

# Internal Controls and the Audit Process

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# OVERVIEW

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- Definition and historical perspective of internal auditing
  
- Role and responsibilities of the internal auditor
  - Purpose
  - Allocation of resources
  - Auditing standards



# OVERVIEW

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- Developing the Plan
  - Types of audits
  - Identifying risk factors
  - Determining objectives
  - Basic assumptions
  - Review of internal controls



# OVERVIEW

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- Performing the Audit
  - Testing Controls and Procedures, Techniques, Documentation and Specific Audit Approaches
    - Observation
    - Inquiry
    - Inspection
    - Confirmation

# OVERVIEW

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- Performing the Audit
  - Collecting evidence
    - Types of Evidence
      - Qualitative
      - Quantitative
        - Primary
        - External
        - Recurring Internal
        - Nonrecurring Internal
- V. Writing the Report



# Internal Controls

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- The purpose of the review of the system of internal control is to determine whether:
  - The current system provides reasonable assurance that the organization will meet its objectives and goals efficiently and economically;
  - Use of resources is consistent with applicable laws, regulations and policies;
  - Resources are safeguarded against waste, loss and misuse; and
  - Reliable data are obtained, maintained and fairly disclosed in reports.



# Internal Controls

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- Objectives
  - Authorization
  - Recording
  - Safeguarding of assets
  - Reconciliation
  - Valuation
  - Reporting

# Internal Controls

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## □ Definitions

- Control – any action taken by management to enhance the likelihood that established objectives and goals will be achieved. Control results from management's plan, organization and direction of the entity's activities. Controls may be preventive, detective or directive.
- Control structure – integrated set of controls used to achieve the organization's specific objectives and goals.

# Internal Controls

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- Types of controls within the control structure (as defined by the AICPA in Statement of Auditing Standards No. 1):
  - Primary operational controls – the plan of organization and formulation of policies by which the entity will be directed.
  - Administrative controls – the plan of organization and the procedures and records that are concerned with the decision processes leading to management's **authorization** of transactions. Such authorization is a management function directly associated with the responsibility for achieving the objectives of the organization and is the starting point for establishing accounting control of transactions.

# Internal Controls

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- Accounting controls - the plan of organization and the procedures and records that are concerned with the safeguarding of assets and the reliability of financial records and consequently are designed to provide reasonable assurance that:
  - Transactions are **executed** according to management's general or specific authorization.
  - Transactions are **recorded** as necessary to permit preparation of financial statements in conformity with GAAP or any other criteria applicable to such statements and to maintain accountability of assets.



# Internal Controls

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- **Access** to assets is permitted only according to management's authorization.
- The recorded accountability for assets is **compared** with the existing assets at reasonable intervals and appropriate action is taken with respect to any differences.



# Internal Controls

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- Internal control standards (As promulgated by the U.S. General Accounting Office, Accounting Series, *Standards for Internal Controls in the Federal Government*, 1983)



# Internal Controls

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- Standards define the minimum level of quality acceptable for internal control systems in operation and constitute the criteria against which systems are to be evaluated. These ICS apply to all operations and administrative functions but are not intended to limit or interfere with duly granted authority related to development of legislation, rulemaking or other discretionary policymaking in an agency.

# Internal Controls

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- General Standards
  - *Reasonable Assurance* – Internal control systems provide reasonable assurance that the objectives of the system will be accomplished.
  - *Supportive Attitude* – Managers and employees maintain and demonstrate a positive and supportive attitude toward internal controls at all times.
  - *Competent Personnel* – Managers and employees have personal and professional integrity and maintain a level of competence that allows them to accomplish their assigned duties, as well as understand the importance of developing and implementing good internal controls.

# Internal Controls

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- *Control Objectives* - Internal control objectives are identified or developed for each agency activity and are logical, applicable and reasonably complete.
- *Control Techniques* - Internal control techniques are to be effective and efficient in accomplishing their internal control objectives.
- **Specific standards**
  - *Documentation* - Internal control systems and all transactions and other significant events are to be clearly documented, and the documentation is to be readily available for examination.
  - *Recording of Transactions and Events* - Transactions and other significant events are to be promptly recorded and properly classified.

# Internal Controls

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- *Execution of Transactions and Events* – Transactions and other significant events are to be authorized and executed only by persons acting within the scope of their authority.
- *Separation of Duties* – To reduce the risk of error, waste, or wrongful acts or to reduce the risk of their going undetected, no one individual should control all key aspects of a transaction or event. Rather, duties and responsibilities should be assigned systematically to several individuals to ensure that effective checks and balances exist. Key duties and responsibilities include authorizing, approving and recording transactions; issuing and receiving assets; making payments and reviewing or auditing transactions.

# Internal Controls

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- *Supervision* - Qualified and continuous supervision is to be provided to ensure that internal control objectives are achieved.
- *Access to and Accountability for Resources* - Access to resources and records is to be limited to authorized individuals. Accountability for the custody and use of resources is to be assigned and maintained. Periodic comparisons shall be made of the physical resources with the recorded amounts to determine whether the two agree. The basic idea behind restricting access to resources is to help reduce the risk of unauthorized use or loss. Restricting access to resources depends upon the vulnerability of the asset as well as the perceived risk of loss, both of which should be periodically assessed.

# Internal Controls

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- Audit resolution standard
  - *Prompt, Responsive Action* – Managers are required to take prompt, responsive action on all findings and recommendations made by auditors. Responsive action is that which corrects identified deficiencies. Where audit findings identify opportunities for improvement rather than cite deficiencies, responsive action is that which produces improvement.
  - *Monitoring Results* – Auditors are responsible for following up on audit findings to document that deficiencies have been resolved; improvements have been implemented and are producing the anticipated benefits; or the original audit findings have been proven invalid.

# Internal Controls

- Basic Internal Audit Plan for Evaluation of Internal Control
  - Evaluate the office, department or agency
    - Gain an understanding of **the specific office, department or agency** and its systems, including the internal or external forces to which it must react, such as statutory changes.
    - Identify the **key functions and personnel** that are important in the processing of transactions.
    - Determine the **administrative controls** currently in place and ascertain that the controls are achieving their objectives.
    - Verify that **financial reports** provide accurate compliance with both statutory and management requirements for external and internal financial reporting.



# Internal Controls

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- Evaluate the **control environment** to provide reasonable assurance that a proper environment and control discipline exist so that internal accounting control objectives can be achieved.
- Identify **potential areas of risk** such as embezzlement or fraud, excessive costs, insufficient revenues, loss or destruction of assets, statutory sanctions, erroneous record keeping and erroneous management decisions.
- Formulate internal accounting **control objectives** – determine what can go wrong and the controls needed to prevent the error or loss.

# Internal Controls

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- Broad objectives
  - Authorization
  - Recording
  - Safeguarding of assets
  - Reconciliation
  - Valuation
  - Reporting
- Functional or specific objectives
  - Statutes specific to a fee office
  - Conditions specific to an office or activity

# Internal Controls

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- Evaluate whether control techniques achieve the objectives
  - Obtain an understanding of the transaction processing system through a preliminary survey of the system using narratives, flowcharts, etc.
  - Evaluate whether or not there is an appropriate segregation of duties both within and among the various functions.
  - Evaluate whether or not the administrative and internal accounting control procedures will provide reasonable assurance that the objectives will be achieved.
  - Identify those objectives that will not be achieved due to inherent weaknesses and suggest the appropriate control procedures that should be implemented to correct the deficiency.

# Internal Controls

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- Through documented testing, confirm the validity of those controls most likely to achieve the internal accounting control procedures.
- Based on cost-benefit analysis, recommend those procedures that should be instituted to remedy any weaknesses and effectively reduce risk.
- Prepare the summary report based on the results of testing.



# Warning Signals of Possible Fraud

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- Personal traits of employees
  - Financial difficulties of elected officials or management personnel
    - High inflation rates with absence of corresponding pay adjustments
    - Excessive use of drugs or alcohol
    - Excessive gambling
    - High personal debts or financial losses
    - Inadequate income for lifestyle



# Warning Signals of Possible Fraud

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- Rationalization of contradictory behavior
- Lack of a strong code of personal ethics
- “Wheeler-dealer” personality
- Lack of stability
- Criminal or questionable background



# Warning Signals of Possible Fraud

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- Indications of management override of significant internal accounting controls
- Significant decline in the volume or amount of transactions affecting cash disbursements
- Widely dispersed locations accompanied by highly decentralized management and inadequate responsibility reporting system



# Warning Signals of Possible Fraud

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- Understaffing, which appears to require certain employees to work unusual hours, forgo vacations and/or put in substantial overtime
- High turnover rate in key financial or accounting positions
- Frequent change of independent auditors or outside legal counsel



# Warning Signals of Possible Fraud

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- Known material weakness in internal controls that could practically be corrected but remain uncorrected such as:
  - Inadequately controlled access to computer equipment or data entry devices
  - Incompatible duties that remain combined

# Warning Signals of Possible Fraud

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- Material transactions with related parties or transactions that may involve conflicts of interest
- Possible connections with organized crime
- Analytical review procedures disclosing significant fluctuations that cannot be reasonably explained such as:
  - Material account balances
  - Financial or operational interrelationships
  - Physical inventory variances
  - Budget vs. actual variances
  - Year to year variances



# Warning Signals of Possible Fraud

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- Large or unusual transactions, particularly at year end
- Unusually large payments for services by attorneys, consultants, agents and others, including employees.
- Difficulty in obtaining audit evidence with respect to incomplete or missing documentation
- Alterations in documentation or accounts
- Sudden delays by elected officials or management officials in scheduled audits
- Evasive or unreasonable responses of management to audit inquiries



# Areas Prone to Fraudulent Activity

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- Cash transactions – wherever cash (the most liquid of all assets) is handled, fraudulent opportunities and related risk factors are most significant.
- Petty cash – use of false inadequate documentation for disbursements
- Accounts receivable/lapping – theft from one customer account receivable covered up by applying later receipts from another customer.



# Areas Prone to Fraudulent Activity

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- Accounts payable
  - Use of fictitious companies and dummy invoices
  - "Adjustment" of invoices from existing suppliers
- Payroll - fictitious employees
- Kickbacks - for services and materials

# Example #1

## Guide in Evaluating Cash Receipts

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- **Objectives: Recording, Safeguarding**
- **Test: Cash transactions are recording correctly as to account, amount and period are deposited.**

### System Attributes to Consider

- *Mail Receipts*
  - Mail opened independently of cashier, accounts receivable bookkeeper, other employees who may initiate or post journal entries
  - Record of checks and cash (cash transactions) received prepared by person opening the mail; list used as posting source and subsequently compared to daily deposit.
  - Lock box used

# Example #1

## Guide in Evaluating Cash Receipts

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- *Cash transactions*

- Independent check of *pre-numbered* receipts and refund slips
- Cash register tape totals compared with amount of cash in drawer
- Clerks handling cash closely supervised
- Cash refunds require approval
- Cash activity reconciled with daily transaction log and receipts written.

# Example #1

## Guide in Evaluating Cash Receipts

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### ■ *General*

- Employees handling receipts bonded
- Cash transactions not handled by employees having access to accounts receivable records or general ledger
- Cash transactions not handled by employees responsible for petty cash fund.
- Each day's cash deposited intact and without delay.
- Independent employees responsible for reconciling authenticated duplicate deposit, mail receipts listing, cash receipts book, bank statement.

# Example #1

## Guide in Evaluating Cash Receipts

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- Each cash fund assigned to one individual, independent of any other cash funds (cash register, cash drawer, petty cash fund etc.).
- Branch offices make deposits to "home" office account intact and without delay.
- Cash or checks not immediately deposited kept in fireproof vault or safe.
- Miscellaneous receipts such as disposition sales, rents and reimbursements monitored to detect misappropriation.
- Bank accounts regularly reconciled independently of cash receipts, general ledger or accounts receivable functions.
- Monthly statements sent to delinquent payors; complaints handled independently of cashier or account receivable department.

# Example #1

## Guide in Evaluating Cash Receipts

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### What Can Go Wrong

#### ■ Errors

- Cash or checks lost.
- Incorrect recording of cash transactions.

#### ■ Irregularities

- Cash transaction occurs but no sale recorded or recorded at lesser amount; cash misappropriated.
- Cash transaction occurs; cash refund documentation prepared; cash misappropriated.
- Checks received are deposited but not recorded; checks written to employee for same amounts that are also not recorded.
- Collections on account misappropriated, concealed by debits to other than cash accounts (expense accounts) or by improper issuance of credit memo.



# Example #1

## Guide in Evaluating Cash Receipts

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- *Accounts Affected*
  - Cash
  - Accounts receivable
  - Fee/Fine income
  - Miscellaneous income
  - Miscellaneous expenditures

# Example #1

## Guide in Evaluating Cash Receipts

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- **Objective: Recording**
- **Test: Cash receipts are properly applied to customer balances**

### System Attributes to Consider

- Employees responsible for posting to receivable accounts have no access to cash.
- Employees responsible for initiating or approving credits or writeoffs have no access to cash transactions or detail receivable records.
- Cash transactions applied to specific charges or invoices rather than to current balances.
- Postings to receivable accounts independently reconciled to total of cash received.
- Monthly statements sent to delinquent payors; complaints handled independently of cashier or account receivable department.
- Delinquent investigated independently of cashiers.

# Example #1

## Guide in Evaluating Cash Receipts

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### What Can Go Wrong

- *Errors*

- Receivables properly stated in the aggregate, but individual customer accounts misstated

- *Irregularities*

- Collectible accounts written off or otherwise credited; customer remittances misappropriated
- "Lapping" - cash misappropriated, shortages covered by delaying postings

- *Accounts Affected*

- Cash
- Accounts receivable



# Example #2

## Audit Program for Cash Receipts

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### General

- Obtain a copy of the current organizational chart relative to the finance/treasury function for purposes of orientation and reference during the audit. This provides documentation of reporting relationships as well as the degree to which duties are segregated. Any difference noted during the audit should be discussed with management and resolved.
- Obtain a copy of the investment policy for the county. Verify that it is in conformity with applicable statutes.

# Example #2

## Audit Program for Cash Receipts

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- Obtain a copy (if available) or prepare a written narrative of the procedures and related documentation identifying and evaluating controls over cash receipts and disbursements for the permanent audit files.
- Through interviews with elected officials and employees, determine in what ways, if any, the written procedures are not current or are not followed. Adjust documentation of the permanent audit files accordingly.
- During the audit, by observation, interview, etc., note any evidence of
  - Resource problems
  - Personnel incompetence
  - Dishonest acts

# Example #2

## Audit Program for Cash Receipts

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### Authorization / Execution of Transactions

- Select at random from the period under review a specific number of cash receipts transactions (based on a statistical sample or other reasonable, documented basis) from the cash receipts records and check for evidence of the following:
  - Listing on validated duplicate deposit slip or remittance advice
  - Verification of amount by accounting department personnel
  - Timely deposit - compare date of deposit with remittance date
  - If processed via data processing:
    - Inclusion in batch
    - Recording of batch in control log
    - Comparison of output with data in control log

# Example #2

## Audit Program for Cash Receipts

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- Review journal entries that record cash disbursements for the year noting consistency and approval. Investigate any large or unusual items.
- Obtain supporting data for the current day's deposit and test for:
  - Agreement of deposit amount with surprise count (if applicable)
  - Completeness of supporting detail
  - Agreement with listing prepared by person receiving cash (if any)
  - Unusual items such as stale deposits
  - Accuracy of deposit data by tracing to actual checks or cash received
  - Restrictive endorsements



# Example #2

## Audit Program for Cash Receipts

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- Scan records of deposit activity such as cash receipt records, bank statements and bank reconciliations for any evidence of deviations from daily deposit activity requirements.

### Safeguarding

- Obtain evidence of insurance and fidelity bond coverage for the permanent audit files.
- Inspect physical means by which cash receipts and receipt forms are stored (safe, locked box, drawer, etc.)
- Observe areas where cash receipts are handled (mail room, teller areas, cashier windows, etc.) and note evidence of restriction such as signs, locked doors, alarms etc.




# Example #2

## Audit Program for Cash Receipts

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### Reconciliation

- Review reconciliations through the year and note evidence of balancing total cash receipts record with bank statement. This is also known as a proof of cash.
- Perform surprise cash counts regularly.




## Example #3

# Internal Control Questionnaire for Cash Disbursements

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### Authorization

- Do written procedures describe the methods and required approvals for establishing and closing bank accounts?
- Are there control procedures to cover the variety of ways disbursements may be accomplished (check, wire transfer etc.) and which clearly set forth authority for approval, execution and recording?
- Are the control procedures in conformity with applicable statutes?



## Example #3

# Internal Control Questionnaire for Cash Disbursements


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- If signatures on checks are accomplished by means of facsimile plates or similar devices, do control procedures identify the individuals having custody and usage of the plates?
- Do procedures identify the individuals responsible for maintaining custody of blank check stock?

## Recording

Do procedures require that:

- All regular disbursements be made by checks prepared on the basis of adequate and approved documentation?



## Example #3

# Internal Control Questionnaire for Cash Disbursements

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- The check signer reviews evidence of adequate and approved documentation before signing?
- All checks be prenumbered and that someone accounts for the sequence of numbers periodically?
- All checks are recorded in a cash disbursement record in sufficient detail to permit accurate summarizing and posting?
- The total record of cash disbursements be balanced periodically with the total of detail charges to vendor accounts?

# Example #3


## Internal Control Questionnaire for Cash Disbursements

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### Safeguarding

Do procedures require that:

- All disbursements are in compliance with budgeted amounts?
- All disbursements be by check or other authorized means?
- Checks be used in sequence?
- Unused checks be stored in a restricted area in the custody of a specified individual?
- Checks be made of protective paper?
- Checks be prepared by persons independent of voucher approval functions?
- Checks be signed by persons independent of check preparation and voucher approval functions?
- Checks be made payable to specific payees?



## Example #3


# Internal Control Questionnaire for Cash Disbursements

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### Safeguarding (Continued)

Do procedures require that:

- A check protector be used?
- Retaining voided or mutilated checks?
- Facsimile signature plates are kept in a restricted, secure place separate from blank check stock and are used only in the presence of the specified custodian?
- Checks over a specified amount be signed manually?




## Example #3

### Internal Control Questionnaire for Cash Disbursements

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- Only complete checks be signed (never blank checks)?
- Supporting documents and vouchers be canceled immediately after signing?
- Filing and accounting for the sequence of canceled checks cleared by the bank?
- Disbursement function segregated from record keeping, cash receipts and procurement?



# Example #3

## Internal Control Questionnaire for Cash Disbursements

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### Reporting / Reconciliation

- Each batch of signed disbursement checks be totaled and compared to the cash disbursements journal before mailing?
- Periodically reconcile the total of the cash disbursements record to bank records of checks cleared with appropriate investigation and resolution of differences? This procedure is also called a "proof of cash". While it can be done in conjunction with a bank reconciliation, it is an additional step not normally performed in the usual bank reconciliation procedures.
- Periodic comparison of actual disbursements with budgeted amounts and appropriate investigation of large or unusual differences