **complete control** over any important aspect of the business operation. Every employee's action should come under the review of another person.
   b) **Staff duties** should be **rotated** from time to time so that members do not perform the same function for a considerable length of time.
   c) **Every member** of the staff should be encouraged to go on leave **at least once a year**.
   d) Persons having physical custody of assets must **not** be permitted to have access to the books of accounts.
   e) There should **exist** an accounting control in respect of each class of assets, in addition, there should be periodical inspection so as to establish their physical condition.

f) Mechanical devices should be used, where ever practicable **to prevent loss or misappropriation of cash.**

INTERNAL AUDIT

1) Internal audit may be defined as, an independent appraisal function established within an organization to examine and evaluate its activities as a service to the organization.
2) The scope of the internal audit is determined by the management. **(Refer Chapter 16 for more details)**

V - Review of the System of Internal Controls

1) The control environment **sets the tone of an organization**, influencing the control consciousness of its people.
2) 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.
3) **Implementation of a control** means that the **control exists** and that the **entity is using** it.
4) An **entity's system of internal control** contains **manual elements** and often contains **automated elements.**
5) The use of manual or automated elements in internal control also affects the manner in which transactions are **initiated, recorded, processed, and reported.**
6) **Manual elements** in internal control may be more suitable where **judgment and discretion** are required such as for the following circumstances:
   a) **Large, unusual** or **non-recurring** transactions.
   b) **Circumstances** where errors are difficult to **define, anticipate or predict.**
   c) In changing circumstances that require a control response outside the scope of an existing **automated control.**
   d) In monitoring the **effectiveness** of automated controls.

THE REVIEW OF THE INTERNAL CONTROL SYSTEM ENABLES THE AUDITOR

1) **To formulate** his opinion as to the **reliance** he may **place on the system** itself i.e. whether the system is such as would enable the management to produce a **true and fair** set of financial statements; and
2) **To locate** the **areas of weakness** in the system so that the audit programme and the nature, timing and extent of **substantive and compliance audit procedures** can be adjusted to meet the situation.

VI - Internal Control Assessment & Evaluation

Following are some of the key components to assess & evaluate the controls environment:

Standard Operating Procedures (SOPs): A well-defined set of SOPs helps define role, responsibilities, process & controls & thus helps clearly communicate the operating controls to all touch points of a process. The controls are likely to be clearly understood & consistently applied even during employee turnover.

1) Enterprise Risk Management	An organization which has **robust process** to identify & mitigate risks across the enterprise & its periodical review will assist in early identification of gaps & taking effective control measures.
2) Segregation of Job Responsibilities	Segregation of duties is an important element of control such that **no two commercial activities should be conducted by the same person.**
3) Job Rotation in Sensitive Areas	Any job carried out by the same person over a long period of time is likely to lead to **complacency & possible** misuse in sensitive areas. It is therefore important that in key commercial functions, the job rotation is regularly followed to avoid degeneration of controls.
4) Delegation of Financial Powers Document	A **clearly defined** document on delegation of powers allows controls to be clearly operated without being dependent on individuals.
5) Information Technology based Controls	With the advent of computers & enterprise resource planning (ERP) systems, it is much **easier to embed controls** through the system instead of being human dependent. The failure rate for IT embedded controls is likely to be low, is likely to have better audit trail & is thus easier to monitor.

TECHNIQUES OF EVALUATION OF INTERNAL CONTROL

The following are the methods of recording:

QUESTIONNAIRE

1) A questionnaire is a set of questions framed in an organised manner, about each functional area, which has as purpose the evaluation of the effectiveness of control and detection of its weakness if any.
2) A questionnaire **usually consists of several separate sections** devoted to areas such as purchases, sales, trade receivables, trade payables, wages, etc.
3) The questionnaire is **intended to be filled by the company executives** who are in charge of the various areas.
4) Questions are so framed as generally to dispense with the requirement of a detailed answer to each question. For this purpose, often **one general question is broken down into a number of questions and sub-questions** to enable the executive to provide a just 'Yes', 'No' or 'Not applicable' form of reply.

5) Questions are also framed in such a manner **that generally a "No" answer will reflect weakness in the control system**.
6) The only thing that should be borne in mind is that the scheme of **questions should be consistent, sequential, logical, and if possible corroborative**.
7) For the **first year of engagements issue of questionnaire is necessary**.
8) **For subsequent years**, the auditor, instead of issuing a questionnaire again, may request the client to confirm **whether any change in the nature and scope of business has taken place** that necessitated a corresponding change in the control system, or whether, even without a change in the nature and scope of business, the control system has undergone a change.
9) **If there has been a change**, the auditor should take note of its and enter appropriate comments on the relevant part of the questionnaire.

In the use of standardized internal control questionnaire, certain basic assumptions about elements of good control are taken into account. These are -

a) Certain procedures in general used by most business concerns are essential in achieving reliable internal control. This is a **time-tested assumption**.
b) Organisations are such that **permit** an extensive division of duties and responsibilities.
c) Employees concerned with accounting function are **not** assigned any custodial function.
d) **No single person** is thrust with the responsibility of completing a transaction all by himself.
e) The **work performed** by each one is **expected to come under review** of another in the usual course of routine.

CHECK LIST

1) It is a **series of instructions or questions** on internal control which the auditor must follow or answer. When a particular instruction is carried out, the auditor initials the space opposite the instruction.
2) If **it is in the form of a question**, the answer generally **'Yes', 'No' or 'Not Applicable'** is entered opposite the question.
3) A check list is more in the nature of a **reminder** to the auditor about the matters to be checked for testing the internal control system. While a questionnaire is basically a set of questions put to the client, a check list which may be in a **form of instructions**, **questions** or **just points** to be checked may be meant for the auditor's own staff it is a set of instructions or points; it may be meant for the client if it is in the form of questions.

The basic distinction between internal control questionnaire and check list are as under:

1) The ICQ incorporates a large number of detailed questions but the check list generally contains questions relating to the main control objective with the area under review.
2) ICQ, the weaknesses are highlighted by the 'Yes' while in the check list, it is indicated by 'No'.
3) The significance of 'No' in an ICQ does indicate a weakness but the significance of that weakness is not revealed automatically. However, in the check list, a specific statement is required where an apparent weakness may prove to be material in relation to the accounts as a whole.

FLOW CHART

1) It is a **graphic presentation** of internal controls in the organisation and is normally drawn up to show the controls in each section or sub-section.
2) As distinct from a narrative form, it provides the **most concise and comprehensive** way for reviewing the internal controls and the evaluator's findings.
3) It gives a **bird's eye view** of the system and is drawn up as a result of the auditor's review thereof. It should, however, not be understood that details are not reflected in a flow chart.
4) Essentially a flow chart is a **diagram full with lines and symbols** and, if judicious use of them can be made, it is probably the most effective way of presenting the state of internal controls in the client's organisation.

A properly drawn up flow chart can provide a neat visual picture of the whole activities of the section or department involving flow of documents and activities. More specifically it can show -

(i) At what point a document is raised internally or received from external sources;
(ii) The number of copies in which a document is raised or received;
(iii) The intermediate stages set sequentially through which the document and the activity pass;
(iv) Distribution of the documents to various sections, department or operations;
(v) Checking authorisation and matching at relevant stages;
(vi) Filing of the documents; and
(vii) Final disposal by sending out or destruction.

VII - Reporting to Clients on Internal Control Weaknesses

1) During the course of audit work, the audit may notice material weaknesses in the internal control system. Material weaknesses are defined as **absence of adequate controls on flow of transactions** that **increases the possibility of errors and frauds** in the financial statements of the entity.

   Example:

   In case, if monthly age-wise analysis of trade receivables is not performed then it may result in inadequate provisioning of bad debts for the fiscal year under audit.
2) The auditor should communicate such material weaknesses to the management or the audit committee, if any, on a timely basis. This communication should be, preferably, in writing through a letter of weakness or management letter.
3) **Important points with regard to such a letter are as follows:**

(a)	The letter lists down the area of weaknesses in the system and offers suggestions for improvement.
(b)	It should clearly indicate that it discusses only weaknesses which have come to the attention of the auditor as a result of his audit and that his examination has not been designed to determine the adequacy of internal control for management.

(c)	This letter serves as a valuable reference document for management for the purpose of revising the system and insisting on its strict implementation.
(d)	The letter may also serve to minimize legal liability in the event of a major defalcation or other loss resulting from a weakness in internal control.

In certain cases, the auditor was acquitted of the charge of negligence for employee's fraud in view of the fact that he had already informed the client about the unsatisfactory state in the specific areas of accounts and had suggested improvements which were not acted upon by the management.

SA 265 ON "COMMUNICATING DEFICIENCIES IN INTERNAL CONTROL TO THOSE CHARGED WITH GOVERNANCE AND MANAGEMENT"

1) This Standard on Auditing (SA) deals with the **auditor's responsibility to communicate appropriately to TCWG and management deficiencies in internal control that the auditor has identified in an audit of financial statements.** This SA does not impose additional responsibilities on the auditor regarding obtaining an understanding of internal control and designing and performing tests of controls over and above the requirements of SA 315 and SA 330.
2) The objective of the auditor is **to communicate** appropriately to those charged with governance and management deficiencies in internal control that the auditor has identified during the audit and that, in the auditor's professional judgment, are of sufficient importance to merit their respective attentions.
3) The auditor shall determine whether, on the basis of the audit work performed, the auditor has identified one or more deficiencies in internal control.
4) If the auditor has **identified** one or more deficiencies in internal control, the auditor shall determine, on the basis of the audit work performed, whether, individually or in combination, they constitute significant deficiencies.
5) The auditor shall communicate in writing **significant deficiencies** in internal control identified during the audit to TCWG on a timely basis.
6)

The auditor shall also communicate to management at an appropriate level of responsibility on a timely basis:	(a)	In writing, **significant deficiencies in internal control** that the auditor has communicated or intends to communicate to those charged with governance, unless it would be inappropriate to communicate directly to management in the circumstances; and
	(b)	**Other deficiencies in internal control** identified during the audit that have not been communicated to management by other parties and that, in the auditor's professional judgment, are of sufficient importance to merit management's attention.

7)	**The auditor shall include in the written communication of significant deficiencies in internal control:**	(a) A **description of the deficiencies** and an explanation of their potential effects; and
		(b) **Sufficient information** to enable TCWG and management to understand the context of the communication. In particular, the auditor shall explain that: i) The purpose of the audit was for the auditor to express an opinion on the financial statements; ii) The audit included consideration of internal control relevant to the preparation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of internal control; and iii) The matters being reported are limited to those deficiencies that the auditor has identified during the audit and that the auditor has concluded are of sufficient importance to merit being reported to those charged with governance.

Based upon Risks of Material Misstatements Identified and Assessed by the Auditor, Auditor Develops Responses to Assessed Risks. [SA 330]

OBJECTIVE OF AUDITOR IN THIS SA

1) The objective of the auditor in accordance with SA 330 is to obtain sufficient appropriate audit evidence about the **assessed risks of material misstatement**, through designing and implementing appropriate responses to those risks.
2) **SA 330** states that:
   a) The auditor shall design and implement **overall responses** to address the assessed risks of material misstatement at the financial statement level.
   b) The auditor shall **design and perform further audit procedures** whose nature, timing and extent are based on and are responsive to the assessed risks of material misstatement at the assertion level.

SCOPE OF THIS SA

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

IN DESIGNING THE FURTHER AUDIT PROCEDURES TO BE PERFORMED, THE AUDITOR SHALL

1) **Consider the reasons for the assessment given to the risk of material misstatement at the assertion level for each class of transactions, account balance, and disclosure, including:**

a) The likelihood of material misstatement due to the particular characteristics of the relevant class of transactions, account balance, or disclosure (i.e., the inherent risk); and
b) Whether the risk assessment takes into account the relevant controls (i.e., the control risk), thereby requiring the auditor to obtain audit evidence to determine whether the controls are operating effectively (i.e., the auditor intends to rely on the operating effectiveness of controls in determining the nature, timing and extent of substantive procedures); and

2) Obtain more persuasive audit evidence the higher the auditor's assessment of risk.

THE AUDITOR SHALL DESIGN & PERFORM TESTS OF CONTROLS TO OBTAIN SUFFICIENT APPROPRIATE AUDIT EVIDENCE AS TO THE OPERATING EFFECTIVENESS OF RELEVANT CONTROLS WHEN

1) The auditor's assessment of risks of material misstatement at the assertion level includes an expectation that the controls are operating effectively (i.e., the auditor intends to rely on the operating effectiveness of controls in determining the nature, timing and extent of substantive procedures); or
2) Substantive procedures alone cannot provide sufficient appropriate audit evidence at the assertion level.
3) In designing and performing tests of controls, the auditor shall obtain more persuasive audit evidence the greater the reliance the auditor places on the effectiveness of a control. Irrespective of the assessed risks of material misstatement, the auditor shall design and perform substantive procedures for each material class of transactions, account balance, and disclosure.

VII - INTERNATIONAL INTERNAL CONTROL FRAMEWORKS

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

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

1) **COSO's Internal Control – Integrated Framework** was introduced in 1992 as guidance on how to establish better controls so companies can achieve their objectives.
2) COSO categorizes entity -level objectives into **operations, financial reporting, and compliance.**
3) The framework includes more than 17 basic principles representing the fundamental concepts associated with its five components:
   a) **Control environment,**
   b) **Risk assessment,**
   c) **Control activities,**
   d) **Information and communication, and**
   e) **Monitoring.**
4) **Here are the tiles of the 17 internal control principles by internal control component as presented in COSO's framework:**

Control Environment	Risk Assessment	Control Activities	Information and Communication	Monitoring
• Demonstrates commitment to integrity and ethical values • Exercises oversight responsibility • Establishes structure, authority, and responsibility • Demonstrates commitment to Competence • Enforces accountability	• Specifies suitable objectives • Identifies and analyses risk • Assesses fraud risk • Identifies and analyses significant change	• Selects and develops control activities • Selects and develops general controls over technology • Deploys through policies and procedures	• Uses relevant information • Communicates internally • Communicates externally	• Conducts ongoing and/or separate evaluations • Evaluates & communicate deficiencies

5) **The COSO Framework is designed to be used by organizations to assess the effectiveness of the system of internal control to achieve objectives as determined by management. The Framework lists three categories of objectives as below:**
   a) **Operations Objectives**
   b) **Reporting Objectives**
   c) **Compliance objectives**

B. Guidance on Assessing Control published by the Canadian Institute of Chartered Accountants (CoCo)

1) CoCo was introduced in 1992 with the objective of improving organizational performance and decision-making with better controls, risk management, and corporate governance.
2) **The Criteria of Control (CoCo)** framework was developed by the Canadian Institute of Chartered Accountants with the objective of improving organisational performance and decision making with better controls, risk management, and corporate goverance.
3) The framework includes 20 criteria for effective control in four areas of an organization: purpose (direction), commitment (identity and values), capability (competence), and monitoring and learning (evolution).
5) The CoCo framework outlines criteria for effective control in the following four areas:
   a) Purpose b) Commitment
   c) Capability d) Monitoring and Learning

C. Control Objectives for Information and Related Technology (COBIT)

1) COBIT stands for **Control Objectives for Information and Related Technology.**
2) It is a framework created by the ISACA (Information Systems Audit and Control Association) for IT governance and management.
3) COBIT has **34 high-level processes that cover 210 control objectives** categorized in four domains:
   a) **Planning and organization,**
   b) **Acquisition and implementation,**
   c) **Delivery and support, and**
   d) **Monitoring and evaluation.**
4) It is designed as a supportive tool for managers and allows bridging the crucial gap between technical issues, business risks and control requirements.
5) **This framework guides an organization on how to use IT resources (i.e., applications, information, infrastructure,** and people) to manage IT domains, processes, and activities to respond to business requirements, which include compliance, effectiveness, efficiency, confidentiality, integrity, availability, and reliability.

D. Internal Control: Guidance for Directors on the Combined Code, published by the Institute of Chartered Accountants in England & Wales (known as the Turnbull Report)

1) **The key principles of the Code are enunciated as below:**
   a) **The board should maintain a sound system of internal control to safeguard shareholders' investment** and the company's assets.
   b) The directors should, at least annually, conduct a review of the effectiveness of the group's system of internal control and should report to shareholders that they have done so. The review should cover all controls, including financial, operational and compliance controls and risk management.
   c) **Companies which do not have an internal audit function should from time to time review the need** for one.
2) The guidance requires directors to exercise judgement in reviewing how the company has implemented the requirements of the Code relating to internal control and reporting to shareholders thereon.

E. Sarbanes-Oxley Section 404

1) SOX Section 404 (Sarbanes-Oxley Act Section 404) mandates that all publicly-traded companies must establish internal controls and procedures for financial reporting and must document, test and maintain those controls and procedures to ensure their effectiveness.
2) The purpose of SOX is **to reduce the possibilities of corporate fraud by increasing the stringency** of procedures and requirements for financial reporting.

3) It regulates the audits of public companies and SEC-registered brokers and dealers in order to protect investors and further the public interest in the preparation of informative, accurate, and independent audit reports.

4) The SEC rules and PCAOB standard require that:

a) Management perform a formal assessment of its controls over financial reporting including tests that confirm the design and operating effectiveness of the controls.

b) Management include in its annual report an assessment of ICFR.

c) The external auditors provide two opinions as part of a single integrated audit of the company:

i) An independent opinion on the effectiveness of the system of ICFR.

ii) The traditional opinion on the financial statements.

Guidance Note on Audit of Internal Financial Controls Over Financial Reporting:

ICAI has issued a **Guidance Note on Audit of Internal Financial Controls Over Financial Reporting** which covers aspects such as

- ✓ Scope of reporting on internal financial controls under Companies Act 2013,
- ✓ essential components of internal controls,
- ✓ Technical guidance on audit of Internal Financial Controls,
- ✓ Implementation guidance on audit of Internal Financial Controls.