Lecturer responsible for AUE2602:
Topic 2: Internal Controls
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What is Internal Controls?

Procedures designed to address and limit potential risks

Types of risks:

- Safeguarding assets of company
- Preventing fraud
- Complying with laws and regulations
- Producing reliable financial information → Financial Statements
- Effective and efficient operation of business

Who is responsible?

- Board of Directors - overall responsibility and accountability

- Management - identify risks
  - design and implement policies and procedures to address risks
  - maintaining processes →ensure policies & procedures are carried out

- Employees - execution of IC procedures
  - success depends on them

Characteristics of Internal Controls

1. IC's is a process
2. IC's are effected by people
3. IC's are not sole responsibility of management
4. IC's are not static
5. IC's are not foolproof
6. Is not 1 IC to address 1 risk

In the exam you should be able to elaborate on above – refer to J&S p 5/4 for detailed explanations

Definition of Internal Controls

When you take what you've learned above into account it's easy:

"Internal control can be defined as the process designed, implemented and maintained by those charged with governance(board), management and other personnel to provide reasonable assurance about the achievement of an entity's objectives with regard to:

- The reliability of the entity's financial reporting
- The effectiveness and efficiency of its operations and
- Its compliance with applicable laws and regulations."

What is the entity's objectives?

Management assertions / IC objectives:

- Valid (Occurred and authorised)

- Accurate

- Complete

Refer to the definitions in J&S p 1/19 – 1/20

and the study guide p 28

Limitations of Internal Controls

1. Cost – benefit ratio
2. IC's normally for routine transactions
3. Human error → carelessness, distraction etc
4. Intentional circumvention of IC's
5. Abuse of IC procedure responsibility
6. IC procedures not keeping up to date with changes in company

In the exam you must be able to give a short explanation of the above to show you understand the meaning of the above.

Components of Internal Controls

1. Control environment
2. Risk assessment
3. Information systems
4. Control activities
5. Monitoring of controls

Components of Internal control
1. Control Environment

- It sets the "tone" of the entity and creates the atmosphere in which employees go about their duties
- "Control consciousness" of entity – all are aware of controls implemented and it is being followed and monitored

Points relating to this component:

* Integrity and ethical values
* Commitment to competence
* Participation of those charged with governance (e.g. Board of directors)
* Management's philosophy and operating style organisational structure
* Assigning authority and responsibility
* Human resource policies and practices.

Read J&S p 5/7 – 5/8 Section 4.1

Components of Internal control
2. Risk Assessment

- Deals with identifying and addressing risks the entity faces
- Risk assessment process involves:
    - → assessing likelihood and frequency of risk identified
    - → estimating the potential impact if risk was to occur

Points relating to this component:

* Define the objectives of entity, the departments and functions
* Identify and assess risks:
    - → operational
    - → financial reporting
    - → compliance
* Respond to risk
    - → information system (combined process / method of initiating, recording, processing and reporting transactions, manually / through computers / a combination of both)
    - → control activities

Read J&S p 5/8 – 5/10 Section 4.2

Components of Internal control
3. Information Systems

Points relating to this component:

* Valid, accurate and complete (when initiating, recording, processing and reporting transactions)
* Procedures to deal with transactions:
  → initiating   → recording
  → processing   → correcting
  → posting (to ledgers)
* Related accounting records
  → documents used
  → document design (NB - refer to J&S p 5/11 section 4.3.3)
* Capturing events and conditions other than transactions (e.g. depreciation)
* Journal entries
* Accumulate, record, process and summarise information for the preparation of the financial statements

Read J&S p 5/10 – 5/12 Section 4.3

Components of Internal control
4. Control Activities

• The actions which are carried out to manage or reduce risks and to achieve the entity's internal control objectives

Points relating to this component:

* Actions, procedures supported by policies:
  → approval, authorisation
  → segregation of duties (J&S p 5/13 – 5/15)
  → isolation of responsibility (J&S p 5/15)
(Make sure you understand the difference between segr of duties and isol of resp)
  →access / custody (security)
  → comparison and reconciliations
    (there is no point in comparisons and recons if differences are not followed up and remedial actions taken)
  → performance reviews
* Preventative, detective, corrective
* General and application controls (J&S p 5/17 – a good & simple explanation)

Read J&S p 5/12 – 5/17 Section 4.4

Components of Internal control
5. Monitoring of controls

- If not monitored → The board/management will not know if:
  - * entities financial reporting is effective
  - * operations are being effectively and efficiently conducted
  - * the entity is complying with applicable laws and regulations

Points relating to this component:

* Assessment over time
* Are objectives still being met?
* Assessment at all levels:
   → directors   → management   → department heads
* Independent assessment
   → internal audit   → external bodies   → customers
* Remedial action

Read J&S p 5/17 – 5/18 Section 4.5

Controls in a computerised environment

General controls

Vs

Application controls

- Can be manual / computerised

- Normally classify as general or application in computerised environment, but may also apply in manual system

- Preventative and Detective controls

General Controls

The **overall framework** of control for computerised activities

Categories of general controls:

1. ### Control environment
   - What is management's attitude towards controls?

2. ### Systems development & implementation
   - In-house development & implementation
   - Packaged software
   - Programme change controls

3. ### Access controls
   - Access to hardware, accessing the computer itself, documentation
   * Physical access - e.g. access cards
   * Logical access – e.g. password controls

General Controls (cont.)

The **overall framework** of control for computerised activities

4. ### Continuity of operations
   - Risk assessment
   - Physical security e.g. to protect the environment against power surges
   - Disaster recovery e.g. back ups

5. ### System software & operating controls
   - Control the use of hardware on system
   - Control the use of application & end-user software on system

6. ### Documentation
   - Sound document controls and standards

Application Controls

Set of procedures & programs to satisfy all users assigned a specific task → Application controls are controls within an application.

- • A transaction follows 3 stages:
- – Input → read in sales transaction
- – Processing→ calculation of VAT on sales transaction
- – Output → printout of invoice on sales transaction

- • Controls to ensure **validity, accuracy and completeness** at each stage

Application Controls (cont.)

Application controls are **controls within an application**.

Categories of application controls:

1. Segregation of duties
2. Isolation of responsibilities
3. Approval and authorisation
4. Custody
5. Access controls
6. Comparison & reconciliations and follow up of discrepancies
7. Performance reviews

Application Controls (cont.)

Application controls are **controls within an application**.

Control techniques & application controls:

- Program checks – input (Jackson & Stent p 8/35)
- Program checks – processing (Jackson & Stent p 8/37)
- Masterfiles (Jackson & Stent p 8/40)