Fundamentals of Internal Control
(Relevant to Paper 8 – Principles of Auditing and Management Information Systems)

David Chow, FCCA, FCPA, CPA (Practising)

The Audit Approach: Systems Approach

It is common for auditors to adopt the systems approach in performing their audits. The systems approach focuses the audit work on the accounting systems and the controls that operate within those systems. The rationale for this approach is that if the controls in the system are properly designed and operating effectively, then the figures produced by the system are likely to be true and fair.

Internal Control

Hong Kong Standard on Auditing 315 (Revised 2016) *Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment* defines internal control as the process designed, implemented and maintained by those charged with governance, management and other personnel to provide reasonable assurance about the achievement of an entity's objectives with regard to reliability of financial reporting, effectiveness and efficiency of operations, and compliance with applicable laws and regulations.

Entity's Concerns

The way in which internal control is designed, implemented and maintained varies with an entity's size and complexity. Nevertheless, with the setting up of a system of internal controls entities can achieve the following objectives:

(i) Business transactions are properly recorded, processed and summarized;

(ii) Accounting records are properly maintained;

(iii) Accurate financial information is generated for decision-making;

(iv) The reliability of financial reporting is ensured;

(v) Assets and records are safeguarded;

(vi) Business is carried on in an orderly and efficient manner;

(vii) Fraud and errors can be prevented and detected;

(viii) Business operations are effective and efficient;

(ix) Compliance with applicable laws and regulations is ensured; and

(x) Risks that threaten the achievement of any of these objectives are identified and responded to.

Auditor's Concerns

It is useful for an auditor to obtain an understanding of a client's internal control processes relevant to the audit because doing so assists the auditor in:

(i) Assessing control risk;

(ii) Identifying types of potential misstatements;

(iii) Considering factors that affect the risks of material misstatements; and

(iv) Designing the nature, timing and extent of further audit procedures.

Preventive and Detective Controls

When considering internal controls the auditor should also be aware of the difference between preventive controls and detective controls. Both are designed to identify errors, but the distinction is based on the timing of their application. Entities generally use a combination of both preventive and detective controls.

Preventive controls are applied before the subsequent processing step. They aim to prevent the errors from occurring or being processed any further. One example of this is accounting for the completeness of all items in a batch through the use of batch totals.

Detective controls are applied at or after the subsequent processing step. Their strength depends on factors such as the time lag between the performance of the internal control and the performance of the processes being controlled. Examples include reconciliations, reviews and comparisons by individuals not involved in the activity being controlled.

From an audit perspective, it is often more efficient for the auditor to test for the effectiveness of a detective control, rather than a preventive control, because detective controls are often designed to identify errors that have occurred at more than one control point.

On the other hand, the client may place more emphasis on preventive controls rather than detective controls, depending on cost-benefit considerations and the risks involved. Management will consider the cost of implementing preventive controls as opposed to the possible losses that might occur without them. In practice, an auditor should only suggest to clients internal control structures that are commercially viable.

Reconciliation controls between two independent information streams can detect the errors relating to the completeness, existence, and accuracy at several different control points. However, reconciliation controls are detective in nature and do not prevent errors from occurring, nor do they identify the sources of any errors detected. Some entities rely exclusively on reconciliation controls to detect processing errors. Entities with a large number of transactions tend to have population and accuracy controls specific to individual processes in addition to reconciliation controls, usually to prevent errors arising or to facilitate the correction of errors. An example of reconciliation control is bank reconciliation between bank statements and bank accounts.

Controls Relevant to the Audit

An entity generally has controls relating to objectives that are not relevant to an audit, and therefore auditors need not consider such controls as are unrelated to financial reporting. For example, if a purchase is made at an excessively high price, the accounting system should reflect the price paid, since that reflects the exchange. However, management would normally wish to institute internal control to ensure that the prices paid were not excessive, and hence such control would not be relevant to the audit.

The following controls may be relevant to an audit:

(i) Controls over the completeness and accuracy of information produced by the entity

If the auditor intends to utilize such information in designing and performing further audit procedures

(ii) Controls relating to operations and compliance objectives

If the auditor evaluates the data controlled or uses these data in applying audit procedures

(iii) Internal control over safeguarding of assets

These controls include control processes relating to both financial reporting and operations objectives. The auditor's consideration of such controls is generally limited to those relevant to the reliability of financial reporting.

Design and Implementation of Relevant Internal Controls

The auditor's evaluation of the design of control processes involves considering whether the control framework is capable of effectively preventing, or detecting and correcting material misstatements. An improperly designed control framework may represent a significant deficiency in overall internal control.

Implementation of a control framework means that the control procedures exist and that the entity is using them. However, this does not necessarily mean that the implemented controls have been properly carried out. The auditor has to carry out a test of controls to verify whether those controls are functioning properly.

Walk-through Test

Inquiry of entity personnel is one of the risk assessment procedures used by an auditor to ascertain the design and implementation of a control framework. However, other risk assessment procedures should be performed to obtain audit evidence about the design of controls and whether such controls have been implemented. Those procedures may include:

(i) Observing the application of specific controls;

(ii) Inspecting reports and documents; and

(iii) Tracing transactions through the information system relevant to financial reporting.

The tracing of one or a few documents from the initiation of a transaction type through the entire accounting process to its (their) final place in the accounting ledgers is a walk-through test.

Purpose of Risk Assessment Procedures Performed by the Auditor

First, the auditor makes an inquiry of client personnel as the most direct method of ascertaining any changes in the system of internal control. In order to distinguish the changes since the last audit, the auditor may refer to the prior year's system documentation.

Sometimes the auditor can identify changes in internal control procedures by reading the updates on the client's systems manuals. Through the examination of such documents and records, the auditor can bring his or her understanding of the manuals to life. Any discrepancies identified should be clarified with the management to ensure that there has been no misunderstanding or misinterpretation of a procedure.

Through the observation of system processes and operations the auditor can also enhance his or her understanding of the internal control framework and can ensure that the controls being considered have been properly implemented and carried out. It is important for the auditor to document his or her understanding of the system of controls so as to support his or her assessment of control risk, to provide communication among audit engagement team members, and to serve as a reference for future audits.

Lastly, the auditor performs a walk-through test to confirm his or her understanding of the system of controls and to ensure that the actual control procedures carried out are the same as those documented by the auditor.

Inherent Limitations of Internal Control

Despite an entity having designed and implemented effective internal controls, there can only be reasonable assurance about the entity's achieving its financial reporting objectives. This may be due to the following inherent limitations of internal control:

(i) The potential for human error, such as carelessness;

(ii) Incompetent staff members who do not understand the control's purpose or fail to take appropriate actions;

(iii) The possibility of collusion to "get around" controls that segregate duties;

(iv) The management overriding of controls;

(v) Obsolete controls not yet changed to reflect changes in business activities or organisation structure;

(vi) The costs of implementing the internal control system may outweigh its benefits; and

(vii) Internal controls normally do not cover non-recurring transactions (such as year-end adjustments) or unusual transactions, which are often large and prone to error.

Smaller Entities

Smaller entities usually have fewer employees. This may limit the application of segregation of duties, but this does not necessary imply weaker control. Especially in a small owner-managed entity, the owner-manager may be able to exercise tighter control than in a larger entity. This oversight may compensate for the generally more limited opportunities for segregation of duties.

Reference:

HKSA 315 (Revised 2016) *Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment*, revised January 2016 by the Hong Kong Institute of Certified Public Accountants

Internal Control and CEADISC Guide, March 1988, by KPMG U.S.