E-Resources on the topic of

"AUDIT RISK AND INTERNAL CONTROL SYSTEM"

(Paper Name: CC 5.1 Ch - Auditing & Assurance)

For Students of 5th Semester,
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Unit – III: Audit Risk and Internal Control System (10M 10L)

 Audit Risk – Concept and Types only

 Internal Control - Definition, Objectives

 Internal Check - Definition, Objectives

 Internal Audit - Definition, Objectives, Regulatory Requirement, Reliance by Statutory Auditor on Internal Auditor's Work

(This unit should be studied with SA 610)

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- **Audit Risk:**

Audit risk is the risk that the auditor may give an inappropriate opinion when financial statement is 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. 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:**

i) *Inherent Risk* – Risk that derived from the characteristics of the enterprise and of its environment.

ii) *Control Risk* – Risk that internal controls will not prevent or detect material errors.

iii) *Detection Risk* – Risk that the auditor may fails to detect misstatements.

- **Internal Control:**

The Internal controls are exercised to ensure accuracy and reliability of accounting data and other records, to detect weaker areas of operation and to improve them, to increase operatorial efficiency of the business, to safeguard its assets and to ensure orderly conduct of business. The American Institute of Public Accountants has defined Internal Control as "The plan of organisation and all the coordinate methods, and measures adopted within a business to safeguard its assets, check the accuracy and the reliability of its accounting data, promote operational efficiency and encourage adherence to prescribed managerial policies. A system of Internal Control extends beyond those matters which relate directly to the functions of the accounting and financial departments". The Institute of' Chartered Accountants of England and Wales defines internal control as "Internal Control means not only internal check or internal audit, but the entire system of control, financial and otherwise, established by management in order to carry on the business of the company in an orderly manner, safeguard its assets and secure as far as possible accuracy and reliability of its records". Thus, internal control involves a sort of vigilance and direction over important matters, like budget and finance, purchases and sales and internal administration by the management.

- **Objectives of Internal Control:**

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.

i) To minimise, if not completely eliminate, wastages and inefficiencies in business operations and to safeguard the assets of the business.

ii) To ensure high degree of accuracy and reliability of accounting data and promote operational efficiency.

iii) To measure how far the policies of the management are being implemented.

iv) To evaluate the efficiency of performance in all aspects of business activities and to highlight the weaknesses.

- **Internal Check:**

Internal check is a system or method introduced with defined instructions given to the staff as to their sphere of work with a view to control and verification of their work and also maintenance of accurate record as the ultimate aim. 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 is a continuous process and is part of the day-to-day routine. It relates to all the transactions that take place every day.

- **Objectives of Internal Check:**

i) To reduce the chance of frauds and errors that may be committed by any member of the staff.

ii) To detect fraud and errors easily and correct them promptly.

iii) To exercise moral pressure among the members of the staff.

iv) To allocate duties and responsibilities of every person in such a way that he can be taken into task for any lapse on his part.

v) To increase overall efficiency of the members of the staff by assigning duties based on the principle of division of labour.

vi) To have an accurate and reliable record of all business transactions.

- **Comparison between Internal Check and Internal Control -**

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:**

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 of Internal Audit:**

i) 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.

ii) 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.

iii) 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.

iv) 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. Besides 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.

v) 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.

vi) 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.

- **Internal Audit applicability under section 138 of the Companies Act 2013**

Section 138 of the Companies Act 2013:

Internal audit –

i) 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.

ii) 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.

- **Comparison between External audit and Internal audit -**

	External audit	Internal audit
Reports to	Shareholders or members who are outside the organisation's governance structure.	The board and senior management who are within the organisation's governance structure.
Objectives	Add credibility and reliability to financial reports from the organisation to its stakeholders by giving an opinion on the report.	Evaluate and improve the effectiveness of governance, risk management and control processes. This provides members of the boards and senior management with assurance that helps them fulfil their duties to the organisation and its stakeholders.
Coverage	Financial reports, financial reporting risks.	All categories of risk, their management, including reporting on them. Including non-financial areas.
Responsibility for improvement	None, however there is a duty to report problems.	Improvement is fundamental to the purpose of internal auditing. But it is done by advising, coaching and facilitating in order to not undermine the responsibility of management.