

ACC531: Auditing and Assurance Services

Ch5. Internal Controls

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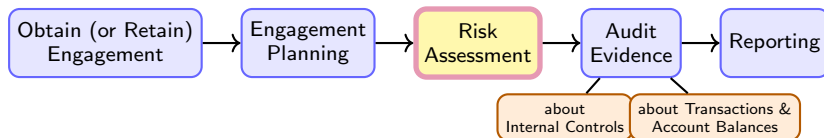
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LO 5-1

Define and describe what is meant by internal controls.

Where Are We?

- In Ch4, we introduced **Control Risk (CR)**: the probability that material misstatements will **not** be prevented or detected by the client's internal controls.
- To assess CR, auditors must first **understand** the client's internal control system.



Motivating Example

EX 1. Suppose you run a retail store. You hire one employee to do all of:



Q 1. What could go wrong?

- Employee could steal cash from the register.
- Then alter records to conceal the theft.
- No one else would catch it — no _____¹.

¹An example of control activities.

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Q 1. What could go wrong?

- Employee could steal cash from the register.
- Then alter records to conceal the theft.
- No one else would catch it — no segregation of duties.¹

¹An example of control activities.

Definition: Internal Controls²

Internal Controls (COSO, 2013)

A process, effected by an entity's board of directors, management, and other personnel, designed to provide reasonable assurance regarding the achievement of objectives in:

- ① _____ — effectiveness and efficiency; safeguarding assets
- ② _____ — reliability of financial reporting
- ③ _____ — adherence to applicable laws and regulations

Auditors' primary focus is Internal controls over _____.

²Committee of Sponsoring Organizations of the Treadway Commission (COSO), *Internal Control — Integrated Framework*, 2013.

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- ① Operations — effectiveness and efficiency; safeguarding assets
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Auditors' primary focus is Internal controls over financial reporting (ICOFR).

²Committee of Sponsoring Organizations of the Treadway Commission (COSO), *Internal Control — Integrated Framework*, 2013.

Three Key Elements of IC

(1) A Process

Ongoing actions;
not a one-time
event

(2) People

Board, MGT,
and *all* personnel
are involved

(3) Reasonable Assurance

High confidence,
not certainty

Key Insight

ICs are designed & operated by people — inherently subject to human limitations.



Why can't IC provide **absolute** assurance?

- Cost-benefit constraint — eliminating all risk would be prohibitively expensive
- _____ — people make unintentional mistakes
- _____ — employees can cooperate to bypass controls
- _____ — authority can be used to circumvent controls

Implication

These limitations are why auditors must **independently** assess IC, rather than simply accepting MGT's representations.



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- **MGT override** — authority can be used to circumvent controls

Implication

These limitations are why auditors must **independently** assess IC, rather than simply accepting MGT's representations.

- ❶ Which of the following is **not** one of the three primary objectives of effective internal control? ³
- A) Reliability of financial reporting
 - B) Efficiency and effectiveness of operations
 - C) Compliance with laws and regulations
 - D) Assurance of elimination of business risk
- ❷ Internal control is **not** designed to provide reasonable assurance that ⁴
- A) All frauds will be detected
 - B) Transactions are executed in accordance with management's authorization
 - C) The company's resources are used efficiently and effectively
 - D) Company personnel comply with applicable rules and regulations

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LO 5-2

Distinguish between the responsibilities of MGT and auditors regarding an entity's internal control.

The Core Distinction

MGT

Responsible for
designing, implementing,
maintaining & assessing
internal controls

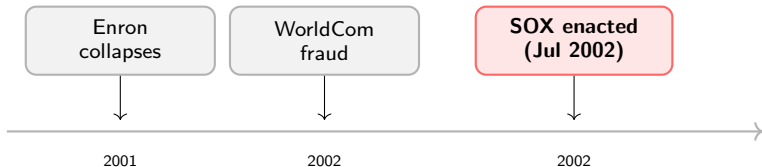
vs.

External Auditors

Responsible for
understanding & assessing
internal controls

Background: Why Does This Distinction Matter?

- Before 2002, there were no formal requirements for MGT to _____ or _____ IC.
- High-profile corporate frauds exposed the cost of weak MGT accountability.

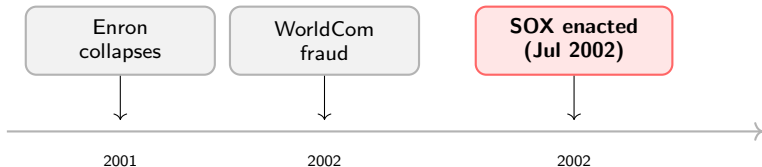


The Sarbanes-Oxley Act (SOX) formalized MGT's personal accountability for ICFR and required independent auditor _____.⁵

⁵Only for public companies.

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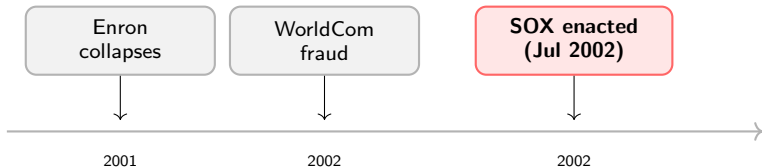


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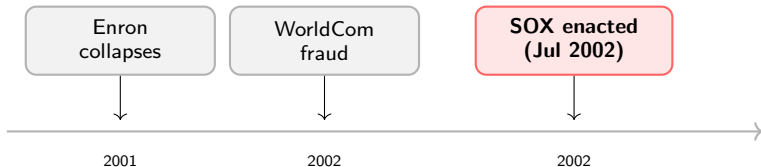


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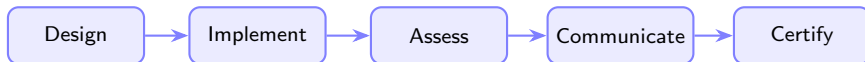


The Sarbanes-Oxley Act (SOX) formalized MGT's personal accountability for ICFR and required independent auditor attestation.⁵

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Management's Responsibilities

MGT is responsible for IC:



SOX Section 302

CEOs and CFOs must personally certify in each 10-Q and 10-K filing that:

- They have _____ ICFR.^a
- They have _____ any **MW** or **SD** to auditors and the audit committee.
- The FS are not **materially misleading**.

^aICFR: Internal Controls over Financial Reporting

⁶Included in the 10-K (annual) and 10-Q (quarterly) filings.

ICFR: Internal Controls over Financial Reporting;

MW: Material Weakness;

SD: Significant Deficiency

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SOX §404(a) — MGT's Annual Report on ICFR

In the *Form 10-K*, MGT must:

- 1 State responsibility for establishing and maintaining ICFR
- 2 Provide an assessment of ICFR effectiveness as of fiscal year-end
- 3 Identify the framework used (typically: _____)

Consequence of Weak ICFR

If one or more MW exist, MGT must conclude that ICFR is ineffective.

⁷Included in the 10-K (annual) filing.

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SOX §404(b) — External Auditor's Role

For **AFs**, the external auditor must:

- 1 **Independently** assess the design and operating effectiveness of ICFR
- 2 **Attest to and report on** MGT's assessment (not merely review it)
- 3 Issue a _____ on ICFR effectiveness

Scope

Required for **AFs** under PCAOB AS 2201. **NAFs** (smaller public companies) are **exempt** from 404(b).

⁸Included in the 10-K (annual) filing.

ICFR: Internal Controls over Financial Reporting;

AFs: Accelerated Filers: Public firms with public float of \$75M+;

NAFs: Non-Accelerated Filers: Public firms with public float of less than \$75M;

Public float: market value of common stock held by non-affiliates. Conceptually, it's similar to market capitalization, but excludes stock held by insiders and large institutional investors.

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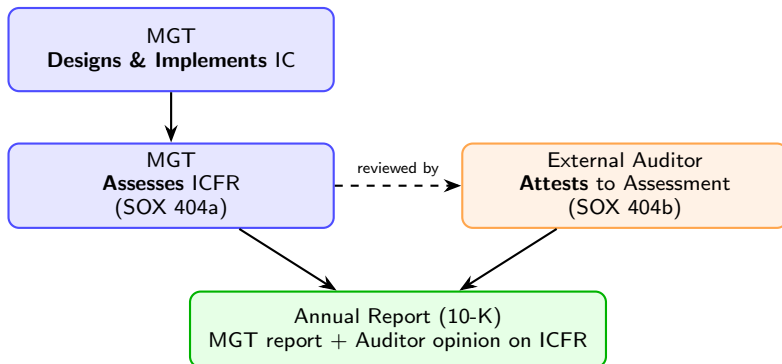
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Auditors' Responsibilities

Auditors must:⁹

- Obtain an understanding of ICFR relevant to the audit
- Evaluate the _____ of controls
- Test _____ effectiveness of controls
- Assess _____ risk and set planned detection risk accordingly
- For AFs: express an opinion on _____¹⁰

⁹ [PCAOB AS 2201](#) (public) / [AU-C 315](#) (non-public).

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- A) Insufficient
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 - C) Ineffective
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- ❸ [T/F] Only larger public companies (accelerated filers) are required to obtain an auditor report on ICFR.¹³
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LO 5-3

Describe the five basic components of internal control.
Specify some of their characteristics.

Overview: Five Components (COSO 2013)



All five components must be present and functioning for internal control to be effective.

Control Environment

The **foundation** for all other components; sets the organizational **tone, culture, and structure** within which IC operates. Often called the **“tone at the top.”**

Key elements:

- Commitment to _____ and ethical values
- Board of directors' _____ and oversight
- Clear organizational structure and assignment of authority
- Commitment to recruit and retain competent personnel
- _____ for performance

Key Point

The control environment has a **pervasive effect** on all other components — a weak foundation undermines everything built on top of it.

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Enron (2001):

- Board approved conflicting-interest transactions without scrutiny
- CFO had authority to _____ financial reporting controls
- Written code of conduct existed — culture did not enforce it

WorldCom (2002):

- CEO pressured staff to “make the numbers”
- Internal audit lacked _____ from MGT
- \$11B in operating expenses improperly _____

Lesson

SOX was enacted largely in response to control environment failures — not failures of specific control activities.

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SOX was enacted largely in response to control environment failures — not failures of specific control activities.

Risk Assessment

A dynamic and iterative process for identifying and analyzing risks to achieving objectives, forming the basis for determining how risks should be managed.

- Firms need to manage the full range of business risks including reporting risks.
- MGT must _____ and analyze risks to the objectives.
- MGT must _____ and _____ to the risks.
- Although a client's risk assessment process should relate to all its objectives, auditing standards require that the audit team focus on financial reporting risks including fraud risk.

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Control Activities

The actions and procedures that help ensure MGT's risk-mitigation directives are carried out.

Three types of control activities:¹⁵

- _____ controls - stop errors before they occur
- _____ controls - catch errors after the fact
- _____ controls - correct errors after the fact

¹⁵In some sense, all IC activities might be understood as “preventive” as they help to prevent errors before they occur.

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The actions and procedures that help ensure MGT's risk-mitigation directives are carried out.

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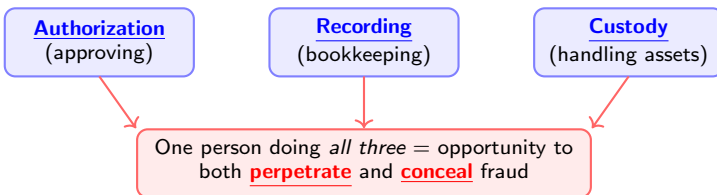
¹⁵In some sense, all IC activities might be understood as “preventive” as they help to prevent errors before they occur.

- **Management review controls** — MGT is primary responsible for the IC process, so it is important to review the IC process to ensure it is effective.
- **Information processing controls** — ensure that the information is processed correctly and efficiently.
 - ▶ **Automated controls** — use technology to control the process.
 - ▶ **Manual controls** — use manual processes to control the process.
- **Physical security controls** — safeguard assets, data, documents, and records, etc.
- **Separation of duties** — ensure that no one person has control over all aspects of a process.

¹⁶ Organizations have a wide range of control activities, and the following are just a few examples.

Control Activities: Segregation of Duties

Three incompatible functions should be kept separate:



Information & Communication

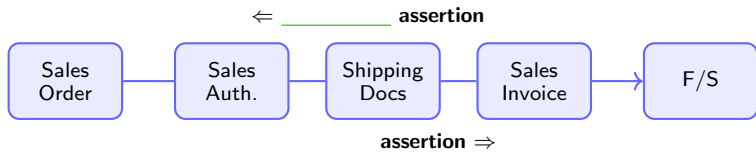
MGT obtains or generates relevant, quality information to support IC, and communicates it internally and externally.

- MGT must have access to timely, reliable, and relevant information.
- MGT must generate relevant, quality information to support IC.
- MGT must communicate the information internally and externally.

Information system produces a trail of activities (a.k.a. audit trail) from data identification to financial reports.

- From the source documents (purchase orders, sales orders, etc.)
- To the financial reports.

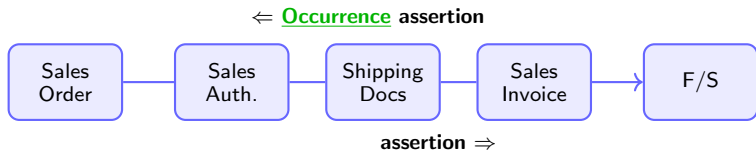
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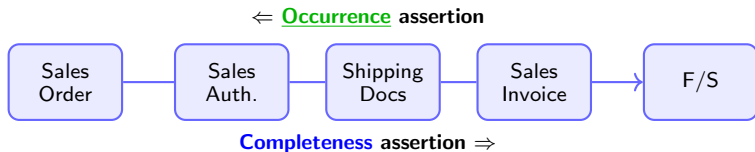
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- From the source documents (purchase orders, sales orders, etc.)
- To the financial reports.

Auditors often follow this trail forward and backward to assess management assertions:



Monitoring Activities

Ongoing and/or separate evaluations used to ascertain whether each component of IC is present and functioning, with deficiencies communicated timely.

- **Ongoing and separate evaluations**: Ongoing evaluations of controls that are separate from other types of evaluations enable MGT to determine whether the other components of IC continue to function over time.
- **Reporting deficiencies**: IC deficiencies are identified and communicated in a timely manner to those parties responsible for taking corrective action and MGT and BOD as appropriate.

Effective monitoring involves ongoing evaluation of controls:

- **Periodic evaluation of controls** by the internal audit department.
- Analysis of and appropriate **follow-up** of operating reports or metrics that might identify anomalies indicative of a control failure.
- **Supervisory review of controls**, such as reconciliation reviews as a normal part of processing.
- **Self-assessment** by BOD and MGT regarding the tone they set in the organization and the effectiveness of their oversight functions.
- **Audit committee inquiries** of internal and external auditors.
- **Quality assurance reviews** of the internal audit department.

① Control Environment

- ① The organization demonstrates a commitment to **integrity** and **ethical values**.
- ② The BOD demonstrates **independence** from MGT and exercises oversight of the development and performance of IC.
- ③ MGT, with board oversight, establishes 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 alignment with objectives.
- ⑤ The organization holds individuals **accountable** for their IC responsibilities.

② Risk Assessment

- ① The organization specifies **objectives** with sufficient clarity to enable the identification and assessment of risks relating to objectives.
- ② The organization identifies and analyzes **risks** to the achievement of its objectives.
- ③ The organization considers the potential for **fraud** in assessing risks to the achievement of objectives.
- ④ The organization identifies and assesses **changes** that could significantly impact the system of internal control.

3 Control Activities

- 1 The organization selects and develops control activities that contribute to the mitigation of risks to the achievement of objectives to acceptable levels.
- 2 The organization selects and develops general controls over technology to support the achievement of objectives.
- 3 The organization deploys control activities through policies and procedures.

4 Information and Communication

- 1 The organization obtains or generates and uses relevant, quality information to support the functioning of IC.
- 2 The organization internally communicates information, including objectives and responsibilities for IC, necessary to support the functioning of IC.
- 3 The organization communicates with external parties regarding matters affecting the functioning of IC.

5 Monitoring Activities

- 1 The organization selects, develops, and performs ongoing and/or separate evaluations to ascertain whether the components of IC are present and functioning.
- 2 The organization evaluates and communicates IC deficiencies in a timely manner to those parties responsible for taking corrective action.

- ① Without an effective _____, the other COSO components are unlikely to result in effective IC, regardless of their quality.¹⁷
- A) Risk assessment policy
 - B) Monitoring policy
 - C) Control environment
 - D) System of control activities
- ② Proper segregation of functional responsibilities calls for separation of¹⁸
- A) Authorization, execution, and payment
 - B) Authorization, recording, and custody
 - C) Custody, execution, and reporting
 - D) Authorization, payment, and recording

¹⁷

¹⁸

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¹⁷ C

¹⁸ B

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- 1 Definition of Internal Control
- 2 MGT vs. Auditors' Responsibility for Internal Control
- 3 Components of Internal Control
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- 4 Appendix: IT Controls
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 - Tests of Controls
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- 7 Conclusion

Modern accounting systems are **IT-based**: transactions are initiated, processed, and stored electronically.

Key risks introduced by IT:

- **Systematic errors** — one programming error affects *all* transactions processed
- **Unauthorized access** — centralized data accessible remotely
- **Collapsed duties** — IT systems may perform authorization *and* recordkeeping automatically, violating _____

Two types of IT controls:

- _____ controls — apply to the entire IT environment
- _____ controls — apply to a specific software application

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General Controls

Controls that relate to the overall IT environment and have a pervasive effect on all software applications.

Category	Examples
Administration	IT steering committee; IT policies and procedures
Segregation of IT Duties	Systems development Computer operations Data control
Systems Development	Testing and user approval of new/changed programs
Physical & Online Security	Locked computer rooms; key-card access; passwords; firewalls
Backup & Contingency	Off-site backup copies; disaster recovery plan
Hardware Controls	Parity checks; echo checks; error detection

Application Controls

Controls that apply to the processing of individual transaction types within a specific software application.

Input Controls

Verify data entry:
valid employee ID;
field format checks;
batch totals

Processing Controls

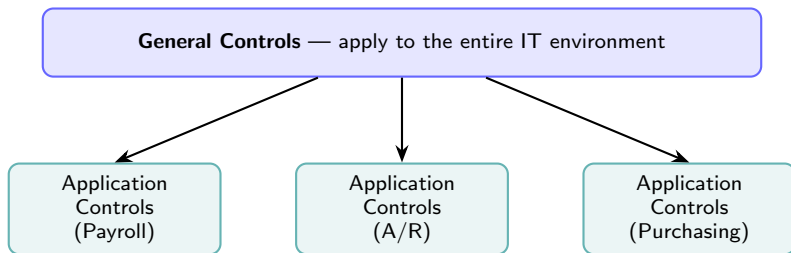
Ensure complete
and accurate
processing:
sequence checks;
run-to-run totals

Output Controls

Verify outputs
are complete and
sent to authorized
recipients only

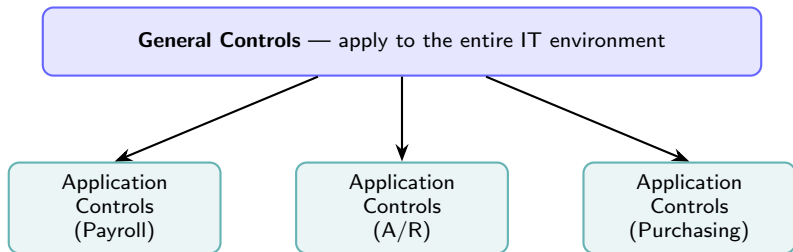
Example: A payroll application that rejects time records with employee IDs not in the HR database is an input control.

Appendix: General Controls vs. Application Controls



Critical Rule

If **general controls are weak**, application controls **cannot be relied upon** — regardless of their apparent design quality. Auditors test _____ controls first.



Critical Rule

If **general controls are weak**, application controls **cannot be relied upon** — regardless of their apparent design quality. Auditors test **general** controls first.

- ① General controls include all of the following **except**¹⁹
- A) Systems development
 - B) Online security
 - C) Processing controls
 - D) Hardware controls
- ② Which best explains the relationship between general controls and application controls?²⁰
- A) Application controls are effective even if general controls are extremely weak.
 - B) Application controls are likely to be effective only when general controls are effective.
 - C) General controls have no impact on application controls.
 - D) None of the above.

¹⁹

²⁰

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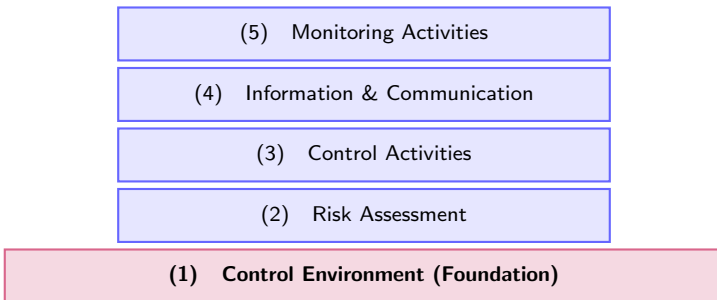
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LO 5-4

Explain the process the audit team uses to assess control risk.
Understand its impact on the RMM and how it affects the nature, timing, and extent of further audit procedures.

Step 1: Obtain an Understanding of IC

Before assessing risk, auditors must **obtain and document** an understanding of all five COSO components:



Step 1: Obtain an Understanding of IC

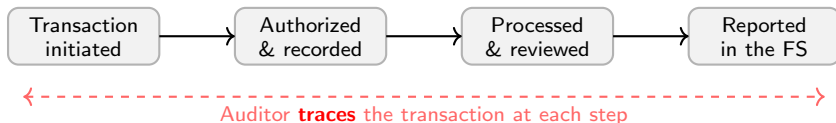
Auditors mainly use four methods to obtain an understanding of IC:

- **Narratives** — written descriptions of the client's IC.
- **Questionnaires** — standardized checklists of IC questions.
- **Flowcharts** — visual diagrams of the flow of transactions through the accounting system.
- **Walk-through** — tracing a transaction from initiation through recording to reporting.

Step 1: Obtain an Understanding of IC — Walk-Through

Walk-Through

Tracing **one or a few transactions** through the entire information system — from initiation to recording in the FS — to confirm the auditor's understanding of IC.



Walk-thorough usually includes four methods used to perform Tests of Controls later:²¹

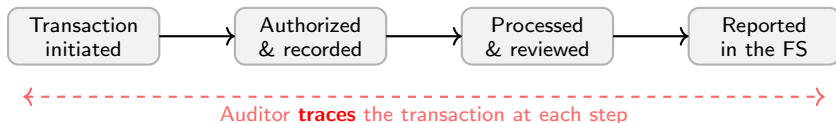
- 1 _____
- 2 _____
- 3 _____
- 4 _____

²¹Here we're in Step 1: Understanding and Documenting IC. These methods will be used in Step 3: Tests of Controls much more extensively.

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Tracing **one or a few transactions** through the entire information system — from initiation to recording in the FS — to confirm the auditor's understanding of IC.



Walk-thorough usually includes four methods used to perform Tests of Controls later:²¹

1 **Inquiry**

2 _____

3 _____

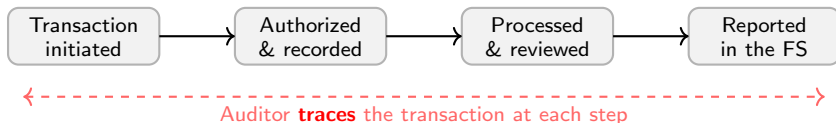
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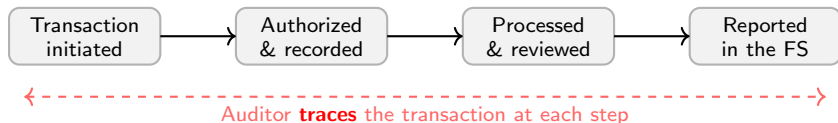
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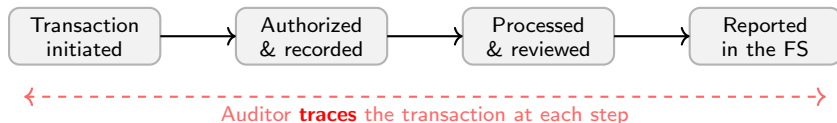
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- 1 **Inquiry**
- 2 **Observation**
- 3 **Inspection**
- 4 **Re-performance**

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- ① Narratives, flowcharts, and IC questionnaires are three common methods of²²
 - A) Testing IC
 - B) Documenting the auditor's understanding of IC
 - C) Designing audit procedures
 - D) Documenting organizational structure
- ② [T/F] Walkthroughs combine observation, inspection, and inquiry to confirm that controls designed by management have been implemented.²³
- ③ [T/F] Auditors are required to use narratives when documenting their understanding of IC.²⁴
- ④ [T/F] When using questionnaires, “no” responses typically indicate a potential IC deficiency requiring follow-up.²⁵

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Control Risk (CR)

The probability that material misstatements will not be prevented or detected by the client's internal controls.

- Auditors assess how well controls prevent or detect misstatements.
- The assessment is important for auditors to decide whether to rely on _____ or perform _____.
- The assessment directly affects the nature, timing, and extent (NTE) of further procedures.

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Control Risk (CR)

The probability that material misstatements will not be prevented or detected by the client's internal controls.

- Auditors assess how well controls prevent or detect misstatements.
- The assessment is important for auditors to decide whether to rely on controls or perform substantive procedures.
- The assessment directly affects the nature, timing, and extent (NTE) of further procedures.

- Controls are _____ at preventing or detecting misstatements.
- Audit team _____ rely on controls.

Audit response (N/T/E):

- **Nature:** more substantive _____ (vouching, confirmations).
- **Timing:** testing near year-end (closer to balance sheet date).
- **Extent:** _____ sample sizes and _____ procedures.

- Controls are **not effective** at preventing or detecting misstatements.
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- **Timing:** testing **near year-end** (closer to balance sheet date).
- **Extent:** **larger** sample sizes and **more** procedures.

- Controls are _____ at preventing or detecting misstatements.
- Audit team can _____ on controls.

Audit response (N/T/E):

- **Nature:** more analytical _____ (relative to tests of details).
- **Timing:** testing at an interim date (before fiscal year-end).
- **Extent:** _____ sample sizes and _____ procedures.

- Controls are **effective** at preventing or detecting misstatements.
- Audit team can _____ on controls.

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Audit response (N/T/E):

- **Nature:** more analytical **procedures** (relative to tests of details).
- **Timing:** testing at an **interim date** (before fiscal year-end).
- **Extent:** **smaller** sample sizes and _____ procedures.

- Controls are effective at preventing or detecting misstatements.
- Audit team can rely on controls.

Audit response (N/T/E):

- **Nature:** more analyticalprocedures (relative to tests of details).
- **Timing:** testing at an interim date (before fiscal year-end).
- **Extent:** smaller sample sizes and fewer procedures.

Control Risk Assessment: Summary

	CR High	CR Low
Controls effective?	No — cannot be relied upon	Yes — can be relied upon
Nature	Substantive tests of details	More analytical procedures
Timing	Near year-end	Interim date
Extent	Large sample sizes	Smaller sample sizes

Control Risk Matrix

The control risk matrix links specific controls to audit objectives, helping auditors identify where CR is low or high.

Audit Objective	Control A	Control B	Assessed CR
Occurrence	✓		<u>Low</u>
Completeness		✓	<u>Low</u>
Accuracy	✓	✓	<u>Low</u>
Cut-off			<u>High</u>

- Entity-level controls (e.g., strong audit committee) can reduce CR across many objectives
- Objectives with no applicable controls = maximum CR $\Rightarrow$ more substantive testing required
- A compensating control elsewhere may offset the absence of a primary control

Control Deficiency Types²⁶

When assessing CR, auditors classify any problems found:

Type	Definition
<u>CD</u>	A control is missing or not operating effectively.
<u>SD</u>	Less severe than a material weakness, but important enough to merit attention by those charged with governance.
<u>MW</u>	Reasonable possibility that a material misstatement will not be prevented or detected on a timely basis.



If there is one or more MW, the ICFR is **ineffective**.

²⁶ CD: Control Deficiency;
SD: Significant Deficiency;
MW: Material Weakness

- ❶ Which deficiency exists if a necessary control is **missing** or not properly implemented?²⁷
- A) Control deficiency
 - B) Significant deficiency
 - C) Design deficiency
 - D) Operating deficiency
- ❷ A _____ exists if one or more control deficiencies are less severe than a material weakness, but important enough to merit attention by those charged with governance.²⁸
- A) Potential misstatement
 - B) Significant weakness
 - C) Significant deficiency
 - D) Fraud symptom

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²⁷ C

²⁸ —

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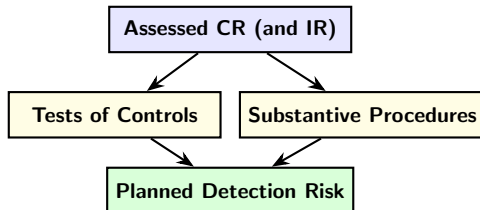
²⁷ C

²⁸ C

Control Risk and Audit Planning

Recall: $AR = IR \times CR \times DR$. Solving for DR:

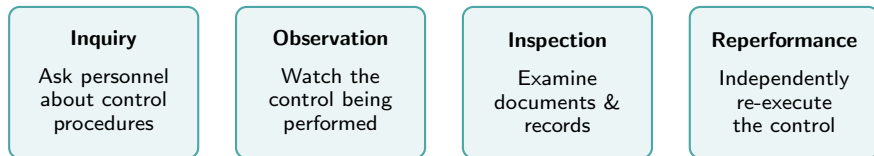
- Higher CR $\Rightarrow$ lower allowable DR $\Rightarrow$ more substantive testing
- Lower CR $\Rightarrow$ higher allowable DR $\Rightarrow$ less substantive testing



Tests of Controls

Audit procedures designed to evaluate the operating effectiveness of controls in preventing or detecting material misstatements at the assertion level.

- Auditors perform tests of controls when they plan to rely on controls to reduce substantive testing.
- Indeed, auditors would like to reduce substantive testing by relying on controls while maintaining acceptable audit risk.

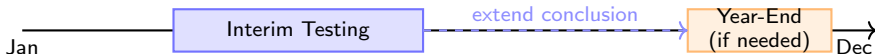


Least persuasive

Most persuasive

- **Inquiry alone** is insufficient — auditors must corroborate with observation, inspection, or re-performance.
- **Observation** — Employees may perform the control differently under being observed.
- **Reperformance** — Auditors directly perform the control to assess its effectiveness.

Timing and Extent of Tests of Controls

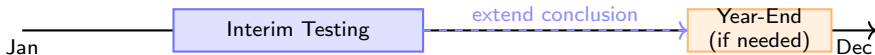


- **Timing:** _____ common
→ extend conclusion to year-end with limited additional work
- **Manual vs. Automated:**
 - ▶ _____ controls: consistent $\Rightarrow$ prior-year reliance possible²⁹
 - ▶ _____ controls: variable $\Rightarrow$ more frequent testing required³⁰

²⁹ assuming no changes to the control; still should be tested every three years under Auditing Standards.

³⁰ likely to include human error; so should be tested every year.

Timing and Extent of Tests of Controls

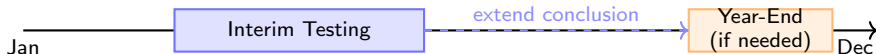


- **Timing:** Interim testing common
→ extend conclusion to year-end with limited additional work
- **Manual vs. Automated:**
 - ▶ _____ controls: consistent $\Rightarrow$ prior-year reliance possible²⁹
 - ▶ _____ controls: variable $\Rightarrow$ more frequent testing required³⁰

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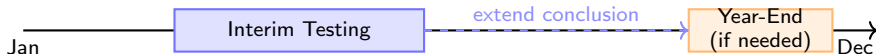


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 - ▶ Manual controls: variable $\Rightarrow$ more frequent testing required³⁰

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Tests of Controls vs. Substantive Procedures

	Tests of Controls	Substantive Procedures
Purpose	Evaluate whether IC is <u>operating</u> effectively	Detect <u>material misstatements</u> in account balances / transactions
Target	Controls (policies, procedures)	Financial statement assertions
When used	When auditor plans to <u>rely</u> on controls	<u>Always</u> performed (extent varies with CR)
Result	Supports assessed CR	Direct evidence on FS amounts

Once again, the goal of tests of controls is to evaluate the _____ of controls in preventing or detecting material misstatements at the assertion level.

If not effective, auditors will _____ the extent of substantive procedures to compensate.

In the end, the ultimate goal is to maintain the desired level of _____ risk.

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- ① Tests of controls are³¹
- A) Procedures used to test the effectiveness of controls in support of a reduced assessed control risk
 - B) Used to support ending balances in the balance sheet and income statement accounts
 - C) Performed only at the end of the audit
 - D) Designed to detect fraud
- ② [T/F] Controls applied throughout the period must be tested at **both** an interim date and again on the balance sheet date.³²
- ③ [T/F] Auditing standards require auditors to test some prior-year controls each year to ensure rotation throughout a three-year period.³³

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32

33

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³¹ A

³² —

³³ —

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³³ **T**

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- 6 Internal Control Communication
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LO 5-5

Explain the communication of internal control deficiencies to those charged with governance such as audit committee and other key MGT personnel.

Deficiency

A deficiency exists when a control does **not** allow MGT/employees to prevent or detect misstatements timely. Two root causes:

- **Design deficiency** — control is **missing** or poorly conceived
- **Operating deficiency** — control is designed well but **not functioning** as intended

- If a deficiency, or a combination of deficiencies, results in a reasonable possibility that a MM will not be prevented or detected on a timely basis, it is a ____.
- If a deficiency, or a combination of deficiencies in IC is less severe than a **MW**, it is a ____.
- Audit team must communicate both SD and MW to the MGT, BOD, and AC in writing.³⁴

³⁴ MGT: Management; BOD: Board of Directors; AC: Audit Committee

³⁵ **MW**: Material Weakness; **SD**: Significant Deficiency

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Types of Opinions on ICFR (Integrated Audit)

Opinion Type	Condition
Effective	No MWs
Ineffective	1+ MWs exist
No Conclusion	Scope limitation ³⁶

Implications of Adverse Opinion on ICFR

An **adverse opinion (i.e., ineffective)** on ICFR does **not** automatically mean that the FS includes MM. It only means higher likelihood of MM.

³⁶cannot obtain sufficient evidence

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Internal controls should be:

- _____ properly to prevent and detect MM and
- _____ effectively as intended.

Effective internal controls would:

- _____ the need for substantive testing.

Reporting: Opinions on ICFR:

- Public firms with public float of \$75M+: required by _____
- Other public firms and all private firms: exempt.
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Effective internal controls would:

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Classification of Control Activities

We covered various control activities in the previous slides. It is important to organize them into a systematic way.

By the degree of scope:

- 1 Entity-level controls — apply to the entire entity.
- 2 Transaction-level controls

By functions:

- 1 Preventive controls
- 2 Detective controls
- 3 Corrective controls

By locations for controls:

- 1 Physical controls
- 2 IT general controls (ITGCs) — apply to the entire IT environment.
- 3 IT application controls

By the degree of automation:

- 1 Purely manual controls
- 2 Manual controls with system-generated reports
- 3 Automated controls