

## **Chapter 9—Understanding Internal Controls**

### **Definition of Internal Control**

- 1. Control environment—sets the tone of an organization, influencing the control consciousness of its people. It is the foundation for all other components of IC providing discipline and structure.**
- 2. Risk assessment—is the entity’s identification and analysis of relevant risks to achievement of its objectives, forming a basis for determining how the risks should be managed.**
- 3. Control activities—are the policies and procedures that help ensure that management directives are carried out.**
- 4. Information and communication—are the identification, capture, and exchange of information in a form and time frame that enable people to carry out their duties.**
- 5. Monitoring—is a process that assesses the quality of IC performance over time.**

## **Consideration of Internal Controls in Planning an Audit**

- identify types of potential misstatements**
- consider factors that affect the risk of material misstatement**
- design substantive tests**

## **Internal Control Components**

**--integrity and ethical values—the effectiveness of controls cannot rise above the integrity and ethical values of the people who create, administer, and monitor them**

**--commitment to competence**

**--board of directors or audit committee participation—an entity's control consciousness is influenced significantly by the entity's board of directors or audit committee. Attributes include the board or audit committee's independence from management, the experience and stature of its members, the extent of its involvement and scrutiny of activities**

- management's philosophy and operating style**
- organizational structure**
- assignment of authority and responsibility**
- human resource policies and practices**

## **Risk Assessment**

- changes in the operating environment**
- new personnel**
- new or revamped information systems**
- rapid growth**
- new technology**
- new lines, products, or activities**
- corporate restructurings**
- foreign operations**

**--accounting pronouncements**

## **Obtaining an Understanding of Internal Control and Assessing Control Risk**

### **1—potential material misstatements**

**--the understanding should permit the auditor to identify the types of potential errors and irregularities and assess the likelihood they will occur**

### **2—design of tests**

**--information obtained should allow the auditor to design effective tests of details of transactions and balances and analytical procedures**

### **3—detection risk**

**--information about the IC is used to assess control risk for each control objective which affects planned detection risk**

### **4—auditability**

**2 important considerations about the initial assessment:**

**1--The initial assessment does not have to be done in a formal manner**

**2—the level of control risk assessed is limited to the level supported by the evidence obtained**

## **Procedures to Obtain an Understanding**

**For many larger clients, especially repeat engagements, the auditor plans on a low assessed level of CR for most parts of the audit.**

### **Procedures to obtain an understanding:**

**1—auditor's previous experience with the client**

**2—inquiries of client personnel**

**3—client's policy and system manuals**

**4—inspection of documents and records**

**5—observation of entity activities and operations**

**--observation, inspection, and inquiry can be combined in a transaction walk-through (tracing of selected transactions through the accounting system)**

# **Documenting the Understanding**

## **1—narrative description**

**A proper narrative includes 4 characteristics:**

**1-origin of every document and record in the system**

**2-all processing that takes place**

**3-disposition of every document and record in the system**

**4-indication of control procedures relevant to assessment of control risk**

## **2—flowcharts**

## **3—IC questionnaires**

**--asks a series of questions about the controls in each audit area**

**--one advantage is the relative completeness of coverage of each audit area**

**--one disadvantage is that individual parts of the client's systems are examined without providing an overall view**