AUDITING & ASSURANCE

SEMESTER-V

AUDIT RISK & INTERNAL CONTROL

As per AS 200,"overall objectives of the Independent Auditor and the conduct of an audit in accordance with standards of Auditing", Audit risk is the risk that the auditor may give an inappropriate opinion when financial statement are materially misstated.

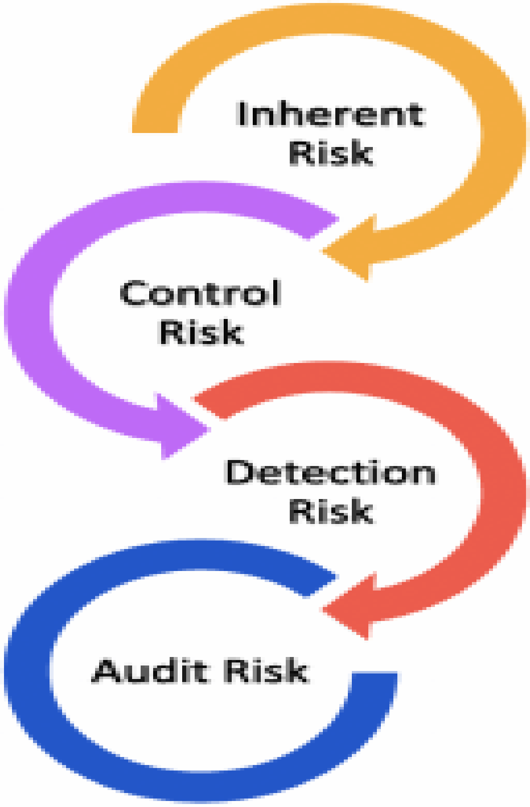
Audit risk is the danger of financial statement being significantly inaccurate unless the audit opinion notes that the financial results are free from any factual mistakes. An audit aims to reduce the audit risk by adequate testing and appropriate evidence to a suitably low level.

Since creditors, investors, and other stakeholders depend on the financial statements, audit risk can be subject to legal liability for an audit work of a CPA company.

An auditor performs inquiries and checks on the general ledger and the relevant documents during an audit. If any mistakes are found during the study, the auditor demands that management recommend that the journal entries be corrected.

At the end of an audit, an auditor gives a written opinion after any corrections have been made as to whether the financial statements are free of material misstatement. Auditing companies provide insurance to handle the audit risk and the possible legal liability.

TYPES OF AUDIT RISK



TYPES of AUDIT RISK

The risk that the accounts may contain misstatements

INHERENT RISK	CONTROL RISK	DETECTION RISK
risk derived from the characteristics of the enterprise and of its environment	the risk that internal controls will not prevent or detect material errors	the risk that the auditor may fail to detect misstatements

RISK ASSESSMENT PROCEDURE

INQUIRIES

ANALYTICAL PROCEDURE

OBSERVATION

INSPECTION

REVIEW EXTERNAL INFORMATION

OUTSIDE COUNSELLING

INTERNAL CONTROL

Internal control is the process, effected by an entity's Board of Trustees, management, and other personnel, designed to provide reasonable assurance regarding the achievement of objectives in the following categories:

- Reliability of financial reporting,
- Effectiveness and efficiency of operations, and
- Compliance with applicable laws and regulations.

OBJECTIVES

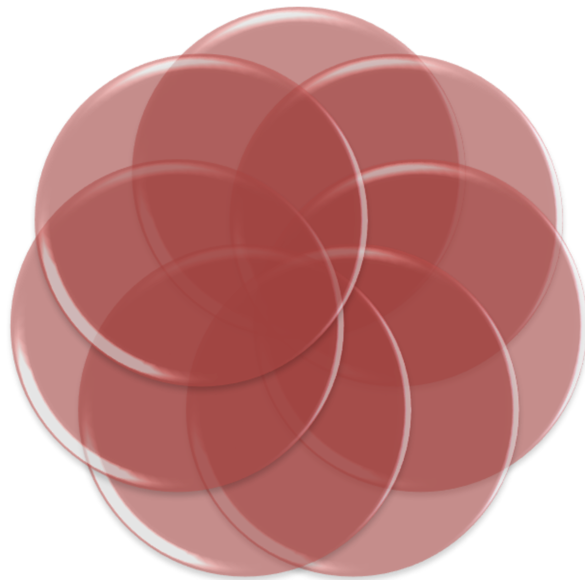
Internal Audit evaluates internal control by accessing the ability of individual process controls to achieve seven pre-defined control objectives. The control objectives include authorization, completeness, accuracy, validity, physical safeguards and security, error handling and segregation of duties.

- Authorization - The objective is to ensure that all transactions are approved by responsible personnel in accordance with specific or general authority before the transaction is recorded.

- Completeness - The objective is to ensure that no valid transactions have been omitted from the accounting records.
- Accuracy - The objective is to ensure that all valid transactions are accurate, consistent with the originating transaction data and information is recorded in a timely manner.
- Validity - The objective is to ensure that all recorded transactions fairly represent the economic events that actually occurred, are lawful in nature, and have been executed in accordance with management's general authorization.

- Physical Safeguards & Security - The objective is to ensure that access to physical assets and information systems are controlled and properly restricted to authorized personnel.
- Error handling - The objective is to ensure that errors detected at any stage of processing receive prompt corrective action and are reported to the appropriate level of management.
- Segregation of Duties - The objective is to ensure that duties are assigned to individuals in a manner that ensures that no one individual can control both the recording function and the procedures relative to processing the transaction.

FEATURES



Proper Organisation structure

Scheme of authorisation & procedure

Internal check

Suitable personnel

Internal audit system

Progressive outlook of management

Audit committee

LIMITATION

No matter how well internal controls are designed, they can only provide reasonable assurance that objectives have been achieved. Some limitations are inherent in all internal control systems. These include:

- Judgment: The effectiveness of controls will be limited by decisions made with human judgment under pressures to conduct business based on the information at hand.
- Breakdowns: Even well designed internal controls can break down. Employees sometimes misunderstand instructions or simply make mistakes.

Errors may also result from new technology and the complexity of computerized information systems.

- Management Override: High level personnel may be able to override prescribed policies and procedures for personal gain or advantage. This should not be confused with management intervention, which represents management actions to depart from prescribed policies and procedures for legitimate purposes.
- Collusion: Control systems can be circumvented by employee collusion. Individuals acting collectively can alter financial data or other management information in a manner that cannot be identified by control systems.

INTERNAL CHECK

- Internal check means practically a continuous internal audit carried on by the staff itself, using which other members of the staff independently check the work of each individual.
- An internal check has been defined by The Institute of Chartered Accountants of England and Wales (ICAEW) as; “the checks on -a day to day transactions which operate continuously as part of the routine system, where the work of one person is proved independently or in complementary to the work of another, the object is the prevention or early detection of errors or frauds.”

An internal check is a continuous process and is part of the day-to-day routine. It relates to all the transactions that take place every day. An internal check is achieved by a complimentary allocation of duties and by independent verification of the work of one person by another.

OBJECTIVES

- To minimize the possibility of error, fraud, and irregularity.
- To prevent the misappropriation of cash and goods.
- To allocate duties and responsibilities to every clerk in the organization.
- To ensure an accurate recording of all business transactions.
- To enhance the efficiency of the clerk in the organization.
- To exercise moral influence over the staff member.
- To prepare a final account with ease and efficiency.

S.No	Basis	Internal Check	Internal Control
1.	Meaning	A system of allocation of responsibility, division of work, and methods of recording transactions, whereby the work of an employee is checked continuously by another.	It consists of all the methods and procedures adopted to assist in achieving the objective of efficient conduct of business. It includes internal check and internal audit.
2.	Scope	It operates in routine to double check every part of a transaction at the time of occurrence and recording of the same.	In internal control systems, work of one person is automatically checked by another.
3.	Objective	Its objective is to ensure that no one employee has exclusive control over any transaction or group of transactions and their recording in the books.	Its object is to ensure adherence to management policies, safeguarding of assets, prevention and detection of frauds and errors, accuracy and completeness of accounting records.
4.	Point of Time	Methods of recording transactions are devised where work of an employee is checked continuously by correlating it with the work of others.	In internal control system, checking is done simultaneously with the conduct of work. Every transaction is checked as soon as it is entered.
5.	Thrust of System	The thrust of internal check system is to prevent errors.	The thrust of internal control lies in fixing of responsibility and division of work to avoid duplication.
6.	Cost Involved	It is a part of internal control and a method of division of work, therefore does not add to the cost.	The system proves to be costly in case of small businesses because more number of employees are engaged.
7.	Report	The summary of day to day transactions work as report to the senior.	Internal control provide for built in MIS reports.


INTERNAL
AUDIT

DEFINITION

- Internal audit refers to an independent service to evaluate an organisation's internal controls, its corporate practices, processes, and methods. An internal audit helps in securing compliance with the various laws applicable to an organization. An organization can prepare its accounts and records as per the applicable legal requirements and reporting.

OBJECTIVES

- .Proper Control - One of the main objectives of an internal audit is to keep stringent control over all the activities of an organization. The management needs assurance of the authenticity of the financial records and the efficiency of the operations of the firm. An internal audit helps establish both.

- Perfect Accounting System- An internal audit keeps a very close check on the accounting system of an organization. It checks everything from the vouchers, to the authority of transactions to mathematical accuracy. All entries are verified against documents and other proof. Chances of mistakes or frauds are greatly reduced.

- Review of Business -The purpose of an internal audit is to keep a check on the financial and operational aspects of a business. So as the current financial year is ongoing, internal audit can point out the mistakes, weak points, and strengths of the business. This will allow an ongoing review, instead of waiting till the year-end.

- Asset Protection -In the process of internal audit, there is always a valuation and verification of an asset. There is also a physical verification of the ownership and possession of the asset.And in case of special transactions like sale, purchase or revaluation of the asset, the authorization of this is also audited in an internal audit. So the assets enjoy complete protection.

- Keeps a Check on Errors -In a financial audit, the auditor will be able to determine if any mistakes were made in the financial records. But this only happens at the end of the financial year. And the mistakes are corrected thereafter. But in case of an internal audit, the mistakes are spotted as soon as they are made, and corrected immediately.

- Detection of Fraud -In case the company has an internal audit in place, the detection of fraud becomes much easier. This is because there is a year-round check on the employees.In fact, an employee is less likely to attempt fraud in the presence of an internal auditor. He will not have any time gap between the occurrence of fraud and its detection to cover it up. This will dissuade employees from committing fraud.

Qualifications of Internal Auditor

They can be conducted by Certified Internal Auditor (CIA), Chartered Account (CA), Cost Accountant, or any authorized person. Moreover, an auditor should possess the following expertise:

- Special expertise was necessary to evaluate the management control system, for example, financial and accounting controls
- .
- Accounting and financial expertise to be able to discharge his duties;
- Ability to evaluate operational and non-monetary operational controls;
- Knowledge of the technology, commerce, laws, taxation, Cost Accounting
- , Economics, Quantitative Methods, and EDP systems;
- Integrity and detachment of a professional;
- She/he should be able to assure the management that the confidentiality of such information would be maintained.

Functions of Internal Auditor

- Monitoring of Internal Controls – Management should maintain Internal control. Internal Auditor may be appointed to monitor whether Internal control is operating or not? And also to suggest any measures to achieve the improvements.
- Examination of Financial and Operating Information – They may review the means used to measure the financial and other information. Auditor may make inquiries for transaction balances and other specific matters.
- Review of Operating Activities – They have to review the operating activities
- of an organization, for example, the Examination of purchase, Production, HR dept, and also to check that whether these departments are efficient, effective, and economical.
- Review of Compliance with Laws and Regulation – They are required to examine whether the organization is following the laws and regulations.
- Governance – They may check whether an entity is following ethical values and whether they are fair or not. Auditor should always suggest measures to improve the same.
- Risk Management – They should guide the management in improving the risk management system.

Internal Audit applicability under section 138 of the Companies Act 2013

Section 138 of the Companies Act 2013: Internal audit

(1) Such class or classes of companies as may be prescribed shall be required to appoint an internal auditor, who shall either be a chartered accountant or a cost accountant, or such other professional as may be decided by the Board to conduct internal audit of the functions and activities of the company.

(2) The Central Government may, by rules, prescribe the manner and the intervals in which the internal audit shall be conducted and reported to the Board.]

Rule 13 of the Companies (Accounts) Rules, 2014: Companies Required to Appoint Internal Auditor

(1) The following class of companies shall be required to appoint an internal auditor which may be either an individual or a partnership firm or a body corporate, namely:-

(a) every listed company;

(b) every unlisted public company having-

(i) paid up share capital of Rs. 50 crore or more during the preceding financial year; or

(ii) turnover of Rs. 200 crore or more during the preceding financial year; or

(iii) outstanding loans or borrowings from banks or public financial institutions exceeding Rs. 100 crore or more at any point of time during the preceding financial year; or

(iv) outstanding deposits of Rs. 25 crore or more at any point of time during the preceding financial year; and

(c) every private company having-

(i) turnover of Rs. 200 crore or more during the preceding financial year; or

(ii) outstanding loans or borrowings from banks or public financial institutions exceeding Rs.100 crore or more at any point of time during the preceding financial year:

Provided that an existing company covered under any of the above criteria shall comply with the requirements of section 138 and this rule within six months of commencement of such section.

Explanation.- For the purposes of rule 13 –

(i) the internal auditor may or may not be an employee of the company;

(ii) the term “Chartered Accountant” or “Cost Accountant” shall mean a “Chartered Accountant” or a “Cost Accountant”, as the case may be, whether engaged in practice or not’.]

(2)The Audit Committee of the company or the Board shall, in consultation with the Internal Auditor, formulate the scope, functioning, periodicity and methodology for conducting the internal audit.

Can internal auditors be used to provide direct assistance to the external auditor for purposes of audit?

Much of the work performed by a company's internal audit function can overlap with the work conducted by the external auditor, specifically in areas dealing with the assessment of control processes. It is likely that in carrying out detailed work evaluating and reviewing the company's internal control framework internal audit perform procedures on financial controls relevant to the external audit. As such, the external auditor, rather than duplicating these procedures, may be able to place reliance on the work carried out by the internal auditor.

This article focuses on the provision of direct assistance by the internal auditors, which historically has been a very controversial issue. Internal auditors are the employees of the entity, which could result in threats to independence (either in fact or perceived) if direct assistance is provided by the internal auditors. On the other hand, the following benefits relating to provision of direct assistance by the internal auditors cannot be ignored:

There will be a strengthened relationship between the external and internal auditors through a more effective dialogue
With the knowledge of the internal auditors, the external auditor can gain additional insights into the entity
The external auditor can use internal auditors who may have relevant expertise in particular areas, and
The external audit team can focus on the more significant audit issues.

Where such use is not prohibited by law or regulation, the ISA provides a robust framework to ensure that direct assistance is obtained only in appropriate circumstances, that the external auditor considers the relevant limitations and safeguards, and that the auditor's responsibilities are clearly set out.

Responsibilities of the external auditor using internal auditors to provide direct assistance

The external auditor should note the following responsibilities at different stages of the audit when using internal auditors to provide direct assistance:

(1) After determining the use of internal auditors to provide direct assistance

The external auditor has to:

Communicate the nature and extent of the planned use of internal auditors with those charged with governance (in accordance with ISA 260, Communication with Those Charged with Governance) so as to reach a mutual understanding that such use is not excessive in the circumstances of the engagement. This communication not only dispels any perception that the external auditor's independence might be compromised by the use of direct assistance but also facilitates appropriate dialogue with those charged with governance.

Evaluate whether the external auditor is still sufficiently involved in the audit.

(2) Prior to the use of internal auditors to provide direct assistance
The external auditor has to obtain written agreement from two parties:

From an authorised representative of the entity stating that: (i) the internal auditors will be allowed to follow the external auditor's instructions, and (ii) the entity will not intervene in the work the internal auditor performs for the external auditors.
From internal auditors stating that they will: (i) keep confidential specific matters as instructed by the external auditor and (ii) inform the external auditor of any threat to their objectivity.

(3) During the audit
The external auditor has to:

Direct, supervise and review the work performed by internal auditors on the engagement, bearing in mind that the internal auditors are not independent of the entity. It is therefore expected that such supervision and review will be of a different nature and more extensive than if members of the audit engagement team perform the work.
Remind the internal auditors to bring accounting and auditing issues identified during the audit to the attention of the external auditors.
Check back to the underlying audit evidence for some of the work performed by the internal auditors.
Make sure the internal auditors have obtained sufficient appropriate audit evidence to support the conclusions based on that work.

(4) Documenting the audit evidence
The documentation requirements evidencing the application of the important safeguards in ISA 610 (Revised 2013) have been expanded when the external auditor uses the internal auditors to provide direct assistance. The external auditor should document the following in the working papers:

Evaluation of the existence and significance of the threats to the objectivity of the internal auditors and the level of competence of the internal auditors used to provide direct assistance

The basis for the decision regarding the nature and extent of the work performed by the internal auditors

Who reviewed the work performed and the date and extent of that review in accordance with ISA 230, Audit Documentation

The written agreements obtained from an authorised representative of the entity and the internal auditors

The working papers prepared by the internal auditors providing direct assistance on the audit engagement.

SA 610 Using the Work of Internal Auditors

Internal Audit Function – “An appraisal activity established or provided as a service to the entity. Its function includes, amongst other things, examining, evaluating and monitoring the adequacy and effectiveness of internal control”

If an entity has an internal audit function and its relevance to the external auditor’s work, then the external auditor should determine:

A. If the specific work of the internal auditor can be used and if so, to what extent

B. Such work is adequate for the audit purpose

SA 610 Using the Work of Internal Auditors is effective for an audit of financial statements for periods beginning on or after 1st April 2010

The relationship between Internal Auditor and External Auditor

Particulars	Internal Audit Function/ Internal Auditor	External Auditor
Role and Scope	Determined by the management	Statutory and defined by the applicable law and regulation
Objective/ Functions	Set by the management and different from the external auditor	Different objectives but some functions performed to achieve objective may be similar
IIndependence& Responsibility	Not independent of the entity irrespective of the degree of autonomy and objectivity	Sole responsibility for the audit opinion expressed and not reduced by the use of internal auditor's work

Whether and to What Extent to Use of Internal Auditor Work

External auditor should determine:

- A. If the internal auditor’s work is adequate for audit purpose and evaluate:

- Objectivity of internal audit function
- Internal auditor’s technical competence
- Internal auditor’s work is carried out with professional care
- Effective communication between the internal auditor and the external auditor

- B. Planned effect of internal auditor’s work on the nature, timing or extent of external auditor’s procedures and consider:

- Nature and scope of specific work performed or to be performed
- Assessed risk of material misstatement at the assertion level for a particular class of transaction, account balance and disclosure
- The degree of subjectivity involved in evaluating the audit evidence to support the relevant assertions

- Example of the internal auditor’s work
- ✓ Examining of financial and operating information
- ✓ Monitoring and reviewing of internal controls
- ✓ Risk management
- ✓ Review of compliance with laws and regulation etc

Specific work of Internal Auditor & Documentation

To use the work of the internal auditors, external auditor should evaluate and perform audit procedures in that work to determine its adequacy if:

- Work performed exhibits adequate technical training and proficiency
- Properly supervised, reviewed and documented
- Sufficient audit evidence has been obtained to draw reasonable conclusions

Conclusions reached are appropriate

- Reports are consistent with the working papers
- Exceptions or unusual matters, if any are properly resolved

The External auditor should perform all the above-mentioned procedures and document the same.

THANK YOU!