

ADVANCED AUDIT AND ASSURANCE

CORPORATE LEVEL

TUTE 07.3

EVALUATION OF INTERNAL CONTROLS (FROM AUDITOR'S PERSPECTIVE INCLUDING S.L.Au.S - 265)



by

Jeewantha Perera

(FCA, ACCA, MBA, B.Sc Accountancy (sp))

EVALUATION OF INTERNAL CONTROLS

Introduction

The Auditor shall assess the adequacy of the Internal Control Systems and shall identify the Risk of Material Misstatements. The proper assessment of the internal controls will provide a basis for designing and performing further audit procedures.

From the perspective of the auditors, they will be focusing on the following aspects

- ✚ Assess the adequacy of the accounting system as a basis for preparing the accounts
- ✚ Identify the types of potential misstatements that could occur in the accounts
- ✚ Consider factors that affect the risk of misstatements
- ✚ Design appropriate audit procedures

Risks arising from poor control environments are unlikely to be confined to particular assertions in the financial statements, and, if severe, may even raise questions about whether the financial statements are capable of being audited; that is, if control risk is so high that audit risk cannot be reduced to an acceptable level.

On the other hand, some control procedures may be closely connected to an assertion in financial statements; for example, controls over the inventory count are closely connected with the existence and completeness of inventory in the financial statements.

There may be occasions where substantive procedures alone are not sufficient to address the risks arising. Where such risks exist, auditors shall evaluate the design and determine the implementation of the controls, that is by controls testing

Recording Accounting and Control Systems

The auditors must keep a record of the client's systems which must be updated each year. This can be done through the use of narrative notes, flowcharts, questionnaires or checklists.

There are several techniques for recording the assessment of control risk, that is, the system. One or more of the following may be used, depending on the complexity of the system.

- ✚ Narrative notes
- ✚ Questionnaires
- ✚ Flow Charts
- ✚ Check lists

Narrative Notes

The purpose of narrative notes is to describe and explain the system, at the same time as making any comments or criticisms which will help to demonstrate an intelligent understanding of the system.

Advantages	Disadvantages
They are relatively simple to record and can facilitate understanding by all audit team members.	Describing something in narrative notes can be a lot more time consuming than, say, representing it as a simple flowchart, particularly where the system follows a logical flow.
They can be used for any system due to the method's flexibility	They are awkward to update if written manually
Editing in future years can be relatively easy if they are computerised.	It can be difficult to identify missing internal controls because notes record the detail of systems but may not identify control exceptions clearly.

Flow Charts

Flow charts are graphical illustrations of the physical flow of information through the Accounting Systems. Flowlines represent the sequences of process and other symbols represent the inputs and outputs to a process.

Advantages	Disadvantages
After a little experience, they can be prepared quickly	Major amendments are difficult without re-drawing
As the information is presented in a standard format, easy to understand and review	Time can sometimes be wasted by charting areas that are no audit significance
It eliminates the need for extensive narrative and can be helpful in highlighting the salient points of control and deficiencies in the system	

Internal Control Questionnaires (ICQ's)

This is a questionnaire designed to check the ***design*** of the related internal control (How good is the system of internal controls). It consists of list of questions designed to determine whether desirable controls are present or not.

One of the effective ways of designing the questionnaire is to design the questions so that all the answers can be given as "YES" or "NO". If an answer received to a question as "NO", indicates a deficiency in the system.

Eg:

Lined area for writing, featuring horizontal dotted lines and a large, light blue watermark reading "JMC vLearning - your virtual learning partner".

Advantages	Disadvantages
If drafted thoroughly, they can ensure all controls are considered.	The questionnaire can be drafted vaguely, hence misunderstood and important controls not identified.
Easy to use and control and more understandable	It may consist of large number of irrelevant questions
Highlight deficiencies where extensive substantive testing will be required and enabling the Auditor to identify key controls which needed to be tested during the control testing.	The client may overstate controls.

Checklist

Checklists may be used instead of questionnaires to document and evaluate the internal control systems. The difference with these is that, instead of asking questions, statements are made to "Mark Off" and tick boxes are used to indicate whether the statement holds true.

Evaluation of Internal Controls

If the auditor believe that the System of Internal Controls are strong, they will choose the Test of Controls to assess whether they can rely on the controls having operated effectively.

The auditor shall 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 the enquiry from the entity personnel.

A) Confirming the Understanding of the Internal Control Systems

The Auditor needed to have an understanding on the internal controls relevant to the Audit. In order to confirm their understanding of the control systems, in addition to enquiry, auditors will often carry out **walk-through tests**. These procedures involve picking up a transaction and following it through the system to see whether all the controls they anticipate should be in existence were actually in operation with regard to that transaction.

B) Evaluating the Internal Control Systems

In order to evaluate internal controls, the auditor should be aware of three aspects for evaluation.

a) The Design of the Control (design effectiveness)

Evaluating the design of a control involves considering whether it is capable of effectively preventing, or detecting and correcting material misstatements.

A control may be in place with the intention of preventing a misstatement or mitigating a risk but it may be badly designed. In such a situation, there is little point in the auditor assessing the implementation or operating effectiveness as the imperfect design will prevent the auditor from relying on it.

b) Implementation of the Control Continuously

Having ascertained that a control has been adequately designed, an auditor will need to obtain evidence that it has been implemented continuously. This may be done by a combination of enquiry, observing the control or inspecting related documents.

c) Operating Effectiveness

Evidence may be obtained that a control was in place at a point in time during the period under review (eg by observing that control on a given day). However, this does not give reasonable evidence that the control was operating effectively throughout the period. The auditor will have to use tests of controls to assess operating effectiveness.

Tests of controls

Tests of controls are tests performed to obtain audit evidence about the effectiveness of the:

- a) Design of the accounting and internal control systems, ie whether they are suitably designed to prevent, or detect and correct, material misstatement at the assertion level; and
- b) Operation of the internal controls throughout the period, Continuously and Effectively.

Test of Controls will include the followings

- a) **Inspection of documents** supporting controls or events to gain audit evidence that internal controls have operated properly
- b) **Enquiries about internal controls**
- c) **Re-performance of control procedures**, to ensure they were correctly performed by the entity
- d) **Observation of controls** to consider the manner in which the control is being operated
- e) **Testing of internal controls** operating on computerised systems or over the overall IT function

A series of horizontal dotted lines for writing, spanning the majority of the page.



JMC vLearning
"your virtual learning partner"

Communicating deficiencies in Internal Control to Those Charged with Governance and Management – (S.L.Au.S -265)

Deficiencies in Internal Controls

A deficiency in internal control exists when a control is designed, implemented or operated in such a way that it is unable to prevent, or detect and correct, misstatements in the financial statements on a timely basis; or a control necessary to prevent, or detect and correct, misstatements in the financial statements on a timely basis is missing.

A significant deficiency in internal control is a deficiency or combination of deficiencies in internal control that, in the auditor's professional judgement, is of sufficient importance to merit the attention of those charged with governance.

Significant deficiencies in internal control shall be communicated in writing to those charged with governance in a report to management in accordance with SLAuS 265 Communicating deficiencies in internal control to those charged with governance and management, which states that the objective of the auditor is to communicate appropriately, to those charged with governance and management, any deficiencies in internal control identified during the audit which the auditor considers are of sufficient importance to warrant their attention.

Factors to be considered when determining whether a deficiency in internal control is significant or not.

- a) The likelihood of the deficiency, resulting a material misstatement in the FS in future.
- b) The importance of the Controls to the financial reporting process.
- c) The cause and frequency of the exceptions identified as a result of the deficiency.
- d) The Amounts exposed to the deficiencies

Following are considered as the Key Indicators of Significant Deficiency of Internal Control Systems

- a) Evidence of ineffective aspects of the Control Environment
- b) Absence of a proper risk assessment process/Evidence of an ineffective entity risk assessment process.
- c) Evidence of ineffective responses to identified significant risks
- d) Management inability to oversee the preparation of FS
- e) Restatement of previously issued financial statements that were corrected for a material misstatement due to fraud or error.

Reporting Deficiencies in Internal Controls

The auditor **must** include the following in the written communication:

- a) A description of the deficiencies and an explanation of their potential effects (but there is no need to quantify the effects).
- b) Sufficient information to enable those charged with governance and management to understand the context of the communication.
 - ✚ The purpose of the audit was for the auditor to express an opinion on the financial statements.
 - ✚ The audit included consideration of internal control relevant to the preparation of the financial statements in order to design audit procedures appropriate in the circumstances, but not to express an opinion on the effectiveness of internal control.
 - ✚ The matters being reported are limited to those deficiencies identified during the audit and which the auditor has concluded are sufficiently important to merit being reported to those charged with governance.
 - ✚ Including a statement, stating that the communication is provided for the use of the Management only.

The auditor may also include suggestions for remedial action on the deficiencies, management's actual or proposed responses, and a statement as to whether or not the auditor has undertaken any steps to verify whether management's responses have been implemented.

Impact of deficiencies on the auditor's reliance on internal control

If the controls are not adequately designed or not operating effectively, the auditor needs to re-visit the risk assessment and design sufficient substantive testing over that financial statement area.

Therefore, where significant deficiencies are identified, unless there are robust compensating controls, the auditor will have no choice but to use purely substantive procedures to obtain sufficient appropriate audit evidence. The auditor will not seek to place reliance on internal controls.

30th August 2024
 ABC & Co
 Chartered Accountants
 181/20 Polhengoda Road
 Colombo, Sri Lanka

The Board of Directors
 Manufacturing Ltd
 Colombo.

Members of the Board,

Financial statements for the year ended 31st March 2024

Please find below the report to management which sets out deficiencies in internal control we identified as a result of our review of the accounting systems and procedures operated by your company during our recent audit.

The matters dealt with in the report came to our notice during the conduct of our normal audit procedures, which are designed primarily for the purpose of expressing our opinion on the financial statements.

Related Process	Deficiency Identified	Implications/Impact	Recommendation of the Auditor
Purchase and Creditors – Payable Ledger Reconciliation	Although your procedures require that the payable ledger is reconciled against the Creditors Control Account on the General Ledger at the end of every month, this was not done for the months of December and January	The balance on the payable ledger was short by Rs *** with the General Ledger Control Account in the months of December and January and for which no explanation could be provided. This implies a serious breakdown in the purchase invoice and/or Cash Payment Batching and posting procedures	It is important in future that this reconciliation is performed regularly by a responsible official

Please note that this report only sets out those significant deficiencies identified during our audit. If more extensive procedures on internal control had been carried out, we may have identified and reported more deficiencies.

This letter has been produced for the sole use of your company. It must not be disclosed to a third party, or quoted or referred to, without our written consent. No responsibility is assumed by us to any other person.

We should like to take this opportunity of thanking your staff for their co-operation and assistance during the course of our audit.

Yours faithfully

ABC & Co

