
GREENPEN Summary[©]

Overview of components of internal control

ISA 315 requires the auditor to obtain an understanding of internal control relevant to the audit. Although most controls relevant to the audit are likely to relate to financial reporting, not all controls that relate to financial reporting are relevant to the audit. When obtaining an understanding of controls that are relevant to the audit, the auditor shall evaluate the design of those controls and determine whether they have been implemented, by performing procedures in addition to inquiry of the entity's personnel (compare ISA 315, paragraphs 12 and 13).

The auditor's understanding of the organisation's accounting and information system and related internal controls provides necessary knowledge for the identification of risk factors which assist the auditor to assess the likelihood of occurrence and magnitude of risks of material misstatement of the financial statements. The information presented and disclosed in the financial statements is a product of the organisation's accounting and information system and related internal controls.

The following is an overview of the components of internal control in respect of which the auditor should obtain an understanding.

Refer to ISA 315, Par. 14 – 23, A38 – A97 and Appendix 1 for details in respect of the auditor's consideration of an entity's internal control and the various components of internal control.

A NATURE OF INTERNAL CONTROL

Internal control refers to the policies, processes, procedures and measures implemented and maintained by management of an entity, both in respect of the entity as a whole and in respect of individual operational areas, business units and divisions, to provide reasonable assurance regarding the achievements of the following management objectives:

- To ensure the achievement of strategic goals, in line with the vision and mission of the entity
- To ensure the economy, efficiency and effective of operations
- To safeguard the entity's resources
- To ensure compliance with laws and regulations
- To ensure reliable financial reporting.

The auditor is concerned with internal control *relevant to the audit*, which primarily pertains to financial reporting.

B THE FIVE COMPONENTS OF INTERNAL CONTROL

- 1 Control environment
- 2 Risk assessment process

- 3 Information system, including the accounting system
- 4 Control activities
- 5 Monitoring

The small entity context:

- Owner-manager directly involved; performs various functions
- Potential positive contribution of the owner-manager: Close involvement in operations, oversight, direct supervision of major transactions and events, direct and continuous communications with financial and accounting personnel, his/her/their attitude, behaviour and example, etc.
- Potential negative contribution of the owner-manager: Dominating positions, overrides suggestions and decisions, increased risk in respect of management override of controls.
- Not highly formalised; less formal means; informal implementation and application
- Simpler processes and procedures; less complex and less extensive

1 Control environment

For example: Organisational structure, governance structures (including audit committee), oversight exercised by those charged with governance, assignment of authority and responsibility for operating activities, supervision by directors (also owner-manager), commitment to integrity, ethical values and competence, code of conduct, formal adoption of best practice management principles (within various critical areas of financial management – policies, strategies and implementation plans), human resources policies and practices, utilisation of policy manuals, procedure manuals, financial reporting manuals, related communications to personnel, attitudes and actions towards information processing and financial reporting, etc.

The control environment includes the governance and management functions and the attitudes, awareness, and actions of those charged with governance and management concerning the entity's internal control and its importance in the entity. The control environment sets the tone of an organization, influencing the control consciousness of its people. A strong control environment provides a basis for the effective operation of other components of internal control, including detail control activities at a business process level. Conversely, a weak control environment ordinarily undermines the effectiveness of other components of internal control.

Elements of the control environment that may be relevant to the audit include:

- Communication and enforcement of integrity and ethical values
- Commitment to competence: Competence levels for specific jobs; requisite skills and knowledge
- Participation by those charged with governance – their independence from management, their experience and stature, their involvement and the information they receive, their scrutiny of activities and the appropriateness of their actions.

- Management's philosophy and operating style – taking and managing of business risks, attitudes and actions toward financial reporting and attitudes and actions in respect of information processing and accounting functions and personnel.
- Organizational structure: The framework within which the entity's activities are planned, executed, controlled and reviewed.
- Assignment of authority and responsibility
- Human resource policies and practices

The small entity context:

- Lack of formal documentation relating to policies and procedures
- Informal communication relating to policy issues and control matters
- Owner manager's attitude, example and actions in respect of creating an environment/culture of honesty, integrity, compliance, low tolerance for error, correcting weaknesses, etc.

2 Risk assessment process

For example: Approach to taking and managing business risks, formal risk assessment process (or if not formalised, how management identifies and addresses business risks), documented risk assessment policy and process, business risks identified and specific actions implemented to address those risks, fraud prevention plan, legal and other advisors, etc.

The auditor shall obtain an understanding of whether the entity has a process for identifying business risks relevant to financial reporting objectives, estimating the significance of the risks, assessing the likelihood of their occurrence and deciding about actions to address those risks. If the entity has established such a process, the auditor shall obtain an understanding of it, and the results thereof. If the risk assessment process is appropriate to the circumstances, including the nature, size and complexity of the entity, it assists the auditor in identifying risks of material misstatement.

If the entity has not established such a process or has an ad hoc process, the auditor shall discuss with management whether business risks relevant to financial reporting objectives have been identified and how they have been addressed.

The small entity context:

- Lack of formally established risk management process
- Owner-manager aware of major business risks and has instituted actions to address those risks

3 Information system, including the accounting system

The information system relevant to financial reporting includes the accounting system, and comprises the procedures and records designed and established to initiate, record, process, and report entity transactions and to maintain accountability for the related assets, liabilities, revenue and expenses. Furthermore, such procedures involve:

- Resolving incorrect processing of transactions
- Processing and accounting for system overrides or bypasses to controls
- Transferring information from transaction processing systems to the general ledger
- Capturing information relevant to financial reporting for events and conditions other than transactions (such as the depreciation and amortization of assets and changes in the recoverability of accounts receivables)
- Ensuring information required to be disclosed is accumulated, recorded, processed, summarized and appropriately reported in the financial statements.

Furthermore, the use of IT affects the nature and functioning of the information system, as well as the way that control activities (refer to component 4, hereunder) are implemented. Controls over IT aim to maintain the integrity of information and the security of the data such systems process, and include general IT-controls and application controls:

- General IT-controls are policies and procedures that relate to many applications and support the effective functioning of application controls. General IT-controls commonly include controls over data center and network operations, system software acquisition, change and maintenance, program changes, access security and application system acquisition, development and maintenance.
- Application controls are manual or automated procedures that typically operate at a business process level and apply to the processing of individual applications. Application controls relate to procedures used to initiate, record, process and report transactions or other financial data. These controls help ensure that transactions occurred, are authorized, and are completely and accurately recorded and processed.

The accounting system, as part of the overall information system, is relevant to the audit and affects the various transaction cycles / systems / streams that produce financial information which is ultimately presented in the financial statements.



Refer to individual transactions and financial reporting systems in Section C, hereunder

4 Control activities

Control activities are the policies and procedures that help ensure that management directives are carried out. Examples of specific control activities include those relating to the following:

- Authorization
- Performance reviews
- Information processing
- Physical controls
- Segregation of duties

The small entity context:

- Management's oversight and other measures may compensate for the lack of formal control activities. Such measures may include:
 - Foster a corporate culture that emphasizes the importance of control
 - Hire competent staff

- Monitor revenues and expenditures against an established budget
 - Approve all major transactions
 - Monitor key performance indicators
 - Assign responsibilities among staff so as to maximize the segregation of duties.
- Active role of owner-manager may compensate of lack of segregation of duties and/or lack of other formal checks.
 - The auditor's understanding will ordinarily focus on certain main transaction cycles, such as revenues, purchases and employment expenses.

Control activities operate together with other components of internal control and contribute to the proper functioning of the accounting system, as part of the overall information system. Control activities may affect the various transaction cycles / systems / streams that produce financial information which is ultimately presented in the financial statements.



Refer to individual transactions and financial reporting systems in Section C, hereunder

5 Monitoring of controls

For example: Processes for assessing the effectiveness of controls, corrective actions to address internal control weaknesses, emphasis on the ongoing monitoring of controls and reporting of control weaknesses or deviations, management attitude towards effective control and the correction of weaknesses, management supervision and the regular review of management information (also involvement of the owner-manager), sources and reliability of management information, oversight by those charged with governance, role of the internal audit function, etc.

Monitoring of controls is a process to assess the effectiveness of internal control performance over time. It involves assessing the effectiveness of controls on a timely basis and taking necessary corrective actions. Management accomplishes monitoring of controls through ongoing activities, separate evaluations or a combination of the two.

Ongoing monitoring activities are often built into the normal recurring activities of an entity and include regular management and supervisory activities.

The internal audit function also contributes to the monitoring of an entity's activities. Refer to ISA 610, "Considering the Work of Internal Audit" for guidance on the auditor's consideration of the work of internal auditing.

The small entity context:

- Oversight by, and direct involvement of owner-manager
- Actions by owner manager to identify and correct problems/deviations/weaknesses

C INDIVIDUAL TRANSACTIONS AND FINANCIAL REPORTING SYSTEMS

In obtaining an understanding of internal control relevant to the audit, the auditor focuses attention on the information system and control activities in respect of financial reporting. In this regard it is important to obtain an understanding of the manual and IT elements of significant transactions and financial reporting systems, which may include:

- General ledger processing, including the closing and balancing of the general ledger
- Journal entries
- Accounting estimates
- Revenue and collections cycle
- Acquisition and payments cycle
- Personnel and personnel costs cycle
- Other major transaction cycles, e.g. inventory and production, investments, etc.
- Preparation of financial statements

Internal control considerations

C.1 Major transaction cycles and classes of transactions

An understanding of the *transaction trail* is important – from initiation of a transaction up to the recording of the transaction in the general ledger, including the nature of different transactions concerned, regularity of transactions, software applications utilised, manual and computerised procedures, etc. Understanding of the transaction trail includes an understanding of the internal control activities implemented and applied to ensure the achievement of the key control objectives (authorisation, validity, completeness, accuracy, classification and timeliness); and should ordinarily cover the following matters as appropriate in the auditee’s circumstances:

- a Assigned responsibilities, including communication and understanding of financial reporting roles
- b Segregation of incompatible functions (authorisation, execution, recording, control over assets/resources)
- c Initiation of a transaction (*initiation event*), including authorisation and evidence of such authorisation
- d Initial source documentation
- e Initiation of transaction via the CIS, including access control, edit checks, numerical sequence checks, programmed approval checks, etc.
- f Documentation voucher pack (composition of voucher pack and adequacy in circumstances) – summary of all available supporting documentation for the transaction; both manual and electronic
- g Document design and numbering. Numbering of documents utilised to help ensure the completeness and validity of recorded transactions.
- h Approval along the transaction trail (one person checking another persons’ work) and evidence of such checks performed
- i “Book of first entry”, including relevant input and processing controls (edit checks, numerical sequence checks, programmed approval checks, etc.)
- j Checking transaction details before recording
- k How incorrect processing is identified and resolved
- l Ability to override the system (including access control and authorization levels), and how system overrides and bypasses are identified and followed up
- m Can automated controls be suspended in any circumstances and what happens if they fail to operate?
- n Subsidiary ledger transaction processing. Subsidiary ledger utilised and normal/usual transactions recorded – timing and method of recording.

- o General ledger transaction processing. General ledger accounts utilised, including control accounts and suspense accounts. Normal/usual transactions recorded – timing and method of recording
- p Transfer information from transaction processing system to general ledger or financial reporting system
- q Independent checks on transactions processed and processing results, including evidence that such checks have been performed (i.e. internal verification procedures)
- r Management information reviewed on a regular basis and evidence of such reviews performed
- s Regular and independent reconciliations
- t Physical inspections and comparing results to accounting records
- u How exceptions are reported and acted on.

Furthermore, in relation to individual classes of transactions and/or account balances affected:

- v The capture of information in relation to events and conditions other than transactions (such as the depreciation/amortization of assets and changes in the recoverability of accounts receivables)
- w Record and control with respect to the use of standard and non-standard journal entries, including the controls to ensure authorisation, validity and accuracy of journal entries.
- x Accumulation, summarising and recording of information required to be disclosed by the applicable financial reporting framework.

- C.2 Process and procedures for general ledger processing, closing and balancing of the general ledger, accumulating, combining and summarising of financial information and finalising material financial statement items.
- C.3 Nature and extent of journal entries in respect of material financial statement items – distinguishing between standard journal entries, adjusting journal entries (non-standard, non-recurring journal entries); and year-end journal entries or adjustments. It is important to understand the nature of journal entries, as well as the controls to ensure authorisation, validity and accuracy of journal entries.
- C.4 Process to ensure that information required to be disclosed by the applicable financial reporting framework is accumulated, recorded, processed, summarized, and appropriately reported in the financial statements.
- C.5 Process for preparing and reviewing the financial statements, including selecting and applying accounting policies, adjustments to the financial statements and presentation of, and disclosures in the financial statements.