Section 404 Audits of Internal Control and Control Risk

Chapter 10
Learning Objective 1

Describe the three primary objectives of effective internal control.
Management has three broad objectives in designing an effective internal control system:

- Compliance with laws and regulations
- Reliability of financial reporting
- Efficiency/effectiveness of operations
Learning Objective 2

Contrast management’s responsibilities for maintaining and reporting on internal controls with the auditor’s responsibilities for understanding, testing, and reporting on internal controls.
Management’s Responsibilities for Establishing Internal Control

- Management must establish and maintain the entity’s internal controls.
- Management’s design and implementation of internal controls is based on two key underlying concepts:
  - Reasonable assurance
  - Inherent limitations
Management’s Section 404 Reporting Responsibilities

Management of all public companies to issue an internal control report that includes the following:

- An acknowledgement of responsibility for internal controls
- Results of annual internal control assessment

2010 federal financial reform laws permanently exempted nonaccelerated filers from reporting on internal controls.
Management’s Assessment of Internal Controls

- Management must first test the design of internal controls over financial reporting.
- Management must also test the operating effectiveness of those controls.
Management’s Assessment of Internal Controls

FIGURE 10-1 Example Section 404 Management Report on Internal Control Over Financial Reporting

The management of Marble Corporation is responsible for establishing and maintaining adequate internal control over financial reporting. Marble’s internal control system was designed to provide reasonable assurance to the company’s management and board of directors regarding the preparation and fair presentation of published financial statements.

Marble management assessed the effectiveness of the company’s internal control over financial reporting as of December 31, 2011. In making this assessment, it used the criteria set forth by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) in *Internal Control—Integrated Framework*. Based on our assessment, we believe that, as of December 31, 2011, the company’s internal control over financial reporting is effective based on those criteria.

Marble’s independent auditors have issued an audit report on our assessment of the company’s internal control over financial reporting. This report appears on the following page.

February 15, 2012

Fred Narsky, President
Karen Wilson, Chief Financial Officer
Auditor Responsibilities for Understanding Internal Control

- Second GAAS fieldwork standard
- Must assess control risk in every audit
- Primarily concerned about controls over:
  - reliability of financial reporting
  - classes of transactions
# Sales Transaction-related Audit Objectives

<table>
<thead>
<tr>
<th>Transaction-Related Audit Objective—General Form</th>
<th>Sales Transaction-Related Audit Objectives</th>
</tr>
</thead>
<tbody>
<tr>
<td>Recorded transactions exist (occurrence).</td>
<td>Recorded sales are for shipments made to existing customers.</td>
</tr>
<tr>
<td>Existing transactions are recorded (completeness).</td>
<td>Existing sales transactions are recorded.</td>
</tr>
<tr>
<td>Recorded transactions are stated at the correct amounts (accuracy).</td>
<td>Recorded sales are for the amount of goods shipped and are correctly billed and recorded.</td>
</tr>
<tr>
<td>Recorded transactions are correctly included in the master files and are correctly summarized (posting and summarization).</td>
<td>Sales transactions are correctly included in the master files and are correctly summarized.</td>
</tr>
<tr>
<td>Transactions are correctly classified (classification).</td>
<td>Sales transactions are correctly classified.</td>
</tr>
<tr>
<td>Transactions are recorded on the correct dates (timing).</td>
<td>Sales are recorded on the correct dates.</td>
</tr>
</tbody>
</table>
Auditor Responsibilities for Testing Internal Control

- Obtains understanding of controls
- Performs tests of controls:
  - significant account balances
  - classes of transactions
  - disclosures and related financial statement assertions
Learning Objective 3

Explain the five components of the COSO internal control framework.
Five Components of Internal Control

FIGURE 10-2
Five Components of Internal Control

Control Environment

- Risk Assessment
- Control Activities
- Information and Communication
- Monitoring
The Control Environment

- Integrity and ethical values
- Commitment to competence
- Board of directors or audit committee participation
The Control Environment

Management’s philosophy and operating style

Human resource policies and practices

Organizational structure
Risk Assessment

- Identify factors that may increase risk
- Estimate the significance of the risk
- Assess the likelihood of the risk occurring
- Determine actions necessary to manage the risk
Control Activities

1. Adequate separation of duties
2. Proper authorization of transactions and activities
3. Adequate documents and records
4. Physical control over assets and records
5. Independent checks on performance
# Adequate Separation of Duties

<table>
<thead>
<tr>
<th>Custody of assets</th>
<th>from</th>
<th>Accounting</th>
</tr>
</thead>
<tbody>
<tr>
<td>Authorization of transactions</td>
<td>from</td>
<td>The custody of related assets</td>
</tr>
<tr>
<td>Operational responsibility</td>
<td>from</td>
<td>Record-keeping responsibility</td>
</tr>
<tr>
<td>IT duties</td>
<td>from</td>
<td>User departments</td>
</tr>
</tbody>
</table>
Proper Authorization of Transactions and Activities

Transaction Approval Policies

General Authorization

Specific Authorization
Adequate Documents and Records

- Prenumbered consecutively
- Prepared at the time of transaction
- Designed for multiple use
- Constructed to encourage correct preparation
Physical Control Over Assets and Records

The most important type of protective measure for safeguarding assets and records is the use of physical precautions.
Independent Checks on Performance

The need for independent checks arises because internal control tends to change over time unless there is a mechanism for frequent review.
Information and Communication

The purpose of an accounting information and communication system

Initiate

Record

Process

Report transactions

Maintain Accountability for Related Assets
Monitoring activities deal with management’s ongoing and periodic assessment of the quality of internal control performance...

to determine whether controls are operating as intended and modified when needed.
Learning Objective 4

Obtain and document an understanding of internal control.
Process for Understanding Internal Control and Assessing Control Risk

**FIGURE 10-3** Process for Understanding Internal Control and Assessing Control Risk

<table>
<thead>
<tr>
<th>Phase 1</th>
<th>Obtain and document understanding of internal control design and operation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Phase 2</td>
<td>Assess control risk</td>
</tr>
<tr>
<td>Phase 3</td>
<td>Design, perform, and evaluate tests of controls</td>
</tr>
<tr>
<td>Phase 4</td>
<td>Decide planned detection risk and substantive tests</td>
</tr>
</tbody>
</table>
Obtain and Document Understanding of Internal Control

Auditing standards require auditors to obtain an understanding of internal control for every audit.

Procedures to obtain an understanding:

- Design of internal controls
- Whether placed in operation
- Uses this information as a basis for the integrated audit
Methods Used

- Narrative
- Flowchart
- Internal control questionnaire
Narrative

1. The origin of every document and record in the system
2. All processing that takes place
3. The disposition of every document and record in the system
4. An indication of the controls relevant to the assessment of control risk
Evaluating Internal Control: Operation

- Update and evaluate auditor’s previous experience with the entity
- Make inquiries of client personnel
- Examine documents and records
- Observe entity activities and operations
- Perform walk-throughs of the accounting system
Learning Objective 5

Assess control risk by linking key controls, significant deficiencies, and material weaknesses to transaction-related audit objectives.
Assess Control Risk

Assess whether the financial statements are auditable.

Determine assessed control risk supported by the understanding obtained assuming the controls are being followed.

Use a control risk matrix to assess control risk.
Control Risk Matrix

Many auditors use the *control risk matrix* to assist in the control risk assessment process.
Control Risk Matrix

- Identify audit objectives
- Identify existing controls
- Associate controls with related audit objectives
- Identify and evaluate control deficiencies, significant deficiencies, and material weaknesses
Evaluating Significant Control Deficiencies

**FIGURE 10-6** Evaluating Significant Control Deficiencies

<table>
<thead>
<tr>
<th>LIKELIHOOD</th>
<th>SIGNIFICANCE</th>
</tr>
</thead>
<tbody>
<tr>
<td>Remote</td>
<td>Material Weakness</td>
</tr>
<tr>
<td>Immaterial</td>
<td>Reasonably Possible</td>
</tr>
</tbody>
</table>

Identify Deficiencies and Material Weaknesses

- Identify existing controls
- Identify the absence of key controls
- Consider the possibility of compensating controls
- Decide whether there is a significant deficiency or material weakness
- Determine potential misstatements that could result
Communications to Those Charged with Governance

- Auditor must communicate in writing significant deficiencies and material weaknesses to the audit committee.

- Management letters from the auditor
  - less significant control weaknesses
  - ideas for operational improvements

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Learning Objective 6

Describe the process of designing and performing tests of controls.
Tests of Controls

The procedures to test effectiveness of controls in support of a reduced assessed control risk are called *tests of controls*. 
Procedures for Tests of Controls

- Inquire of client personnel
- Examine documents, records, reports
- Reperform client procedures
- Observe control-related activities
Extent of Procedures

- Reliance on evidence from prior year’s audit
- Testing of controls related to significant risks
- Testing less than the entire audit period
### Relationship of Assessed Control Risk and Extent of Procedures

<table>
<thead>
<tr>
<th>Type of procedure</th>
<th>Assessed Control Risk</th>
</tr>
</thead>
<tbody>
<tr>
<td>Inquiry</td>
<td>High level: Procedures to obtain an understanding</td>
</tr>
<tr>
<td>Documentation</td>
<td>Yes–extensive</td>
</tr>
<tr>
<td></td>
<td>Yes–with transaction walk-through</td>
</tr>
<tr>
<td>Observation</td>
<td>Yes–with transaction walk-through</td>
</tr>
<tr>
<td>Reperformance</td>
<td>No</td>
</tr>
<tr>
<td></td>
<td>Lower level: Tests of controls</td>
</tr>
<tr>
<td></td>
<td>Yes–some</td>
</tr>
<tr>
<td></td>
<td>Yes–using sampling</td>
</tr>
<tr>
<td></td>
<td>Yes–at multiple times</td>
</tr>
<tr>
<td></td>
<td>Yes–using sampling</td>
</tr>
</tbody>
</table>
Decide Planned Detection Risk and Design Substantive Tests

- Control risk assessment process results
- Tests of controls
- Control risk assessments
- Planned detection risk
- Related substantive tests
- Balance related audit objectives
Learning Objective 7

Understand Section 404 requirements for auditor reporting on internal control.
Section 404 Reporting on Internal Control

The scope of the auditor’s report on internal control is limited to obtaining reasonable assurance that material weaknesses in internal control are identified.
Types of Opinions

- No material weaknesses
  - No scope restrictions
  - Unqualified

- One or more material weaknesses
  - Adverse

- Scope limitation
  - Qualified or disclaimer
Learning Objective 8

Describe the differences in evaluating, reporting, and testing internal control for nonpublic companies.
Evaluating, Reporting, and Testing Internal Control for Nonpublic Companies

1. Reporting requirements
2. Extent of required internal controls
3. Extent of understanding needed
4. Assessing control risk
5. Extent of tests of controls needed
Differences in Scope of Controls Tested

- Internal controls over financial reporting
- Internal controls used to assess control risk below maximum
- Controls that must be tested in an audit of internal controls
- Controls that must be tested in an audit of financial statements
End of Chapter 10