

INTERNAL CONTROL

BASIC CONCEPTS

Internal control – The process designed, implemented and maintained by those charged with governance, management and other personnel to provide reasonable assurance about the achievement of an entity's objectives with regard to reliability of financial reporting, effectiveness and efficiency of operations, safeguarding of assets, and compliance with applicable laws and regulations. The term "controls" refers to any aspects of one or more of the components of internal control.

Internal Control in CIS Environment: The internal controls include both manual procedures and procedures designed into computer programs. They comprise the overall controls affecting the CIS environment (general CIS controls) and the specific controls over the accounting applications (CIS application controls).

General CIS Controls :

- a. Organization and management controls
- b. Application systems development and maintenance controls
- c. Computer operation controls.
- d. Systems software controls.
- e. Data entry and program controls.

CIS Application Controls :

- A. Controls over input.
- B. Controls over processing and computer data files.
- C. Controls over output.

"Internal check: Internal check has been defined by the Institute of Chartered Accountants of England and Wales as the "checks on day to day transactions which operate continuously as part of the routine system whereby the work of one person is proved independently or is complementary to the work of another, the object being the prevention or early detection of errors or fraud".

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A Flow Chart: It is a graphic presentation of each part of the company's system of internal control.

Internal Audit: It is a thorough examination of the accounting transactions as well as that of the system according to which these have been recorded, with a view to reassuring the management that the accounts are being properly maintained and the system contains adequate safeguards to check any leakage of revenue or misappropriation of property or assets and the operations have been carried out in conformity with the plans of the management

Examination in Depth: It implies examination of a few selected transactions from the beginning to the end through the entire flow of the transaction, i.e., from initiation to the completion of the transaction by receipt or payment of cash and delivery or receipt of the goods.

Audit Trail: An audit trail refers to a situation where it is possible to relate 'one-to-one' basis, the original input along with the final output.

Audit Risk:

Audit risk is the risk that an auditor may give an inappropriate opinion on financial information which is materially misstated. There are three components of audit risk:

- (i) **Inherent risk:** the susceptibility of the subject matter information to a material misstatement, assuming that there are no related controls; and
- (ii) **Control risk:** the risk that a material misstatement that could occur will not be prevented, or detected and corrected, on a timely basis by related internal controls. When control risk is relevant to the subject matter, some control risk will always exist because of the inherent limitations of the design and operation of internal control; and
- (iii) **Detection risk:** the risk that the practitioner will not detect a material misstatement that exists.

Audit around the Computer: Audit around the computer involves forming of an audit opinion wherein the existence of computer is not taken into account. Rather the principle of conventional audit like examination of internal controls and substantive testing is done.

Auditing through the Computer: This approach involves actual use of computer for processing the information by auditor

Computer Aided Audit Techniques (CAATs): The use of computers may result in the design of systems that provide less visible evidence than those using manual procedures. CAATs are such techniques applied through the computer which are used in the verifying the data being processed by it.

Requirements of CARO, 2003

Clause 4(vii) of CARO, 2003 requires the auditor to comment whether the company has an internal audit system commensurate with the size and nature of the business. The clause is required to be commented upon by the auditor in case of companies having a paid-up capital and reserves exceeding rupees 50 lakhs as at the commencement of the financial year concerned, or having an average annual turnover exceeding five crores rupees for a period of three consecutive financial years immediately preceding the financial year concerned.

Question 1

Comment on the overall objective and scope of an audit does not change in an EDP environment.

Answer

The principal objective of an audit of financial statements, prepared within a framework of recognised accounting policies and practices and relevant statutory requirements, if any, is to ensure that the financial statements reflect a true and fair view. The scope of an audit of financial statements is determined by the auditor having regard to the terms of the engagement, the requirements of relevant legislation and the pronouncements of the Institute. This would involve assessment of reliability and sufficiency of the information contained in the accounting records and other source data by study and evaluation of accounting system and internal controls in operation.

The overall objective and scope of an audit does not change in an EDP environment but the use of a computer changes the processing and storage of financial information and may affect the organisation and procedures employed by the entity to achieve adequate internal control. Accordingly, the procedures followed by the auditor in his study and evaluation of the accounting system and related internal controls and nature, timing and extent of his other audit procedures may be affected by an EDP environment. The computerisation of accounts would also have an impact on the increase in fraud and errors. Thus when auditing in an EDP environment, the auditor should have sufficient understanding of computer hardware, software and processing systems to plan the engagement and to understand how EDP affects the study and evaluation of internal control and application of auditing procedures including computer-assisted audit techniques. The auditor should also have sufficient knowledge of EDP to implement the auditing procedures, depending on the particular audit approach adopted.

Thus, it is clear from the above that overall objective and scope of audit does not change irrespective of fact that whether the accounting information is generated manually or through EDP.

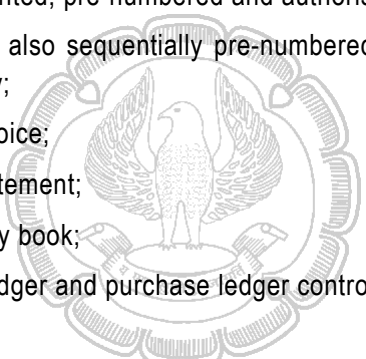
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Question 2

Write a short note on - Examination in Depth.

Answer

Examination in Depth: It implies examination of a few selected transactions from the beginning to the end through the entire flow of the transaction, i.e., from initiation to the completion of the transaction by receipt or payment of cash and delivery or receipt of the goods. This examination consists of studying the recording of transactions at the various stages through which they have passed. At each stage, relevant records and authorities are examined; it is also judged whether the person who has exercised the authority in relation to the transactions is fit to do so in terms of the prescribed procedure. For example, a purchase of goods may commence when a predetermined re-order level has been reached. The ensuing stages may be summarised thus:

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- (i) Requisitions are pre-printed, pre-numbered and authorised;
 - (ii) official company order, also sequentially pre-numbered, authorised and placed with approved suppliers only;
 - (iii) receipt of supplier's invoice;
 - (iv) receipt of supplier's statement;
 - (v) entries in purchases day book;
 - (vi) postings to purchase ledger and purchase ledger control account;
 - (vii) cheque in settlement;
 - (viii) entry on bank statement and returned "paid" cheque (if requested);
 - (ix) cash book entry;
 - (x) posting from cash book to ledger and control account, taking into account any discounts.
 - (xi) receipt of goods, together with delivery/advice note;
 - (xii) admission of goods to stores;
 - (xiii) indication, by initials or rubber stamp on internal goods inwards note, of compliance with order regarding specification, quantity and quality;
 - (xiv) entries in stores records.

It should be noted that the above list is not necessarily comprehensive, nor does its constituent stages inevitably take place in the sequence suggested. The important point to note is that from the moment it was realised that once a re-order level had reached, a chain of

events was put in motion, together leaving what may be termed as “audit trail”. Each item selected for testing must be traced meticulously, and although sample sizes need not be large, they must, of course, be representative.

It is an acceptable practice to check a slightly smaller number of transactions at each successive stage within a depth test, on the statistical grounds (based on probability theory) that the optimum sample size decreases as the auditor’s “level of confidence” concerning the functioning of the system increases. Examination in depth has been found indispensable in modern auditing practice and, if intelligently conducted, its reconstruction of the audit trail reveals more about the functioning (or malfunctioning) of the client’s system in practice than the haphazard and mechanical approach to testing.

Question 3

*‘Doing an audit in an EDP environment is simpler since the trial balance always tallies’
Analyse critically?*

Answer

Though it is true that in an EDP environment the trial balance always tallies, the same cannot imply that the job of an auditor becomes simpler. There can still be some errors of omissions like omission of certain entries, compensating errors, duplication of entries, etc. in the books of accounts even when the trial balance tallied. In today’s complex business environment, the importance of trial balance in an audit has to be gauged not from the view point of arithmetical accuracy but the nature of transaction to be recorded which in fact have become very complex. The emergence of new forms of financial instruments like option and futures, derivatives, off-balance sheet financing, etc. have given rise to further complexities in recording and disclosure of transactions. In an audit besides the tallying of a trial balance, there are also other issues like estimation of depreciation, valuation of inventories, etc. which still require judgement to be exercised by the auditor. The total time taken in an audit may still be considerably higher even though the trial balance has tallied than an audit where the trial balance has not tallied. That responsibility of the auditor will still remain even in an EDP environment. Therefore, simply because of EDP environment and the trial balance has tallied do not make the audit simpler.

Question 4

Write a short note on - Audit Trail.

Answer

Audit Trail: An audit trail refers to a situation where it is possible to relate ‘one-to-one’ basis, the original input along with the final output. The work of an auditor would be hardly affected if “Audit Trail” is maintained i.e. if it were still possible to relate, on a ‘one-to-one’ basis, the

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original input with the final output. A simplified representation of the documentation in a manually created audit trail.

For example, the particular credit notes may be located by the auditor at any time he may wish to examine them, even months after the balance sheet date. He also has the means, should he so wish, of directly verifying the accuracy of the totals and sub-totals that feature in the control listing, by reference to individual credit notes. He can, of course, check all detailed calculations, casts and postings in the accounting records, at any time.

In first and early second-generation computer systems, such a complete and trail was generally available, no doubt, to management's own healthy scepticism of what the new machine could be relied upon to achieve – an attitude obviously shared by the auditor.

It is once iterated that there is an abundance of documentation upon which the auditor can use his traditional symbols of scrutiny, in the form of colored ticks and rubber stamps. Specifically:

- (i) The output itself is as complete and as detailed as in any manual system.
- (ii) The trail, from beginning to end, is complete, so that all documents may be identified by located for purposes of vouching, totalling and cross-referencing.

Any form of audit checking is possible, including depth testing in either direction.

Question 5

What are the different design and procedural aspects of EDP systems?

Answer

The different design and procedural aspects of EDP systems are:

- (i) **Consistency of Performance:** EDP systems perform functions exactly as programmed and are potentially more reliable than manual systems, provided that all transaction type and conditions that could occur are anticipated and incorporated into the system.
- (ii) **Programmed Control Procedures:** The nature of computer processing allows the design of internal control procedures in computer programs. These procedures can be designed to provide controls with limited visibility (e.g., protection of data against unauthorized access may be provided by passwords). Other procedures can be designed for use with manual intervention, such as review of reports printed for exception and error reporting, and reasonableness and limit checks of data.
- (iii) **Single Transaction Update of Multiple or Data Base Computer Files:** A single input to the accounting system may automatically update all records associated with the transaction (e.g., shipment of goods documents may update the sales and

customers' accounts receivable files as well as the inventory file). Thus, an erroneous entry in such a system may create errors in various financial accounts.

- (iv) **Systems Generated Transactions:** Certain transactions may be initiated by the EDP system itself without the need for an input document. The authorization of such transactions may neither be supported by visible input documentation nor documented in the same way as transactions which are initiated outside the EDP system (e.g., interest may be calculated and charged automatically to customers' account balances on the basis of pre-authorized terms contained in a computer program).
- (v) **Vulnerability of Data and Programme Storage Media:** Large volumes of data and the computer programs used to process such data may be stored on portable or fixed storage media, such as magnetic discs and tapes. These media are vulnerable to theft, or intentional or accidental destruction.

Question 6

Explain the Internal controls in an EDP Environment.

Answer

Internal controls in an EDP Environment

The internal controls over computer processing, which help to achieve the overall objectives of internal control, include both manual procedures and procedures designed into computer programmes. Such manual and computer controls affect the EDP environment (general EDP controls) and the specific controls over the accounting applications (EDP application controls).

General EDP Controls: The purpose of general EDP controls is to establish a framework of overall control over the EDP activities and to provide a reasonable level of assurance that the overall objectives of internal control are achieved. These controls may include:

- (a) Organisation and management controls are designed to establish an organizational framework over EDP activities, including:
 - (i) Policies and procedures relating to control functions.
 - (ii) Appropriate segregation of incompatible functions.
- (b) Application systems development and maintenance controls are designed to establish control over:
 - (i) Testing, conversion, implementation and documentation of new or revised systems.
 - (ii) Changes to application systems.

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- (iii) Access to systems documentation
- (iv) Acquisition of application systems from third parties.
- (c) Computer operation controls are designed to control the operation of the systems and to provide reasonable assurance that:
 - (i) The systems are used for authorised purposes only.
 - (ii) Access to computer operations is restricted to authorised personnel.
 - (iii) Only authorised programs are used.
 - (iv) Processing errors are detected and corrected.
- (d) Systems software controls include:
 - (i) Authorisation, approval, testing, implementation and documentation of new systems software and systems software modifications.
 - (ii) Restriction of access to systems software and documentation to authorised personnel.
- (e) Data entry and program controls are designed to provide reasonable assurance that :
 - (i) An authorisation structure is established over transactions being entered into the system.
 - (ii) Access to data and programs is restricted to authorised personnel.
 - (iii) Offsite back-up of data and computer programmes.
 - (iv) Recovery procedures for use in the event of theft, loss or intentional or accidental destruction.
 - (v) Provision for offsite processing in the event of disaster;

EDP Application Controls: The purpose of EDP application controls is to establish specific control procedures over the accounting applications to provide reasonable assurance that all transactions are authorised and recorded, and are processed completely, accurately and on a timely basis. These include:

- (a) *Controls over input are designed to provide reasonable assurance that:*
 - (i) Transactions are properly authorised before being processed by the computer.
 - (ii) Transactions are accurately converted into machine readable form and recorded in the computer data files.
 - (iii) Transactions are not lost, added, duplicated or improperly changed.
 - (iv) Incorrect transactions are rejected, corrected and if necessary, resubmitted on a timely basis.

- (b) *Controls over processing and computer data files are designed to provide reasonable assurance that:*
 - (i) Transactions, including system generated transactions, are properly processed by the computer.
 - (ii) Transactions are not lost, added, duplicated or improperly changed.
 - (iii) Processing errors are identified and corrected on a timely basis.
- (c) Controls over output are designed to provide reasonable assurance that:
 - (i) Results of processing are accurate.
 - (ii) Access to output is restricted to authorised personnel.
 - (iii) Output is provided to appropriate authorised personnel on a timely basis

Question 7

Write a short note on - the Audit Risk.

Answer

Audit Risk: Audit risk is the risk that an auditor may give an inappropriate opinion on financial information which is materially misstated. An auditor may give an unqualified opinion on financial statements without knowing that they are materially misstated. Such risk may exist at overall level, while verifying various transactions and balance sheets items. There are three components of audit risk:

- (i) **Inherent Risk:** is a risk that material errors will occur. Inherent risk is the susceptibility of an account balance or class of transactions to misstatement that could be material, individually or when aggregated with misstatements in other balances or classes, assuming that there were no related internal controls.
- (ii) **Control Risk:** is the risk that the client's system internal control will not prevent or correct such errors, to assess control risk, the auditor should consider the adequacy of control design as well as test adherence to control procedure.
- (iii) **Detection Risk:** is the risk that an auditor's procedures will not detect a misstatement that exists in an account balance or class of transactions that could be material, individually or when aggregated with misstatements in other balances or classes. The level of detection risk relates directly to the auditor's procedures. Some detection risk would always be present.

The inherent and control risks are functions of the entity's business and its environment and the nature of the account balances or classes of transactions, regardless of whether an audit is conducted. Even though inherent and control risks cannot be controlled by the auditor, the

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auditor can assess them and design his substantive procedures to produce on acceptable level of detection risk, thereby reducing audit risk to an acceptable low level.

Question 8

Can the Statutory Auditor rely upon the work of an Internal Auditor?

Answer

Reliance on the Work of Internal Auditor: According to SA 610, “Relying upon the Work of an Internal Auditor”, the scope and objective of internal audit are dependent upon the size and structure of the entity and the requirements of its management and, where applicable, those charged with governance. Internal audit is an integral part of internal control system prevailing in any organisation. While the external auditor has sole responsibility for his report and for the determination of the nature, timing and extent of the auditing procedures, much of the work of the internal audit function may be useful to him in his examination of the financial information.

The external auditor should determine the work of the internal auditors is likely to be adequate for purposes of the audit; and if so, the planned effect of the work of the internal auditors on the nature, timing or extent of the external auditor's procedures.

In determining whether the work of the internal auditors is likely to be adequate for purposes of the audit, the external auditor shall evaluate:

- (a) The objectivity of the internal audit function;
- (b) The technical competence of the internal auditors;
- (c) Whether the work of the internal auditors is likely to be carried out with due professional care; and
- (d) Whether there is likely to be effective communication between the internal auditors and the external auditor.

In determining the planned effect of the work of the internal auditors on the nature, timing or extent of the external auditor's procedures, the external auditor shall consider:

- (a) The nature and scope of specific work performed, or to be performed, by the internal auditors;
- (b) The assessed risks of material misstatement at the assertion level for particular classes of transactions, account balances, and disclosures; and
- (c) The degree of subjectivity involved in the evaluation of the audit evidence gathered by the internal auditors in support of the relevant assertions.

In order for the external auditor to use specific work of the internal auditors, the external auditor shall evaluate and perform audit procedures on that work to determine its adequacy for the external auditor's purposes.

To determine the adequacy of specific work performed by the internal auditors for the external auditor's purposes, the external auditor shall evaluate whether:

- (a) The work was performed by internal auditors having adequate technical training and proficiency;
- (b) The work was properly supervised, reviewed and documented;
- (c) Adequate audit evidence has been obtained to enable the internal auditors to draw reasonable conclusions;
- (d) Conclusions reached are appropriate in the circumstances and any reports prepared by the internal auditors are consistent with the results of the work performed; and
- (e) Any exceptions or unusual matters disclosed by the internal auditors are properly resolved.

The degree of reliance that a statutory auditor can place on the work done by the internal auditor is also a matter of individual judgement in a given set of circumstances. The ultimate responsibility for reporting on the financial statements is that of the statutory auditor. It must be clearly understood that the statutory auditor's responsibility is absolute and any reliance he places upon the internal audit system is part of his audit approach or technique and does not reduce his sole responsibility.

Question 9

What is an Audit Trail? Briefly state the special audit techniques using the computer as an audit tool.

Answer

Audit Trail: 'Audit trail' refers to a situation where it is possible to relate, on a "one – to –one" basis, the original input with the final output. In a manual accounting system, it is possible to relate the recording of a transaction of each successive stage enabling an auditor to locate and identify all documents from beginning to end for the purposes of examining documents, totalling and cross – referencing. In first and early second generation computer systems, a complete audit trail was generally available. However, with the advent of modern machines, the EDP environment has become more complex. This led to use of exception reporting by the management which effectively eliminated the audit trail between input and output. The lack of visible evidence may occur at different stages in the accounting process, for example:

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- i. Input documents may be non-existent where sales orders are entered online. In addition, accounting transactions such as discounts and interest calculations may be generated by computer programmes with no visible authorization of individual transactions.
- ii. The system may not produce a visible audit trail of transactions processed through the computer. Delivery notes and suppliers invoices may be matched by a computer programme. In addition, programmed control procedures such as checking customer credit limits, may provide visible evidence only on an exception basis. In such cases, there may be no visible evidence that all transactions have been processed.
- iii. Output reports may not be produced by system or a printed report may only contain summary totals while supporting details are retained in computer files.

Special audit Techniques: In the absence of audit trail, the auditor needs the assurance that the programmes are functioning correctly in respect of specific items by using special audit techniques. The absence of input documents or the lack of visible audit trail may require the use of Computer Assisted Audit Techniques (CAATs) i.e. using the computer as an audit tool. The auditor can use the computer to test:

- the logic and controls existing within the system, and
- the records produced by the system.

Depending upon the complexity of the application system being audited, the approach may be fairly simple or require extensive technical competence on the part of the auditor. The effectiveness and efficiency of auditing procedure may be enhanced through the use of CAATs. Properly, two common types of CAATs are in vogue, viz., test pack or test data and audit software or computer audit programmes.

Question 10

Explain the important requirements which should be kept in mind to establish or evaluate a system of internal control for application process at Service Bureau?

Answer

Requirements of Internal Control System at a Service Bureau: Various requirements to establish or evaluate a system of internal control for applications processed at a service bureau are stated below:

1. Liaison between bureau and user should be clearly defined. Senior member of the user's staff is appointed as liaison officer.
2. Need for a system testing including all clerical procedures at the user company.

3. Control over physical movement of data and in this respect whether a copy or microfilm of documents sent to the service bureau is kept.
4. Planning procedure so that error is identified by documents provided by the bureau. The user must ensure that prompt correction and resubmission of rejection to meet the bureau processing schedule.
5. Establishing a system in the user company to ensure that all exceptional reports are received from bureau.
6. Establish clerical control to verify the accuracy of computer processing.
7. Normally, user has no physical control over the files; therefore, high control over the maintenance of data on master files should be established.

Question 11

“Installation of Computer Operating System has created both benefits and problems for auditors”. Explain the Statement?

Answer

Computer Operating Systems and the Auditor: The installation of computer operating system is an integral and absolutely essential part of a computer even in a stand alone PC-based environment. In fact it is difficult to visualize a computer to be operational without installation of the operating system. With the advancement of technology, the operating systems are part of the server or hard disc and provide lots of options and flexibility to the user. The provision of all these built-in-features is quite beneficial to user and the auditor alike. The data stored in the system can be extracted depending upon the requirement, e.g., records relating to students can be region-wise, city-wise, examination centre-wise, etc to compare the performance. At the same time, these advanced features of operating systems have given rise to several general hazards associated with it. In these circumstances, it becomes essential to restrict the access to data by ensuring proper security system such as passwords and other access controls, etc. However, such system at time can be hacked and then the entire data base is vulnerable to manipulation. Thus, from the auditor's point of view installation of operating system have created both benefits and problems. The major benefits flow from the fact of examination of execution of transactions, taking samples, etc. while problems might arise to potential manipulation of the data. It may however, be noted that benefits from the operating system for outweigh the problems associated with it.

Question 12

Explain briefly the approaches to EDP auditing?

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Answer

Approaches to EDP Auditing

Computerisation of accounts does not affect the basic objective of auditing. However, the auditor would need to modify his audit procedures, approach and technical capabilities so as to be able to form an opinion on the accounts processed in a computerised environment. The auditor must plan whether or not to use the computer. The two approaches are commonly called "auditing around the computer" and "auditing through the computer".

Audit around the Computer: Audit around the computer involves forming of an audit opinion wherein the existence of computer is not taken into account. Rather the principle of conventional audit like examination of internal controls and substantive testing is done. The auditor views the computer as a black box, as the application system processing is not examined directly. The main advantage of auditing around the computer is its simplicity. Audit around the computer is applicable in the following situations:

- (i) The system is simple and uses generalised software that is well tested and widely used.
- (ii) Processing mainly consists of sorting the input data and updating the master file in sequence.
- (iii) Audit trail is clear. Detailed reports are prepared at key processing points within the system.
- (iv) Control over input transactions can be maintained through normal methods, i.e. separation of duties, and management supervision.

Generalised software packages, like payroll and provident fund package, accounts receivable and payable package, etc. are available, developed by software vendors. Though the auditor may decide not to go in details of the processing aspects, if there are well tested widely used packages provided by a reputed vendor. However, he has to ensure that there are adequate controls to prevent unauthorised modifications of the package. However, it may be noted that all such generalised packages do not make the system amenable to audit. Some software packages provide generalised functions that still must be selected and combined to achieve the required application system. In such a case, instead of simply examining the systems input and output, the auditor must check the system in depth to satisfy him about such system. The main disadvantages of the system of auditing around the computer are:

- (a) It is not beneficial for complex systems of large scale in very large multi unit, multi locational companies, having various inter unit transactions. It can be used only in case of small organisations having simple operations.

- (b) It is difficult for the auditor to assess the degradation in the system in case of change in environment, and whether the system can cope with a changed environment

Audit through the Computer: The sophistication of computers have finally reached the point where auditors can no longer audit around the system. They are forced to treat the computers as the target of the audit and audit through it. Auditing through the computer requires that the auditor submits data to the computer for processing. The results are then analysed for the processing reliability and accuracy of the computer programme. Technical and other developments that necessitated this approach include the following:

- On-line data entry.
- Elimination or reduction of print-outs.
- Real time files up dating.

The auditor can use the computer to test:

- (a) the logic and controls existing within the system; and
- (b) the records produced by the system.

Depending upon the complexity of the application system being audited, the approach may be fairly simple or require extensive technical competence on the part of the auditor.

There are several circumstances where auditing through the computer must be used:

- (i) The application system processes large volumes of input and produces large volumes of output that make extensive direct examination of the validity of input and output difficult.
- (ii) Significant parts of the internal control system are embodied in the computer system. For example, in an online banking system a computer programme may batch transactions for individual tellers to provide control totals for reconciliation at the end of the day's processing.
- (iii) The logic of the system is complex and there are large portions that facilitate use of the system or efficient processing.
- (iv) There are substantial gaps in the visible audit trail.

The primary advantage of this approach is that the auditor has increased power to effectively test a computer system. The range and capability of tests that can be performed increases and the auditor acquires greater confidence that data processing is correct. By examining the system's processing, the auditor also can assess the system's ability to cope with environment change.

The primary disadvantages of the approach are generally high costs and the need for extensive technical expertise when systems are complex. However, these disadvantages

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are really not that important if auditing through the computer is the only viable method of carrying out the audit.

Auditing through computer may be conducted through test data, computer programme, etc.

Question 13

Write a short note on - Independence of Internal Auditor.

Answer

Independence of Internal Auditor: The concept of independence is equally relevant for internal auditor also. Internal auditing is an independent, objective assurance and consulting activity designed to add value and improve an organisation's operations. Internal auditor is part of the management but he evaluates the functioning of the management at different levels.

Therefore, to be efficient and effective, the internal auditor must have adequate independence. It may be noted that by its very nature, the internal audit function cannot be expected to have the same degree of independence as is essential when the external auditor expresses his opinion on the financial information. To ensure his independence he is made responsible directly to the Board of Directors through audit committee. Such a channel of communication provides an independent mode whereby an internal auditor can communicate and share his views on the scope of internal audit, findings, etc. If internal auditor is made subordinate to lower level, his independence will be effected which will affect his functioning and effectiveness. An outsider, like a firm of chartered accountants, if acting as internal auditor, is likely to be more independent than an employee of the organization.

Question 14

Why are Computer Aided Audit Techniques (CAAT) required in EDP audit? What are the advantages of CAATs?

Answer

Computer Aided Audit Techniques (CAATs): The use of computers may result in the design of systems that provide less visible evidence than those using manual procedures. CAATs are such techniques applied through the computer which are used in the verifying the data being processed by it. System characteristics resulting from the nature of EDP processing that demand the use of Computer Aided Audit Techniques (CAAT) are:

- (i) **Absence of input documents:** Data may be entered directly into the computer systems without supporting documents. In on-line transaction systems, written evidence of individual data entry authorization, e.g., credit limit approval may not be available.

- (ii) **Lack of visible transaction trail:** Certain data may be maintained on computer files only. In a manual system, it is normally possible to follow a transaction through the system by examining source documents, books of account, records, files and reports. In an EDP environment, however, the transaction trail may be partly in machine-readable form, and it may exist only for a limited period of time.
- (iii) **Lack of visible output:** In a manual system, it is normally possible to examine visually the results of processing. In EDP systems, the results of processing may not be printed or only a summary data may be printed. Thus, the lack of visible output may result in the need to access data retained on machine readable files.
- (iv) **Ease of Access to data and computer programmes:** Data and computer programmes may be altered at the computer or through the use of computer equipment at remote locations. Therefore, in the absence of appropriate controls, there is an increased potential for unauthorized access to, and allocation of, data and programmes by persons inside or outside the entity.

Advantages of CAAT

- (i) **Audit effectiveness:** The effectiveness and efficiency of auditing procedures will be improved through the use of CAAT in obtaining and evaluating audit evidence, for example –
 - (a) Some transactions may be tested more effectively for a similar level of cost by using the computer.
 - (b) In applying analytical review procedures, transactions or balance details of unusual items may be reviewed and reports got printed more efficiently by using the computer.
- (ii) **Savings in time:** The auditor can save time by reviewing the EDP controls using CAAT than through other audit procedures.
- (iii) **Effective test checking and examination in depth:** CAAT permits effective examination in depth of selected transactions since the auditor constructs the lost audit trail.

Question 15

What are the special steps involved in framing a system of Internal Check?

Answer

General Considerations in Framing a System of Internal Check: The term “internal check” is defined as the “checks on day to day transactions which operate continuously as part of the routine system whereby the work of one person is proved independently or is complementary

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to the work of another, the object being the prevention or early detection of errors or fraud". The following aspects should be considered in framing a system of internal check:

- (1) No single person should have an independent control over any important aspect of the business. The work done by one person should automatically be checked by another person in routine course.
- (2) The duties/work of members of the staff should be changed from time to time without any previous notice so that the same officer or subordinate does not, without a break, 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 in a year so that frauds successfully concealed by such a person can be detected in his absence.
- (4) Persons having physical custody of assets must not be permitted to have access to the books of accounts.
- (5) There should be an accounting control in respect of each important class of assets, in addition, these should be periodically inspected so as to establish their physical condition.
- (6) The system of Budgetary Control should be introduced.
- (7) For stock-taking, at the close of the year, trading activities should, if possible, be suspended. The task of stock-taking, and evaluation should be done by staff belonging to other than stock section.
- (8) The financial and administrative powers should be sub divided very judiciously and the effect of such division should be reviewed periodically.
- (9) Finally, the system must be capable of being expanded or contracted to correspond to the size of the concern.

Question 16

Give your comments on the following:

In a medium size trading organisation the accountant was given additional responsibility of making recoveries from the debtors. On one occasion, when an insurance claim of Rs. 25,000 was received, he credited the same to the account of a debtor and misappropriated the cash which he had recovered from the said debtor. Pinpoint weaknesses in the internal control system which led to this situation.

Answer

Following two essential features of internal control are relevant here:

- (i) Breaking the chain of the work in a manner so that no single person can handle a transaction from the beginning to the end and
- (ii) Segregation of accounting and custodial functions.

Weakness in internal control system in the instant case:

- (a) The accountant is receiving cash and also passing the entries in the books. The accountant should not have been allowed to effect recoveries.
- (b) It also appears that system for issuing receipts for amount received - whether cash or cheque is also lacking.
- (c) In a small and to some extent medium size organization, the supervision of the owner offsets the deficiencies in internal control system. But in this case, it appears, that supervision and personal control is also lacking.

Thus, in the given case, the main weakness of the system is that it is ignoring the basic requirements of a good internal control system.

Question 17

Answer the following:

- (a) *State any four important elements of input control in processing of data in a computerised accounting system.*
- (b) *What are the disadvantages of the use of an audit programme?*

Answer

(a) Control over input in a computerized data system (any four)

- (i) The input fed into the computer should be authorized. The authorization levels should be checked. The authorization is effected by levels of access to the entry for the computer system. The access control is operated through use of password and logging procedures.
- (ii) The system should devise controls to check that data input are accurate.
- (iii) The input document should be reviewed and verified by another person after preparation.
- (iv) Transaction should be accurately converted into machine readable language and recorded in a computer data file.
- (v) The transactions are not lost, duplicated, or changed without authorization.
- (vi) There should be validity and cross reference checks inbuilt in the system to throw light on errors which appear in the process of feeding input.

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- (vii) Incorrect transactions are thrown out by a list which must be corrected, resubmitted before the process could run on the inputs.
- (viii) The check digit total of financial information contained in the document or hash total may be used to act as a control tool.
- (ix) The serial control may be used in inputting data that are to follow serial sequence. Any deviation in serial sequence will have to be automatically signaled out.

(b) Disadvantages of the use of an Audit Programme

- (i) The work may become mechanical and particular parts of the programme may be carried out without any understanding of the object of such parts in the whole audit scheme.
- (ii) The programme often tends to become rigid and inflexible following set grooves; the business may change in its operation of conduct, but the old programme may still be carried on.
- (iii) Inefficient assistants may take shelter behind the programme i.e. defend deficiencies in their work on the ground that no instruction in the matter is contained therein.
- (iv) A hard and fast programme may kill the initiative and innovation of efficient and enterprising assistants.

Question 18

Write a short note on - Statutory Auditor versus Internal Auditor.

Answer

Statutory Auditor versus Internal Auditor:

STATUTORY AUDITOR	INTERNAL AUDITOR
1. The extent of the work undertaken by statutory auditor arises from the responsibility placed on him by the statutes.	The extent of the work undertaken by the internal auditor is determined by the management.
2. The approach of this auditor is governed by his statutory duty to satisfy himself that the accounts to be presented to the shareholder show a true and fair view of the financial position.	The approach of this auditor is with a view to satisfy that the accounting system is efficient, so that the accounting information presented to the management is accurate and discloses material facts.

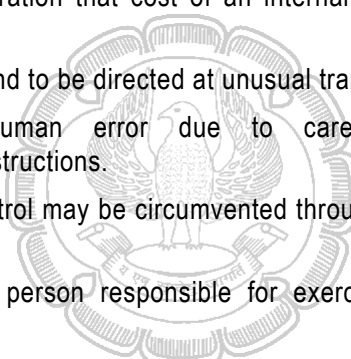
3. This auditor is responsible directly to the shareholder.	This auditor is responsible to management.
4. External auditor is not the employee of the company so he has independent status.	Internal auditor is an employee of the company. So he can not enjoy independence that statutory auditor has.

Question 19

What are the inherent limitations of Internal Control system?

Answer

Internal control can provide only reasonable but not absolute assurance that its objective relating to prevention and detection of errors/frauds, safeguarding of assets etc., are achieved. This is because it suffers from some inherent limitations, such as:-

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- (i) Management's consideration that cost of an internal control does not exceeds the expected benefits.
 - (ii) Most controls do not tend to be directed at unusual transactions.
 - (iii) The potential of human error due to carelessness, misjudgment and misunderstanding of instructions.
 - (iv) The possibility that control may be circumvented through collusion with employees or outsiders.
 - (v) The possibility that a person responsible for exercising control may abuse that authority.
 - (vi) Compliance with procedures may deteriorate because the procedures becoming inadequate due to change in condition.
 - (vii) Manipulation by management with respect to transactions or estimates and judgements required in the preparation of financial statements.
 - (viii) Inherent limitations of Audit.

Question 20

What are the aims of internal control so far as Financial and Accounting aspects are concerned?

Answer

Aims of Internal Control in relation to Financial and Accounting Aspects: Internal controls relating to financial and accounting aspects are concerned with achieving the following objectives –

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- (a) transactions are executed in accordance with management's general or specific authorisation;
- (b) all transactions and other events are promptly recorded in the correct amount, in the appropriate accounts and in the proper accounting period so as to permit preparation of financial statements in accordance with the applicable accounting standards, other recognised accounting policies and practices and relevant statutory requirements, if any, and to maintain accountability for assets;
- (c) assets and records are safeguarded from unauthorised access, use or disposition; and
- (d) the recorded assets are compared with the existing assets at reasonable intervals and appropriate action is taken with regard to any differences.

Thus, it is clear from the above that internal controls relating to accounting and financial aspects primarily aim at providing the flow of work through various stages so as to segregate the authorising, recording and custodial aspects of the transaction.

For example, in a transaction involving purchase of fixed assets, the Board may authorise the Purchase Manager to purchase fixed assets, the recording of the purchase is performed by the Accounts Department, while the custody of assets rests with User Department. At the authorisation stage, the internal controls aim at ensuring that transactions are executed in accordance with the management's authorisation, general or specific. Thus, it ensures compliance with prescribed policies and procedures.

The internal controls at the recording stage, in particular, aim at ensuring that no single person can handle a transaction from the beginning to the end. When obtaining an understanding of the accounting and internal control systems to plan the audit, the auditor obtains knowledge of the design of the accounting and internal control systems, and their operation.

For example, an auditor may perform a "walk-through" test that is, tracing a few transactions through the accounting system. When the transactions selected are typical of those transactions that pass through the system, this procedure may be treated as part of the tests of control. The nature and extent of walk through tests performed by the auditor are such that they alone would not provide sufficient appropriate audit evidence to support a control risk assessment which is less than high.

The nature, timing and extent of the procedures performed by the auditor to obtain an understanding of the accounting and internal control systems will vary with, among other things.

- The size and complexity of the entity and of its information system.

- Materiality considerations.
- The type of internal controls involved.
- The nature of the entity's documentation of specific internal controls.
- The auditor's assessment of inherent risk.



EXERCISES

Question 1

State with reasons your views on the following:

A senior assistant of X & Co., Chartered Accountants drew up his audit programme without evaluating internal controls of T Ltd. When the partner asked firm for the reason, he stated that the controls were developed by the General Manager (Finance) of T Ltd., who is a Chartered Accountants and had written a few books on "Internal Control", and, therefore there was no need to review the said area.

Question 2

"Installation of computer operating systems has created both benefits and problems for auditors" discuss the statement.

Question 3

You have been appointed as Internal Auditor of a company and you have come across certain weaknesses in the Internal Control System. Draft a specimen form of Management Letter indicating at least four areas of weakness relating to internal Control

Question 4

Mention six basic items with which the auditor should be familiar to understand the computer system used by the client.

Question 5

State the steps that you would suggest for proper internal control over stores of a large Textile Mill Company.

Question 6

What are the important features of distinction between computer based system of accounting and those of a conventional nature?

Question 7

Comment on the use of computer facilities by a small enterprise may increase the control risk.

Question 8

What matters should be taken into consideration for evaluating Internal Control over after sale-services?

Question 9

Distinguish between Internal Check and Internal Audit

Question 10

Write short note on Review and testing of the Internal Control systems.

