SESSION 5
INTERNAL CONTROL SYSTEMS

**Learning Objectives:**

- Define internal controls and describe its five main components.
- Define the objective of good internal controls.
- Describe the objective of good internal accounting controls.
- Define the limitation of internal controls.

**ISA 400 RISK ASSESSMENTS AND INTERNAL CONTROL**

The Definition of internal control systems:

"With the best of intentions, most people make mistake. The mistakes may be errors in the end results of their work, needless inefficiencies in achieving those end results, or both. And sometimes without the best of intentions a few people deliberately falsify. Any organisation wishing to conduct its business in an orderly and efficient manner and to produce reliable financial information both for its own and for others’ use needs some controls to minimise the effects of these endemic human failings. When such controls are implemented within the organisation’s systems they are described as internal control. Anderson 1977)".

**Control Environment:**

- The control environment design by the senior management toward the control within the organisation. It means the overall attitude, awareness and action of directors and management regarding internal controls and their importance in the organisation.

- The control environment encompasses the management style and corporate culture and values shared by all employees.

**Numerous factors comprise the control environment. Among these are:**

- management's philosophy and operating style.
- integrity and ethical values.
- commitment to competence.
- organisational structure and assignment of authority and responsibility.
- methods of imposing control, including:

  1. board of directors and audit committee.
2. internal audit.

3. personnel policies and practices.

**Management’s philosophy and operating style**

- Characteristics that form part of a management’s philosophy and operating style and which have an impact on the control environment include the management’s:
  - approach to the taking and monitoring of business risks;
  - reliance on informal face to face contacts with key managers versus a formal system of written policies, performance indicators and exception reports;
  - attitudes and actions toward financial reporting;
  - conservative or aggressive selection of accounting principles from available alternatives;
  - conscientiousness and conservatism in developing accounting estimates;
  - attitudes towards information processing and accounting functions and personnel.

**Integrity and ethical values:**

- In order to emphasise the importance of integrity and ethical values among all personnel of an organisation the management should:
  - Demonstrating integrity and practising ethical behaviour among all employees of the organisation.

**Competence:**

- Personnel at every level in the organisation must possess the knowledge and skills needed to perform their jobs effectively.

**Organisational structure:**

- An organisational structure contributes to an entity's ability to meet its objectives by providing an overall framework for planning, executing, controlling and monitoring the entity's activities.

**Methods of imposing control**

- The board of directors and the audit committee and the manner in which they exercise their governance and oversight responsibilities have a major impact on the control environment. Factors include the:
  - Proportion of outside directors and the establishment of an audit committee.
• Experience of members in audit committee.
• extent of their involvement with and scrutiny of management's activities;
• degree to which they raise and pursue difficult questions with management;
• Nature and extent of their interaction with internal and external auditors.

Internal audit

 Internal audit function strengthens the control environment. To be effective, internal audit auditor need to:

• skilled
• integrity;
• Have appropriate access to the board of directors and the audit committee, and to the external auditors.

Personnel policies and practices

 A fundamental concept of internal control is that it is affected or implemented by people. For the accounting and internal control systems to be effective, human resource policies and practices must ensure that entity personnel possess the expected integrity, ethical values and competence.

Such practices include:

• Developing appropriate recruiting policies.
• Screening prospective employees.
• Developing training policies that communicate prospective roles and responsibilities.
• Exercising disciplinary action for violations of expected behaviour.
• Evaluating, counselling and promoting people based on periodic performance appraisals.
• Implementing compensation programmes that motivate and reward superior performance while avoiding disincentives to ethical behaviour.

Control procedures:

 Control procedures are those policies and procedures which established to achieve the entity’s specific objective.

 They include in particular procedures designed to prevent or detect errors and fraud.

 Control procedures are details check and control which are built into the system
Type of internal control

Organisation:
- Organisational plan
- Define and allocate responsibilities

Segregation of duties:
- No one person should be responsible for the recording and processing of the complete work.
- Segregation of duties reduces the risk of fraud or error.

Physical:
- To safeguard the assets and restrict the access to the authorised personnel. E.g. using password locks.

Authorisation and approval:
- All transaction should require authorisation or approval by an appropriate person.

Arithmetic and accounting:
- To ensure completeness and accuracy of recoding e.g. TBs, reconciliation’s and control accounts.

Personnel:
- Delegation of duties to people with appropriate skills

Supervision:
- All actions by all levels of staff should be supervised. The responsibility for supervision should be clearly laid down,

Management:
- These are control exercised by management, which are outside and over and above the day to day routine of the system.

Limitation of internal control:
- Cost of implementation internal control systems
- Potential human error ( Stress of workload, carelessness)
- The possibility of circumvention of controls either alone or through collusion with parties outside or inside the entity.
Abuse of responsibility

Management override internal control (Robert Maxwell, BCCI, Barings)

RECORDING THE INTERNAL CONTROL SYSTEMS:

Narrative notes:

Advantages:

- More practical where systems are elementary
- Capable of logical appraisal if properly complied:
  - Documents listed in order of processing
  - Cross-referenced to procedures performed on documents
  - Division of duties indicated
  - Authority levels and limit indicated
- Useful supplement to flowcharts and record exception routines (e.g. processing of credit notes in a sales system)

Disadvantages:

- Difficult to appraise complex systems
- Difficult to highlight controls
- Changes in systems might require a complete rewrite

Internal Control Questionnaires

Questions determine accounting procedures, documents raised and controls imposed.

Advantages:

- Comprehensive list of questions on all sub systems and all possible aspects of control automatically highlights strengths, weakness and omissions.
- All aspects of accounting and control are considered
- Review and evaluation are facilitated
- Eases cross-referencing to audit programmes

Disadvantages:

- The questions concentrate on the controls themselves rather than the error, fraud or irregularity the control is designed to prevent or detect.
The questions make no assessment of materiality or relative importance of controls.

It is difficult to determine the existence of compensating or mitigating controls when no answers indicate a weakness.

Experience and judgement are required in evaluation

Standard questions may not apply to the specific situations of different clients.

Following is the internal control questionnaires (Extracts) for bank transactions

1. How often is bank reconciliation prepared?

2. (a) Is the person responsible for function independent of the receipts and payment function?

   (b) Alternatively is the reconciliation independently checked?

3. Where the reconciliation is prepared as in (2a) above does he obtain statements direct from the bank and retain them until the reconciliation is effected?

4. Does the independent reconciliation include?

   (a) A comparison of the debits and credits shown on the bank statements with the cashbook?

   (b) A comparison of paid cheques with the cashbook as to names, dates and amounts?

   (c) A test of the detailed paying-in-slip with the cashbook?

   (d) An enquiry into contra items?

   (e) Are items more than one month old investigated to establish that they are genuine?

Flowcharts
It is unlikely that the construction and analysis of flowchart will be the subject of examination questions.

Advantages:

- Diagrammatic and shorthand symbols give perspective to the system’s description.

- They aid understanding and communications

- The discipline of construction ensures complete recording of processes, documents, files, books and controls.
- Controls and weaknesses are easily highlighted
- Continuity of the audit is facilitated where audit staff changes take place.
- Review is facilitated by those not familiar with the client or system.

**Disadvantages:**

- Complex systems are difficult to evaluate by inexperienced staff
- Changes in systems may require a complete redraft.

**Internal Control Evaluation Questionnaires (ICEQ’s)**

**Features:**

- ICEQs are means of evaluating an already ascertained system (e.g. by flowchart)
- Key question ask whether the possibility of a serious error or fraud can happen
- Supplementary questions in the form of a checklist ask whether desirable controls are present which individually or collectively prevent or detect the error or fraud in the key questions.

**Advantages:**

- ICEQ's facilitate the determination of whether desirable are present to detect, eliminate or prevent the risk of serious error, fraud or irregularity.
- They aid the evaluation process of complex flowchart.
- They provide a logical basis for subsequent design and selection of detailed audit tests-they are easily cross-referenced to audit programme.
- They encourage better comprehension of systems by more junior staff.

**Disadvantages:**

- Too many supplementary questions can turn the ICEQ and ICQ and hence cause confusions