

Chapter 9-Understanding Internal Controls

We have seen that the level of understanding of internal controls to be obtained is determined by the selection of the primarily substantive approach or the lower assessed level of control risk approach. A greater understanding of internal control is required when using the _____ approach.

In understanding internal control, we must keep in mind the Foreign Corrupt Practices Act of 1977. Management and directors of companies that must report under the Securities Exchange Act of 1934 are required to establish and maintain a satisfactory system of internal control.

Definition of Internal Control

Internal control--is a process effected by an entity's B of D, management and other personnel designed to provide _____ assurance regarding the achievement of objectives in the reliability of financial reporting, effectiveness and efficiency of operations, and compliance with laws and regulations.

Internal control consists of the following five interrelated components:

Application of Components to a Financial Statement Audit

The auditor's primary consideration is whether a specific control affects financial statement assertions rather than its classification into any particular component. The five components of internal control are applicable to the audit of every entity. The components should be considered in the context of the following:

- the entity's size
- the entity's organization and ownership characteristics
- the nature of the entity's business
- the diversity and complexity of the entity's operations
- the entity's methods of transmitting, processing, maintaining and accessing information
- applicable legal and regulatory requirements

Limitations of an Entity's Internal Controls

The likelihood of achievement of objectives (noted above) is affected by limitations inherent to internal control. These include the realities that human judgment in decision making can be faulty and that breakdowns in internal control can occur because of such human failures as simple error or mistake. Additionally, controls can be circumvented by the collusion of two or more people or management override of internal control.

Consideration of Internal Controls in Planning an Audit

In all audits, the auditor should obtain an understanding of each of the five components of internal control sufficient to plan the audit by performing procedures to understand the design of controls relevant to an audit of financial statements. In planning the audit, such knowledge should be used to:

The nature, timing and extent of procedures the auditor chooses to perform to obtain the understanding will vary depending on the size and complexity of the entity, previous experience with the entity, the nature of the specific controls involved,, and the nature of the entity's documentation of specific controls.

Understanding Internal Controls

In making a judgment about the understanding of internal control necessary to

plan the audit, the auditor considers the knowledge obtained from other sources about the types of misstatement that could occur, the risk that such misstatements may occur, and the factors that influence the design of substantive tests. Other sources of such knowledge include _____.

The auditor also considers his or her assessment of inherent risk, judgments about materiality, and the complexity and sophistication of the entity's operations and systems, including whether the method of controlling information processing is based on manual procedures independent of the computer or is highly dependent on computerized controls. As an entity's operations and systems become more complex and sophisticated, it may be necessary to devote more attention to internal control components to obtain the understanding of them that is necessary to design effective substantive tests.

Internal Control Components

Control Environment

The control environment sets the tone of an organization, influencing the control consciousness of its people. It is the foundation for all other components of internal control, providing discipline and structure. The control environment encompasses the following factors:

Small and mid-sized entities may implement the control environment factors differently than larger entities. Smaller entities might not have a written code of conduct but, instead, develop a culture that emphasizes the importance of integrity and ethical behavior through oral communication and by management example.

Risk Assessment

Risks relevant to financial reporting include external and internal events and circumstances that may occur and adversely affect an entity's ability to record, process, summarize, and report financial data consistent with the assertions of management in the financial statements. Once risks are identified, management considers their significance, the likelihood of their occurrence, and how they should be managed. Risks can arise or change due to circumstances such as the following:

Control Activities

Generally, control activities that may be relevant to an audit may be categorized as policies and procedures that pertain to the following:

- performance reviews—these control activities include reviews of actual performance versus budgets, forecasts, and prior period performance
- information processing—a variety of controls are performed to check accuracy, completeness, and authorization of transactions. The two broad groupings of information systems control activities are general controls and application controls. General controls commonly include controls over data center operations, system software acquisition and maintenance, access security and application system development and maintenance. Application controls apply to the processing of individual applications.
- physical controls—these activities encompass the physical security of assets, including adequate safeguards, such as secured facilities, over access to assets and records, authorization for access to computer programs and data files.
- segregation of duties—assigning different people the responsibilities of authorizing transactions, recording transactions, and maintaining custody of assets is intended to reduce the opportunities to allow any person to be in a position to both perpetrate and conceal errors or irregularities.

Smaller entities may find that certain types of control activities are not relevant because of controls applied by management. For example, management's retention of authority for approving credit sales, significant purchases, and draw-downs on lines of credit can provide strong control over those activities. An appropriate segregation of duties often appears to present difficulties in smaller organizations.

Information and Communication

An information system encompasses methods and records that:

- identify and record all valid transactions
- describe, on a timely basis, the transactions in sufficient detail to permit proper classification of transactions for financial reporting
- measure the value of transactions in a manner that permits recording their

proper monetary value in the financial statements

- determine the time period in which transactions occurred to permit recording of transactions in the proper accounting period

Communication involves providing an understanding of individual roles and responsibilities pertaining to internal control over financial reporting. Communication takes such forms as policy manuals, accounting and financial reporting manuals, and memoranda.

Monitoring

Ongoing monitoring activities are built into the normal recurring activities of an entity and include regular management and supervisory activities. In many entities, internal auditors or personnel performing similar functions contribute to the monitoring of an entity's activities through separate evaluations. They regularly provide information about the functioning of internal control, focusing considerable attention on evaluating the design and operation of internal controls.

Monitoring activities may include using information from communications from external parties. Customers implicitly corroborate billing data by paying their invoices or complaining about their charges.

Obtaining an Understanding of Internal Control and Assessing Control Risk

The auditor's understanding of internal control must be sufficient to adequately plan the exam in terms of four planning matters:

1--potential material misstatements

2--design of tests

3--detection risk

4--auditability

The auditor needs to obtain information about the integrity of management and nature and extent of accounting records to be satisfied that sufficient competent evidence is present to support the account balances.

Once an understanding of IC that is sufficient for audit planning is obtained, 3 specific assessments must be made:

1--is the entity auditable? What does the auditor do if a client is unauditabile?

2--assess the level of control risk supported by the understanding obtained

The initial assessment is made for each IC objective for each major type of transaction. There are two important considerations about the initial assessment:

3--assess whether it is likely that a lower level of control risk could be supported

Now the auditor must decide on the appropriate level of control risk. The decision as to which level to use is essentially an economic one. It looks at the tradeoffs between the costs of testing relevant controls and costs of substantive tests that could be avoided by reducing assessed levels of CR.

Tests of Controls

Assessment of control risk requires the auditor to consider the design of control policies and procedures to evaluate whether they would be effective in meeting control objectives. Specific evidence must be obtained about the effectiveness of controls

during the audit period to be able to reduce the assessed level of control risk.

Procedures to gather evidence about design and placement in operation during the understanding phase are called procedures to obtain an understanding.

Procedures to test effectiveness in support of a reduced assessed level of control risk are called tests of controls.

When the results of tests of controls support the design of the control policies and procedures the auditor uses the chosen assessed level of control risk. If tests of controls indicate control policies and procedures did not operate effectively the assessed level of control risk must be reconsidered.

The result of the preceding steps is the assessed level of CR for each control objective for each of the entity's major transaction types. Where the assessed level of CR is below the maximum, it will be supported by specific tests of controls. These assessments are then related to the specific audit objectives for the accounts affected by major transaction types. The appropriate level of detection risk for each specific audit objective is then determined using the audit risk model.

Procedures to Obtain an Understanding

The study of internal control and assessment of CR varies a lot from client to client. For small clients for efficiency purposes, control procedures are ignored, CR is assessed at the maximum, and detection risk is low.

Documenting the Understanding

Documentation of understanding IC components is required for all audits. It must be in the working papers. Three main methods of documentation: