

Internal Control – Identification and Filtering

Definition

The **process** designed, implemented and maintained by those charged with governance, management and other personnel **to provide reasonable assurance** about the achievement of an entity's objectives with regard to:

- (a) **reliability of financial reporting,**
- (b) **effectiveness and efficiency of operations, and**
- (c) **compliance with applicable laws and regulations**

Understanding of Relevant Controls

Auditors are required by Auditing Standards to obtain an understanding of internal control **relevant** to the audit.

- Not all controls are relevant to audit, e.g. those to maintain operational efficiency
- Need to use our judgement

Need to evaluate the design of internal controls and whether they have been implemented by performing **procedures in addition to inquiry** to the entity's personnel.

Components of Internal Controls

- (a) Control environment
- (b) Control activities

The auditor need to obtain an understanding of the control environment – foundation for other components of internal control

Understand control activities relevant to the audit in order to assess the risks of material misstatement at the assertion level.

Understand the major activities to monitor internal control over financial reporting.

Limitation of Internal Control

Can provide with only reasonable assurance due to inherent limitations

- human judgement and error in design and implementation
(e.g. person reviewing an exception report may not fully understand its purpose or fails to take appropriate action.)
- controls may be circumvented by collusion

Consideration Specific to Smaller Entities

Smaller entities often have fewer employees which may **limit the extent to which segregation of duties** is practicable. However, in a small owner-managed entity, the owner-manager may be able to exercise **more effective oversight** than in a larger entity. This oversight may compensate for the generally more limited opportunities for segregation of duties.

On the other hand, the owner-manager may be more able to **override controls** because the system of internal control is less structured. This is taken into account by the auditor

when identifying the risks of material misstatement due to fraud.

Controls Relevant to Audit

Controls relevant to audit are usually controls over the **completeness** and **accuracy** of financial information produced.

Controls relating to operations and compliance objectives may be relevant if they relate to data the auditor evaluates or uses in applying audit procedures.

Controls over safeguarding of assets against unauthorized acquisition, use or disposition may be relevant to both financial reporting and operations objectives – auditors' consideration generally limited to those relevant to the reliability of financial reporting.

Audit Evidence

Procedures to obtain audit evidence about the design and implementation of relevant controls may include:

- **Inquiring** of entity personnel.
- **Observing** the application of specific controls.
- **Inspecting** documents and reports.
- **Tracing transactions** through the information system relevant to financial reporting.

Inquiry alone, however, is not sufficient for such purposes.

Control Activities

Categorized of Control Activities:

- **Performance reviews.** These control activities include reviews and analyses of actual performance versus budgets, forecasts, and prior period performance; relating different sets of data – operating or financial – to one another, together with analyses of the relationships and investigative and corrective actions; comparing internal data with external sources of information; and review of functional or activity performance.
- **Information processing -- application controls & general IT controls**, which are

Application controls:

(a) checking the arithmetical accuracy of records, (b) maintaining and reviewing accounts and trial balances, (c) automated controls such as edit checks of input data and numerical sequence checks, and (d) manual follow-up of exception reports.

General IT controls:

(a) program change controls, (b) controls that restrict access to programs or data,

(c) controls over the implementation of new releases of packaged software applications, and (d) controls over system software that restrict access to or monitor the use of system utilities that could change financial data or records without leaving an audit trail.

- **Physical controls.**

- (a) The physical security of assets, including adequate safeguards such as secured facilities over access to assets and records.

- (b) The authorization for access to computer programs and data files.

- (c) The periodic counting and comparison with amounts shown on control records (for example comparing the results of cash, security and inventory counts with accounting records).

- **Segregation of duties.** Assigning different people the responsibilities of authorizing transactions, recording transactions, and maintaining custody of assets. Segregation of duties is intended to reduce the opportunities to allow any person to be in a position to both perpetrate and conceal errors or fraud in the normal course of the person's duties.

Control activities that are relevant to the audit are:

- Control activities that relate to **significant risks**
- Relate to risks for which **substantive procedures alone do not provide sufficient appropriate audit evidence**; or
- Those that are considered to be relevant in the judgment of the auditor.

Considerations Specific to Smaller Entities:

Certain types of control activities are not relevant because of controls applied by management. For example, management's sole authority for granting credit to customers and approving significant purchases can provide strong control over important account balances and transactions, lessening or removing the need for more detailed control activities.

Control activities relevant to the audit of a smaller entity are likely to relate to the main transaction cycles such as revenues, purchases and employment expenses.

Tests of Controls

Tests of controls are performed only on those controls that the auditor has determined are suitably designed to prevent, or detect and correct, a material misstatement in an assertion.

Testing the operating effectiveness of controls is different from obtaining an understanding of and evaluating the design and implementation of controls. However, the same types of audit procedures are used. The auditor may, therefore, decide it is efficient to test the operating effectiveness of controls at the same time as evaluating their design and determining that they have been implemented.

Although some risk assessment procedures may not have been specifically designed as tests of controls, they may nevertheless provide audit evidence about the operating effectiveness of the controls and, consequently, serve as tests of controls. For example, the auditor's risk assessment procedures may have included:

- *Inquiring about management's use of budgets.*

- Observing management's comparison of monthly budgeted and actual expenses.
- Inspecting reports pertaining to the investigation of variances between budgeted and actual amounts.

These audit procedures provide knowledge about the design of the entity's budgeting policies and whether they have been implemented, but may also provide audit evidence about the effectiveness of the operation of budgeting policies in preventing or detecting material misstatements in the classification of expenses.

The auditor may design a test of controls to be performed concurrently with a test of details on the same transaction. Although the purpose of a test of controls is different from the purpose of a test of details, both may be accomplished concurrently by performing a test of controls and a test of details on the same transaction, also known as a dual-purpose test. For example, the auditor may design, and evaluate the results of, a test to examine an invoice to determine whether it has been approved and to provide substantive audit evidence of a transaction. A dual-purpose test is designed and evaluated by considering each purpose of the test separately.

In some cases, the auditor may find it impossible to design effective substantive procedures that by themselves provide sufficient appropriate audit evidence at the assertion level. This may occur *when an entity conducts its business using IT and no documentation of transactions is produced or maintained, other than through the IT system. In such cases, the auditor is required to perform tests of relevant controls.*

Evaluating the Operating Effectiveness of Controls

A material misstatement detected by the auditor's procedures is a strong indicator of the existence of a significant deficiency in internal control.

The concept of effectiveness of the operation of controls recognizes that some deviations in the way controls are applied by the entity may occur.

Deviations from prescribed controls may be caused by such factors as changes in key personnel, significant seasonal fluctuations in volume of transactions and human error.

The detected rate of deviation, in particular in comparison with the expected rate, may indicate that the control cannot be relied on to reduce risk at the assertion level to that assessed by the auditor.

Internal Control Weaknesses

Weaknesses as below should be assessed before reliance on IC of client.

- Lack of segregation of duties
- Lack of physical safeguards
- Lack of independent checks
- Lack of proper authorization
- Lack of proper documents and records
- Overriding of existing controls
- Inadequate accounting system

Communicating Deficiencies In Internal Control To Those Charged With Governance And Management

The auditor shall communicate in writing significant deficiencies in internal control identified during the audit to those charged with governance on a timely basis.

Include:

- (a) Description of the deficiencies and an explanation of their potential effects;
- (b) Sufficient information to enable those charged with governance and management to understand the context of the communication:

Documentation of Internal Controls

- (a) Narrative notes
- (b) Internal control Questionnaire
- (c) Flowcharts
- (d) A combination of two or more of above

Discussions

What are the internal controls that can be identified for the following type of business:

- (a) One-man trading business
- (b) Single retail shop
- (c) Property investment company

Case Study

Identify and explain the system and control weaknesses from the attached flowchart.

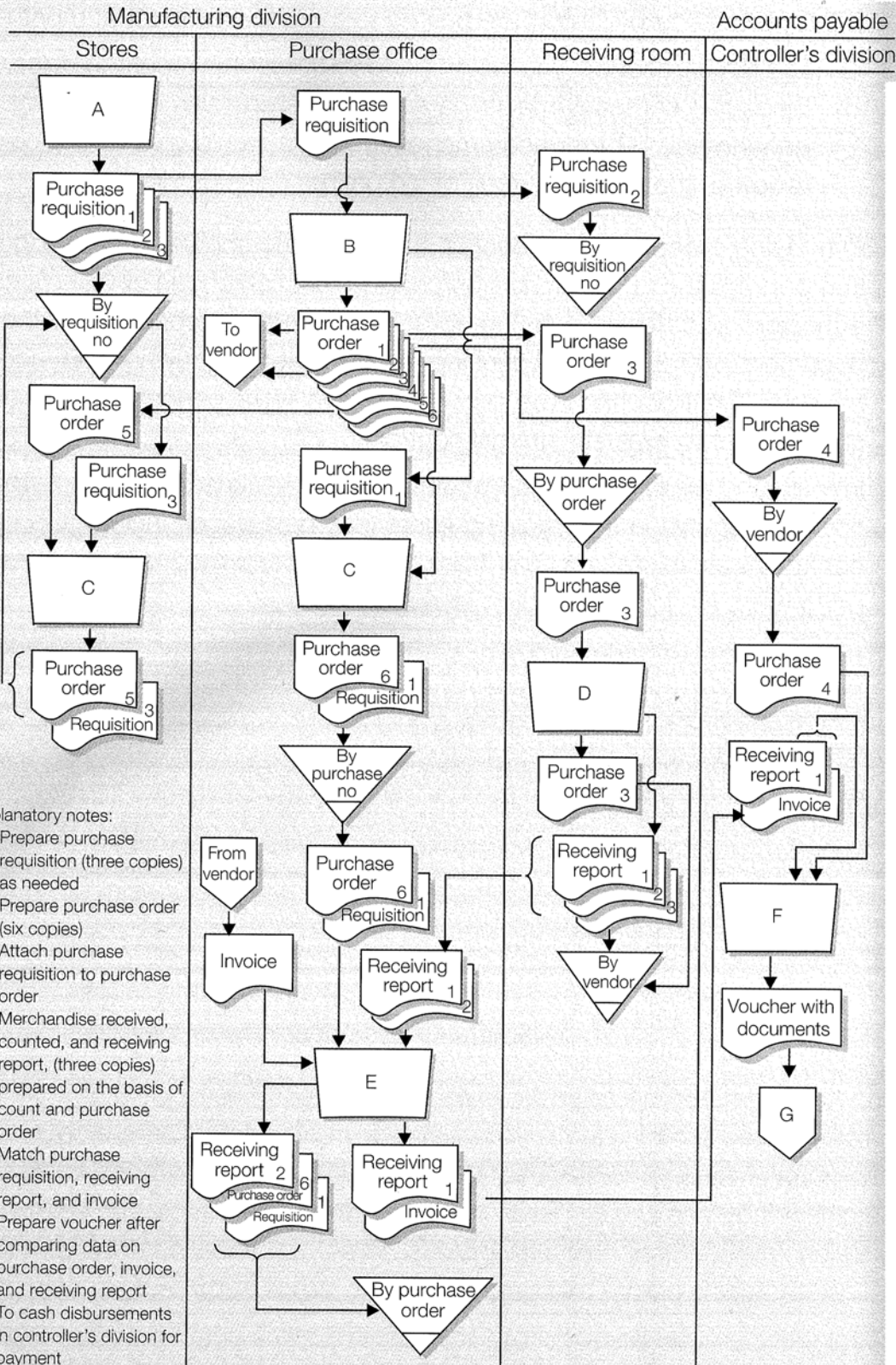
Flowchart Prepared by Auditor

**Medium-sized Manufacturing Company
Flowchart of Raw Materials Purchasing Function**

Date _____

Prepared by _____

Approved by _____



- Explanatory notes:**
- A = Prepare purchase requisition (three copies) as needed
 - B = Prepare purchase order (six copies)
 - C = Attach purchase requisition to purchase order
 - D = Merchandise received, counted, and receiving report, (three copies) prepared on the basis of count and purchase order
 - E = Match purchase requisition, receiving report, and invoice
 - F = Prepare voucher after comparing data on purchase order, invoice, and receiving report
 - G = To cash disbursements in controller's division for payment

APPENDIX 7B

Internal Control Questionnaire

CLIENT _____

ADDRESS _____

Signed by:	Date:	Signed by:	Date:
_____	_____	_____	_____
_____	_____	_____	_____
_____	_____	_____	_____
_____	_____	_____	_____

	Answer		Answer based on		
	Yes	No	Inquiry	Observation	Test
Mail Receipts:					
1. Is the mail opened by someone other than the cashier or accounts receivable bookkeeper?	_____	_____	_____	_____	_____
2. Does the mail routine prohibit the delivery of unopened mail (other than personal mail) to employees having access to the accounting records?	_____	_____	_____	_____	_____
3. (a) Is a record of the money and cheques received prepared by the person opening the mail?	_____	_____	_____	_____	_____
(b) If so, this record given to someone other than the cashier for independent verification of the amount recorded?	_____	_____	_____	_____	_____
(c) Is this record compared with the cash receipts book regularly?	_____	_____	_____	_____	_____
Other Receipts:					
1. Are the receipts of currency relatively insignificant?	_____	_____	_____	_____	_____
2. Are receipts recorded by cash registers or other mechanical devices?	_____	_____	_____	_____	_____
3. If so, are the machine totals checked independently by the accounting department?	_____	_____	_____	_____	_____
4. Are sales books or receipt books used?	_____	_____	_____	_____	_____
5. If so,					
(a) Are the slips or receipts pre-numbered?	_____	_____	_____	_____	_____
(b) Are the daily totals and numerical sequence checked independently by the accounting department?	_____	_____	_____	_____	_____
(c) Are unused books safeguarded?	_____	_____	_____	_____	_____

Examples of Internal Control for Some Major Accounting Cycles

Trial Balance, General Ledger and Journal Entries

Management accounts are produced timely and reviewed by management in detail.

Control accounts are agreed to all sub-ledgers monthly and any difference are investigated and corrected.

All Journal Entries are supported by supporting documents and explanations and are properly reviewed and authorized.

Property, Plant and Equipment (“PPE”)

Maintenance of an asset register and assignment of a unique asset number to each PPE item (or at least for the high value movable items). Label all these PPE with the fixed asset number.

Appropriate level of authorisation is required for acquisition of significant PPE.

Capitalisation policy for PPE should be clearly stated and communicated to responsible staff members.

There should be internal procedure for reviewing PPE conditions periodically. Obsolete, damaged or out-dated assets should be scrapped and disposed of.

Investments

Mainly rely on managerial controls. Acquisition of a significant investment (such as properties) should be approved by the Board of Directors and the minutes of the board meeting should be properly prepared and signed.

For investments in marketable securities, advices and monthly statements from brokers should be checked with the investment records.

Inventories and Work in Progress

There should be segregation of duties among custodian, record keeping and authorisation for inventory movements.

Adequate access controls and safeguard over custody of physical inventories.

Accuracy and completeness in recording of inventory movements.

Proper costing and adequate integration of costing and financial records.

Periodic and surprise physical counting of inventories by persons not involving in custody of inventories and maintaining inventory records.

Receivables

Regular (e.g. monthly) statements are sent to all receivables.

Periodic aging analysis of receivable balances is prepared by account staff independent of the person maintaining accounts receivable and receipts. The aging analysis is reviewed by management.

Bank and Cash Balances

Bank reconciliation performed periodically (at least monthly) by persons not involved in the preparation of cheques, posting bank book, and handling of cash or cheques. Bank reconciliation should be reviewed timely by managerial staff after completion.

There should be segregation of duties between the cashier and accounting function.

Trade and Other Payables and Accrued Charges

Monthly statements received from suppliers must be reconcile to the suppliers' accounts in trade payables sub-ledger. Any discrepancies must be investigated and disposed of as soon as possible.

There should be reconciliation of the general ledger trade payable control account and the total balance of all individual trade creditors in the sub-ledger.

The level of provision accounts must be reviewed by senior staff members periodically based on latest available information. Excess and shortage should be adjusted as early as possible. The monthly charges to the provision accounts should be adjusted accordingly. Examples of provisions are provision of bonus, claims, warranty, royalties, commission etc. (Provision for bad and doubtful debts is dealt with during the audit of receivables)

There must be adequate control on payments such as:

Stamp "Paid" on invoices immediately after payment and state the cheque number and date.

Adequate procedures to maximise the benefits of payment discounts by making payments on suitable date.

Taxation

Taxation computation is performed by a person with appropriate expertise and subject to review by qualified professional.

Execution of tax saving plan is reviewed periodically and the plan is revised based on latest development in tax legislation and cases.

Share Capital and Reserves

Complied with the requirement of the Companies Ordinance.

Handled by staff member with sufficient company secretarial experience or by external professionals.

Approval of change in share capital and the transfer-in and transfer-out from reserves must be given by a Board of Directors.

The minutes of the meetings must be properly maintained by client or their company secretary.

Turnover (Sales & Income)

There should be segregation of duties among (i) accepting customers' orders, (ii) control and despatch of goods, (iii) processing and recording of invoices and (iv) cash collections. i.e. segregation of authorisation, custody and recording functions.

Acceptance of orders by responsible person after checking credit worthiness of customer, if not cash on delivery.

Authorised internal price list should be issued periodically.

Sales discounts must be authorised. Different level of sales staff members should be given different levels of discount authority.

Delivery note (Goods despatch note) should be prepared and authorised before sending to warehouse for packing and delivery. Its also prefer to have invoices prepared and authorised at the same time.

There should be numeric control on both delivery notes and invoices. Pre-numbering is preferred. All cancelled or void delivery notes and invoices must be defaced and retained for future checking.

There should be periodic internal check procedures to ensure that all delivery notes are invoiced and all invoices are recorded in books.

Monthly statement should be sent to customer with open account.

All discrepancies reported by customers must be reconciled and investigated.

Purchases

The following internal controls (or similar controls) are expected in a well established business. Lack of one or more of the controls does not mean that there are material internal control weaknesses. The company may have other form of controls operating.

Requisition of goods is authorised by user department head.

Ordering of goods should be made on pre-numbered order forms and authorised by purchasing department head. Void order forms are properly defaced and filed.

Goods received are recorded on goods received note (pre-numbered) and/or daily goods received report.

All invoices are received by the accounts department and are registered to ensure all received invoices are processed.

Invoices are checked to goods received notes or goods received report by purchasing department.

Check cast, extension, calculation and unit prices of invoices are checked. Details of invoices are matched against the purchase orders by the purchasing department.

Final approval of the invoices by the user department.

Recording of invoices in purchase day book and accounts payable sub-ledger in accounts department are controlled by reference to the goods received notes or goods received report and the invoices register.

Reconciliation of purchase ledger accounts with suppliers' statements by accounts department.

For smaller businesses where segregation of duties is not always possible, managerial controls (i.e. the close involvement of the owner in the management and supervision of daily operations) may be the most effective and efficient form of control.

Costs and Expenses

Invoices should be signed by the recipient of the goods or services as evidence of acceptance.

All invoices must be properly approved by user/responsible departments senior official before payment.

All paid invoices should be effectively cancelled and dated, e.g. chopped "PAID", after payment. If payment by cheque, the cheque number should be written as well.

Payrolls

Wage rates/salaries are properly authorised by responsible officials.

Payroll is cross-checked by responsible official after completion to relevant records.

Segregation of duties for payroll calculation, recording in accounting records, and making payments (or authorising autopay sheet)