Internal control

Learning Objectives

Upon completion of this chapter, you will be able to

1. Explain what internal control is, and its importance to management and auditors.
2. Identify the components of internal control.
3. Discuss the limitations on an entity's internal control.
4. Identify the tools available for documenting the understanding of internal control.
5. Describe how to plan an audit strategy based on a preliminary understanding of an entity's internal control.
6. Explain how to assess and document the level of control risk using tests of controls to support a reliance strategy.
7. Outline the considerations for the timing of audit procedures.
8. Outline the auditor's responsibilities when the client has accounting services performed by an outside service organisation.
9. Review the auditor's communication of internal control-related matters.
10. Briefly describe the effect of information technology on internal control.

EARTHWEAR'S INTERNAL CONTROL—A KEY COMPONENT

EarthWear One of the most important components of EarthWear's financial reporting system is its system of *internal control*. EarthWear's system of internal control, created and maintained by management, often with oversight by the board of directors, particularly the audit committee, consists of policies, procedures, and practices designed to facilitate the achievement of EarthWear's objectives. Examples of such objectives are efficient and effective conduct of business, ensuring compliance with ethical standards, applicable laws and regulations, and timely, accurate generation, recording, and transmission of financial information. EarthWear makes use of such procedures as segregation of duties, review and authorization of purchase and sales transactions, reconciliation of subsidiary accounts to control accounts, and physical safeguards such as limited access requiring passcards, to achieve its objectives.

It is the controls over the generation, recording, and transmission of financial information that are of particular significance to Willis & Adams' audit of EarthWear. If after studying, understanding, and testing those controls, the auditors conclude that they provide reasonable assurance that the financial information of EarthWear, as reported in their financial statements, is materially correct, the evidence that the auditors have collected and documented about the internal control system becomes part of the sufficient appropriate audit evidence on which they will base their audit opinion. The nature, timing, and extent of the audit procedures that Willis & Adams will employ are very much influenced by EarthWear's internal control.

Because EarthWear is listed on the TSX, senior management of EarthWear is required to provide, in its annual filings with the Ontario Securities Commission, specific certifications related to internal control over financial reporting. Willis and Adams will provide assistance with these required certifications by performing, in addition to the audit, a series of agreed-upon procedures examining specific components of EarthWear's internal control over financial reporting. This is not an assurance engagement, nor will it result in any expression of opinion by Willis and Adams. Willis and Adams will provide to the senior management of EarthWear a written report, for their internal use only, identifying the agreed-upon procedures they applied to the internal controls and the results of those procedures. The purpose of this report is to assist management in making the assessments necessary to issue the above-mentioned certifications.

This chapter focuses on the auditors' study of the internal control system and their assessment of control risk. It illustrates the importance of internal control and its components, and describes how the evaluation of internal control relates to substantive testing. It also discusses the timing of audit procedures and the communication of internal control-related matters.

Internal control

Internal control is designed by the board of directors, management, and other personnel to provide reasonable assurance about the achievement of the objectives with regards to reliability of financial reporting, effectiveness and efficiency of operations, and compliance with applicable laws and regulations.

Management 's perspective

Management needs a reasonable assurance that adequate control exists over the entity's assets and records by developing internal controls that require employees to follow corporate policies and procedures such as proper authorization for transactions.

Management also needs control system that generates reliable information for decision making.

The components of Internal control

Table 6–1 Components of Internal Control

Control environment The control environment sets the tone of an organization, influencing the control consciousness of its people. It is the foundation for effective internal control, providing discipline and structure. The control environment includes the attitudes, awareness, policies, and actions of management and the board of directors concerning the entity's internal control and its importance in the entity.

The entity's risk assessment process The process for identifying and responding to business risks and the results thereof. For financial reporting purposes, the entity's risk assessment process includes how management identifies risks relevant to the preparation of financial statements that are fairly presented in conformity with generally accepted accounting principles, estimates their significance, assesses the likelihood of their occurrence, and decides upon actions to manage them.

The entity's information system and related business processes relevant to financial reporting, and communication The information system relevant to financial reporting objectives, which includes the accounting system, consists of the procedures, whether automated or manual, and records established to initiate, record, process, and report entity transactions and to maintain accountability for the related assets, liabilities, and equity. Communication involves providing an understanding of individual roles and responsibilities pertaining to internal control over financial reporting.

Control procedures Control procedures are the policies and procedures that help ensure that management directives are carried out, for example, that necessary actions are taken to address risks to achievement of the entity's objectives. Control procedures, whether automated or manual, have various objectives and are applied at various organizational and functional levels.

Monitoring of controls A process to assess the quality of internal control performance over time. It involves assessing the design and operation of controls on a timely basis and taking necessary corrective actions.

Risk assessment process

This risk assessment process should consider external and internal events and circumstances that may arise and adversely affect the entity's ability to initiate, record, process, and report financial data consistent with the assertions of management in the financial statements. Once risks have been identified by management, it should consider their significance, the likelihood of their occurrence, and how they should be managed. Management should initiate plans, programs, or actions to address specific risks. In some instances, management may accept the consequences of a possible risk because of the costs to remediate or other considerations. Client business risks can arise or change due to the following circumstances:

- ***Changes in the operating environment.*** Changes in the regulatory or operating environment can alter competitive pressures and create significantly different risks.
- ***New personnel.*** New personnel may have a different focus on, or understanding of, internal control.
- ***New or revamped information systems.*** Significant and rapid changes in information systems can change the risk relating to internal control.
- ***Rapid growth.*** Significant and rapid expansion of operations can strain controls and increase the risk of a breakdown of controls.
- ***New technology.*** Incorporating new technologies into production processes or information systems may change the risk associated with internal control.
- ***New business models, products, or activities.*** Entering business areas or transactions with which an entity has little experience may introduce new risk associated with internal control.
- ***Corporate restructuring.*** Restructuring may be accompanied by staff reductions and changes in supervision and segregation of duties that may change the risk associated with internal control.
- ***International operations.*** The expansion or acquisition of international operations carries new and often unique risks that may impact internal control.
- ***Accounting pronouncements.*** Adopting new accounting principles or changing accounting principles may affect the risk involved in preparing financial statements.

Information and communication

The information system relevant to the financial reporting objectives, which includes the accounting system, consists of methods and records established to record, process, summarize, and report an entity's transactions and to maintain accountability for the related assets and liabilities. An effective accounting system gives appropriate consideration to establishing methods and records that will

- identify and record all valid transactions
- describe the transactions on a timely basis 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 their recording in the proper accounting period
- properly present the transactions and related disclosures in the financial statements

of management.

The auditor should obtain sufficient understanding of the information system relevant to financial reporting to understand the following:

- the classes of transactions in the entity's operations that are significant to the financial statements
- the procedures, both automated and manual, by which transactions are initiated, recorded, processed, and reported from their occurrence to their inclusion in the financial statements
- the related accounting records, whether electronic or manual, supporting information, computer media, and specific accounts in the financial statements that are involved in initiating, recording, processing, and reporting transactions
- how the information system captures other events and conditions that are significant to the financial statements
- the financial reporting process used to prepare the entity's financial statements, including significant accounting estimates and disclosures

Limitations of internal control

Management override of internal control

Right reasons: maintain good relation with an important customer

Wrong reasons: force a lower level employee to record inappropriate entries

Human errors

Employees may misunderstand instructions or make errors of judgement

collusion

The effectiveness of segragation of duties lies in individuals' performing only their assigned tasks. There could be collusion between employees.

Relevance

An internal control system should be designed and operated to provide reasonable assurance that an entity's objectives are being achieved. Not all of the objectives and their related internal control are relevant to a financial audit.

Documenting the understanding of internal control

A number of method are available to the auditor to document the understanding of internal control.

- Procedures manuals and organizational charts
- narrative descriptions
- internal control questionnaires
- flowcharts

Procedures manuals and organizational charts

Many organization prepare procedures manuals that document their policies and procedures. Here one can find documentation of the accounting systems and related control procedures.

Narrative description

The understanding of internal control may be documented in a memorandum.

An Example of a Partial Audit Memorandum for Documenting the Auditor's Understanding of an Entity's Control Environment

WORCESTER WOOLEN MILLS
Audit Memo—Control Environment and Procedures
December 31, 2007

The company manufactures high-quality woolen cloth for women's outerwear. There is one location in Toronto, Ontario. Jonathan Worcester is chairman of the board and chief executive officer. His son Wally is chief operating officer. The family controls 97 percent of the common stock. The board of directors is composed of family members, but Jonathan and Wally monitor the business and make most of the business decisions.

Jim Johansen, the controller, and Mary Margarita, the bookkeeper, handle most of the significant accounting functions. Wally reviews cash receipts and cash disbursements and signs the cheques. Jonathan and Wally have conservative attitudes toward accounting, and they consider lower taxes to be important. Our firm is consulted on the accounting for unusual transactions, and there are rarely any adjustments for errors from routine transaction processing.

The company uses a microcomputer and a standard accounting software package. Access to the computer and files is limited to Wally, Jim, and Mary. Jonathan and Wally review the computerized prepared financial statements and monitor revenues and expenses as compared to budget and prior-year results.

Internal control questionnaires

Questionnaires serve as memory joggers in that they provide a systematic means for the auditor to investigate.

A Partial Questionnaire for Documenting the Auditor's Understanding of Control Procedures

MONITORING QUESTIONNAIRE

Client: EarthWear Clothiers		**Balance Sheet Date:** 12/31/2006
Completed by: SAA **Date:** 9/30/06		**Reviewed by:** DRM **Date:** 10/15/06

Management should monitor internal control in the ordinary course of operations. This monitoring includes regular management and supervisory activities and other actions personnel take in performing their duties that assess the quality of internal control.

	Yes, No, N/A	Comments
How many customer complaints are received about billings? Are complaints investigated for underlying causes and any internal control deficiencies corrected?	*Yes*	*Customer complaints are generally very low (1 out of every 5,000 invoices). Most complaints relate to delays in receiving goods that are on order by the company.*
Does the entity have an internal audit function?	*Yes*	
Are internal control recommendations made by internal and external auditors implemented?	*Yes*	*Recommendations that management and the board feel are cost-beneficial are implemented.*
Does the entity conduct separate evaluations of internal control?	*Yes*	The board of directors focuses on the control environment and monitoring activities. The audit committee meets regularly with the internal and external auditors about control-related activities.

Flowcharts

Flowcharts provide a diagrammatic representation, or picture o f the accounting system. The flow chart outlines the configuration of the system in terms of functions, documents, processes, and reports.

An Example of a Flowchart for the Order Entry Portion of the Revenue Cycle

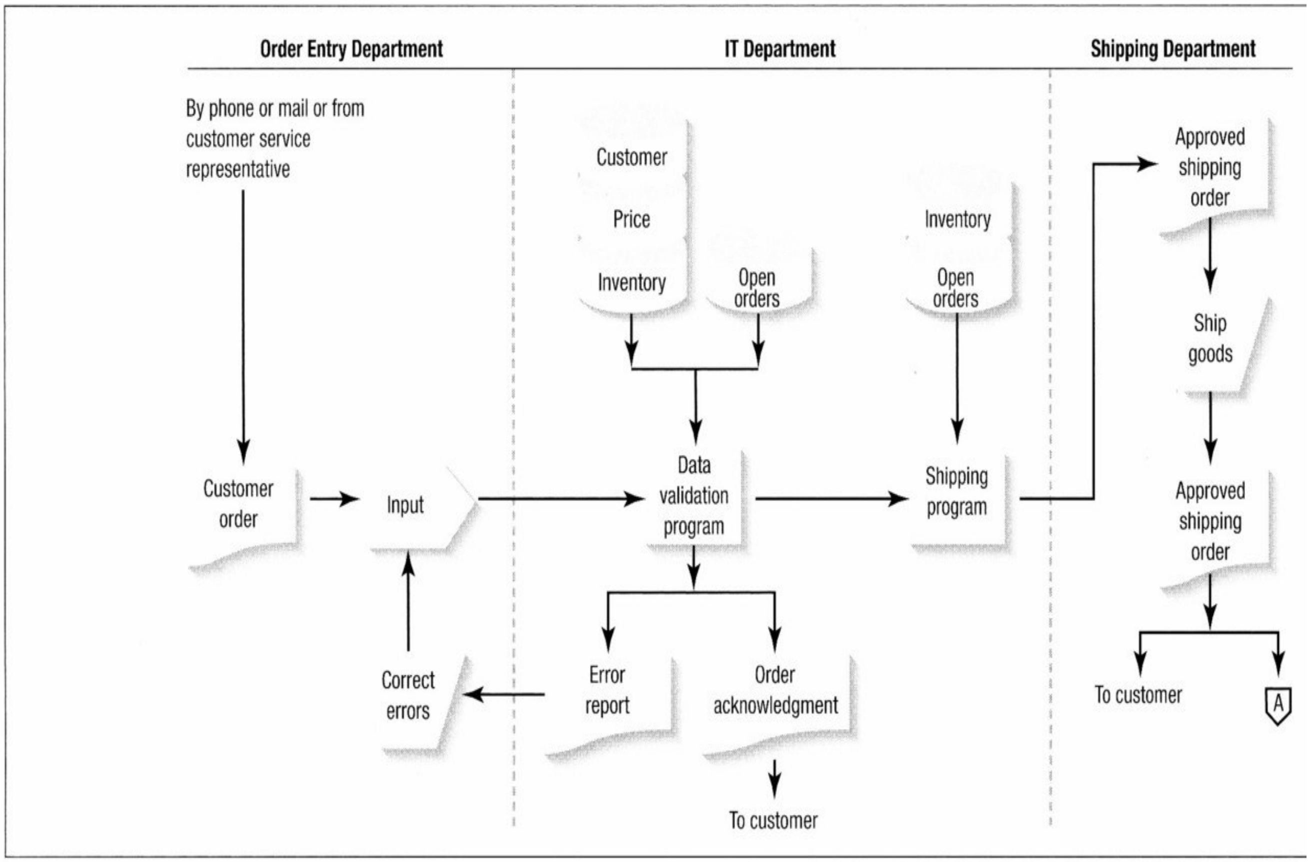

Table 6–5 Examples of Internal Control Weaknesses

Deficiencies in Internal Control Design:

- Inadequate overall internal control design.
- Absence of appropriate segregation of duties consistent with appropriate control objectives.
- Absence of appropriate reviews and approvals of transactions, accounting entries, or systems output.
- Inadequate procedures for appropriately assessing and applying accounting principles.
- Inadequate provisions for safeguarding assets.
- Absence of other control techniques considered appropriate for the type and level of transaction activity.
- Evidence that a system fails to provide complete and accurate output that is consistent with objectives and current needs because of design flaws.

Failures in the Operation of Internal Control:

- Evidence of failure of identified controls in preventing or detecting misstatements of accounting information.
- Evidence that a system fails to provide complete and accurate output consistent with the entity's control objectives because of the misapplication of control procedures.
- Evidence of failure to safeguard assets from loss, damage, or misappropriation.
- Evidence of intentional override of internal control by those in authority to the detriment of the overall objectives of the system.
- Evidence of failure to perform tasks that are part of internal control, such as reconciliations not prepared or not prepared in a timely fashion.
- Evidence of wilful wrongdoing by employees or management.
- Evidence of manipulation, falsification, or alteration of accounting records or supporting documents.
- Evidence of intentional misapplication of accounting principles.
- Evidence of misrepresentation by client personnel to the auditor.
- Evidence that employees or management lack the qualifications and training to fulfill their assigned functions.

Other:

- Absence of a sufficient level of control consciousness within the organization.
- Failure to follow up and correct previously identified internal control deficiencies.
- Evidence of significant, unusual, or extensive undisclosed related-party transactions.
- Evidence of undue bias or lack of objectivity by those responsible for accounting decisions.

6-36 TameBird Industries produces meals for airlines and nursing homes. For the prior two audit engagements, your firm has written a management letter recommending that TameBird establish better segregation of duties in the accounts receivable and accounts payable functions. Tom Tuffnut, controller for TameBird, has received authorization to hire an additional clerk to work in the accounting area. Tom now has three accounting clerks available, and he has asked you to provide advice on how to best assign the following functions:

1. Responsibility for petty cash fund.
2. Opening of mail and listing of cash receipts.
3. Depositing cash receipts in bank.
4. Maintaining accounts receivable subsidiary records.
5. Determining which accounts receivable are uncollectible.
6. Maintaining cash disbursements journal.
7. Preparing cheques for signature.
8. Reconciling bank statements.

Required:

Prepare a recommendation to Tom Tuffnut on how best to distribute the various functions among the three accounting clerks.

6-40 Ken Smith, the partner in charge of the audit of Houghton Enterprises, identified the following conditions during the audit of the December 31, 2007, financial statements:

1. Controls for granting credit to new customers were not adequate. In particular, the credit department did not adequately check the creditworthiness of customers with an outside credit agency.
2. There were not adequate physical safeguards over the company's inventory. No safeguards prevented employees from stealing high-value inventory parts.

Required:

Draft the required communications to the management of Houghton Enterprises.

6-41 Alto Co. Ltd. is a manufacturer and seller, at the wholesale level, of fine furniture. One of its key business processes is the sales/accounts receivable/cash receipts cycle. The following scenarios below describe four different aspects of Alto Co.'s operations of this cycle.

1. The retail consumer market for furniture is quite volatile and companies in the retail consumer market can be "here today and gone tomorrow." For that reason Alto is very concerned about selling to bad credit risks. Poor credit control could result in large bad debts. Therefore the credit department manager has to approve every credit sale. She indicates approval by initialling the customer order, which is attached to a copy of the sales invoice and filed by date in the accounting department.

2. Billing clerks use a standardized price list to price the goods in the shipment. The amounts are entered on the three-part invoice. Copy one goes to the customer, copy two is the basis for recording the sales amount and is then filed in the accounts receivable department by date. Copy three is sent to the billing department where it is filed by date.
3. Alto's policy is to recognize a sale when the goods are shipped to the customer. There is a two-part prenumbered shipping document—one part goes, with the order, to the customer as a packing slip and the other is kept in the shipping department where it is filed in numerical order. The shipping clerk notes the date, quantity shipped, and shipping order number on copy three of the invoice. It is sent to the billing department where it is filed after the information is entered as a sale.
4. Sales to subsidiary companies are handled slightly differently. A billing supervisor reviews each invoice copy two to ensure that if the sale was to a subsidiary company, the invoice is stamped "Sale to subsidiary."

Required:

For each of the preceding descriptions:

a. Identify the account(s) where potential misstatement(s) could occur, and the nature of the misstatement(s).
b. State whether you think the control procedure(s) in place would prevent the potential misstatement identified in part (a).
c. If you believe the control procedure(s) are insufficient, state what additional procedure(s) you would put in place.
d. Identify one test of controls that you would use to see if the stated control procedure(s) are being performed. Make sure you identify the audit procedure you would apply and where you would obtain the document to test.