Internal control

Definition

- ***Internal Control Defined***
- ***Internal control***, 'is a process, designed by an entity's board of directors, management and other personnel, designed to provide reasonable assurance regarding the achievement of objectives in the following categories:
  - *effectiveness and efficiency of operations,*
  - *reliability of financial reporting,*
  - *compliance with applicable laws and regulations and*
  - *safeguarding of assets against unauthorized acquisition, use or disposition.*

Definition

- We can also define IC as
  - *policies and procedures designed to provide management with reasonable assurance that the company achieves its objectives and goals.*

This definition reflects certain fundamental concepts:

- ***Internal control is a process***. Internal control is not one event or circumstance, but a series of actions that permeate an entity's activities.
- ***Internal control is designed by people***. People establish the entity's objectives and put control mechanisms in place.
  - Its effectiveness depends on the competency and loyalty of the people using it.
- **Internal control should provide reasonable but not absolute assurance**; to an entity' management and board that the company's objectives are achieved.
- ***Internal control is designed to the achievement of objectives***: Objectives fall into Four categories:

1. Operations: relating to effective and efficient use of the entity's resources;
2. Financial reporting: relating to preparation of reliable published financial statements;
3. Compliance: relating to the entity's compliance with applicable laws and regulations;
4. safeguarding of assets. *against unauthorized acquisition, use or disposition*

Internal controls can be categorized as

A. *Administrative controls*

are primarily concerned with the promotion of operational efficiency and the adherence to prescribed managerial policies.

- Administrative controls are related to *operational audits* and *compliance audits*.

B. Accounting controls

are principally concerned with safeguarding assets and providing assurance that the financial statements and the underlying accounting records are reliable.

Internal controls can be categorized as

- *Accounting controls* are designed to provide reasonable assurance that:

1. Transactions are executed in accordance with management's general or specific organization.
2. Transactions are recorded to permit preparation of financial statements in conformity with Acceptable accounting standards and to maintain accountability of assets.
3. Access to assets is permitted only in accordance with management's authorization. and
4. The recorded accountability of assets is compared with the existing assets at reasonable intervals.

Management and Auditor Responsibilities For Internal Control

- Management is responsible for *designs systems of internal control* to accomplish all above objectives.
- Management must test and report the *operating effectiveness of those* controls.
- Auditors responsibility
- The auditor's responsibilities include understanding and testing internal control over financial reporting.
- The field work standard states "The auditor must obtain a sufficient understanding of the entity and its environment, *including its internal control, to assess the risk of material misstate*ment of the financial statements whether due to error or fraud and to design the nature, timing, and extent of further audit procedures."

COMPONENTS OF INTERNAL CONTROL

- There are *five components* of internal control that management *designs and implements* to provide reasonable assurance that its control objectives will be met.

1. *Control environment*
2. *Risk assessment process*
3. *Control activities*
4. *Information and communication system*
5. *Monitoring*

1. Control environment

- The heart of an effectively controlled organization lies in the *attitude of its management*.
- If top management believes that *control is important*, others in the organization will sense this commitment and respond by carefully observing the controls established.
- The *control environment* consists of the actions, policies, and procedures that reflect the overall attitudes of top management, directors, and owners of an entity *about internal control* and *its importance* to the entity.
- The control environment serves as the *umbrella* for the other four components.
- Without an effective control environment, the other four are unlikely to result effective internal control, regardless of their quality.

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1. Control Environment

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2. Risk assessment Process

- *Risk assessment for financial reporting:*
- The process used to *identify*, *analyze* and *manage* the relevant risks which may affect the achievement of the entity's objectives, including the preparation of financial statements that conform to IFRS.
- Once management identifies a risk, it *estimates the significance of that risk*, assesses the likelihood of the risk occurring, and *develops specific actions* that need to be taken *to reduce the risk* to an acceptable level.

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2. Risk assessment

- If management effectively assesses and responds to risks, the *auditor will typically accumulate less evidence* than when management fails to identify or respond to significant risks.

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3. Control activities

- ***Control activities:***
  - are the policies and procedures that help ensure that necessary actions are taken *to address risks* to the achievement of the entity's objectives.
- The control activities generally fall into the following five types:

1. *Adequate separation of duties*
2. *Proper authorization of transactions and activities*
3. *Adequate documents and records*
4. *Physical control over assets and records*
5. *Independent checks on performance*

4. Information and communication System

- The purpose of an entity's accounting information and communication system is used to *initiate, record, process, and report* an entity's transactions and to maintain accountability for related assets.
- Information systems produce reports about
  - operations,
  - financial, and
  - compliance with laws, rules, & regulations

5. Monitoring

- The *assessment of internal control performance* over time.
- Is the process that *assesses the quality of internal control* over time.
- *Why monitoring? To determine whether:*
  - Internal control is operating as intended
  - Any modifications are necessary

Methods of monitoring internal controls

a. *Ongoing monitoring*: Regularly performed supervisory & management activities
b. *Separate (periodic) evaluation*: performed on non-routine basis (*e.g. peer review, self-assessment or* periodic audits by the internal auditors)

- For many companies, especially larger ones, an *internal audit department* is essential for effective monitoring.

Components of Internal Control (Summary)

Component	Description of Component	Further Subdivision (if applicable)
Control environment	Actions, policies, and procedures that reflect the overall attitude of top management, directors, and owners of an entity about internal control and its importance	Subcomponents of the control environment: • Integrity and ethical values • Commitment to competence • Board of director and audit committee participation • Management's philosophy and operating style • Organizational structure • Human resource policies and practices
Risk assessment	Management's identification and analysis of risks relevant to the preparation of financial statements in accordance with appropriate accounting frameworks such as GAAP or IFRS	Risk assessment processes: • Identify factors affecting risks • Assess significance of risks and likelihood of occurrence • Determine actions necessary to manage risks

Control activities	Policies and procedures that management has established to meet its objectives for financial reporting	Types of specific control activities: • Adequate separation of duties • Proper authorization of transactions and activities • Adequate documents and records • Physical control over assets and records • Independent checks on performance
Information and communication	Methods used to initiate, record, process, and report an entity's transactions and to maintain accountability for related assets	Transaction-related audit objectives that must be satisfied: • Occurrence • Completeness • Accuracy • Posting and summarization • Classification • Timing
Monitoring	Management's ongoing and periodic assessment of the quality of internal control performance to determine whether controls are operating as intended and are modified when needed	

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The Auditor's consideration of Internal Controls

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Use of Internal control information to the auditor

1. *Plan the audit*

- Understand the design and implementation of internal controls by the client
- Used to determine the nature, extent, & timing of substantive tests

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Use of Internal control information to the auditor

2.Assess control risk

- May be high or low
- High control risk means the controls are *weak*. This implies that the auditor must increase the scope of substantive tests
- Low control risk means the controls are *strong*. This implies that the auditor must decrease the scope of substantive tests

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Obtain and Document Understanding of Internal Control

- The independent auditor must also evaluate whether the designed controls are actually placed in operation

Methods of Studying Internal Controls

- review prior year's working papers
- interview prior year auditors
- interview client personnel
- study client policies and procedures
- study client documents, records, information and communication system

Methods of Studying Internal Controls

- *Walkthrough*: In a walkthrough, the auditor selects one or a few documents for the initiation of a transaction type and traces them through the entire accounting process.

Methods of Documenting Understanding Internal controls

1. Narratives. Memoranda that describes the flow of transaction cycles, identifying the employees performing the different tasks, documents prepared, records maintained, and the division of duties.

Methods of Documenting Understanding Internal controls

2. Flow charts. A diagram or symbolic representation of a system or series of procedures with each procedure shown in sequence.
3. Internal Control (IC) questionnaire
   - a series of questions about internal controls and their application to groups of accounts and cycles
   - are designed to answer 'How good is the system of controls?'

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Example of IC Questionnaire

- Is cash received deposited in time?
- Is person responsible for cash receipt different from the one responsible for recording?
- Is bank reconciliation prepared monthly?
- Generally, a "no" answer indicates an internal control weakness

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When should internal control weaknesses be reported to the client?

When there are significant deficiencies in the design or operation of internal control.

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Assignment

- Select an organization (your employer company)
- Assess the internal control system based on the checklists (Internal Control, Internal Audit and Audit Committee Checklists)
- Identify the deficiencies (design or operation) in the system of internal control,
- Determine the potential misstatements that could result
- Identify and provide the recommendations of internal controls to mitigate those deficiencies (Professional Recommendations)

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