Analyzing Internal Controls and Communication with those Charge with Governance

Presented by:

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AGENDA

1. Understanding Internal Control
2. Auditors' Requirements to evaluate internal controls
3. Results of the evaluation and Communication to Management
   - SAS 114: Letter to Governance Body
   - SAS 115: Management Letter
4. Documentation Examples
   - Narratives and Walkthrough
   - Documentation of Understanding of Internal Controls
   - Test of Controls

Welcome/Instructions

- Speakers:

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What is Internal Control?

INTERNAL CONTROL is a process for assuring achievement of an:

1) Organization's objectives in operational effectiveness and efficiency,
2) Reliable financial reporting, and
3) Compliance with laws, regulations and policies.

A broad concept, internal control involves everything that controls risks to an organization.

Why companies need Internal Control?

System of accounting procedures and process that are designed by Management and implemented by an Organization personnel to:

1. Promote reliable financial reporting
   - Accurate and reliable data entry
2. Ensure compliance with Law and Regulations
   - Accounting standards & Management Policy
3. Promote Effective and Efficient operations
   - Fraud and Loss of Assets

OBJECTIVES

Why companies need Internal Control?

Internal Control is an entire system that dictates how accounting data should be Recognized, Recorded and Presented. It is not just one particular act, but rather dictates how all activities are performed and objectives are reached.

Without Internal Controls:

- Reliable Financial Reporting –
  - The F/S does not reflect the correct financial position (Unreliable Financial Statements).
- Compliance with Laws and Regulations –
  - May results in fines and disciplinary actions and contribute to unreliable Financial Reporting.
- Effective and Efficient Operations –
  - Resources are wasted or lost to fraud causing unusually higher expenses and losses.

Why companies need Internal Control?

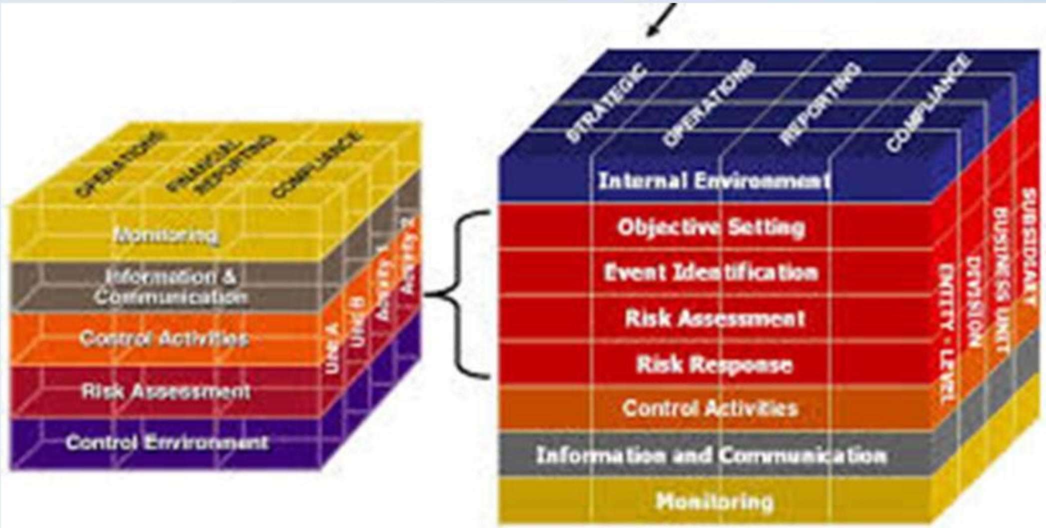
Internal Control plays an important role in detecting and preventing fraud and protecting the entity's resources, (physical and intangible).

Components of Internal Control:

1. Control Environment
   - Management structures operations in a way that promotes integrity and ethics.
2. Risk Assessment
   - Identify and analyze relevant risks that compromise resources and operations.
3. Control Activities
   - Policies and procedures set by Management that make up the Internal Control System.
4. Information and Communication
   - Personnel must be clear that internal control measures must be complied with. There must be an effective channel to communicate information readily, either internally or externally.
5. Monitoring
   - Use regular management, supervisory activities and external auditing to maintain the quality of internal control. Any vulnerability in the system are to be reported.

Understanding of Internal Controls

1. AU-C 315.15.25: requires an understanding of the five (5) interrelated components of internal control (COSO – Integrated Framework):



The **Committee of Sponsoring Organizations of the Treadway Commission** (**COSO**) is a joint initiative to combat corporate fraud. It was established in the United States by five private sector organizations, dedicated to guide executive management and governance entities on relevant aspects of organizational governance, business ethics, internal control, enterprise risk management, fraud, and financial reporting. COSO has established a common internal control model against which companies and organizations may assess their control systems. COSO is supported by five supporting organizations, including the Institute of Management Accountants (IMA), the American Accounting Association (AAA), the American Institute of Certified Public Accountants (AICPA), the Institute of Internal Auditors (IIA), and Financial Executives International.

Understanding of Internal Controls

COSO's 17 principles of internal control – summarized

Control environment	Risk assessment	Control activities	Information and communication	Monitoring activities
1 Demonstrates commitment to integrity and ethical values	6 Specifies suitable objectives	10 Selects and develops control activities	13 Uses relevant information	16 Conducts ongoing and/or separate evaluations
2 Exercises oversight responsibilities	7 Identifies and analyzes risk	11 Selects and develops general controls over technology	14 Communicates internally	17 Evaluates and communicates deficiencies
3 Establishes structure, authority, and responsibility	8 Assesses fraud risk	12 Deploys through policies and procedures	15 Communicates externally	
4 Demonstrates commitment to competence	9 Identifies and analyzes significant change			
5 Enforces accountability				

Source: Audit Committee Brief, March 2014. Deloitte Development Corporation. All rights reserved.

Auditors Requirements

AU-C Section 315

Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement

1. AU-C 315.13.25: establishes requirements for auditors related to consideration of internal control as part of an audit.
2. Auditors should obtain an understanding of internal control that is sufficient to assess the risk of material misstatement of the Financial Statements due to error or fraud and design the nature, timing, and extent of further audit procedures.

Auditors Requirements

AU-C 315.13.-.14:

Requires auditors to obtain an understanding of internal control relevant to the audit.

To obtain that understanding, auditors should perform risk assessment procedures to:

a. Evaluate the design of controls that are relevant to the audit and
b. determine if they have been implemented

Auditors Requirements

A key consideration is whether and how the entity's internal control:

1. Prevents
2. Detects
3. Corrects

…material misstatements in relevant assertions related to transaction classes, account balances, or disclosures.

Auditors Requirements

Evaluation of design considers whether the control, individually or in combination with other controls, is capable of effectively preventing, or detecting and correcting, material misstatements.

In other words, the auditor considers the effectiveness of the control in achieving its objective. If a control is improperly designed, a control deficiency may exist that needs to be communicated to management and those charged with governance.

Auditors Requirements

- The auditor need to determine if the control, as documented or described, actually exists and the entity is using it.
- Generally, the auditor uses procedures such as observation or inspection, along with inquiries, to verify implementation.
- Inquiry alone cannot provide a sufficient understanding of internal control.

Auditors Requirements

- Obtaining an understanding that is sufficient to assess the risks of material misstatement necessitates that the auditor develop a fairly thorough and robust knowledge of the components of internal control.
- AU-C 315.26-.27 indicates that the auditor is <u>not</u> permitted to simply <u>default to "high control risk"</u>.

Auditors Requirements

- The auditor is not required to obtain an understanding and evaluate all of the controls at the client, but rather those controls that are considered to be key.

- The use of the auditor’s professional judgement is paramount in determining which controls are relevant to the audit.

Auditors Requirements

The extent of the understanding, along with the nature, timing, and extent of the risk assessment procedures performed to obtain the understanding, are affected by factors such as the following:

1. The auditor's prior experience with the client.
2. Materiality.
3. Significance of the related risk.
4. Size of the entity.
5. Nature of the client's business, including its organization and ownership characteristics.
6. Diversity and complexity of operations.
7. Nature and complexity of systems within the organization, including the use of service organizations.

Auditors Requirements

7. Applicable legal and regulatory requirements.
8. Level of business and financial sophistication of the client.
9. The circumstances and applicable control component.
10. Whether and how a specific control, individually or in combination with other controls, prevents, or detects and corrects, material misstatements.

Auditors Requirements

According to AU-C 315, the auditor should understand and evaluate the following specific matters:

- The design and implementation of controls, including relevant control activities, related to significant risks (AU-C 315.30).
- The controls over risks for which substantive procedures alone are not sufficient (i.e., risks requiring tests of controls to obtain sufficient audit evidence) (AU-C 315.31).
- The effect of IT on internal control, specifically how IT risks affect control activities (AU-C 315.22).

Auditors Requirements

AU-C 315.30 indicates that the auditor's understanding of internal control should include the entity's programs and controls that address risks of material misstatement that are considered significant risks.

Fraud risks and **Revenue recognition** are always considered to be significant risks.

Auditors Requirements

Controls that address fraud risks frequently relate to the following:

a. *Control Environment*: Fraud programs designed to prevent, deter, and detect fraud. For example, programs to promote a culture of honesty and ethical behavior.

b. *Control Activities*: Specific controls designed to mitigate specific risks of fraud. For example, controls to address specific assets susceptible to misappropriation.

Auditors Requirements

- In addition to understanding and evaluating controls related to significant risks, auditors are required by AU-C 315.31 to understand and evaluate controls related to risks for which substantive procedures alone are not sufficient.
- For those risks, the auditor will have to perform tests of the operating effectiveness of controls to obtain sufficient audit evidence.

Communication to Management

The auditor is responsible to appropriately communicate to those charged with governance ("TCWG") and management the deficiencies in internal control that the auditor has identified in an audit of the financial statements.

- **Deficiency in internal control:**
  - Exists when the design or operation does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct, misstatements on a timely basis.

Communication to Management

Deficiency in design exists when:

(a) a control necessary to meet control objective is missing, or

(b) an existing control is not properly designed so that, even if the control operates as designed, the control objective would not be met.

Deficiency in operation exists when:

1) a properly designed control does not operate as designed or
2) when the person performing the control does not possess the necessary authority or competence to perform the control effectively.

Communication to Management

Material weakness:

A deficiency, or combination of deficiencies, in internal control such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented, or detected and corrected, on a timely basis.

Significant deficiency:

A deficiency, or combination of deficiencies, in internal control that is less severe than a material weakness yet important enough to merit attention by those charged with governance.

Communication to Management

Communication of Deficiencies

1. In writing – significant deficiencies and material weaknesses that the auditor has communicated or intends to communicate.

2. In writing or orally – deficiencies identified during the audit that have not been communicated by management by other parties and are in the auditor's judgment, of sufficient importance to merit management's attention.

3. On a timely basis

Communication to Management

Timing of Communication

- Should be no later than 60 days following the report release date.
- The best timing is at the report release date.
- Regardless of the written communication (and before the draft is provided), the deficiencies may be informed orally to management and those charged with governance to assist them in taking timely remedial action to minimize the risks of material misstatement.
- Oral communication does not relieve the auditor of the responsibility to inform them in writing.

Communication to Management

Level of detail to communicate depends on:

- The nature of the entity
- The size and complexity of the entity
- The nature of significant deficiencies and material weaknesses that the auditor has identified.
- The entity's governance composition. Legal or regulatory requirements.

Communication to Management

Repeated findings…

- ✓ If the finding was informed in a previous year but the remedial action was not performed, the auditor will have to include it in the current year.
- ✓ It may be repeated or reference to the previous communication and the corresponding date.
- ✓ The failure to act (without a reasonable explanation) may represent a significant deficiency or material weakness.

Communication to Management

Examples of Circumstances that may be Deficiencies
Design of controls

- Preparation of financial statements
- Poor documentation of the internal control
- Poor tone at the top and control environment
- Inadequate segregation of duties
- Inadequate controls over safeguarding of
- assets.

Communication to Management

Examples of Circumstances that may be Deficiencies

Design of controls

- Preparation of financial statements
- Poor documentation of the internal control
- Poor tone at the top and control environment
- Inadequate segregation of duties
- Inadequate controls over safeguarding of assets.
- Inadequate design of Information Systems
- Unqualified employees or management
- Absence of internal process to report deficiencies
- Absence of risk assessment process

Communication to Management

Examples of Circumstances that may be Deficiencies

Operation of controls

- Bias or lack of objectivity in accounting decisions
- Management override of controls
- Misrepresentation by entity personnel to the auditor
- Failure to reconcile accounts

Communication to Management

Management Letter

1. Documentation of the finding must be in the workpapers (actual work and/or summary of findings).
2. If an exception/finding will not be included in the Management Letter, document the reason (isolated case, etc).
3. Include the finding and the recommendation.
4. There should be a Management's Response for each finding
5. If responses are never received, the letter should be issued.

Communication to Management

Findings and Issues

- What are the findings and issues
- Actions taken
- Evidence obtained to address the findings and issues
- Who did we talked to? (position)
- What was discussed, asked and replied?
- When was this discussed?

Documentation Examples

1. Narratives and Walkthrough
   - Appendix 2 and 3

2. Documentation of Understanding of Internal Controls
   - Appendix 4

3. Test of Controls
   - Appendix 5

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