Q1. CA. R is conducting **statutory audit of a Divisional office (DO) of a public sector insurance company**. On going through delegation of powers laid down by company's head office, it is noticed that **surveyors in claims under property insurance policies beyond estimated amounts of 30 lac are to be appointed by Divisional Claims Committee (DCC).** However, on going through surveyor appointment **details of 10 such claims during the year, 5 instances have come to his notice where above delegation of powers has not been followed** and **appointments were made by Divisional manager in place of DCC.**

In the **beginning**, the auditor had **assessed risks of material misstatement to be low. Describe why above finding would change auditor's assessment in relation to above.** ***(TYU-SM)***

Answer

Evaluation of internal controls influences auditor's assessment of risks of material misstatement. Risks of **material misstatement also consists of control risk.**

In the given situation of **statutory audit of a Divisional office of a public sector insurance company,** it is noticed that procedure relating to delegation of powers has not been followed and surveyor appointments have been **made in violation of laid down procedures. It is a serious violation and shows that controls are not operating effectively as laid down by company management.**

Such deviations from established controls may lead auditor to conclude that **control risk needs to be revised. Revision of control risk assessment is likely to lead to revision in risks of material misstatement. It may also result in modification of nature, timing and extent of planned substantive procedures.**

Q2. You have recently been appointed as an **auditor of NGO** working in the field of "upholding democracy" for the first time. The **last year accounts of NGO were unaudited** and its activities were limited at a small scale. However, it is only in the **current year that NGO has received substantial donations including foreign funds**. The said NGO is also crowdfunding its donations. The **government** has now legislative **power to cancel FCRA certificate of NGO**. <u>Since it is working in field which encompasses political and social fields, accusations and counter-accusations are flying thick and fast.</u>

What **factors you may consider for assessing audit risk**? ***(TYU-SM)***

Answer

For assessing audit risk, auditor shall consider all components of audit risk. The said NGO is working in a political-cum-social field which can make its activities inherently risky. Crowdfunding donations may have to be seen in relation to constitution of NGO which may make these risky. Since the NGO is in receipt of foreign funds, it may make transactions inherently risky. **The credibility and integrity of persons behind NGO is important. Shady NGOs** can be **involved** in **money laundering activities** and may be **involved in mis utilizing funds from donors**. Since last year accounts were unaudited, it also **increases inherent risk due to probable effect of misstatements, if any, of last year. Non-compliance with strict laws has the potential to make activities of NGO inherently risky.**

Since NGO has received substantial donations in current year and its activities were on a relatively small scale during last year, formal controls may not be in place. Lack of formal controls may lead to non-compliance with laws. **Non-compliance with FCRA can have serious consequences including cancelling such certificate of NGO. Therefore, control risk could be high.**

Further, audit for NGO has been accepted for the first time. There may be a lack of understanding of activities of NGO. It may **lead to higher detection risk due to inappropriate sampling procedures or faulty application of audit procedures.**

Q3. RK Living Limited is engaged in manufacturing and processing of textile fabrics. It **purchases its raw material** from a company based in Silvassa taxable @ 12%. **It takes about 3-4 days for raw materials to reach the company's plant**. Recently, the **company has revamped its internal control system** for recording its transactions. You have also assumed charge as head of internal audit department of the company few days before.

It is **noticed** that **information system requires booking of purchases in purchase ledger and stock records from date of purchase invoice only**. How you would deal with above matter as internal auditor of the company? ***(TYU-SM)***

Answer

Internal audit involves **continuous and critical appraisal of functioning of an entity** with a view to suggest improvements thereto and add value to and strengthen the overall governance mechanism of the entity including its strategic risk management and internal control system.

Internal audit also involves evaluation of internal control to **provide assurance to management** regarding design, implementation and operating effectiveness of control.

In the given situation, information system requires booking of purchases in purchase ledger and stock records from date of invoice. **Such a control system is likely to present a distorted picture of stocks of the company**. It would **show stocks of raw material as received whereas these goods could be in transit.** Therefore, **design of the control itself is faulty** which allows booking from date of purchase invoice only. Further, such a system **can have implications with respect to GST laws.**

The internal auditor should report above matter asking management for corrective action.

Q4. A company as part of its internal control set up has a **system under which quarterly budgeted targets in respect of sales are analysed with respect to actual performance achieved**. It also involves **fixing responsibilities of different product departmental heads and taking timely correction**. In case of product departmental heads **not achieving quarterly budgeted targets**, they have to **give a detailed justification** for the same and also lay down how shortfalls would be compensated in ensuing quarters.

Identify and explain component of internal control alluded to in above scenario. ***(TYU-SM)***

Answer

The above referred component of internal control is **"Control activities"**. **Control activities that may be relevant to an audit include policies and procedures that pertain to "performance reviews".**

Such **control activities include** **<u>reviews and analyses of actual performance versus budgets, forecasts, and prior period performance</u>**; relating different sets of data – operating or financial – to one another, together with **analyses of the relationships** and **investigative and corrective actions**; comparing internal data with external sources of information; and review of functional or activity performance.

The control activities pertaining to analysis of budgeted target of sales with respect to actual performance, fixing of responsibilities and taking timely corrective action falls in nature of performance reviews. Such performance reviews are part of control activities which is a component of internal control.

Q5. What are the **components of an internal control framework?** **(SM-TYK)**

Answer

There are **five components of an internal control framework.** They are as follows:

- **Control Environment;**
- **Risk Assessment;**
- **Information & Communication;**
- **Monitoring;**
- **Control Activities.**

Q6. Explain briefly the **Flow Chart technique** for evaluation of the Internal Control system. **(SM-TYK)**

Answer

- Flow charting technique can also be resorted to for **evaluation of IC** system.
- It is a **graphic presentation of IC** in the org. and is normally drawn up to show the controls in each section or sub-section.
- It gives a **bird's eye view of the system** and is drawn up as a result of the auditor's review thereof.
- **As distinct from a narrative form**, it provides the <u>most concise & comprehensive way for reviewing IC</u> and the evaluator's findings.
- It should, however, not be understood that details are not reflected in a flow chart. Every detail relevant from the control point of view and the details about how an operation is performed can be included in the flow chart.
- 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) **no. of copies** in which a document is raised or received;
(iii) **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.

Drawing of a flow chart - A flow chart is normally a horizontal one in which documents and activities are shown to flow horizontally from section to section and the concerned sections are shown as the vertical column heads; in appropriate cases an individual also may be shown as the vertical column head.
Care should be taken to see that the first column head is devoted to the section or the individual wherefrom a transaction originates, and the placements of other column heads should be in the order of the actual flow of the transaction.

Q7. As auditor of Z Ltd., you would like to limit your examination of account balance tests. What are the control objectives you would like the accounting control system to achieve to suit your purpose? **(SM-TYK)**

OR

One of the objectives of Internal control relating to the accounting system is that all transactions are promptly recorded in an appropriate manner to permit the preparation of financial information and to maintain accountability of assets. To achieve this objective, certain matters should be ensured by accounting controls. **List down matters to be ensured by accounting controls.** **(PYQ-July21+MTP)**

Answer

Basic Accounting Control Objectives: The **basic accounting control objectives which are sought to be achieved by any accounting control system are -**

(i) Whether all **transactions are recorded;**
(ii) Whether **recorded transactions are real;**
(iii) Whether all **recorded transactions are properly valued;**
(iv) Whether all transactions are **recorded timely;**
(v) Whether all transactions are **properly posted;**
(vi) Whether all transactions are **properly classified and disclosed;**
(vii) Whether all transactions are **properly summarized.**

OR

Matters to be ensured by accounting controls –

Basic Accounting Control Objectives: The basic accounting control objectives which are sought to be achieved by any accounting control system are –

(i) Transactions are executed in accordance **with management's general or specific authorisation.**
(ii) Transactions and other events are real & promptly/timely **recorded at correct amounts;**
(iii) Transactions should be classified in **appropriate accounts** and in the **appropriate period** to which it relates;

(iv) Transactions are **properly posted.**

(v) Transactions 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;

(vi) Transactions are **properly disclosed.**

(vii) Recording of transactions should facilitate **maintaining accountability for assets;**

(viii) Assets and records are required to be protected from unauthorized access, use or disposition;

(ix) Records of assets, such as sufficient description of the assets (to facilitate identification, its location should also be maintained, so that the assets could be physically verified periodically.

(x) Transactions are properly summarized.

Q8. New Life Hospital is a multi-speciality hospital which has been facing a lot of pilferage and troubles regarding their inventory maintenance and control. On investigation into the matter it was found that the **person in charge of inventory inflow and outflow from the store house is also responsible for purchases and maintaining inventory records**. According to you, **which basis system of control has been violated?** Also list down the **other general conditions pertaining to such system which needs to be maintained and checked by the management. (SM-TYK)**

Answer

Basic system of Control: Internal Checks and Internal Audit are important constituents of Accounting Controls. 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.

In the given case of New Life Hospital, the person-in-charge of inventory inflow and outflow from the store house is also responsible for purchases and maintaining inventory records. Thus, one of the basic system of control i.e. **internal check which includes segregation of duties or maker and checker has been violated** where transaction processing are 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.

The general condition pertaining to the internal check system may be summarized as under-

1) **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.
2) **Staff duties should be rotated** from time to time so that members do not perform the same function for a considerable length of time.
3) Every member of the staff should be encouraged to **go on leave at least once a year**.
4) Persons having **physical custody** of assets must **not** be permitted to have **access to the books of accounts**.
5) There should **exist** an **accounting control** in respect of <u>each class of assets</u>, in addition, there should be **periodical inspection** so as to establish their physical condition.
6) **Mechanical devices** should be used, where ever practicable to prevent loss or misappropriation of cash.
7) **Budgetary control** should be **exercised** and **wide deviations observed** should be **reconciled**.

Q9. Compute the overall Audit Risk if looking to the nature of business there are chances that **40% bills of services provided would be defalcated,** inquiring on the same matter management has assured that internal control can **prevent such defalcation to 75%.** At his part the Auditor assesses that the procedure he could apply in the remaining time to complete Audit gives him satisfaction **level of detection of frauds & error to an extent of 60%.**

Analyse the Risk of Material Misstatement and find out the overall Audit Risk. (SM-TYK)

Answer

According to SA-200, "Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Standards on Auditing", the Audit Risk is a risk that Auditor will issue an inappropriate opinion while Financial Statements are materially misstated.

Audit Risk, has two components: Risk of material Misstatement and Detection Risk. The relationship can be defined as follows.

Audit Risk = Risk of material Misstatement X Detection Risk

Risk of material Misstatement: - Risk of Material Misstatement is anticipated risk that a material Misstatement may exist in Financial Statement before start of the Audit. It has two components Inherent risk and Control risk. The relationship can be defined as

Risk of material Misstatement = Inherent risk X control risk

Inherent risk: it is a susceptibility of an assertion about account balance; class of transaction, disclosure towards misstatements which may be either individually or collectively with other Misstatement becomes material before considering any related internal control which is 40% in the given case.

Control risk: it is a risk that there may be chances of material Misstatement even if there is a control applied by the management and it has prevented defalcation to 75%.

Hence, control risk is 25% (100%-75%)

Risk of material Misstatement: Inherent risk X control risk i.e. 40% X 25 % = 10%

Chances of material Misstatement are reduced to 10% by the internal control applied by management.

Detection risk: It is a risk that a material Misstatement remained undetected even if all Audit procedures applied, Detection Risk is 100-60=40%

In the given case, overall Audit Risk can be reduced up to 4% as follows:

Audit Risk: Risk of Material Misstatement X Detection Risk = 10X 40% = 4%

Q10. ST Ltd is a growing company and currently engaged in the business of manufacturing of tiles. The company is planning to expand and diversify its operations. The management has increased the focus on the internal controls to ensure better governance. The management had a discussion with the statutory auditors to ensure the **steps required to be taken so that the statutory audit is risk based and focused on areas of greatest risk** to the achievement of the company's objectives. Please advise the management and the auditor on the steps that should be taken for the same. **(SM-TYK)**

OR

PADHAM Ltd is engaged in the business of manufacturing of carpets. The company is planning to expand and diversify its operations. Management has increased focus on internal controls to ensure better governance. The management discussed with the statutory auditors to ensure the steps required to be taken so that the statutory audit is risk based and focused on areas of greatest risk to the achievement of company's objectives.

(a) Name the **key steps and phases involved in Risk Based Audit.**

(b) Also, discuss the **steps to be taken for the risk assessment phase of the audit.** **(RTP-M22)**

Answer

The auditor's objective in a risk-based audit is to obtain reasonable assurance that no material misstatements whether caused by fraud or errors exist in the financial statements.

a) This involves the following **three key steps:**

- **Assessing ROMM in** FS
- **Designing and performing** further audit procedures that **respond** to assessed risks and **reduce ROMM** in FS to an acceptably low level; and
- **Issuing** an appropriate audit report based on the audit findings.

The risk-based audit process is presented in three distinct phases:

- Risk assessment.
- Risk response; and
- Reporting.

b) 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** RAP to understand the business and identify inherent and control risks;
4) **Assessing ROMM** in FS;
5) **Communicating** any material weaknesses in the design and implementation of IC to Mgt. and TCWG;

Q11. Y Co. Ltd. has five entertainment centers to provide recreational facilities for public especially for children and youngsters at 5 different locations in the peripheral of 200 kilometers. Collections are made in cash. Specify the adequate system towards collection of money. **(SM-TYK)**

Answer

Control System over Selling and Collection of Tickets: In order to achieve proper internal control over the sale of tickets and its collection by the Y Co. Ltd., following system should be adopted –

(i) **Printing of tickets:** Serially numbered pre-printed tickets should be used and designed in such a way that any type of ticket used cannot be duplicated by others in order to avoid forgery. Serial numbers should not be repeated during a reasonable period, say a month or year depending on the turnover. The separate series of the serial should be used for such denomination.

(ii) **Ticket sales:** The sale of tickets should take place from the Central ticket office at each of the 5 centres, preferably through machines. There should be proper control over the keys of the machines.

(iii) **Daily cash reconciliation:** Cash collection at each office and machine should be reconciled with the number of tickets sold. Serial number of tickets for each entertainment activity/denomination will facilitate the reconciliation.

(iv) **Daily banking:** Each day's collection should be deposited in the bank on next working day of the bank. Till that time, the cash should be in the custody of properly authorized person preferably in joint custody for which the daily cash in hand report should be signed by the authorized persons.

(v) **Entrance ticket:** Entrance tickets should be cancelled at the entrance gate when public enters the centre.

(vi) **Advance booking:** If advance booking of facility is made available, the system should ensure that all advance booked tickets are paid for.

(vii) **Discounts and free pass:** The discount policy of the Y Co. Ltd. should be such that the concessional rates, say, for group booking should be properly authorized and signed forms for such authorization should be preserved.

(viii) **Surprise checks:** Internal audit system should carry out periodic surprise checks for cash counts, daily banking, reconciliation and stock of unsold tickets etc.

Q12. The **effectiveness of controls cannot rise above the integrity and ethical values of the people who create, administer, and monitor them**. Explain. **(SM-TYK)**

Answer

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**.

Integrity and ethical behavior are the <u>product of the entity's ethical and behavioral standards</u>, **how they are communicated**, and **how they are reinforced in practice**.
The **enforcement of integrity and ethical values includes**, for example, <u>management actions to eliminate or mitigate</u> **incentives or temptations that might prompt personnel to engage in dishonest, illegal, or unethical acts.**
The communication of entity policies on integrity and ethical values may include the communication of behavioral standards to personnel **through policy statements and codes of conduct and by example.**

Q13. Your engagement team is seeking advice from you as engagement partner regarding **steps for risk identification**. Elaborate. **(SM-TYK)**

Answer

Steps for Risk Identification

1) **Assess significance** of assessed risk, **impact** of its occurrence & also **revise materiality** accordingly for specific account balance.
2) Determine **likelihood** for assessed risk to occur and **its impact** on auditing procedures.
3) **Document assertions** that are effected.
4) Consider **impact of the risk** on each of the assertions.
5) (completeness, existence, accuracy, validity, valuation and presentation) **relevant** to the account balance, class of transactions, or disclosure.
6) **Identify degree of significant risks** that would require separate attention and response by the auditor. Planned audit procedures should directly address these risks.
7) **Enquire & document** the **Mgt. 's response**.
8) Consider **nature of IC system in place** and its possible effectiveness in mitigating risks involved. Ensure the controls:
   - Routine in nature (occur daily) or periodic such as monthly.
   - Designed to prevent or detect and correct errors.
   - Manual or automated.
9) Consider **any unique characteristics** of the risk.
10) Consider **existence of any particular characteristics (inherent risks)** in the class of transactions, account balance or disclosure that need to be addressed in designing further audit procedures.

Q14. BSF Limited is engaged in the business of trading leather goods. You are the internal auditor of the company for the year 2019-20. In order to review internal controls of the Sales Department of the company, you visited the Department and noticed the **work division as follows:**

1) **An officer was handling the sales ledger and cash receipts.**
2) **Another official was handling dispatch of goods and issuance of Delivery challans.**
3) **One more officer was there to handle customer/ debtor accounts and issue of receipts.**

As an internal auditor, you are required to **briefly discuss the general condition pertaining to the internal check prevalent in internal control system.** Do you think that there was **proper division of work in BSF Limited? If not, why? (SM-TYK)**

Answer

The general condition pertaining to the internal check system may be summarized as under:

1) **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.
2) **Staff duties should be rotated** from time to time so that members do not perform the same function for a considerable length of time.
3) Every member of the staff should be encouraged to **go on leave at least once a year**.
4) Persons having **physical custody** of assets must **not** be permitted to have **access to the books of accounts**.

5) 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.
6) **Mechanical devices** should be used, where ever practicable to prevent loss or misappropriation of cash.
7) **Budgetary control** should be **exercised** and **wide deviations observed** should be **reconciled**.

Division Of Work:
In the given scenario, Company has **not done proper division of work** as:

(i) the **receipts of cash should not be handled by the official handling sales ledger** and
(ii) delivery challans should be verified by an authorised official other than the officer handling dispatch of goods.

Q15 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 financial reporting framework, estimates their significance, assesses the likelihood of occurrence and decides upon actions to respond to and manage them and the results thereof. **Elucidate the circumstances in which risks can arise or change. (PYQ Nov-19)**

Answer

Entity's Risk Assessment Process: Risks can arise or change due to circumstances such as the following-

1) **Changes in operating environment**. Changes in the regulatory or operating environment can result in changes in competitive pressures and significantly different risks.
2) **New personnel:** New personnel may have a different focus on or understanding of IC.
3) **New or revamped information systems:** Significant and rapid changes in IS can change risk relating to IC.
4) **Rapid growth**: Significant and rapid expansion of operations can strain controls and increase the risk of a breakdown in controls.
5) **New technology**: Incorporating new technologies into production processes or IS may change the risk associated with IC.
6) **New business models, products, or activities**: Entering into business areas or transactions with which an entity has little experience may introduce new risks associated with IC.
7) **Corporate restructurings**: Restructurings may be accompanied by staff reductions and changes in supervision and segregation of duties that may change the risk associated with IC.
8) **Expanded foreign operations**: Expansion or acquisition of foreign operations carries new and often unique risks that may affect IC.
9) **New accounting pronouncements**: Adoption of new accounting principles or changing accounting principles may affect risks in preparing FS.

Q16. Prabhu Ltd., a manufacturing concern wants to develop internal control system. You are an expert in developing the internal control system, hereby called to brief about the same. In view of above, you are required to **brief about internal control system and inherent limitations of the internal control?**
(RTP May 18)

Answer

Internal Control System and its Inherent Limitations: As per Guidance Note on Audit of Internal Financial Control over Financial Reporting, internal controls are a system consisting of specific policies and procedures designed to provide management with reasonable assurance that the goals and objectives it believes important to the entity will be met.

"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, the **orderly and efficient conduct of its business**, including **adherence to management policies,** the **safeguarding of assets, the prevention and detection of fraud and error, the accuracy and completeness of the accounting records, and the timely preparation of reliable financial information.**

To state whether a set of financial statements presents a true and fair view, it is essential to benchmark and check the financial statements for compliance with the framework. The Accounting Standards specified under the Co. Act, 1956 (which are deemed to be applicable as per Section 133 of the 2013 Act, read with Rule 7 of Companies (Accounts) Rules, 2014) is one of the criteria constituting the financial reporting framework on which companies prepare and present their financial statements under the Act and against which the auditors evaluate if the financial statements present a true and fair view of the state of affairs and the results of operations of the company in an audit of the financial statements carried out under the Act.

The fundamental therefore is that effective internal control is a process effected by people that supports the organization in several ways, enabling it to provide reasonable assurance regarding risk and to assist in the achievement of objectives.

Fundamental to a system of internal control is that it is integral to the activities of the company, and not something practiced in isolation.

An 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.**

Limitations of Internal Control - 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. Internal control systems are subject to certain inherent limitations, such as:

1) Mgt. consideration that **cost of an IC doesn't exceed** expected benefits to be derived.
2) **Potential for human error**, such as, due to carelessness, distraction, mistakes of judgement and misunderstanding of instructions.
3) **Possibility of circumvention of IC** through collusion with employees or with parties outside the entity.
4) **Possibility** that a person responsible for exercising an IC could **abuse** that responsibility, for example, a member of Mgt. overriding an IC.
5) **Manipulations by Mgt.** w.r.t transactions or estimates and judgements required in the preparation of FS.

Q17. While conducting statutory audit of MPT Limited, a listed company, CA Z has understood various IT controls relating to data centre and network operations, system software acquisition, change and maintenance, program change, access security and application system acquisition, development and maintenance operating in the company. Besides, he has also gained **knowledge of application controls designed to ensure the integrity of accounting records.**
Which one of the internal control components of the company is referred to in the above description? Besides activities gathered from the above description, **give examples of any other two activities relevant for an audit included in the above identified "component of internal control" of the company. (MTP Oct '23)**

Answer

CA Z has gained an understanding of various IT controls operating in the company including General IT controls and application controls. **Such activities form part of "control activities", which is one of the components of internal control of an organization.**

Control activities are the policies and procedures that help ensure management directives are carried out. Control activities, whether within IT or manual systems, have various objectives and are applied at various organisational and functional levels. Examples of specific control activities include those relating to the following:

Performance reviews: These control activities include
- **reviews and analyses** of **actual performance vs** budgets, forecasts, and prior period performance;
- **comparing** internal data with external sources of info. and
- **review** of functional or activity performance.

Physical controls

Controls that encompass:
- The **physical security of assets,** including adequate safeguards such as secured facilities over access to assets and records.
- The **periodic counting and comparison** with amounts shown on control records (for example, comparing the results of cash, security and inventory counts with accounting records).

Q18. During the course of audit of Treasure Ltd., CA Himanshu is concerned with the quality and effectiveness of internal control. Towards achieving his objective, he wants to assess and evaluate the control environment. **Guide CA Himanshu with well-defined set of the Standard Operating Procedures in the assessment and evaluation of control. (PYQ-M19/D21+RTP)**

Answer

Guidance to CA Himanshu with well defined set of Standard Operating Procedure is given hereunder:

(i) **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.

(ii) **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**. In such organizations, surprises of failures in controls is likely to be few.

(iii) Segregation of Job Responsibilities: A key element of control is that multiple activities in a transaction/decision should not be concentrated with one individual. Segregation of duties is an important element of control such that **no two commercial activities should be conducted by the same person.**

A buyer should not be involved in receiving of materials or passing of bills. Similarly bank reconciliation should be prepared by a person other than the one who maintains bank book.

(iv) **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. For example, if the same buyer continues to conduct purchase function for long period, it is likely that he gets into comfort zone with existing vendors & hence does not exercise adequate controls in terms of vendor development, competitive quotes etc.

(v) Delegation of Financial Powers Document: As the organization grows, it needs to delegate the financial & other powers to their employees. A **clearly defined document on delegation of powers allows controls to be clearly operated without being dependent on individuals.**

(vi) **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. For example, at the stage of customer invoicing, application of correct rates in invoices or credit control can all be exercised directly through IT system improving control environment.

Q19. **In the use of standardized Internal Control Questionnaire (ICQ), certain basic assumptions about elements of a good internal control system are taken into account.** List down few such assumptions. **(MTP)**

Answer

Basic Assumption about Elements of Good Control in Standardized Internal Control Questionnaire:
In the use of standardized internal control questionnaire, certain basic assumptions about elements of good control are taken into account. These are –

1) Organisations are such that permit an **extensive division of duties and responsibilities.** larger the org. the greater is the scope of such division.
2) Employees concerned with **accounting function are not assigned any custodial function**.
3) **No single person** is thrust with the responsibility of <u>completing a transaction all by himself.</u>
4) There should always be **evidence to identify the person** <u>who has done the work</u> whether involving authorization, implementation or checking.
5) The <u>work performed by each one</u> is expected to **come under review of another** in the usual course of routine.
6) There is **proper documentation** and <u>recording of transactions</u>.

Q20. Explain the concept of **Integrated framework** issued by Committee of the Sponsoring Organizations of the Tredway Commission (COSO Framework) duly mentioning its **four out of five components** and discuss the **three category of objectives that can be achieved as per COSO framework.** **(PYQ-Jan21)**

Answer

Concept of COSO:

COSO's Internal Control – Integrated Framework was introduced in 1992 as guidance on how to establish better controls so companies can achieve their objectives. COSO categorizes entity-level objectives into operations, financial reporting, and compliance. The framework includes more than 17 basic principles representing the fundamental concepts associated with its **five components: control environment, risk assessment, control activities, information and communication, and monitoring**.

Some of the principles include key elements for compliance, such as integrity and ethical values, authorities and responsibilities, policies and procedures, and reporting deficiencies.

Five Components of COSO are as follows:

a) Control Environment
b) Risk Assessment
c) Control Activities
d) Information and Communication
e) Monitoring

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:**

1. **Operations Objectives – related to the effectiveness and efficiency** of the entity's operations, including operational and financial performance goals, and safeguarding assets against loss.
2. **Reporting Objectives** – related to **internal and external financial and non-financial reporting to stakeholders**, which would encompass reliability, timeliness, transparency, or other terms as established by regulators, standard setters, or the entity's policies.
3. **Compliance objectives** – In the Framework, the compliance objective was described as "relating to the entity's **compliance with applicable laws and regulations."** The Framework considers the increased demands and complexities in laws, regulations, and accounting standards.

Q21. State the **considerations** on which **effectiveness of an efficient system of internal check depends.**

Answer

Considerations for the effectiveness of a System of Internal Check: The effectiveness of an efficient system of internal checks 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. A well-integrated **organizational chart depicting the names of responsible persons associated with specific functions** may help to fix up responsibility.

(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. Then, it is suggested that rotation of different employees through various components of job should be effectively implemented.

(iii) Standardization - The entire process of accounting should be standardized **by creating suitable policies** commensurate with the nature of business, so as to strengthen the system of internal checks.

(iv) **Appraisal - Periodic review** should be made of the chain of operations and flow. Such process may be carried out by preparing an audit flow chart.

SA 265 – "Communicating Deficiencies in Internal Control to Those Charged with Governance and Management"

Q22. During the course of his audit, the auditor noticed material weaknesses in the internal control system and he wishes to communicate the same to the management. You are required to elucidate the **important points** the **auditor should keep in the mind while drafting the letter of weaknesses in internal control system.** ***(SM)***

Answer

Important Points to be kept in Mind While Drafting Letter of Weakness: As per **SA 265**, "Communicating Deficiencies in Internal Control to Those who Charged with Governance and Management", the auditor shall include in the **written communication** of significant deficiencies in internal control -

(i) A **description** of the deficiencies and an explanation of their potential effects; and

(ii) **Sufficient information** to enable those charged with governance and management to understand the context of the communication.

In other words, the auditor should communicate 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. **Important points with regard to such a letter are as follows-**

1) Letter lists down the **area of weaknesses in the system** and offers suggestions for improvement.
2) **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 Mgt**.
3) letter serves as a **valuable reference** document for Mgt. for the purpose of revising the system and insisting on its strict implementation.
4) Serve to **minimize legal liability** in the event of a major defalcation or other loss resulting from a weakness in internal control.

Q23.CA. N has been appointed as an auditor of TRP Ltd. While conducting the audit he has identified some deficiencies in the Internal control. He needs to determine whether a deficiency or combination of deficiencies in internal control constitutes a "significant deficiency" and has to communicate them in writing to TCWG and management on a timely basis. Guide CA. N with some **examples of matters to be considered while determining 'significant deficiency' in internal control** with reference to relevant SA. **(PYQ-Nov '20)**

Answer

As per **SA 265** "Communicating Deficiencies in Internal Control to Those Charged with Governance and Management", **significant deficiency in internal control** means a **deficiency** or **combination of deficiencies** in internal control that, in the auditor's professional judgement, is of **sufficient importance to merit the attention of those charged with governance.**

Examples of matters that CA N, auditor of TRP Ltd **may consider in determining whether a deficiency or combination of deficiencies in internal control constitutes a significant deficiency include:**

1) **likelihood of the deficiencies** leading to MM in the FS in future.

2) **Susceptibility** to loss or fraud of the related asset or liability.
3) **Subjectivity and complexity** of determining estimated amounts, such as fair value accounting estimates.
4) **Financial statement amounts exposed** to the deficiencies.
5) **Volume of activity** that has occurred or could occur in A/c balance or class of transactions exposed to the deficiency or deficiencies
6) **Importance of the controls** to financial reporting process; for ex:
   - General monitoring controls (such as oversight of Mgt.).
   - Controls over the prevention and detection of fraud.
   - Controls over selection & application of significant accounting policies.
   - Controls over significant transactions with related parties.
   - Controls over significant transactions outside the entity's normal course of business.
   - Controls over the period-end financial reporting process.
7) **Cause and frequency of the exceptions** detected as a result of the deficiencies in the controls.
8) **Interaction** of the deficiency with other deficiencies in Internal Control.

Q24. CA. S is statutory auditor of a listed company. **On reviewing internal controls** of the company, he is of the view that there can be possible situations **where insurance premiums** for keeping insurance policies current in respect of various assets of company may have **become due and payable but internal control systems** established by the company **may not be able to capture it**. **Elaborate how he should proceed to deal with the above matter. (SM)**

Answer

A deficiency in internal control exists when: -

(i) A **control is designed, implemented or operated** in such a way that it is **unable to prevent, or detect and correct, misstatements** in the financial statements on a timely basis or

(ii) A **control necessary to prevent, or detect and correct**, misstatements in the financial statements **on a timely basis is missing.**

In above situation, **there is a possibility that internal control systems established** by the company **may not be able to capture insurance premiums** which may have become due and payable. It is a **significant deficiency** as failure to keep insurance policies current would render assets of the company uninsured. It may lead to losses for the company in case of any eventuality.

Further, in accordance with **SA 265,** the significance of a deficiency or a combination of deficiencies in internal control depends **not only on whether a misstatement has actually occurred, but also on the likelihood** that a misstatement could occur and the potential magnitude of the misstatement. Significant deficiencies may, therefore, exist even though the auditor has not identified misstatements during the audit.
The **susceptibility to loss of an asset is a factor** in determining **whether a deficiency constitutes significant deficiency in internal control.**
The auditor shall communicate in writing significant deficiency in internal control to those charged with governance and include in the written communication of significant deficiencies in internal control:

(i) A **description** of the deficiencies and an explanation of their potential effects and

(ii) **Sufficient information** to enable those charged with governance and management to understand the context of the communication.

Q25. Auditors are required to obtain an understanding of internal control relevant to the audit when identifying and assessing its effectiveness and risk of material misstatement. During the audit of Acharya Ltd., you observed that significant deficiency exists in the internal control system, and you want to ascertain the same. Elucidate the **various indicators of significant deficiencies which will help you in assessing the efficiency of internal control system of the organization**. **(PYQ Jan'21)**

Answer

In the given case of Acharya Ltd, Auditors, while conducting audit has come across significant deficiency existing in the internal control system and also auditors wanted to ascertain that deficiency.

As per SA 265, "Communicating Deficiencies in Internal Control to Those Charged with Governance and Management ", **Indicators of significant deficiencies in internal control include, for example:**

1) **Evidence** of ineffective aspects of **control environment**, such as:
   - **Indications** that significant transactions in which Mgt. is financially interested are **not being appropriately scrutinised** by TCWG.
   - **Identification** of **Mgt. fraud**, whether or not material, that was **not prevented by the entity's Internal control.**
   - **Mgt.'s failure** to implement appropriate remedial action on significant deficiencies **previously communicated.**
2) **Absence** of a risk assessment process within the entity where such a process would ordinarily be expected to have been established.
3) Evidence of an **ineffective entity risk assessment process**, such as
   Mgt.'s failure to identify a risk of MM that the auditor would expect the entity's risk assessment process to have identified.
4) Evidence of an **ineffective response** to identified significant risks (e.g., absence of controls over such a risk).
5) Evidence of **Mgt.'s inability** to oversee the preparation of the FS.
6) **Misstatements detected** were not prevented, or detected and corrected, by **entity's IC**.
7) Disclosure of a MM due to error or fraud as prior period items in the current year's Statement of P&L.

SA 315 – "Identifying and Assessing the ROMM Through Understanding the Entity and Its Environment"

Q26. While commencing the statutory audit of Alex Co. Ltd., **what would you consider as an auditor to assess risk of material misstatement and responses to such risks? (RTP May 18)**

Answer

Considerations of Auditor for Assessing the Risk of Material Misstatement: As per SA 315 "Identifying and Assessing the Risk of Material Misstatement through understanding the Entity and its Environment", the auditor shall identify and assess the risks of material misstatement at the financial statement level; and the assertion level for classes of transactions, account balances, and disclosures to provide a basis for designing and performing further audit procedures. For this purpose, the auditor shall:

1) **Identify risks** throughout the process of obtaining an understanding of the entity and its environment, including relevant controls that relate to the risks, and by considering classes of transactions, account balances, and disclosures in FS;
2) **Assess** the **identified risks**, and **evaluate whether** they relate more pervasively to the FS as a whole and potentially affect many assertions;
3) **Relate** the identified risks **to what can go wrong** at assertion level, taking account of relevant controls that the auditor intends to test; and
4) **Consider likelihood of misstatement**, including the possibility of multiple misstatements, and whether potential misstatement is of a magnitude that could result in a material misstatement.

Auditor's Responses to Assessed Risk of Material Misstatement: According to SA 330 "The Auditor's Responses to Assessed Risks", auditor shall design & implement overall responses to address the assessed ROMM. In designing audit procedures to be performed, the auditor shall:

a) **Consider reasons for the assessment given to the ROMM at the assertion level for each class of transactions, account balance, and disclosure, including:**
   (i) **likelihood of MM** due to the particular characteristics of the relevant class of transactions, account balance, or disclosure (i.e., the inherent risk); and
   (ii) 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
b) **Obtain more persuasive audit evidence the higher the auditor's assessment of risk.**

Q27. The identified risks are assessed by Auditor as to its significance on account of its likely impact, by way of material misstatement appearing in financial statements or by affecting internal control system. **What may be the points of indication that may direct the Auditor to judge that the risks identified may be significant? (PYQ Jan'21)**

Answer

Points of Indication that may direct the Auditor to Judge that the Risks Identified may be Significant: As per SA 315"Identifying and Assessing the ROMM through Understanding the Entity & Its Environment", as part of the risk assessment the auditor shall determine whether any of the risks identified are, in the auditor's judgment, a significant risk. In exercising this judgment, the auditor shall exclude the effects of identified controls related to the risk.

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

1) Whether **risk is a risk of fraud**;
2) Whether **risk is related to** recent significant economic, accounting, or other developments like changes in regulatory environment, etc., and, therefore, requires specific attention;
3) **Complexity of transactions;**
4) Whether risk involves **significant transactions with related parties**;
5) **Degree of subjectivity** in measurement of financial information related to the risk, especially those measurements involving a wide range of measurement uncertainty; and
6) Whether risk involves **significant transactions** that are **outside the normal course** of **business**, or that otherwise appear to be unusual.

SA 320– "Materiality in Planning and Performing an Audit"

Q28. CA. B was appointed as the auditor of ABC Limited for the financial year 2022-23. During the course of planning for the audit, **CA. B intends to apply the concept of materiality** for the financial statements as a whole. Please **guide him** with respect to the **factors that may affect the identification of an appropriate benchmark for this purpose.**

What benchmark should be adopted by CA. B, if ABC Limited is engaged in:

(i) **the manufacture and sale of air conditioners and is having regular profits.**

(ii) the **construction of large infrastructure projects and incurred losses in the previous two financial years,** due to pandemic. **(TYK-SM)**

Answer

Use of Benchmarks in Determining Materiality for the Financial Statements as a Whole: As per SA 320, determining materiality involves the exercise of professional judgment. **A percentage is often applied to a chosen benchmark as a starting point in determining materiality for the financial statements as a whole.**

Factors that may affect the identification of an appropriate benchmark include the following:

1) **Elements** of the FS (for example, assets, liabilities, equity, revenue, expenses);
2) Whether there are items on which the **attention of the users of the particular entity's FS tends to be focused**
   (for ex, for the purpose of evaluating financial performance users may tend to focus on profit, revenue or net assets);
3) **Nature of the entity**, where the entity is at in its **life cycle**, and industry and economic environment in which the **entity operates**;
4) Entity's **ownership structure** and the **way it is financed**
   (for ex, if an entity is financed solely by debt rather than equity, users may put more emphasis on assets, and claims on them, than on the entity's earnings); and
5) **Relative volatility of the benchmark.**

Determining a percentage to be applied to a chosen benchmark involves the exercise of professional judgment. There is a relationship between the percentage and the chosen benchmark, such that a percentage applied to profit before tax from continuing operations will normally be higher than a percentage applied to total revenue.

In case if ABC Limited is engaged in manufacture and sale of air conditioner, and is having **regular profits**: CA. B, the auditor may **consider profit before tax /Earnings.**

In case if ABC Limited is engaged in the construction of large infrastructure projects and **incurred losses** in the previous two financial years, due to pandemic: CA. B, the auditor **may consider Revenue or Gross Profit as benchmarking.**

Alternatively, CA B, the auditor may **consider** the criteria relevant for audit of the **entities doing public utility programs/ projects, Total cost or net cost (expenses less revenues or expenditure less receipts) may be appropriate benchmarks** for that particular program/project activity. Where an entity has custody of the assets, assets may be an appropriate benchmark.

Q29. As an auditor of RST Ltd. **Mr. P applied the concept of materiality** for the financial statements as a whole. On the basis of obtaining additional information of significant contractual arrangements that draw attention to a particular aspect of a company's business, **he wants to re-evaluate the materiality concept. Please, guide him.**

Answer

In the instant case, **Mr. P**, as an auditor of RST Ltd. has applied the concept of materiality for the financial statements as a whole. But he wants to re-evaluate materiality concept **on the basis of additional information of significant contractual arrangements which draws attention to a particular aspect of company's business**.

As per **SA 320** "Materiality in Planning and Performing an Audit", **while establishing the overall audit strategy,** the auditor. shall determine materiality for financial statement as a whole.

He should set the benchmark on the basis of which he performs his audit procedure. If, in the specific circumstances of the entity, **there is one or more particular classes of transactions, account balances or disclosures** for which misstatements of lesser amounts than the materiality for financial statements as a whole could reasonably be **expected to influence the economic decisions of users taken on the basis of the financial statements**, the auditor shall also determine the materiality level or levels to be applied to those particular classes of transactions, account balances or disclosures.

The auditor shall **revise materiality** for financial statements **in event of becoming aware of information during audit that would have caused the auditor to have determined a different amount initially.**

If the auditor **concludes a lower materiality** for the same, **then he should consider the fact that whether it is necessary to revise performance materiality and whether the nature, timing and extent of the further audit procedures remain appropriate.**

Thus, Mr. P can re-evaluate the materiality concepts after considering the necessity of such revision.

SA 330 – "The Auditor's Responses to Assessed Risks"

Q30. In the course of audit of Z Ltd, its auditor wants to rely on audit evidence obtained in previous audit in respect of effectiveness of internal controls instead of retesting the same during the current audit. As an auditor **discuss the factors that may warrant a re-test of controls. (RTP May 22/Nov 18)**

Answer

As per **SA 330 on "The Auditor's Responses to Assessed Risks"**, changes may affect the relevance of the audit evidence obtained in previous audits such that there may no longer be a basis for continued reliance.

The auditor's decision on whether to rely on audit evidence obtained in previous audits for control is a matter of professional judgment. In addition, the length of time between retesting such controls is also a matter of professional judgment.

Factors that may warrant a re-test of controls are-

1) A **deficient** control environment.
2) **Deficient** monitoring of controls.
3) **Personnel changes** that significantly affect the application of the control.
4) **Changing circumstances** that indicate the need for changes in the control.
5) **Deficient general IT-controls**.
6) A **significant manual element** to the relevant controls.

Q31. While conducting a statutory audit of "Hope Solutions Limited", CA Y has assessed the risk of material misstatement to be low at the financial statement level and at the assertion level due to a stable, established and relatively less risky business and extremely satisfactory internal controls operating in the company. However, despite the low assessed risk of material misstatement, **he chooses to send external confirmation requests to third parties for confirmation of certain material contracts entered into with them by the company.** By doing so, **he intends to obtain evidence** regarding certain assertions contained in the financial statements of the company. **Do you think his approach is in accordance with Standards on Auditing? Justify your answer with reasons. (MTP Oct '23)**

Answer

SA 330 states that **irrespective of the assessed risk of material misstatement**, the **auditor shall design and perform substantive procedures for each material class of transactions, account balance and disclosure.**
In the given situation, the auditor has assessed the risk of material misstatement to be low. However, despite such assessment, substantive procedures have to be performed.

SA 330 further states that the auditor shall consider whether external confirmation procedures are to be performed as substantive audit procedures. External confirmation procedures frequently are relevant when addressing assertions associated with account balances and their elements but need not be restricted to these items. For example, the auditor may request external confirmation of the terms of agreements, contracts, or transactions between an entity and other parties.

Despite the low assessed risk of material misstatement, substantive procedures have to be performed due to the following reasons: -

(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.

It is also in accordance with the spirit of professional skepticism. Therefore, as discussed above, the **approach of CA Y is in accordance with Standards on Auditing.**