

## INTERNAL CONTROL

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### Question 1

*Explain the following in brief:*

*Relationship between Statutory Auditor and internal Auditor. (5 Marks) (May 2007)*

### Answer

**Relationship between Statutory Auditor and internal Auditor:** The function of an internal auditor being an integral part of the system of internal control, it is obligatory for a statutory auditor to examine the scope, independence and effectiveness of the work carried out by the internal auditor. CARO, 2004 also requires the statutory auditor to comment on the internal audit system.

Though the roles and primary objectives of internal and statutory audit differs, some of their means of achieving their respective objectives are similar. Thus, much of the work of the internal auditor may be useful to the statutory auditor in determining the nature, timing and extent of his audit procedures. Depending upon such evaluation, the statutory auditor may be able to adopt less extensive procedures.

If the statutory auditor is satisfied on an examination of the work of the internal auditor, that the internal audit has been efficient and effective, he may accept the checking/evaluation carried out by the internal auditor in the area of internal control, verification of assets and liabilities etc.

It must however be mentioned that the area of co-operation between the statutory and internal auditor is limited by the fact that both owe their allegiance to separate authorities, the shareholders in the case of statutory auditor and the management in the case of internal auditor.

### Question 2

*Distinguish between the following:*

*Internal Control Questionnaire and Internal Control Evaluation. (5 Marks) (May 2007)*

### Answer

**Internal Control Questionnaire (ICQ) and Internal Control Evaluation (ICE):** The internal control questionnaires show the area where weakness occur or likely to occur.

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They do not give any idea of the importance of those weaknesses. The Internal Control Evaluation brings to light importance of those weakness disclosed by ICQ.

Main points of distinctions are:

- (i) ICQ incorporates a large number of detailed questions but does not attempt to distinguish their relation in materiality. ICE isolates the main control objectives within the area of review.
- (ii) Weaknesses are highlighted by answer "Yes" on ICE compared with 'No' on ICQ.
- (iii) Answer 'no' in ICQ indicates a weakness real or potential, but its significance is not revealed. Whereas ICE requires audit personnel to state whether, an apparent weakness may prove to be material in relation to the accounts as a whole.
- (iv) The 'Control Checklist' in ICE is more than a summary of key control factors, and is no substitute for ICQ.

### Question 3

*State the circumstances where the auditing through the computer must be used.*

*(5 Marks) (May 2007)*

### Answer

**Auditing Through the Computer:** 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 makes 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.
- (iii) The logic of the system is complex and there are portions that facilitate use of the system or efficient processing.
- (iv) Because of cost-benefit considerations, there are substantial gaps in the visible audit trail.

### Question 4

*State with reasons (in short) whether the following statements are true or false.*

- (i) *There is a direct relationship between detection risk and combined level of inherent and control risk.*
- (ii) *If internal control is satisfactory, external evidence is more reliable than internal evidence.*
- (iii) *Internal auditor of the company cannot also be its cost auditor.*

*(2 Marks each) (Nov 2007)*

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### Answer

- (i) **False:** There is inverse relationship between detection risk and combined level of inherent and control risk. When inherent and control risk are high, detection risk needs to be low to reduce overall audit risk.
- (ii) **False:** In the case of satisfactory internal control system, internal evidence is more reliable since the situation will reveal appropriate evidence. (SA 500 "Audit Evidence")
- (iii) **True:** As per notification issued by the DCA, cost auditor should not be the internal auditor of a company for the period for which he is conducting the cost audit. If the cost auditor is also the internal auditor, he would not be able to discharge his duties properly.

### Question 5

*Why are computer assisted audit techniques (CAAT) needed in a Computer Information Systems (CIS) environment and how it helps the auditor in obtaining and evaluating audit evidences?*  
(6 Marks)(Nov 2007)

### Answer

Computer Assisted audit techniques (CAAT) may be required in a CIS environment in the following circumstances:

- ◆ The absence of input documents (e.g. order entry in on-line systems) or the generation of accounting transactions by computer programs (e.g. automatic calculation of discounts) may preclude the auditor from examining documentary evidence.
- ◆ The lack of a visible audit trail will preclude the auditor from visually following transactions through the computerized accounting system.
- ◆ The lack of visible output may necessitate access to data retained on files readable only by the computer.

The effectiveness and efficiency of auditing procedures may be improved through the use of computer-assisted audit techniques in obtaining and evaluating audit evidence, for example:

- (i) Some transactions may be tested more effectively for a similar level of cost by using the computer to examine all or a greater number of transactions than would otherwise be selected.
- (ii) In applying analytical review procedures, transactions or balance details may be reviewed and reports printed of unusual items more efficiently by using the computer than by manual methods.

### Question 6

*What are the inherent limitations of internal control?*

(7 Marks)(Nov 2007)

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### Answer

Internal control system can provide only reasonable and not absolute assurance that their objectives are achieved. This is due to inherent limitations of Internal control such as:-

- (i) Management's consideration that cost of an internal control system should not exceeds the expected benefits to be derived.
- (ii) The fact that most controls do not tend to be directed of transaction of unusual nature.
- (iii) The potential of human error like carelessness, mistake of judgement etc.
- (iv) The possibility of circumvention of controls through collusion with employees or outside parties.
- (v) The possibility that a person responsible for exercising the control could abuse the authority.
- (vi) The possibility that procedures may become inadequate due to changing condition.
- (vii) Manipulations by management in the preparation of final statement.

### Question 7

*Write short note on Examination in depth.*

*(5 Marks) (Nov 2007)*

### 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. This consists of studying the recording of the transactions at the various stages and examining all such relevant records. It is also judged whether the person exercising the authority in relation to the transaction have the authority to do so. It also helps in evaluating the controls of each stages of the transaction and facilitates test checking process. It is also called vertical vouching as against horizontal vouching. Sometime it is also referred to as the cradle to the grave approach.

### Question 8

*As an auditor how would you react to the following situations/comments?*

- (a) *Director (Finance) of KK Ltd. informed their newly appointed statutory auditor that they have sound Internal control system implemented by a renowned professional firm and he is satisfied with its effectiveness and functioning and therefor, the statutory auditor should concentrate on verifying only the routine books and financial statements.* (8 Marks)
- (b) *PP Ltd., a garment exporter, asked their Internal auditor, a practicing chartered accountant, to conduct physical verification of the year end inventory and the report of such verification was handed over to the statutory auditor for their view and use. Can Statutory auditor rely on such report?* (6 Marks) (May 2008)

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### **Answer**

- (a) The objective of an audit of financial statement is to enable an auditor to determine true and fair view of the financial position and operating results and to express an opinion there on.

As per SA 200A on 'Objective and Scope of The Audit of Financial Statements' scope will be determined having regard to the terms of engagement, requirement of relevant statute and pronouncement of the Institute. The terms of engagement cannot, however restrict the scope of an audit in relation to matters that are prescribed by the legislation or by the pronouncement of the institute.

The report of the auditor is based on his examination of financial statements and the underlying documents and evidences. It is for the auditor to decide based on his evaluation of the internal control as to its existence and effectiveness. The nature, timing and extent of audit procedure are based on such evaluation.

In the instant case, management has no right to guide and place any restriction on the work of the auditor as it would amount to restriction on the scope of the audit. The auditor should ask the management not to impose such restriction on his scope of the audit, that impairs his ability to examine and express an opinion and if the management does not agrees, he should issue a qualified opinion or disclaimer, as appropriate.

- (b) As per SA 610 on "Using the Work of Internal Auditors" the external auditor's general evaluation of the internal audit function will assist him in determining the extent to which he can place reliance upon the work of the internal auditor. In this respect, the statutory auditor should take into consideration the organizational status, scope of function, technical competence and due professional care taken to assist him in determining the level of reliance that can be placed on the internal auditor's work.

In the instant case, the statutory auditor should ascertain the internal auditor's scope of verification, area of coverage and method of verification. He should review the report on physical verification taking into consideration these factors. If possible he should also test check few items.

If the statutory auditor is satisfied about the appropriateness of the verification, he can rely on the report but if he finds that the verification is not in order he has to decide otherwise. The ultimate responsibility to express opinion on the financial statement is that of the statutory auditor.

### **Question 9**

*How would you assess the reliability of internal control system in computerised information system?*  
(6 Marks) (May 2008)

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### Answer

For evaluating the reliability of internal control system in CIS, the auditor would consider the followings:-

- (i) That authorised, correct and complete data is made available for processing.
- (ii) That it provides for timely detection and corrections of errors.
- (iii) That in case of interruption due to mechanical, power or processing failures, the system restarts without distorting the completion of entries and records.
- (iv) That it ensures the accuracy and completeness of output.
- (v) That it provides security to application softwares & data files against fraud etc.
- (vi) That it prevents unauthorised amendments to programs.

### Question 10

*State with reasons (in short) whether the following statements are True or False.*

- (i) *SA 315 has a purpose to Establish Standards to form procedures to be followed to have an understanding of the Accounting and Internal Control system.*
- (ii) *The environment in which internal control operates has no relationship with the effectiveness of the Specific control procedure.* (2 Marks each) (Nov 2008)

### Answer

- (i) **True:** SA 315 enables the auditor to obtain an understanding of the accounting and internal control system, so that he can plan the audit work in effective manner and develop an efficient audit approach.
- (ii) **False:** The environment in which internal control operates has an impact on the effectiveness of the specific control procedure. For example, strong control environment in association with effective internal audit system strengthen the internal control system.

### Question 11

*As an Auditor how would you react to the following situations/comments?*

*A company has Rs.60 lakh of paid up Capital and Rs.3 crore of average Annual Turnovers of past three years preceding the financial year under Audit. The company does not have any Internal Audit system because the Management does not think it necessary.*

(6 Marks) (Nov 2008)

### Answer

As per CARO provisions, an auditor is required to comment on the Company's internal audit system if its paid up capital and reserves exceeds Rs.50 lakh as at the commencement of the financial year or its average annual turnover exceeds Rs.5 crore for consecutive three

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financial years preceding the financial year concerned, whether the company has an internal audit system commensurate with size and nature of the business.

Therefore, in the above case, because company's paid up capital and reserves exceeds Rs.50 lakh, the auditor has to comment under CARO that the company does not have an internal audit system.

### **Question 12**

*In a CIS environment, what are the different Design and Procedural aspects, which are different from those found in Manual systems? (4 Marks) (Nov 2008)*

#### **Answer**

These different design and procedural aspects of systems include:

- (i) Consistency of performance: CIS system performed functions are more reliable provided that all transactions types and conditions that could occur are anticipated and incorporated into the system.
- (ii) Programme control procedures: These procedures can be designed to provide controls with limited visibility.
- (iii) Single transaction update of multiple or data base computer file: A single input into the accounting system may automatically update all records associated with the transaction.
- (iv) Systems generated transactions: Certain transactions may be initiated by the CIS system itself without the need for an input document. E.g., Interest may be calculated and changed automatically to customer's account balances.
- (v) Vulnerability of data and programme storage media: Large volume of data may be stored on portable or fixed storage media, such as magnetic disks and tapes.

### **Question 13**

*Mention any six points to be considered for good internal control for collection of tuition fees from students of college. (6 Marks)(June 2009)*

#### **Answer**

Internal control points for collection of tuition fees:

- (i) There must be a clear cut tuition fee structure approved by the college council.
- (ii) The challan or paying in slip should contain necessary fields for identifying the roll number of the student, class, and period for which fees is paid etc. The slips should have such number of counterfoils to cross check the remittance.
- (iii) The paying in slip when filled by the students, should be checked for its correctness as to applicable amount etc by one clerk and the amount should be entered in a scroll. He must initial the slip which authorises the cashier to accept the fees as per slip.
- (iv) The cashier scroll and the authorising officer/s scroll should be checked by an officer daily.

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- (v) All remittance should be banked each day. No amount should be allowed to be spared for meeting any type of expense.
- (vi) Alternatively, the fees may be directly remitted into bank and banker's daily remittance slip should be scrutinised by college officers.
- (vii) Arrears list should be periodically prepared from the students rolls. Any concession, remission of tuition fees should have approval of competent authority.
- (viii) Delayed remittance should carry fines or compensating charges for delay.
- (ix) When students are readmitted after removal for non-payment of fees, the admission should carry the permission of competent authority.

### Question 14

*Write short note on Letter of Weakness.*

*(5 Marks) (June 2009)*

#### Answer

Letter of weakness

- (1) The auditor does compliance procedure to ascertain that the internal control system exist in the entity; it works effectively; it work continuously in the entity during review period.
- (2) When he comes across any weakness in the control points, he issues letter of weakness.
- (3) Letter of weakness is a report issued by auditor stating the weakness in internal control mechanism. It also suggests measures by which the weakness in the system be corrected and the control system be made better protected.
- (4) Lapses in operation of internal control too are reported in the communication of weakness.
- (5) The communication of weakness is reporting to management of such weakness in design and operation of internal control as have come to notice of auditor during his auditing and it should not be taken to be a review and comment on adequacy of the control mechanism for management purpose.

### Question 15

*State with reasons (in short) whether the following statement is true or false.*

*The overall objective of audit changes in Computer Information System (CIS) environment.*

*(2 Marks) (Nov 2009)*

#### Answer

**False:** Overall objective of audit does not change in Computer Information System (CIS) environment. But the use of computer changes the processing and storage, retrieval and communication of financial information.