

Internal Controls: Documentation and Testing *What the Auditor Is Looking For*



Presented by:

Dennis F. Dycus, CPA, CFE, CGFM, Director
Office of the Comptroller of the Treasury
Division of Municipal Audit

TAUD Administrative Professional's Conference
Radisson at Opryland
December 10, 2010



Internal Controls:

Documentation and Testing

What the Auditor Is Looking For

The Control Environment

No longer are I/Cs something that only the auditors are interested in.

Management has begun to realize the cost/benefit of good I/Cs and that they are ultimately responsible for their implementation and adherence to.



Internal Controls:

Documentation and Testing

Recognition of the control environment (The Tone At The Top) is an important step in enhancing controls.

The control environment is the foundation of I/Cs.

- ◆ COSO says it's **EVERYTHING**



Internal Controls:

Documentation and Testing

Everything is built on the environment, which consists of the following things:

- ◆ Integrity and Ethical Values
- ◆ Commitment to Competence
- ◆ Board of Directors or Audit Committee Participation



Internal Controls:

Documentation and Testing

- ◆ Management's Operating Style
- ◆ Organizational Structure
- ◆ Assignment of Authority and Responsibility
- ◆ Human resource policies and Practices



Internal Controls:
Documentation and Testing
No two control systems are the same. Even for a similar size company in the same industry. Like individuals, everyone is different.



Internal Controls: Documentation and Testing

- ◆ It should be understood that a control system is a series of procedures or a process
- ◆ Can only provide *reasonable* assurance
- ◆ Beyond that, and you're getting into *Red Tape*



Internal Controls: Documentation and Testing

The type of controls to be developed will depend on certain factors such as:



Internal Controls:

Documentation and Testing

- ◆ Size (small, medium or large)
- ◆ Legal structure
- ◆ Organizational structure
(centralized, decentralized, matrix management)
- ◆ Objectives (efficiency, profitability, market share)
- ◆ Management style



Internal Controls:

Documentation and Testing

Management's Operating Style

Although subjective, it is very important that the auditor address this area.

SAS No. 99, *Consideration of Fraud in a Financial Statement Audit*, suggests that the following be taken into consideration in assessing the ...



Internal Controls: Documentation and Testing

... relative risk of material
management fraud:

Management('s)

- ◆ Operating and financing decisions are dominated by a single person
- ◆ Attitude toward financial reporting is unduly aggressive



Internal Controls:

Documentation and Testing

- ◆ Turnover (especially senior accounting personnel) is high
- ◆ Places undue emphasis on meeting earnings projections
- ◆ Reputation in the business community is poor
- ◆ Method of communication to employees



Internal Controls:

Documentation and Testing

- ◆ Is their attitude reactive or proactive? Is the company a leader or a follower in the industry?
- ◆ Does the company have a written code of ethics?



Internal Controls:

Documentation and Testing

“Managers of well-run companies have increasingly accepted the view that “ethics pays” – that ethical behavior is good for business.”

(COSO, 1992, p.20)

(And then along came Enron and Global Crossing and)



Internal Controls:

Documentation and Testing

Based on the information gathered and evaluated, the auditor makes a determination of management's style in relation to overall risk assessment.

(Very important)



Internal Controls: Documentation and Testing

Audit Committee

Depending on the size of the entity,
an audit committee can be very important. In a large corporation, the audit committee has full oversight responsibility for financial reporting and may have the following responsibilities:



Internal Controls: Documentation and Testing

- ◆ Review annual and quarterly financial reports
- ◆ Select external auditor
- ◆ Review internal audit reports
- ◆ Review budgets
- ◆ Develop policies
- ◆ Request special reviews
- ◆ Ensure compliance with laws and regs.



Internal Controls: Documentation and Testing

The audit committee and management are responsible for establishing and maintaining the “Tone at the Top.”



Internal Controls:

Documentation and Testing

To be effective, the audit committee must be able to scrutinize management and ask tough, and sometimes difficult, questions.



Internal Controls:

Documentation and Testing

In order to accomplish this, the members of the audit committee must be independent of management, and as a result, are often outsiders.



Internal Controls: Documentation and Testing Control Methods

What methods does management use to review activities of employees?

First step is to develop a policy and procedures manual (P&P). May review budget for variances. May also have a formal process to follow up on any I/C breaks. The real question is, “Are they involved?”



Internal Controls: Documentation and Testing Internal Audit

- ◆ Serves to strengthen control environment
- ◆ May be viewed as an “overriding control” that monitors effectiveness of all other controls



Internal Controls: Documentation and Testing

- ◆ Internal audit may perform various types of audits such as: Financial, operational or compliance
- ◆ In order to be truly functional, internal audit should be independent of all activities it monitors



Internal Controls:

Documentation and Testing

In the end, Internal Audit is only as effective as management's support of it.



Internal Controls: Documentation and Testing **External Influences**

Some industries, such as banking, financing, chemical, insurance, brokerage houses, etc., are highly regulated

Public opinion is often a major influence



Internal Controls: Documentation and Testing Organizational Structure

- ◆ How is a company organized?
Centralized/decentralized; by product line or geographical location
- ◆ Usually, organizational structure is developed to meet individual needs based on size and nature of a business



Internal Controls: Documentation and Testing Techniques to Obtain an Understanding of the Control Environment

- ◆ The auditor should gain sufficient information to:
 - Understand management's attitude and awareness;



Internal Controls: Documentation and Testing

- ◆ Actions concerning control environment
- ◆ Attitude of Board of Directors
- ◆ Auditor should concentrate on the substance of controls rather than their form



Internal Controls: Documentation and Testing

- ◆ Should always consider the collective effect on the control environment

Things to do in order to gain an understanding of the control environment

- ◆ Review P&P manual
- ◆ Interviews with company personnel



Internal Controls:

Documentation and Testing

- ◆ Observing controls in action (or lack thereof)

First time audit vs reoccurring engagement:

- ◆ The auditor should always be on guard to make sure that any change in the organization has been taken into consideration, such as:



Internal Controls: Documentation and Testing

- ◆ Organization change
- ◆ New technology
- ◆ Procedural change
- ◆ Personnel change

The auditor and professional
skepticism ... **NEVER ASSUME!**



Internal Controls: Documentation and Testing

Risk Assessment

For financial reporting, it's the identification, analysis, and management of risks relevant to the preparation of financial statements that are fairly presented in conformity with GAAP



Internal Controls: Documentation and Testing

For Example, How Does An Entity:

- ◆ Considers the possibility of unrecorded transactions
- ◆ Identifies /analyzes significant estimates recorded in the F/S



Internal Controls: Documentation and Testing

Risks that may adversely affect an entity's ability to record, process, summarize, and report financial data may result for internal and external events such as:

- ◆ Changes in Operating Environment
- ◆ New Personnel



Internal Controls: Documentation and Testing

- ◆ Rapid Growth
- ◆ New Technology
- ◆ New Lines, Products, or Activities
- ◆ Corporate Restructuring
- ◆ Foreign Operations
- ◆ Accounting Pronouncements



Internal Controls: Documentation and Testing

Internal Controls: Documentation and Testing Entity Risk Assessment differs from an auditor's consideration of audit risk in a financial statement audit:

- ◆ Purposes of an entity's risk assessment is to identify, analyze, and manage risks that affect the entity objectives.



Internal Controls: Documentation and Testing

- ◆ In a F/S audit, the auditor assesses IR and CR to evaluate the likelihood that material misstatements could occur in the financial statements.

The auditor should approach every audit with a high degree of professional skepticism.



Internal Controls: Documentation and Testing

- ◆ Remember, management will often tell you what you want to hear, or believe.
- ◆ Always examine the control documents, and to observe system in action.



Internal Controls: Documentation and Testing

Control Activities

P&Ps that help ensure that management directives are carried out and may be classified as follows:

- ◆ Performing Reviews
- ◆ Information Processing



Internal Controls: Documentation and Testing

- ◆ Physical Controls (Be careful that you see what you see)
- ◆ Segregation of Duties

The auditor should gain an understanding of such controls necessary to plan the audit



Internal Controls: Documentation and Testing

- ◆ In gaining an understanding of the controls, the auditor often obtains an understanding of the other components.



•Internal Controls: Documentation and Testing

Monitoring

- ◆ A process that assesses the quality of internal control over time
- ◆ Often accomplished through internal audit function

Internal Controls: Documentation and Testing *What the Auditor Is Looking For*



Presented by:

Dennis F. Dycus, CPA, CFE, CGFM, Director
Office of the Comptroller of the Treasury
Division of Municipal Audit

TAUD Administrative Professional's Conference
Radisson at Opryland
December 10, 2010