CHAPTER 7

Internal Control

Second standard of fieldwork: A sufficient understanding of **internal control** is to be obtained to plan the audit and to determine the nature, timing, and extent of tests to be performed.

Consideration of IC has two primary objectives:
1. Aid in planning remainder of audit
2. Assess control risk

Summary of Internal Control Definition

A **process** ...designed to provide reasonable assurance...regarding, achievement of (the entity’s) objectives on:

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

Some Standard Controls

You want to prevent being ripped off, mistakes, fraudulent reporting, etc. What can you think of that you can do to manage these risks?

- Segregation of duties
  - Is it a good idea to have the person who signs checks also responsible for generating a check?
- Management review
- System barriers
  - Do not pay unless a vendor has been approved
  - Do not sell goods to a customer in excess of their credit limit
  - Do not post an entry which does not balance
- Involve others- like your bank
  - Certain “signers” based on materiality
  - Opening new accounts
- Physical controls
  - Lock things up, put out of reach etc.
Components of Internal Control

I. The Control Environment
II. Risk Assessment
III. The Accounting Information and Communication System
IV. Monitoring
V. Existing control activities

Memory device: “CRIME”

I. Control Environment Factors
- Integrity and ethical values
- Commitment to competence
- Human resource policies and practices
- Assignment of authority and responsibility
- Management philosophy and operating style
- Board of directors or audit committee
- Organizational structure

MEMORY DEVICE: I C H A N B O

II. Risk Assessment--Factors Indicative of Increased Financial Reporting Risk
- Changes in the regulatory or operating environment
- Changes in personnel
- Implementation of a new or modified information system
- Rapid growth of the organization
- Changes in technology affecting production processes or information systems
- Introduction of new lines of business, products, or processes

“Change” / “New”... trend?

III. Objectives of an Accounting System
- Identify and record valid transactions
- Describe on a timely basis the transactions in sufficient detail to permit proper classification of transactions
- Measure the value of transactions appropriately
- “Cut-Off”: Determine the time period in which the transactions occurred to permit recording in the proper period
- Present properly the transactions and related disclosures in the financial statements

“Does this remind you of anything? See next slide (note rearranged)”
Objective linked to Management Assertions

**Cut-off:**
- "Cut-Off": Determine the time period in which the transactions occurred to permit recording in the proper period

**Existence / Completeness:**
- Identify and record valid transactions

**Rights & Obligations:**
- Present properly the transactions and related disclosures in the financial statements

**Valuation:**
- Measure the value of transactions appropriately

**Presentation and disclosure:**
- Present properly the transactions and related disclosures in the financial statements (yes I know it is listed 2x!)
- Describe on a timely basis the transactions in sufficient detail to permit proper classification of transactions

IV. Control Activities

**Here’s a list of broad categories:**
- Prenumbering documents
- Authorization of transactions/ events
- Independent checks
- Documentation
- Timely performance review
- Information processing
- Physical controls
- Segregation of duties

Memory Device: PAID TIPS

V. Monitoring

**DIRECTLY FROM AICPA:**

“A process to assess the effectiveness of internal control performance over time. It involves assessing the effectiveness of controls on a timely basis and taking necessary remedial actions. Management accomplishes monitoring of controls through ongoing activities, separate evaluations, or a combination of the two. Ongoing monitoring activities often are built into the normal recurring activities of an entity and include regular management and supervisory activities.”

Layman’s version: What a company does routinely and sometimes specifically to evaluate if the controls are working and making adjustments based upon that process.

Limitations of Internal Control

- "Human Error": Misunderstandings of instructions, mistakes of judgment, fatigue, just plain oops, etc.
- "Collusion": Segregation of duties may be circumvented by collusion
- "Management Override"
- Compliance may deteriorate over time
- New threats related to Information Tech.
The Auditors’ Consideration of Internal Control

- Obtain an understanding
- Document the understanding
- Determine planned assessed level of control risk
- Design additional tests of control
- Reassess control risk
- If necessary, modify planned substantive tests

AN AUDITOR MAY DO SIGNIFICANT INTERNAL CONTROLS WORK IF THE AUDITOR PLANS TO REDUCE AUDIT TESTWORK BY RELIANCE ON CLIENT CONTROLS.

SARBANES-OXLEY ACT - SECTION 404:
- Requires auditors to opine on the internal controls!
  1. Plan the engagement
  2. Use a “top-down” approach to identify controls to test (i.e. what is management focused on?)
  3. Test Design of controls (TOD)
  4. Test Operating Effectiveness (TOE)
  5. Form opinion

Documenting Internal Control

- Questionnaires
- Written Narratives
- Flowcharts

It is up to the auditor to determine the form and extent of such documentation.

Communication of Control Related Matters

Auditors are required to communicate material weaknesses and significant deficiencies to the audit committee:

A material weakness is a deficiency, or combination of deficiencies, in internal control, such that there is a reasonable possibility that a material misstatement of the entity’s financial statements will not be prevented, or detected and corrected on a timely basis.

A significant deficiency is a deficiency, or a combination of deficiencies, in internal control that is less severe than a material weakness, yet important enough to merit attention by those charged with governance.
An auditor would most likely be concerned with controls that provide reasonable assurance about the

A. Efficiency of management’s decision-making process.
B. Appropriate prices the entity should charge for its products.
C. Methods of assigning production tasks to employees.
D. Entity’s ability to process and summarize financial data.