Exam Review of Chapters 6 & 7

Auditors Assessment of Internal Controls

Management needs reliable information systems in order to make sound business **decisions** and to meet its stewardship responsibilities of safeguarding assets.

Auditor's perspective of internal control to the **second standard of fieldwork** and needs assurance that data generated by the accounting system are **reliable**

Definition of Internal Control

Internal control is designed by an entity's board of directors, management, and other personnel to **provide reasonable assurance** about the achievement of the entity's objectives:

(1) reliability, timeliness, and transparency of internal and external, nonfinancial and financial reporting,
(2) effectiveness and efficiency of operations, including safeguarding of assets, and
(3) compliance with applicable laws and regulations.

Controls Relevant to the Audit

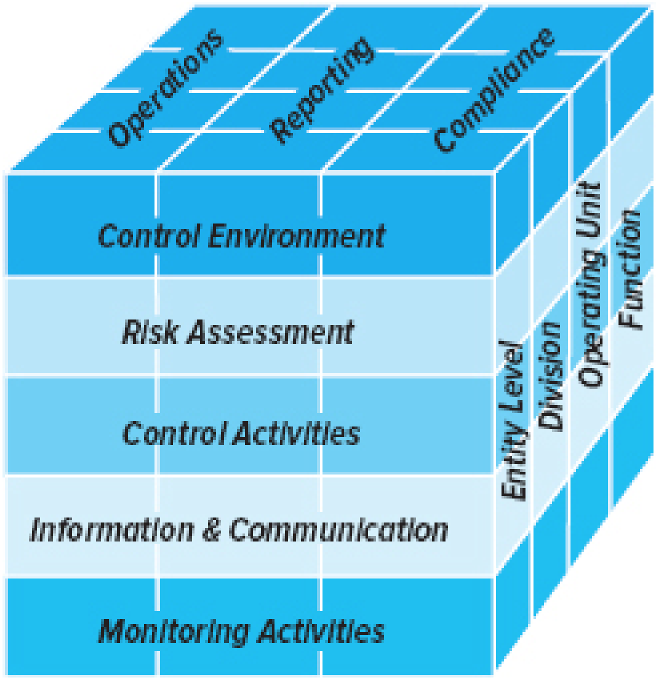
internal controls pertaining to the preparation of financial statements for external purposes are relevant to an audit. Some controls relating to operations and compliance objectives may be relevant when they relate to data the auditor uses to apply auditing procedures. The controls relevant to the audit are those that are likely to **prevent,** or **detect** and **correct,** material misstatements in the financial statements.

Components of Internal Control

- Control environment.
- Entity's risk assessment process.
- Control activities.
- Information and communication.
- Monitoring of controls.

The new COSO Framework (revised in 2013) includes principles that represent fundamental concepts underlying the effectiveness of each of the five components of internal control.

Five components of internal control and the 17 principles from the COSO Framework


Operations
Reporting
Compliance
Control Environment
Risk Assessment
Control Activities
Information & Communication
Monitoring Activities
Entity Level
Division
Operating Unit
Function

The 17 Principles Underlying the Components of Internal Control

Control Environment

1. The organization demonstrates a commitment to integrity and ethical values.

2. The board of directors demonstrates independence from management and exercises oversight of the developm performance of internal control.

3. Management establishes, with board oversight, structures, reporting lines, and appropriate authorities and responsibilities in the pursuit of objectives.

4. The organization demonstrates a commitment to attract, develop, and retain competent individuals in alignme objectives.

5. The organization holds individuals accountable for their internal control responsibilities in the pursuit of objecti

Risk Assessment

6. The organization specifies objectives with sufficient clarity to enable the identification and assessment of risks relating to objectives.

7. The organization identifies risks to the achievement of its objectives across the entity and analyzes risks as a basis for determining how the risks should be managed.

8. The organization considers the potential for fraud in assessing risks to the achievement of objectives.

9. The organization identifies and assesses changes that could significantly impact the system of internal control.

Control Activities

10. The organization selects and develops control activities that contribute to the mitigation of risks to the achievement of objectives to acceptable levels.

11. The organization selects and develops general control activities over technology to support the achievement of objectives.

12. The organization deploys control activities through policies that establish what is expected and procedures that put policies into action.

Information and Communication

13. The organization obtains or generates and uses relevant, quality information to support the functioning of other components of internal control.

14. The organization internally communicates information, including objectives and responsibilities for internal control, necessary to support the functioning of other components of internal control.

15. The organization communicates with external parties regarding matters affecting the functioning of other components of internal control.

Monitoring Activities

16. The organization selects, develops, and performs ongoing and/or separate evaluations to ascertain whether the components of internal control are present and functioning.

17. The organization evaluates and communicates internal control deficiencies in a timely manner to those parties responsible for taking corrective action, including senior management and the board of directors, as appropriate.

Planning an Audit Strategy

Audit risk model

No audit strategy for the entire audit; rather the auditor establishes a separate strategy for individual processes or by specific assertion within a process.

Documenting the Understanding of Internal Control

The various types of tools that are available to the auditor for documenting internal control include:

- Procedures manuals and organizational charts.
- Internal control questionnaires
- Flowcharts
- Narrative description
- The effect of entity size on internal control.
- The limitations of an entity's internal control (Management override of internal control, human errors or mistakes, and collusion).

Assessing Control Risk

When the auditor follows a **substantive strategy**, control risk is set at high. However, when the auditor decides to assess and set control risk at a lower level, three steps are followed:

1. Identify specific controls that will be relied upon.
2. Perform tests of the identified controls.
3. Conclude on the achieved level of control risk given the results of testing.

The **first step** in assessing control risk for a **reliance strategy** is identifying the controls that are present in the entity's accounting system that will be relied upon. These controls would be identified as part of the auditor's understanding of internal control.

Performing Tests of Controls

The **second step** in assessing control risk for a reliance strategy involves performing tests of controls. The procedures that are used as tests of controls:

- Inquiry of appropriate entity personnel.
- Inspection of documents, reports, or electronic files indicating the performance of the control.
- Observation of the application of the control.
- Reperformance of the application of the control by the auditor.

The **last step** in assessing control risk for a reliance strategy involves reaching a **conclusion** on the achieved level of control risk. This assessment is based on the accumulated evidence obtained by the auditor.

Auditing standards state that the auditor should document the basis for the conclusions about the achieved level of control risk.

Substantive Procedures

The last step in the auditor's decision process performing substantive tests.
The assessed level of **inherent risk** and achieved level of **control risk** lead to the level of **detection risk** for substantive tests

Communication of Internal Control-Related Matters

Standards for reporting internal control deficiencies are different for **public** versus **private** companies.

For **public** companies, management must prepare an assertion on the effectiveness of internal control.

For **private** companies, reportable conditions must be communicated to the audit committee.

Auditing Internal Controls

Management Responsibilities under Section 404

- Accept responsibility for the effectiveness of the entity's ICFR.
- Evaluate the effectiveness of the entity's ICFR using suitable criteria (at this point we mention COSO again).
- Support the evaluation with sufficient evidence, including documentation.
- Present a written assessment regarding the effectiveness of the entity's ICFR as of the end of the entity's most recent fiscal year.

Auditor Responsibilities under Section 404 and AS5

Auditors will audit and report on the **effectiveness** of internal control. The auditor must **integrate the audits of the financial statements and the internal control** but realize the two have different objectives. In order for the audits to be integrated, both **must be done by the same** auditor.

Internal Control Deficiencies Defined

A ***control deficiency*** exists when the *design or operation* of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect misstatements on a timely basis.

A ***design deficiency*** exists when

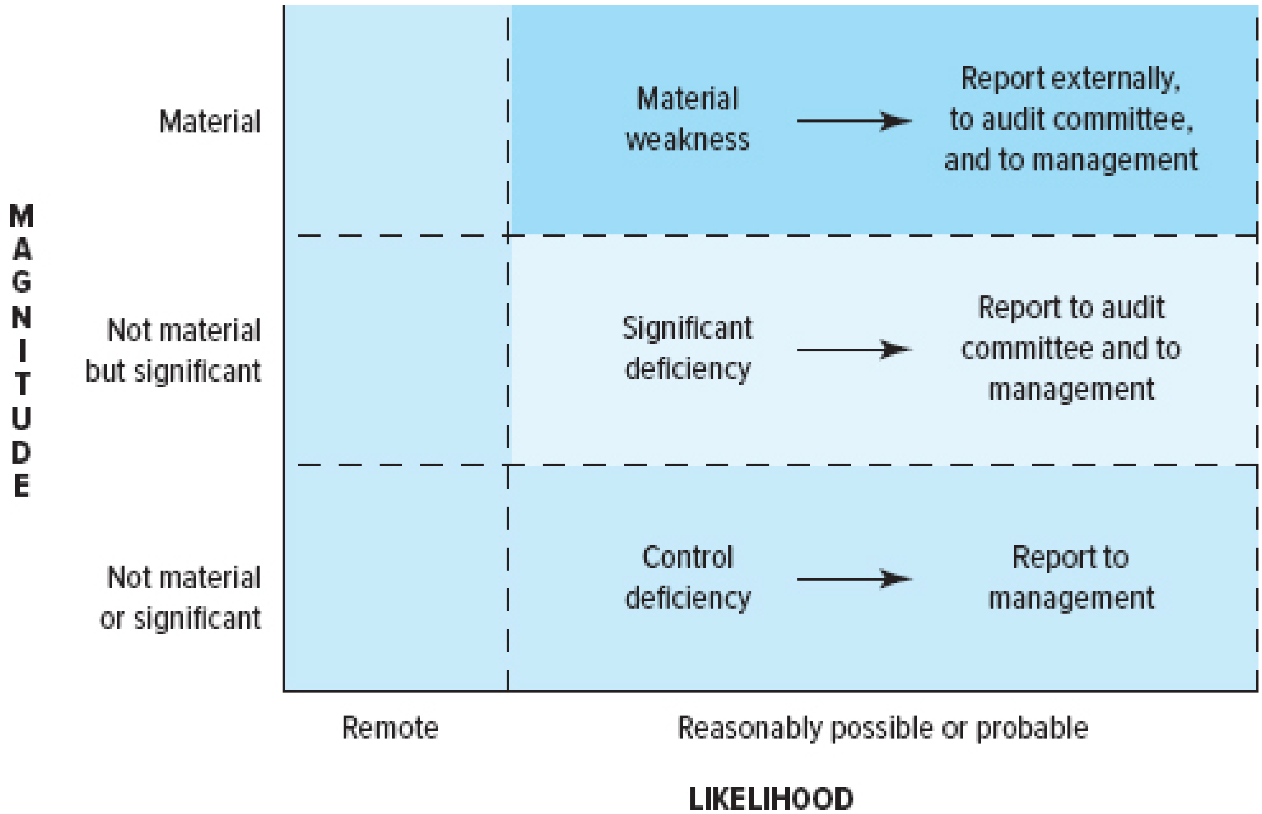
1) a control necessary to meet the relevant control objective is missing or
2) an existing control is not properly designed so that, even if the control operates as designed, the control objective would not be met.

A deficiency in ***operation*** exists when a properly designed control **does not** operate as designed or when the person performing the control does not possess the necessary authority or qualifications to perform the control effectively (AS5, ¶A3).

PCAOB's definitions of **deficiency**, **significant** deficiency, and **material weakness**

likelihood and magnitude.

Focus of AS5 is on **material weaknesses**,
Focus of audit of ICFR is **not** designed to identify significant deficiencies.



Management's Assessment Process

Auditor **cannot** participate in the assessment process since the **auditor must remain independent** in his or her audit of ICFR.

Management is required to base its assessment of the effectiveness of the entity's ICFR on a suitable, recognized control framework established by a body of experts that follows **due-process** procedures.

Documentation of ICFR may take many forms, such as paper, electronic files, or other media. It includes a variety of information, such as policy manuals, process models, flowcharts, job descriptions, documents, and forms.

Performing an Audit of ICFR

The overall goal is to obtain **sufficient, appropriate** evidence about the **design** and **operating effectiveness** of controls over all relevant financial statement assertions relating to significant accounts and disclosures in the financial statements. The auditor does this by planning and performing the audit of internal control to obtain **reasonable assurance** that deficiencies rising to the level of a material weakness are identified.

When an entity has effective ICFR, the auditor should be able to perform sufficient testing of controls to **assess control risk** for all relevant assertions at a low level.

If, however, the auditor assesses control risk as other than low for certain assertions or significant accounts for purposes of the financial statement audit, the auditor should **document the reasons** for that conclusion.

Plan the Audit of ICFR

In planning the engagement, the auditor considers the following activities:

- The role of risk assessment and the risk of fraud.
- Scaling the audit.
- Using the work of others.

A major consideration for the external auditor is **how much the work performed by others** (internal audit function or others working for management) **can be relied on** in adjusting the **nature, timing, or extent** of the auditor's work. In determining the extent to which the auditor may use the work of others, the auditor should consider the risk; that is, as the risk associated with the control increases, the auditor should perform more of the work.

Identify Controls to Test

Auditor should complete the following steps when using a top-down, risk-based approach:

- Identify entity-level controls.
- Identify significant accounts and disclosures and their relevant assertions.
- Understand likely sources of misstatements.
- Select controls to test.

Auditor Documentation Requirements

AS5 requires that the auditor appropriately **document** the processes, procedures, judgments, and results relating to the audit of internal control consistent with the PCAOB's documentation standards.

The auditor's documentation **must include** the

- auditor's **understanding** and evaluation of the design of each of the components of the entity's ICFR, documentation of the process used to determine, and
- the points at which **misstatements** could occur within significant accounts and disclosures,
- the **extent** to which relied upon work performed by others, and
- the **scope** of testing.
- **describe** the evaluation of any deficiencies discovered, as well as any other findings that could result in a modification to the auditor's report.

Auditor Reporting on ICFR

The following reporting issues may require the auditor to modify the standard report:

- Elements of management's report on ICFR are incomplete or improperly presented.
- The auditor decides to refer to the report of other auditors as the basis, in part, for the auditor's own report.
- A significant subsequent event has occurred since the date being reported on.
- There is other information contained in management's report on internal control.
- There is a remediated material weakness at an interim date.

Additional Required Communications in an Audit of ICFR

The auditor has numerous communication responsibilities under Section 404:

- Communicate in **writing** to management and the audit committee **all significant deficiencies** and material weaknesses identified during the audit.
- Communicate to management, in writing, **all control deficiencies** (lesser magnitude than significant deficiencies) identified during the audit and inform the audit committee when such a communication has been made.
- If the auditor has been made aware that **fraud is taking place**, it must be brought to the attention of the appropriate level of management or the audit committee (if the fraud involves senior management).
- If the auditor has discovered **possible illegal acts,** the auditor must assure him or herself that the audit committee is adequately informed unless the matter is clearly inconsequential.

Adapted from
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