Internal Control Evaluation

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Today’s Objectives

• Overall Theme of Module II:

Rich client knowledge → Well informed expectations → High quality risk assessments → High quality audits.

• High quality risk assessments and audit plans involve obtaining a deep understanding of the client’s control environment.

• IT is pervasive within the control environment
  • With a little help from our Case on IT Assurance practice
Internal Control Evaluation
Effectiveness of Controls

- Controls are designed to provide **reasonable assurance** about the achievement of company objectives:
  - Reliability of financial reporting. (primary focus of auditors)
  - Effectiveness and efficiency of operations.
  - Compliance with applicable laws and regulations.
  - Safeguarding of assets. (secondary focus of auditors)

Where do business processes and related controls fit into this conceptualization?
Why Are Controls Important?

- Management perspective:
  - Need reliable accounting systems to make **sound business decisions** and to **meet responsibilities** of safeguarding assets.

- Auditor perspective:
  - Need assurances that data generated by the accounting system is **reliable**.
  - Understanding of internal control is a major factor in determining the **overall audit strategy**.
The Relationship of the Objectives of Internal Control to the Five Components of Internal Control

<table>
<thead>
<tr>
<th>Control Environment</th>
<th>Entity Risk Assessment Process</th>
<th>Control Activities</th>
<th>Information and Communications</th>
<th>Monitoring of Controls</th>
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</table>

Committee of Sponsoring Organisations of the /Treadway Commission. Table 6-2 of MGP has a nice summary of these.
Will Auditor Rely on Controls when Auditing?

Evaluate design of controls

Determine if controls have been implemented

Document understanding of internal control

Auditor choice: Rely on internal controls?

Yes

No
Auditor Will NOT Rely: Substantive Strategy

Auditor does NOT intend to rely on controls

Set control risk at maximum

Document the level of control risk (CR)

Perform substantive procedures given CR
Auditor WILL Rely: Reliance Strategy

Auditor DOES intend to rely on controls

Plan and perform tests of controls

Set control risk based on test results

Document the level of control risk (CR)

Perform substantive procedures given CR

Revise planned substantive procedures if assessed CR < planned CR
Additional Items to Consider

- Whether an auditor chooses to rely on controls or adopt a substantive approach often differs across the audit.
  - May have different strategies for different business processes (or assertions within a process).
  - Even when relying on controls, the amount of assurance the auditor gets from controls often differs by assertion.

- Even a good internal control system is limited if:
  - Management overrides controls.
  - Staff make errors/mistakes or don’t understand system.
  - Staff collude.
Internal Control Over Financial Reporting (ICFR)
ICFR Defined

- Process designed to provide reasonable assurance regarding the reliability of financial reporting and preparation of f/s in accordance with GAAP.

- Controls within ICFR include procedures that:

1. Pertain to the **maintenance of records** that fairly reflect the transactions and dispositions of the assets of the company.

2. Provide reasonable assurance that **transactions are recorded** in accordance with GAAP.

3. Provide reasonable assurance regarding **prevention or timely detection** of unauthorized acquisition, use, or disposition of the company’s assets.
ICFR Responsibilities

- Management (SOX Section 404):
  - Accept responsibility for ICFR effectiveness.
  - Evaluate effectiveness of ICFR using suitable criteria.
  - Present written assessment regarding ICFR effectiveness.

- Auditor (SOX Section 404 & AS5):
  - Audit management’s assertion about ICFR effectiveness.
  - Conduct integrated audit of ICFR and f/s.
Performing an Audit of ICFR

Steps in the Audit of ICFR

1. Plan the audit of ICFR.
2. Identify controls to test using a top-down, risk-based approach.
3. Test the design and operating effectiveness of selected controls.
4. Evaluate identified control deficiencies.
5. Form an opinion on the effectiveness of ICFR.

Top-Down, Risk-Based Approach to the Audit of ICFR

1. Identify entity-level controls.
2. Identify significant accounts and disclosures and their relevant assertions.
3. Understand likely sources of misstatement.
4. Select controls to test.

Source: AS5, ¶21–41.
Controls: Audit of ICFR vs. Audit of F/S

- Objective for tests of controls in the audit of ICFR:
  - To provide evidence of the effectiveness (or not) of the company’s controls over financial reporting at the end of the year.

- Objective for tests of controls in the audit of F/S:
  - To aid in assessing control risk, which influences the nature, timing, and extent of substantive testing.
Testing Operating Effectiveness of Controls

- Whether as part of the audit of ICFR or financial statements, an auditor considers scope of testing.


2. Timing: Interim vs. “as of” /year-end date

3. Extent: nature of control, frequency of operation, importance of control.
Internal Control Deficiencies Defined

Material weakness

Control deficiency

Report externally to audit committee and to management

Report to management

Likehood

Magnitude

Only a material weakness (if not corrected before the “as of” date) results in an auditor providing an adverse ICFR opinion.
Homework Assignment

- Read question 5-38 from chapter 5_MGP and respond to part (a). In addition, having read BPS, respond to the following:

1. Submit Next Class

2. Should you have any questions during the week please send me emails.