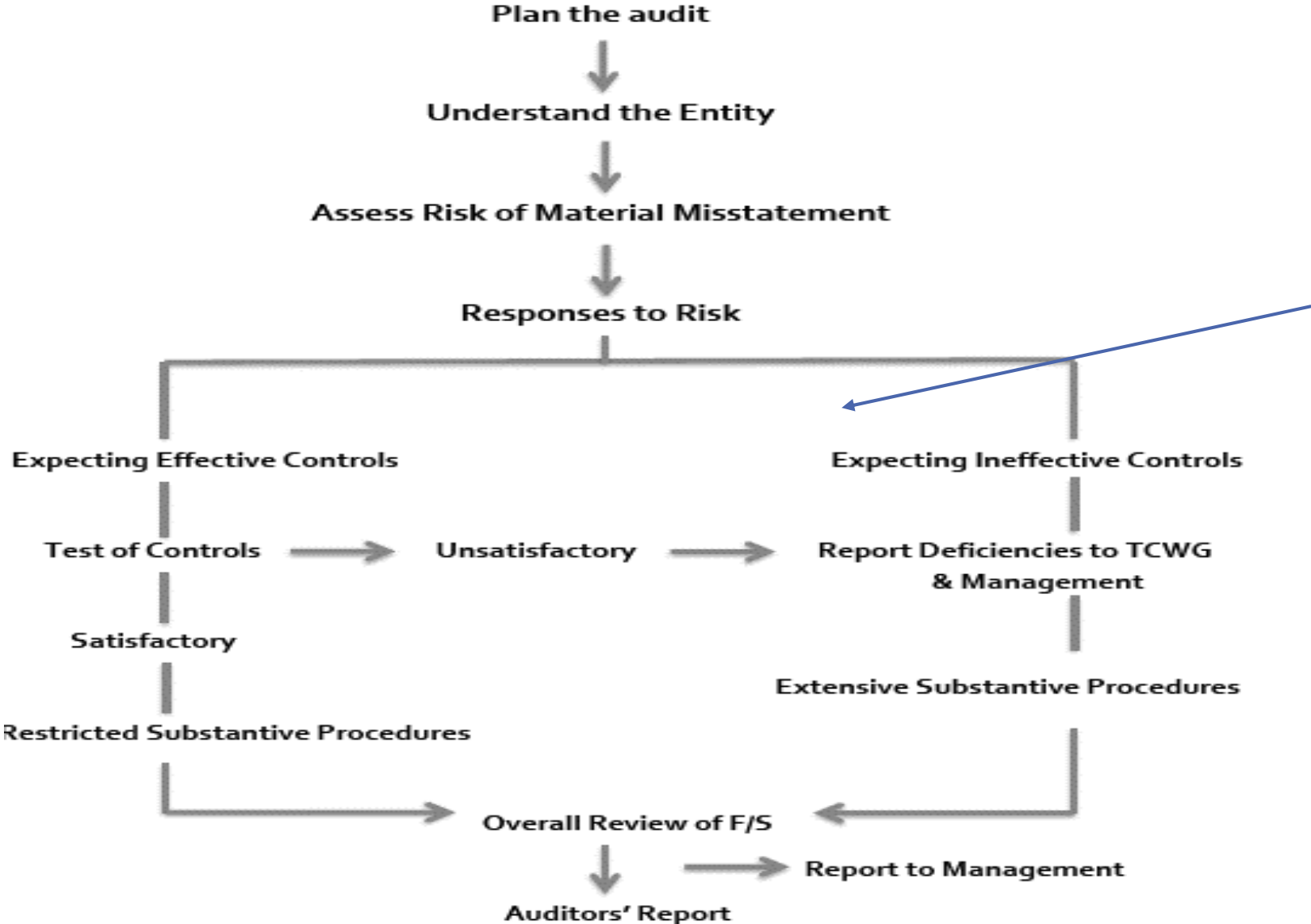


Chapter 6

Internal Control

Stage



Internal Control

The process designed, implemented and maintained by management to provide reasonable assurance about the achievement of an entity's objectives with regard to

- Reliability of financial reporting;
- Effectiveness of operations;
- Compliance with laws.

Components of Internal Control

CE - RP - IS - CA – MC

- **Control Environment** (CE)
- Entity's **Risk Assessment Process** (RP)
- **Information System** relevant to Financial Reporting (IS)
- **Control Activities** (CA)
- **Monitoring of Controls** (MC)

Components of Internal Control



CONTROL ENVIRONMENT

- Governance & management function & management philosophy & operating style.

RISK ASSESSMENT PROCESS

- It forms the basis for how management manage business risk relevant to financial reporting.

INFORMATION SYSTEM

- Business process relevant to financial reporting & communication.

CONTROL ACTIVITIES

- Policies & procedures design to perform operation of the business.

MONITORING OF CONTROLS

- The process of assessing the effectiveness of controls.

Control Activities

Control activities are specific policies and procedures designed:

- To prevent errors/frauds that may arise in processing information
- To detect and correct errors/frauds that may arise in processing of information

To achieve the objective entity needs to develop

- **Preventive Controls** – to stop errors/frauds from occurring.
- **Detective Controls** – to find errors/frauds after they have occurred.
- **Corrective Controls** – to prevent errors/frauds from reoccurring in future.

Categories of Control Activities

ISAs categorizes internal controls into following four types:

- 1. Performance Reviews**
- 2. Information processing**
 - a. Application Controls**
 - b. General Controls**
- 3. Physical controls**
- 4. Segregation of duties**

Limitations of Internal Controls

- **Human error**
- **Cost benefit analysis**
- **Overriding of controls**
- **Collusion**

Smaller Entities & Internal Controls

Many of the control activities that are typically found in a large company such as

- segregation of duties,
- internal audit etc.

may be inappropriate for a small entity because they are

- Too costly or
- Impractical.

Often, control systems in small entities are based on a high level of involvement by the owners (owner managed companies).

Risk in Audit of Smaller Entities

Following risks may arise when control systems rely excessively on the involvement of senior management:

- There may be a lack of evidence of system documentation.
- There may be lack of evidence of controls.
- Management may override controls that are in place.
- Management may lack the expertise necessary to control the entity effectively.

Use of Internal Control by Auditors

Auditors shall

- assess the adequacy of internal controls used for the financial reporting &
- identify risks of material misstatements,

which will provide him the basis for designing & performing audit procedures.

Auditors are only concerned with assessing the policies & procedures which are relevant to financial reporting.

Ascertaining Internal Control

- Enquiries from client's relevant staff
- Observing the controls
- Tracing transaction through the system [Walk-through Test]
- Inspecting documents
- Reading client procedure manual
- Examine previous audit file

Documenting Internal Control

- Narrative Notes (NN)
- Internal Control Questionnaire (ICQs)
- Internal Control Evaluation Questionnaire (ICEQs)
- Flow Charts (FC)
- Organizational Charts (OC)

Testing Internal Control

Having documented the systems the auditor needs to assess whether controls are actually implemented and are effective.

Test of Controls are performed to ensure that the prescribed controls are implemented and operating effectively throughout the audit period.

Types of Auditors' Testing

Test of Controls (ToCs)

Test of Controls are designed to evaluate the operating effectiveness of controls in preventing or detecting and correcting material misstatements.

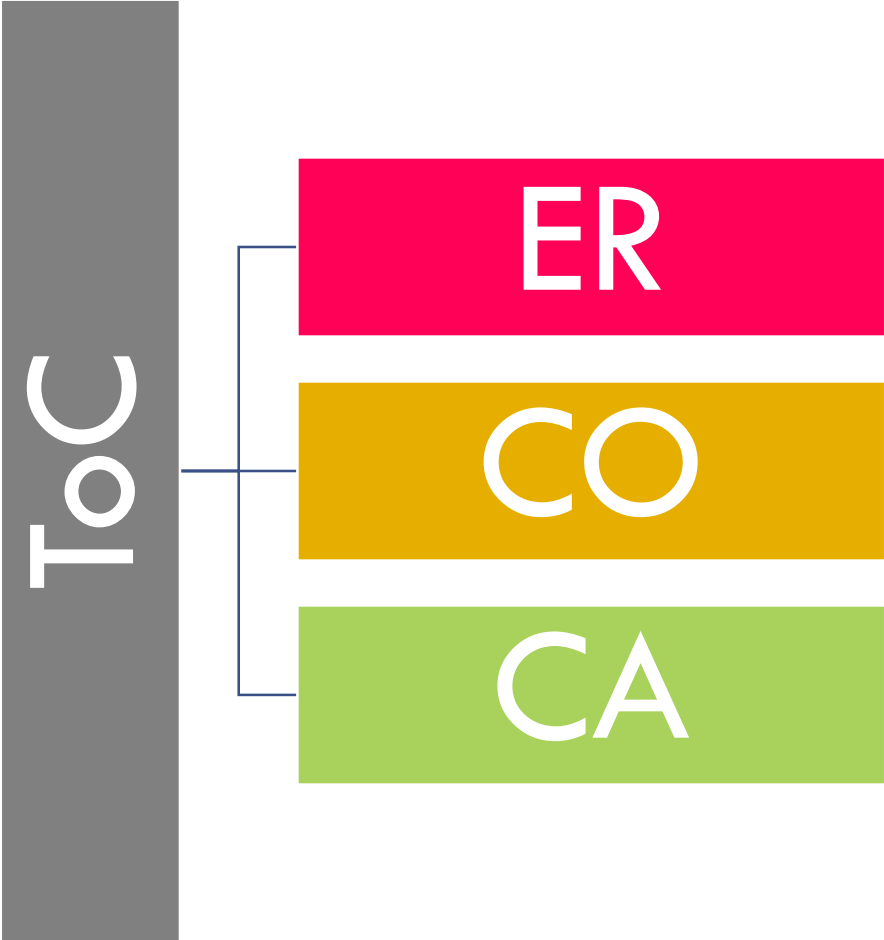
Substantive Procedures (SPs)

Substantive Procedures are designed to detect material misstatement at the assertion level.

Transaction Cycles

- Sales
- Purchase
- Inventory
- Payroll
- Bank & cash balances
- Capital & revenue

ERs - COs - CAs - ToCs



ERs - COs – CAs – ToCs

Entity Risks (ERs).

Risk in transactions processing.

Controls Objectives (COs).

The purpose of internal control.

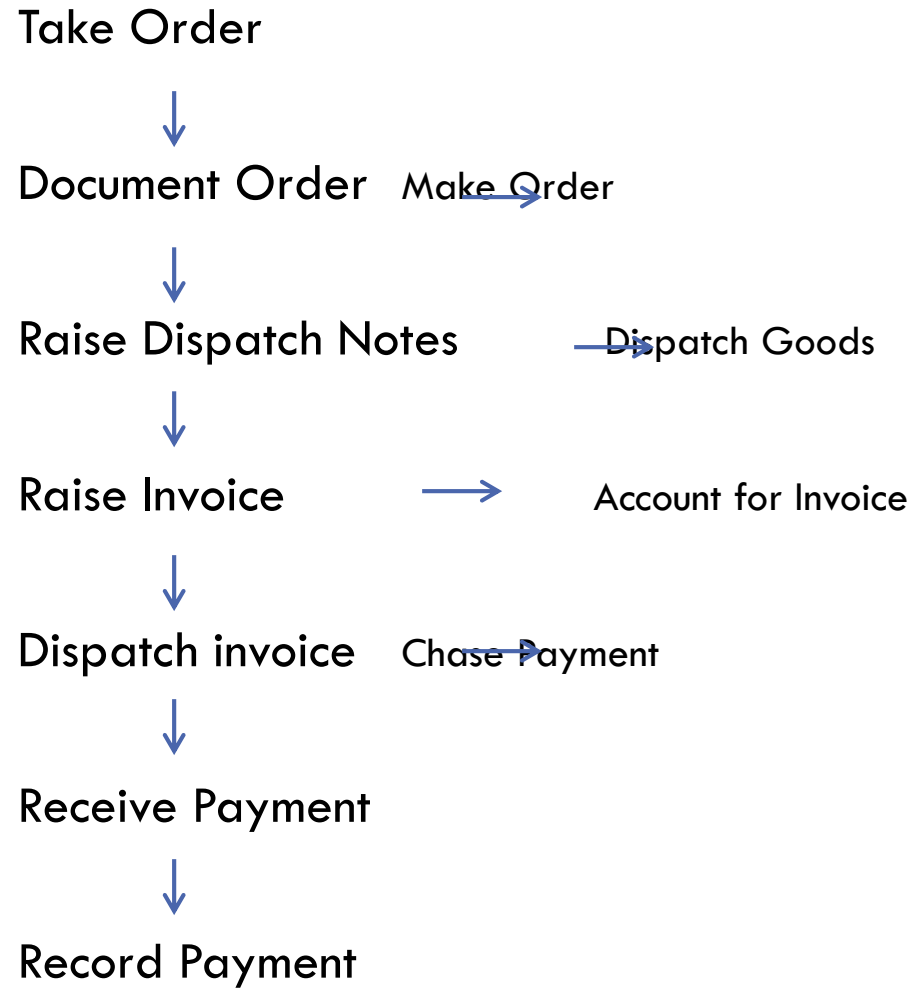
Control Activities / Principal Controls / Control Procedure (CAs/PC/CP).

Policy and Procedures included in internal control.

Test of Control (ToCs).

Whether or not control objectives achieved, and controls are operating effectively.

Sales Cycle



Entity Risks – ERs for Sales - Examples

- Orders may be accepted from existing customers that take them over their credit limit.
- Some orders are overlooked and are not processed. Some orders are processed twice.
- For some customer orders, goods are not dispatched, or the goods are dispatched twice.
- The customer is given a price discount without proper authorization.
- Invoices are not generated for goods that have been dispatched to some customers.

Control Objectives - COs for Sales - Examples

- Goods are supplied only to customers who pay promptly and in full.
- Orders are dispatched promptly and in full to the correct customer.
- Only valid sales are recorded.
- Invoices should be generated for the correct amount.
- All sales and related receivables are recorded accurately & at an appropriate value.
- Sales are recorded in the correct accounting period.

Sales – Principal Control (PC) & Test of Controls (ToC) - Examples

PC

Sales invoices are raised on basis of sales order form & other shipping docs.

ToC

Test a sample of sales invoices for authorized sales order form & shipping docs.

PC

Pre-numbered invoices are raised for all sales.

ToC

Review & test entity's procedures for numerical sequences of invoices.

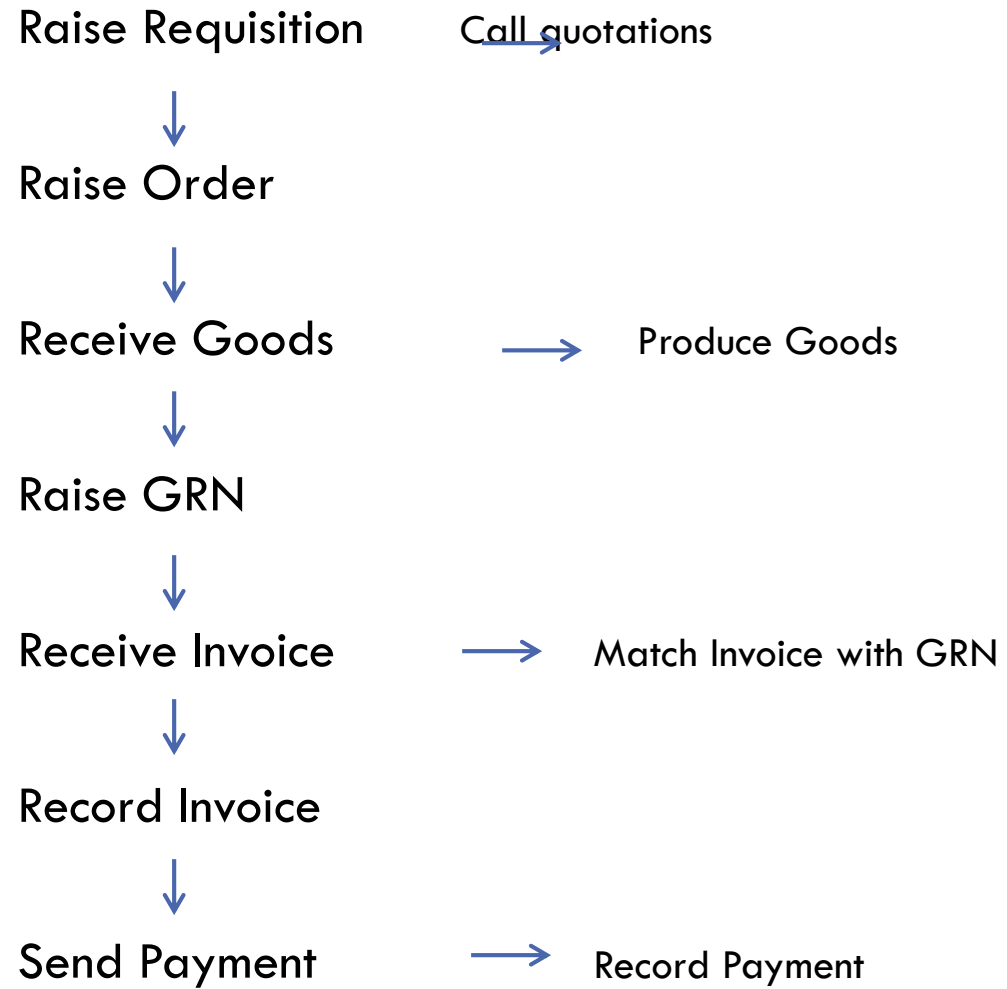
PC

Monthly statement of accounts are sent to all customers.

ToC

Review entity's procedures for sending out monthly statements.

Purchase Cycle



Entity Risks – ERs for Purchase - Examples

- Orders for goods or services are made without approval or authorisation.
- Orders may be placed with suppliers who are not on the “approved list”
- For large orders, suppliers are not asked to submit tenders.
- There is a risk that goods may be accepted from a supplier without having been ordered.
- There is a risk that purchase invoices will be recorded for goods or services that were not provided.

COs for Purchase

- All purchases are properly authorized to ensure only necessary goods are procured
- All purchases are made from approved suppliers.
- All purchases and related payables are recorded accurately and at an appropriate value.
- Purchases are recorded in the correct accounting period..

Purchase – Principal Control (PC) & Test of Controls (ToC) - Examples

PC

Purchases orders are authorized by the 'Director Purchases' based on the need assessment.

ToC

Examine a sample of orders to ensure they are appropriately authorized by 'Director Purchases'.

PC

Purchase orders are matched with related GRN and kept in the same file.

ToC

For a sample of orders, examine the Goods Receipt Notes (GRN) & match it to the order.

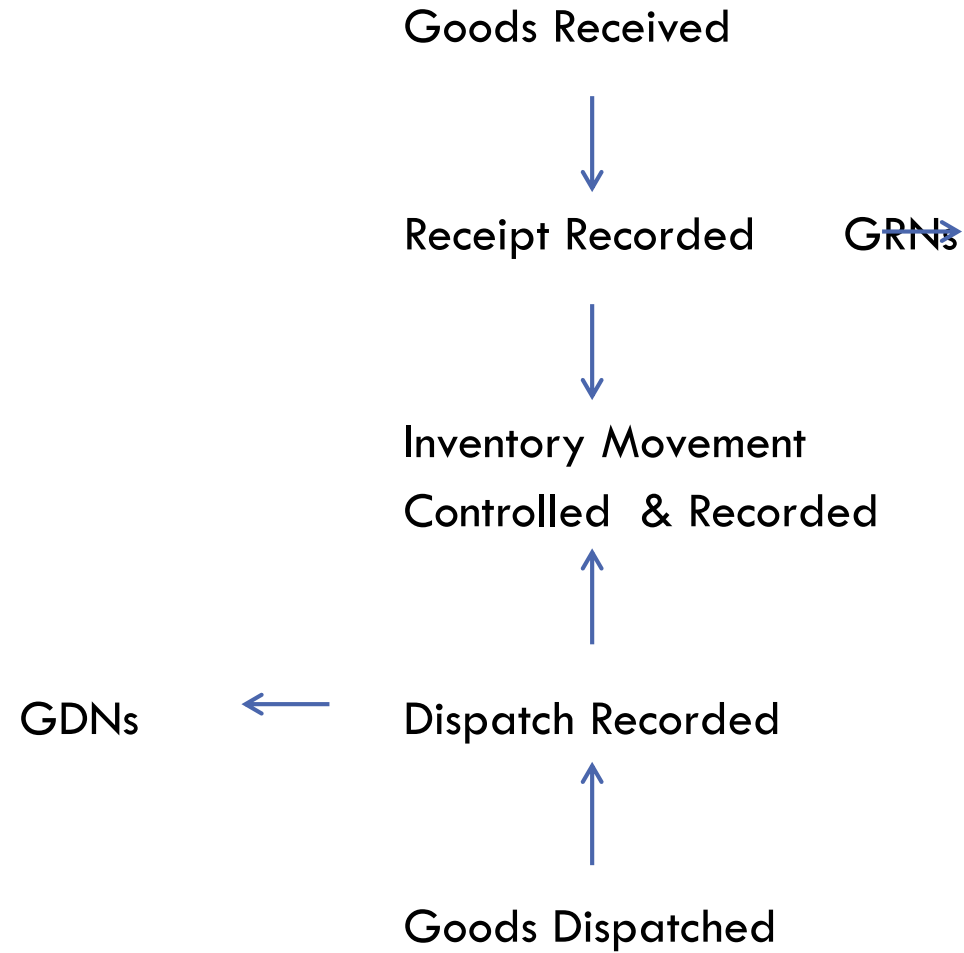
PC

Suppliers' invoices are checked for arithmetical accuracy by the finance staff prior entering into the system.

ToC

Recalculate the arithmetical accuracy of a sample of suppliers' invoices.

Inventory Cycle



Entity Risks – ERs for Inventory - Examples

- Inventory records are inaccurate.
- Inventory may be stolen or damaged.
- Inventory may be valued at incorrect amounts.
- Too little inventory may be held, so that customers' orders cannot be fulfilled.
- Too much inventory may be held, and therefore too much money tied up.

COs for Inventory

- Inventory levels meet the production requirements and customer demand.
- Inventory levels are not excessive, preventing obsolescence and unnecessary storage costs.
- Inventory is safeguarded from theft, loss or damage.
- Inventory movements are recorded on a timely basis.
- All inventory items are recorded.

Inventory – Principal Control (PC) & Test of Controls (ToC) - Examples

PC

Periodic physical stock taking is carried out to establish the physical quantities.

ToC

Review and test entity's procedures for taking physical inventory periodically.

PC

IAS 2 is applied while determining the inventory.

ToC

Review entity's procedures and documentation used to follow IAS 2.

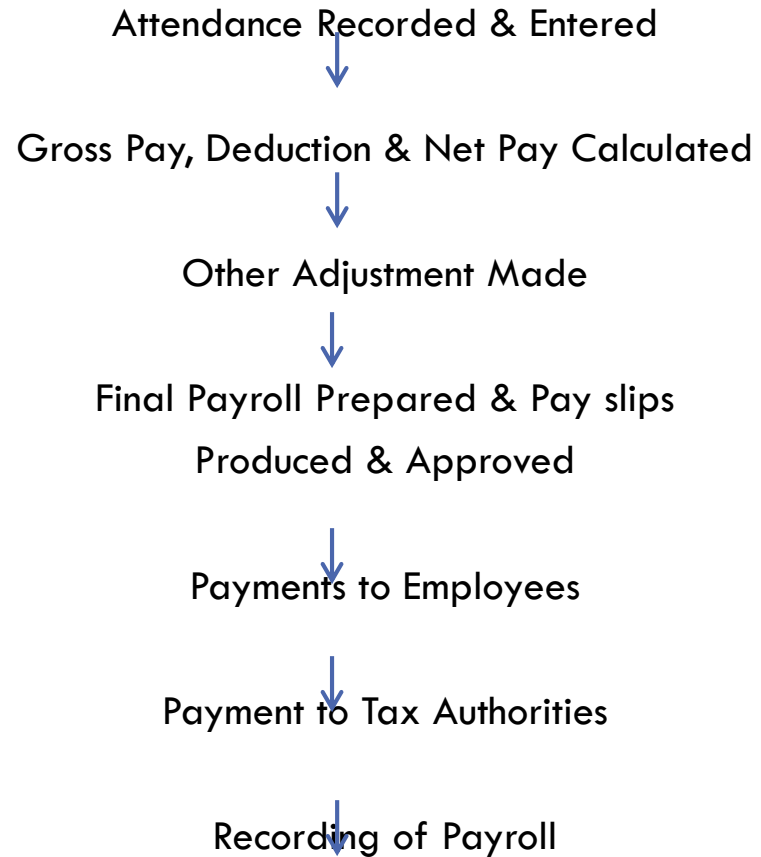
PC

Inventory maximum and minimum levels are determine for all inventory items.

ToC

Review and test entity's procedures for using maximum and minimum level for all inventory items.

Payroll Cycle



Entity Risks – ERs for Payroll - Examples

- Wages and salaries may be paid to individuals who are not employees.
- Employees may be paid for work they have not done.
- Gross wages and salaries could be calculated incorrectly.
- Taxation and other deductions could be calculated incorrectly.
- The principal risk is that gross pay, deductions and net pay may not be properly recorded in the accounts.
- Incorrect amounts of net pay could be paid over to employees.
- Incorrect amounts of deductions could be paid over to the authorities.
- Payment could be made to the wrong employee.

COs for Payroll

- Only genuine employees are paid.
- Employees are only paid for work done.
- Employees are paid at authorized rates of pay.
- Gross pay is calculated and recorded accurately.
- Net pay is calculated and recorded accurately.
- Correct amounts owed are recorded & paid to the tax authorities.

Payroll – Principal Control (PC) & Test of Controls (ToC) - Examples

PC

The gross pay of each individual employee is authorized by Finance Director.

ToC

Test a sample of payrolls sheets to check whether or not the authorization of Finance Director obtained prior to payment.

PC

Personal files of all the employees are maintained in HR department.

ToC

Review a sample of personal files to ensure that personal files are maintained by HR department.

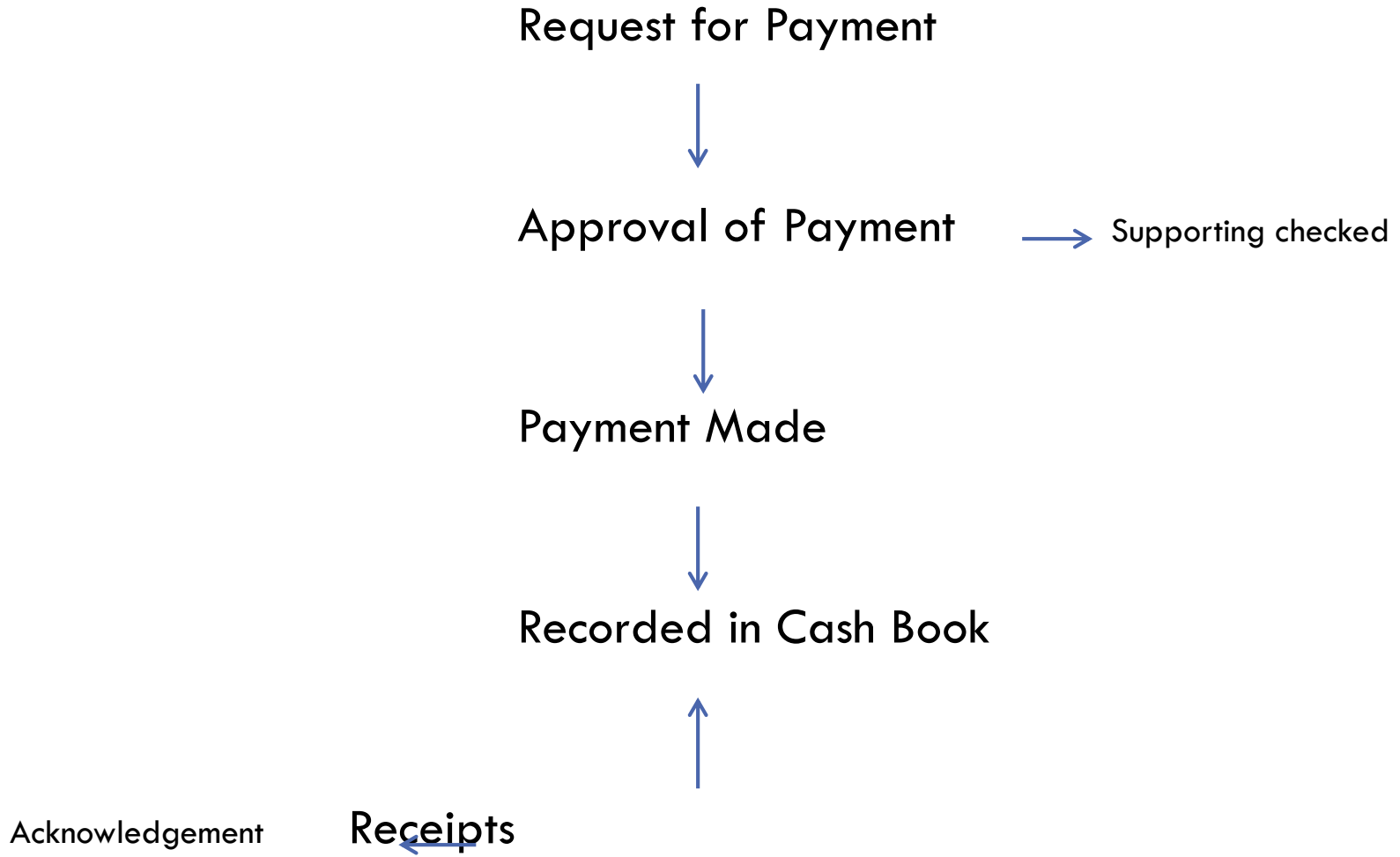
PC

Bonus payments are authorized by the Executive Committee.

ToC

Review that bonuses are authorized by the Executive Committee.

Cash / Bank Cycle



Entity Risks – ERs for Cash / Bank - Examples

- Bank and cash is often one of the most sensitive areas, that it is the asset which is most likely to be misappropriated. Risk includes
 - Theft
 - Misappropriation of sales receipts
 - Misuse of cheque books etc.
 - Misuse of online banking etc.
- Cash payments are also an area of potential risk. Payments might be made to unauthorized persons.
- Individuals might be paid more than they should be paid.

COs for Cash

- Petty cash levels are kept to minimum, preventing theft.
- Cash and Bank Payments can only be made for legitimate business expenses.
- Cash is safeguarded.
- Receipts are banked on a timely basis.
- Cash movements are recorded on a timely basis.

Cash – Principal Control (PC) & Test of Controls (ToC) - Examples

PC

Monthly bank reconciliation statement is prepared at the entity.

ToC

Review the entity's procedure for preparation bank reconciliation statement.

PC

Cash is properly kept in lockers at the entity.

ToC

Check that the cash is kept in lockers at the entity and well safeguarded.

PC

Petty cash level are kept below 10,000 rupees at all offices of the entity.

ToC

Review entity's petty cash levels to check that it does not exceeds 10,000 rupees at any office of the entity.

Communicating Deficiencies in Internal control

Auditor's main responsibility is to report on financial statements however, auditors are encouraged to report deficiencies, if any, in internal controls relevant to financial reporting.

Deficiencies shall be reported in a **DES-R** manner:

Deficiency **E**ffect **S**uggestion **R**esponse

Deficiency	=	Deficiency found by auditor in internal controls.	Weakness
Effect	=	Potential effect of the deficiency.	Implication
Suggestion	=	Auditor Suggestion to overcome the deficiency.	Suggestion
Response	=	Management actual or proposed response for correction.	Expression