

Chapter - 3 "Risk Assessment and Internal Control"

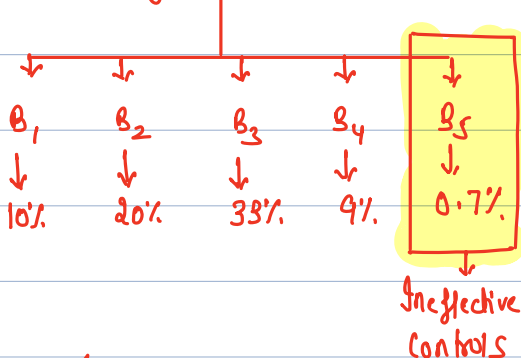
(4) Internal Control:

- (a) Meaning of Internal Control
- (b) Objectives " " "
- (c) Benefits of understanding of I.C.
- (d) Limitations of I.C.
- (e) Components of I.C.
- (f) Controls relevant to audit:

- There is a direct relationship between objectives of an Entity and the Control it implements.
- Controls implemented in the Entity may or may not be relevant for the purposes of audit.
- To determine whether controls, individually or in combination with others, are relevant to audit purposes, auditor may consider the following:

- ✓ (i) Materiality;
- (ii) Significance of related risks;
- (iii) Size of the Entity;
- (iv) Nature of Entity business; its organisation structure and ownership aspects;
- (v) Diversity and complexity of Business operations
- (vi) Applicable legal and regulatory requirements;
- (vii) Nature and complexity of systems forming part of I.C.
- (viii) Circumstances and applicable components of I.C.

Ex: Company - 5 Branches



Ineffective controls

Ex: [R.P. J&W] → Arm length price
(20% - 25%)

- (g) Misc. Topics:
- (i) Controls over completeness and Accuracy of Inv.
 - (ii) " " Safeguarding of Assets
 - (iii) " relating to objectives not relevant for audit
 - (iv) Nature and Extent of understanding of relevant controls
- (Reading Purpose)

Imp:
(5) Risk that require special Consideration (SA 315):

In Exercising judgement as to which risks are significant risk, auditor shall consider the following:

- (a) whether the risk is a risk of fraud;
- (b) " " " is related to significant economic, accounting and other developments [↑↓]
- (c) Complexity of transaction;
- (d) whether risk involves significant transaction with related parties;
- (e) " " " " unusual transaction;
- (f) Degree of subjectivity involved in measurement of financial information.

Fraud; Developments; Complexity; Related Parties; unusual trans; Subjectivity

Note: Significant Risk generally related to significant

(i) Non-Routine transactions

(unusual nature)

ROMM may be greater for significant non-routine transactions arising from following matters:

- (a) Greater Management intervention to specify accounting treatment.
- (b) Complex calculations or accounting principles.
- (c) Greater Manual Intervention for data collection and processing.
- (d) Nature of non-routine transactions which makes it difficult for the Entity to implement effective controls over the identified risk.

(ii) Judgemental Matters

(for Ex.: Accounting Estimates having Significant Estimation Uncertainty)

ROMM may be greater for significant judgemental matters that require development of Accounting Estimates; may arise due to following:

- (a) Accounting Principles for Accounting Estimates or Revenue Recognition may be subject to different interpretation.
- (b) Required judgement may be
 - Subjective; or
 - Complex; or
 - require assumptions about future events.

(6) Evaluation of Internal Control System:

- Evaluation of I.C. System enabled the auditor to obtain reasonable assurance that (a) Accounting System followed in the entity is adequate; and (b) Accounting information which should be recorded, in fact, recorded.
- For the purposes of evaluation of Internal Control System, auditor is required to obtain necessary information, for ex: Important aspects of business activities
Size of Business;
Nature of Operations carried out etc.

Methods to be followed for collection of information for the purposes of evaluation of I.C.: (Four Methods)

- (i) Narrative Records
- (ii) Check List
- (iii) Internal Control Questionnaire
- (iv) Flow chart

(Learning and Noting - H.W.)

Sample ICQ for f.s. Items (Purchases, Creditors, Inventories, etc.): - Reading from Book -

Testing of I.C. System (Performing ToC/ Compliance Procedures - SA 330)

- | | |
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| | SA 300-499 |
| - After <u>reviewing I.C. System</u> ; auditor needs to examine <u>whether</u> and <u>how far</u> the same is actually in operation. | SA-300 "Planning an Audit of f.s." |
| - For this purpose, auditor should plan and perform <u>actual testing of system in operation</u> ; in a manner that all important areas are covered in a <u>span of day, 3 years</u> . | SA-315 "Identifying and Assessing ROMM through -----" |
| - Tests of Controls may be performed through the following methods: | SA-320 "Materiality in planning and performing an audit" |
| | SA-330 " <u>Response to Assessed Risks</u> " |
| | [ToC + Substantive] |

- (a) Inspection of documents supporting transactions to collect audit evidences that internal controls operated effectively.
For Ex: Verifying that a transaction has been authorized.
- (b) Inquiry and observation of I.C. which leave no audit trail.
For Ex.: Determining who actually perform a function; not merely who is supposed to perform it.
- (c) Re-performance of procedure that were originally performed as part of internal control.
For Ex.: Reconciliation of bank accounts.
- (d) Testing of internal control on computerised applications or overall IT function.
For Ex: Access controls or program change controls

Benefits of Evaluation of I.C. System:

(Learning + Noting - H.W.)

Formulating Audit Programme:

(Self-coverage)
