

Chapter - 4 "Materiality, Risk Assessment and Internal Control"

Topics Covered:

- (1) Audit Risk
- (2) Risk Based Audit Approach
- (3) Internal Control System - Nature, Scope, Objective and Structure.
- ✓ (4) Components of Internal Control System

(A) 5 Components:

i) Control Environment: Sets the tone of an organization, influencing the control consciousness of its people. Elements are:

- (a) Communication and Enforcement of Integrity and Ethical values.
- (b) Commitment to Competence.
- (c) Involvement of Top Management
- (d) Management Attitude, philosophy, operating style etc.
- (e) Organisational structure.
- (f) Authority and Responsibilities
- (g) HR Policies and Procedures

ii) Entity Risk Assessment Process (i.e. how management determines (Business Risk) the risks to be managed).

Risk can arise or change due to following:

- (a) change in operating Environment
- (b) New Personnel
- (c) Changes in Accounting Pronouncement
- (d) New or Revamped Info. System
- (e) New Business Models, products, Activities.
- (f) Corporate Restructuring.
- (g) Expanded Foreign Operation
- (h) Rapid Growth
- (i) New Technology

iii) Control Activities (i.e. Policies and Procedures that help ensure that Mngt. Objectives are carried out)

Ex: (i) Segregation of duties (ii) Performance Review

(iii) General IT Control and Application Controls (iv) Physical Controls

(iv) Information System and Communication (i.e. Infrastructure, Software, people, procedure, data). To Ensure:

(a) Identification and Recording of all transactions.

(Occurrence)
+ Completeness

(b) Proper classification of transactions.

(c) Appropriate Measurement of values.

(d) Ensure transactions recorded in App. period.

Cut-off.

(e) Proper presentation and disclosure.

(v) Monitoring (i.e. the process to assess effectiveness of I.C. Performance over time).

(B) Important Constituents of Accounting Controls:

i) Internal Check

ii) Internal Audit - Already Covered
in Chapter - 16

Internal check: Checks on day to day transactions which operate continuously as part of the routine system, whereby the work of each person is either proved independently or is made complementary to the work of another person.

Objectives of Internal check System:

Considerations for efficient System of Internal check:

- From Book -

Imp: General conditions pertaining to Internal check:

(C) Manual and Automated Elements in Internal Control:

Manual Controls: Controls exercised by the Executives e.g. Authorisation of transactions, Signature on Invoices, Controlling work productions etc.

Automated Controls: Controls Embedded in the System (IT System)

e.g. Passwords, setting limits, sequence testing, edit checks etc.

- Internal Control System in an Entity contain Manual and Automated Controls. Extent of Mix of Manual and automated controls varies with the nature and complexity of IT system.
- Manual Elements are considered more suitable where judgements and discretions are required, for example:
 - (a) Large, unusual and non-recurring transactions.
 - (b) Circumstances where errors are difficult to define or predict.
 - (c) " requiring a control response outside the scope of existing automated control.
 - (d) Monitoring effectiveness of automated controls.

(D) Review of I.C. System: - Reading from book -

(5) Internal Control Assessment and Evaluation:

- ✓ (A) Standard operating procedure:
- (i) Enterprise Risk Management (ERM)
 - (ii) Segregation of job Responsibilities (SOD)
 - (iii) Job Rotation in Sensitive Area
 - (iv) Documentation of Delegation of financial Powers.
 - (v) IT Based Controls (General IT controls and Application controls)

- (B) Techniques of Evaluation of Internal Control:
- (i) Narrative Records
 - (ii) Internal Control Questionnaire (ICQ)
 - (iii) Check List
 - (iv) Flow Chart

Assumptions presumed about Elements of Good Control while using standardised ICQ:

- LEARNING and Noting -

(6) Communicating Deficiencies in Internal Control to TCGM and Mngt. (SA 265)

(A) Meaning of Deficiencies in I.C.: I.C. is said to be deficient, if

I.C. required to prevent, or detect and correct material misstatements in the f.s. is Missing
(i.e. Non Existent I.C.)

I.C. unable to prevent, or detect and correct material misstatements in the f.s. on timely basis.
(i.e. Ineffective I.C.)

(B) Auditor's Responsibilities:

(i) Auditor should determine whether deficiencies in Internal Control exist.

For this purpose, auditor is required to

- Plan as per SA 300.
- Perform RAP as per SA 315.
- Perform ToC/Compliance Procedures as per SA 330.

(ii) If based on the procedures performed, auditor is of the opinion that deficiencies in I.C. exist, he should determine, whether such deficiency either individually or in aggregate with other deficiencies, constitute Significant Deficiency.

Deficiencies in I.C. are Significant

Auditor should communicate significant deficiencies, in writing to - TCGM; and Management.

Deficiencies in I.C. are not significant

Auditor should communicate such deficiencies (other deficiencies), in writing, to Mngt.

Indicators of Significant deficiencies:

(i) Evidence of Ineffective aspects of Control Environment.

For Ex: - Significant transactions in which management is interested, not scrutinised by TCWG.

- Mngt. fraud not prevented by I.C.

- Mngt. fails to take corrective/remedial action on deficiencies previously communicated.

(ii) Absence of Entity's Risk Assessment Process.

(iii) Evidence of ineffective Entity Assessment Process.

(iv) Evidence of ineffective responses to identified significant risk.

(v) Evidence of Mngt./TCWG inability to oversee preparation of F.S.

(vi) Correction of prior period items in current year Statement of P&L.

(vii) Misstatements detected by Auditor's procedures that were not prevented, detected and corrected by Entity I.C.

Matters to be considered in determining whether a deficiency or combination of deficiency in Internal Control constitute Significant deficiency:

- Points to be learned and Noting -

(C) Communication of Deficiencies: Communication shall be through a formal letter

known as "Letter of weakness" which shall

comprise of following matters:

(i) Description of deficiency;

(ii) Explanation as to their potential effect;

(iii) Sufficient information so as to explain that purpose of Audit is to express an opinion on F.S.

and

Internal controls are evaluated to design the NTE of Substantive Audit procedures.

(iv) Statement that matters reported in this letter are limited to deficiencies identified and considered significant by the auditor. (i.e. that other deficiencies may exist).

(D) General Points to be covered in Letter of weakness! - Reading from book -