Chapter 12

INTERNAL CONTROL

1. Recording the client's accounting system

One of the first things that the auditor has to do in a new audit is to record the client's accounting system.

This will allow the auditor to evaluate the internal control system and will allow the audit to be conducted more efficiently.

Where it's a repeat audit, the auditor must ensure that their records of the client system are updated and remain accurate.

There are three ways of recording the system:

- Narrative notes
- Flowcharts
- Questionnaires.

With narrative notes, the auditor simply writes a few paragraphs explaining, for example, exactly what happens to a supplier's invoice when it's received: how it may be matched with goods received notes, how the calculations are checked, how it is filed, how it is posted to the payables ledger, and how the amount is eventually paid.

Narrative notes can be relatively quick to prepare. Typically you observe what happens, you ask the client what happens, and you may also look at the accounting procedures which they have established more formally.

The main problem that arises with narrative notes is the lack of structure or discipline. It's very easy for documents to appear in narratives and then not be mentioned again and the audit team is then wondering what happens to these documents, and where they can be found.

In flowcharts, diagrams are used to show the documents, the files, the calculations, and the checks that are performed. Flowcharts can be somewhat slower to produce and are certainly more difficult to amend (though nowadays, flowcharting has been helped greatly by computer graphics systems). Flowcharting imposes a great discipline on how systems are recorded as it has very specific rules about how flowcharts are to be drawn. In addition, there is usually a special symbol which is reserved to show where checks are performed. Auditors are particularly interested where checks are performed because this is helping the client to reduce their control risk.

Questionnaires can be used to record the accounting system, but they go slightly further than mere recording: they actually begin to evaluate the accounting system.

There are two main patterns of questionnaire:

- Internal Control Questionnaire (ICQ).
- Internal Control Evaluation Questionnaire (ICEQ)

In ICQs, when you get the answer "yes" to a question, it is a good sign. An example of a question could be, "Are suppliers' invoices cancelled when they are paid?" The answer "Yes" is good, the answer "No" is bad because it means that those invoices could be inadvertently paid a second time.

The other type of questionnaire is an internal control evaluation questionnaire (ICEQ). Here the answer "No"is good and a typical question might be "Can suppliers' invoices be paid twice?"

One of the ways that they might not be paid twice is that they are cancelled after they are paid, but there may be other ways in which this is done. For example, they could simply be moved from one file to another, from an unpaid invoice file to a paid invoice file. That might not be a perfect control but it is a control.

Internal control evaluation questionnaires are rather more open-ended and flexible. What they are addressing are internal control objectives: the mistakes and errors that we want to stop. Internal control questionnaires seek out specific internal controls which can help internal control objectives to be achieved. ICEQs will almost certainly require greater skill from the auditor. Instead of simply having to find out if invoices cancelled, the auditor has to assess whether or not invoices are liable to be paid twice and that's a rather more highly skilled operation.

2. Components of internal control systems

These are the five components of internal control systems:

- The control environment. We have mentioned this before. We said that it was essentially the regard with which the internal control system is held. It's to do with the ethics and the culture of the organisation and whether internal control and careful recording are held in high esteem by the management of the company and indeed everyone working for it. Under this heading we can also include how people are recruited, trained, the structure of the organisation, responsibility, and accountability.
- The risk assessment process. This looks at how the entity itself assesses material risks which might arise. It has to estimate the significance of those risks and the likelihood that are occurring. Having identified a risk, having assessed the likelihood of its occurring, the entity then has to decide what to do about it. WHat controls would address the risks identified?
- The information system. An example of how a good information system is useful in control can be seen in how the company produces and uses its management accounts. Comparing actual results to budgets can give management warnings that something had gown wrong or been mis-recorded in the accounting system. The auditors also have to have an understanding of the significant accounting estimates and judgments which may be present in the financial statements.
- Control activities. These are defined as those policies and procedures, in addition to the control environment, which are established to achieve the entity's specific objectives
- Monitoring controls. The operation of controls can be monitored first by supervisors, then by managers, then by the finance director, or perhaps nowadays more likely the audit committee. If the operation of controls is not monitored they are likely to fall into this repair.

The heart of establishing a good internal control system is asking what could possibly go wrong and then asking how that can be prevented.

3. Control Activities

Control activities consist of the following:

- Segregation of duties. This means that no single transaction can be carried out by just one person. If a transaction can be carried out by one person, it's very difficult to control that transaction. The person and his work undergo no checking procedures meaning that errors are likely to go uncorrected; it also opens the door to fraud. So, if one person could order the goods, receive the goods, receive the invoice and pay the invoice, then it will be very easy for those goods to be deflected to that person's home or friends and family. In fact, although we always have to be mindful of fraud, the more important aspect of segregation of duties is the fact that one person is checking the work of another and so errors are likely to be identified and corrected.
- Authorisation. The authorisation or approval and control of documents is very important. Transactions should be approved by the appropriate person. For example the purchase of fixed assets, the granting of credit, the writing off of a bad debt, and the approval of employees' overtime.
- Comparison. Comparing, for example, the results of stock takes to the book records of stocks. Another example would be comparing goods receive notes with the original purchase orders to make sure that what has been received was, in fact, what was ordered. Constant comparison means that errors, if they do occur, are much more likely to be discovered.
- Computer controls. More and more entities rely on computerised accounting systems and computer controls are very important. We will see a whole section on these later but, for example, it will be important to ensure the backups of the data are regularly taken. It's worth pointing out at this stage that once a transaction gets into a computerised system it's liable to be automated from then on and there is less chance for 'common sense' to be applied to that transaction later in its life.
- Arithmetic controls. These are perhaps slightly less important now that more calculations are done by computer systems. But nevertheless it's important to make sure that simple calculations are correct, and in many cases it may still be appropriate to re-perform those calculations at least on a test basis.
- Maintaining trial balances and control accounts. If the trial balance doesn't balance or the control accounts don't reconcile then something is amiss, and the sooner that is found, the better.
- Accounting reconciliations. Reconciliations mean comparing a particular balance in the accounting records with what another source says. For example comparing the cash balance with a bank statement or comparing a payables balance with the supplier statement.
- Physical. There should be physical safeguards established over certain assets particularly inventories and cash. These assets can often be desirable, portable and valuable. If they are not safeguarded, they are liable to go missing. Physical controls would also apply to making sure inventories kept in conditions in which they do not deteriorate, for example the warehouse may need to be adequately heated or ventilated to ensure that the inventory doesn't get damp.

4. The inherent limitations of internal controls

Although auditors place reliance on internal controls, you must understand that there are certain inherent limitations:

- **Cost v benefit.** The cost of establishing a system of internal control may be greater than the benefits. To take a ridiculous example, it's very unlikely that anyone is going to establish a system of internal control over the issue of paperclips or envelopes. The amount of management time taken up with authorising trivial amounts of expenditure simply makes it uneconomic. At some stage however the benefits may outweigh the costs and, for example, when it comes to photocopying many organisations do have some sort of authorisation or at least accounting system to track who uses most of the photocopying resource.
- **Human error.** For example, one person makes out an invoice using the wrong selling price and another one checks it and doesn't see the error. This is always a possibility even in the best regulated circumstances.
- **Collusion.** Where two or more employees cooperate to get around the internal control system. The collusion might be to carry out a fraud or it might be to cover up some error that was made. The more segregated duties are, the more people it would need to collude to carry out an entire transaction.
- **Bypass of controls.** Say someone has forgotten to order a vital piece of equipment and that to speed matters up, instead of getting the proper authorisation for the purchase, they issue the purchase order without that authorisation. They are bypassing the controls: it may be done with the best possible intentions, but if bypass of controls becomes too common essentially the controls are not operating.
- **Non-routine transactions.** These are transactions that are so rare that no system of internal control has been devised. An example can be the disposal of non-current assets. Many of these assets are scrapped when they are disposed of, and to establish a system of internal control might not have been thought worthwhile. However, occasionally an asset with a substantial value might be disposed of, and if there is no system for getting the right price and for ensuring that the proceeds come to the organisation, then there is a possibility that those transactions are not properly recorded.

5. A reminder of the audit approach

Let's just review again how audits are carried out.

First of all, the system is evaluated. If suitable controls exists then the audit will tend to proceed by testing those controls and audit tests will be carried out to see if the controls are indeed operating effectively.

If however, it is found that there is no set of internal controls or the internal controls are not operating effectively, then substantive procedures have to be carried out. Substantive procedures means looking at a very high proportion of transactions for direct verification rather than relying on the operation of controls.

Both testing internal controls and substantive procedures can provide evidence that the financial statements are free from material misstatements. Other than choosing the most efficient and effective way of gathering evidence, the auditor does not really care how audit evidence is obtained, though it will usually be more efficient and cost effective to rely on the operation of internal controls if that is feasible.

In some audits, particularly those of small business rather than documenting the system of internal control and testing controls it may actually be more efficient to apply substantive procedures to the relatively small number of actual transactions.

6. Testing internal controls

Internal controls can be tested by the following mechanisms:

Enquiry	Ask employees how they carry out certain transactions. Seek management's views by asking them if they feel the system of internal control is operating effectively. Ask whether at some point in the year, such as when people were on holidays or there were staff shortages, the system of internal control was known to have broken down. Ask management how internal control could be improved. You might be able to find some evidence of management views by looking into board minutes or the minutes of departmental meetings.
Inspection	Look at a result of internal control procedures. For example, inspect the file of paid supplier invoices to see if they have indeed been cancelled or initialed to indicate that they had been paid.
Observation	Watch employees as they carry out certain transactions and procedures. Of course, employees would be on their best behaviour if they knew they were being observed.
Recalculation and re-performance	For example, recalculate the invoice, or the wages and salaries. Re-perform what the employees have done to make sure that they have done it correctly.

7. The management letter/report

If the auditors find that the internal control system is inadequate, or is not operating efficiently, then they will send what is known as a management letter or letter of control weakness to the board of the company (or the audit committee).

The almost universal layout for such a letter is three parts;

1. Say what the problem is.
2. Say what the implications or consequences of those problems might be.
3. Recommend how the problem can be fixed.

So the problem might be that supplier invoices are not cancelled when paid; the consequence of that could be that supplier invoices are paid more than once; the way to prevent that is that you mark or stamp invoices 'Paid'.

Auditors will normally also say that they may not have found all control weaknesses and that others may exist and that is duty of the board of directors, now enshrined in the corporate governance codes, to ensure that there is an adequate system of internal control operating within the company.

- Significant deficiencies should be communicated to those charged with governance. Significance deficiencies are defined as:
- When a control is designed, implemented, or operated …is unable to prevent or detect misstatements on a timely basis; or
- Such a control is missing.

- Other deficiencies should be communicated to management.

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