AUE 2602
Internal Control

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Learn without limits.

UNISA | college of accounting sciences

Important Information

Assignment 1 due: **11 March 2019** (5%)

Assignment 2 due: **15 April 2019** (15%)

Remember the submission of either assignment allows you entry into the exam and will be used in calculating your year mark.

Interesting statistic for the second semester 2018:
Only 5.7% of the students who did assignment one passed the exam compared to 60.4% of the students who did assignment one and two who passed the exam. Therefore you can understand that it is important to work consistently throughout the semester and do the assignments.

Important Information

myUnisa has the following resources:

- Prescribed study material
- All tutorial letters
- Past examination questions
- Discussion forums
- Additional resources
- Etc.

Make sure that you familiarize yourself with the information contained in myUnisa and study guide

Structure of Course

- Topic 1: Corporate governance and statutory matters
- Topic 2: Internal control
- Topic 3: Business cycles
- Topic 4: Revenue and receipts cycles
- Topic 5: Acquisitions and payments cycle
- Topic 6: Inventory and production cycle
- Topic 7: Payroll and personnel cycle
- Topic 8: Finance and investment cycle

Topics covered

- Topic 1: Corporate governance and statutory matters

TOPIC 2
Internal Control

What is an Internal Control?

It is procedures designed to address and limit potential risks

Types of risks

- Safeguarding assets of a company
- Preventing fraud
- Complying with laws and regulations
- Producing reliable financial information → Financial statements
- Effective and efficient operation of business

Internal Control

Are internal controls 100% foolproof?

No, as no single control can neatly address each identified risk. Thus as internal controls can be fallible, they work best in combination.

E.g. Whilst a student card is required to enter the university library, the security guard at the entrance gate should inspect the photo on the student card to confirm that the person entering the library is indeed the authorized user for that card.

Note that there are two controls in place before you can enter the library:

1. **Presenting** your student card
2. **Inspection** of the student card by the security guard

Internal Control

What are the key characteristics of internal controls?

- ➤ Is a process
- ➤ Effected by people
- ➤ Not the sole responsibility of management
- ➤ Is not static
- ➤ Is not fool proof
- ➤ Is not a case of a single control addressing a single risk

Note: In the exam you should be able to elaborate on the above. Refer to Jackson and Stent (2016: 5/4 – 5/5) for detailed explanations

Internal Control

Taking the above into account, internal controls can be defined as follows:

Definition:

ISA 315 **defines internal control** as the process designed, implemented and maintained by those charged with governance, management and other personnel to provide reasonable assurance about the achievement of an entity's objectives with regard to:

➢ The reliability of the entity's financial reporting
➢ The effectiveness and efficiency of its operations
➢ Its compliance with applicable laws and regulations

Internal Control

Does internal controls have limitations?

Yes, as internal controls does not provide absolute assurance that the risks, that threaten the achievement of the objectives of the business, will be adequately responded to. This is due to the **inherent limitations** of internal controls

What are the Inherent limitations of internal controls?

- ➢ **Cost** of internal control does not exceed the expected benefit
- ➢ Tendency to be directed at **routine** transactions
- ➢ Potential for **human error**
- ➢ Possibility of circumvention of internal controls through **collusion** (conspiracy)
- ➢ **Management overriding** an internal controls – abuse of responsibility
- ➢ **Changes** in conditions resulting in internal controls becoming **inadequate**

Internal Control

Who is responsible for internal controls in the business?

Everyone is, this includes the board of directors, management and employees.

➢ The board has overall responsibility and accountability

➢ Management identify risks, design and implement policies and procedures to address risks.

➢ Employees execute internal control procedures.

Thus the success of internal controls depends on **all parties** involved.

Internal Control
Components of internal control

What are the components of internal control?

There are five components to internal controls, they are:

- Control environment
- Risk assessment
- Information systems
- Control activities
- Monitoring of controls

Internal Control
Components of internal control

1. Control environment

The control environment sets the **tone** of the entity and creates the **atmosphere** in which employees go about their duties. The desirable mind set is one of "doing things the right way"

Points relating to this component:

* Integrity and ethical values
* Commitment to competence
* Participation of those charged with governance (e.g. Board of directors)
* Management's philosophy and operating style organisational structure
* Assigning authority and responsibility
* Human resource policies and practices.

Internal Control
Components of internal control

2. Risk Assessment

King IV states that the board should ensure that risk assessments are performed on a continual basis. Risk assessment is important because internal controls are designed and implemented as a **response** to assessed risk. It is therefore critical that the risk assessment process is comprehensive, accurate, thorough and complete.

Points relating to this component:

*   Define the objectives of entity, the departments and functions

*   Identify and assess risks: Operational, financial reporting and compliance

*   Respond to risk:

    →information system (combined process / method of initiating, recording, processing and reporting transactions, manually / through computers / a combination of both)

    →control activities

Internal Control
Components of internal control

3. Information System

The objective of the information system and its subpart, the accounting system, is to produce information that is **Valid, Accurate** and **Complete** and **timeously** produced

Points relating to this component:

* Valid, accurate and complete (when initiating, recording, processing and reporting transactions)
* Procedures to deal with transactions: initiating, recording, processing, correcting, and posting (to ledgers)
* Related accounting records: documents used, document
* Capturing events and conditions other than transactions (e.g. depreciation)
* Journal entries
* Accumulate, record, process and summarise information for the preparation of the financial statements

Internal Control
Components of internal control

4. Control Activities

Control activities are the **actions** carried out to **manage** or **reduce** risks and to achieve the entity's objectives.

Types of control activities include:

➤ Approval, authorization

➤ Segregation (division) of duties

➤ Isolation of responsibility

➤ Access/Custody

➤ Comparison and reconciliation

➤ Performance reviews

Make sure you understand the difference between Segregation of duties and Isolation of responsibilities

There is no point in comparisons and recons if differences are not followed up and remedial actions taken

Control activities can be **Preventative**, **Detective** or **Corrective** in nature.

Internal Control
Components of internal control

5. Monitoring of controls

The monitoring of controls involves the **assessment** of internal control performance over time. If controls are not monitored, the board or management will not know if the entity's financial reporting is reliable and whether the laws, regulations and company policies are being complied with.

Points relating to this component:

*   Assessment over time
*   Are objectives still being met?
*   Assessment at all levels: directors, management, department heads
*   Independent assessment: internal audit, external bodies, customers
*   Remedial action

Controls in a Computerised Environment

What controls are there in a computerised environment?

1. General controls
2. Application controls

Note: General and application controls can be **manual** (performed by humans) or **computerised** (performed by the computer)

Does controls in a computerised environment touch on all components of internal controls?

Yes, refer to your MO001, page **61** for a diagrammatic representation illustrating how general and application controls relate to **all the components of internal controls**

Controls in a Computerised Environment
General controls

Are defined as those controls which establish an **overall framework** of control for computer activities.

They are controls which should be in place **before** any processing of transactions gets underway and they span **across all applications**.

As general controls operate "**around**" the application controls, if your general controls are not adequate, the application controls might not be of much use.

Controls in a Computerised Environment
General controls

General controls can be categorized under the following headings:

- ➢ Control environment
  - Management's attitude
- ➢ Systems development and implementation controls

  -In-house development and implementation, packaged software,   programme change controls
- ➢ Access controls
  - Access to hardware, accessing the computer itself, documentation
  - Physical access (e.g. access cards) vs Logical access (e.g. passwords)
- ➢ Continuity of operations
  - Risk assessment, physical security, disaster recovery
- ➢ System software and operating controls
- ➢ Documentation
  -Sound document controls and standards

Controls in a Computerised Environment
Application controls

Are any control within an application which contributes to the **accurate** and **complete** recording and processing of transactions which have actually **occurred (valid)**, and have been authorized (Occurred, accurate and complete information)

The stages through which a transaction flows through the system can be described as:

- **Input** (e.g. read in sales transaction)
- **Processing** (e.g. calculate VAT on sales transaction)
- **Output** (e.g. printout of invoice on sales transaction)

Application controls can be described in terms of these activities, e.g. an application control relating to input.

Controls in a Computerised Environment
Application controls

Application controls can be categorised under the following headings:

➢ Segregation of duties
➢ Isolation of responsibilities
➢ Approval and authorisation
➢ Custody
➢ Access controls
➢ Comparison and reconciliations and follow up of discrepancies
➢ Performance review

Controls in a Computerised Environment

Application controls

Application controls must also me implemented over the **masterfile**. A masterfile is a file which is used to store only standing information and balances. The masterfile is a very important part of producing **reliable** information and must be **strictly controlled**. E.g. The debtors masterfile will contain name, address credit limit etc.

What does the objectives of controls in a computerised environment center around?

1. Occurrence and authorisation

- Data and transactions are **not** fictitious
- Data and transactions are in accordance with the activities of the business and have been properly **authorised** by management

Controls in a Computerised Environment

2. Accuracy

Is concerned with **minimising errors** by ensuring data and transactions are correctly captured, processed and allocated

3. Completeness

Is concerned with ensuring that data and transactions are **not omitted** or incomplete

Controls in a Computerised Environment

Framework for application controls

	Occurrence and authorisation (Valid)	Accurate	Complete
Input			
Processing			
Output			
Masterfile			

Controls in a Computerised Environment

Study: Jackson & Stent (2016: 8/3 – 8/4 and 8/7-8/25 and 8/26- 8/41)

When doing the activities, tutorial 102 questions, assignments and past examination papers, take note of how the information is given in the scenario, as well as how the solution is presented. This will give you an idea as to how controls in a computerised environment can be tested in an examination

Internal Control
from the Perspective of the External Auditor

Why must an external auditor obtain an understanding of a clients system of internal control?

An understanding of a clients system of internal control assists the external auditor to:

- Identifying types of **potential misstatements** and factors that affect the **risks of material misstatement**, and

- in **designing** the nature, timing and extent of further **audit procedures**.

What is a significant risk?

Significant risks are risks that require **special audit consideration**. Such risks relate to the auditors **risk of material misstatement**. The auditor assesses risk so that he or she can **determine** the nature, timing and extent of further audit procedures.

Internal Control
from the Perspective of the External Auditor

Study: Jackson & Stent (2016: 7/15 – 7/22)

When doing the activities, tutorial 102 questions, assignments and past examination papers, take note of how the information is given in the scenario, as well as how the solution is presented. This will give you an idea as to how internal controls from the perspective of the **external auditor** can be tested in an exam.

Topic 2: Internal controls

Activities:

- Do all the activities related to this Topic

Tutorial letter 102:

- Do all questions under topic 2 from the prescribed textbook, *Graded Questions on Auditing* (2017)

Assignments and past examination papers:

- Do the assignments (tut 101) and past examination questions (on myUnisa) to see how this topic could be examined
- Remember to read the scenario and the questions carefully, and answer what was asked!
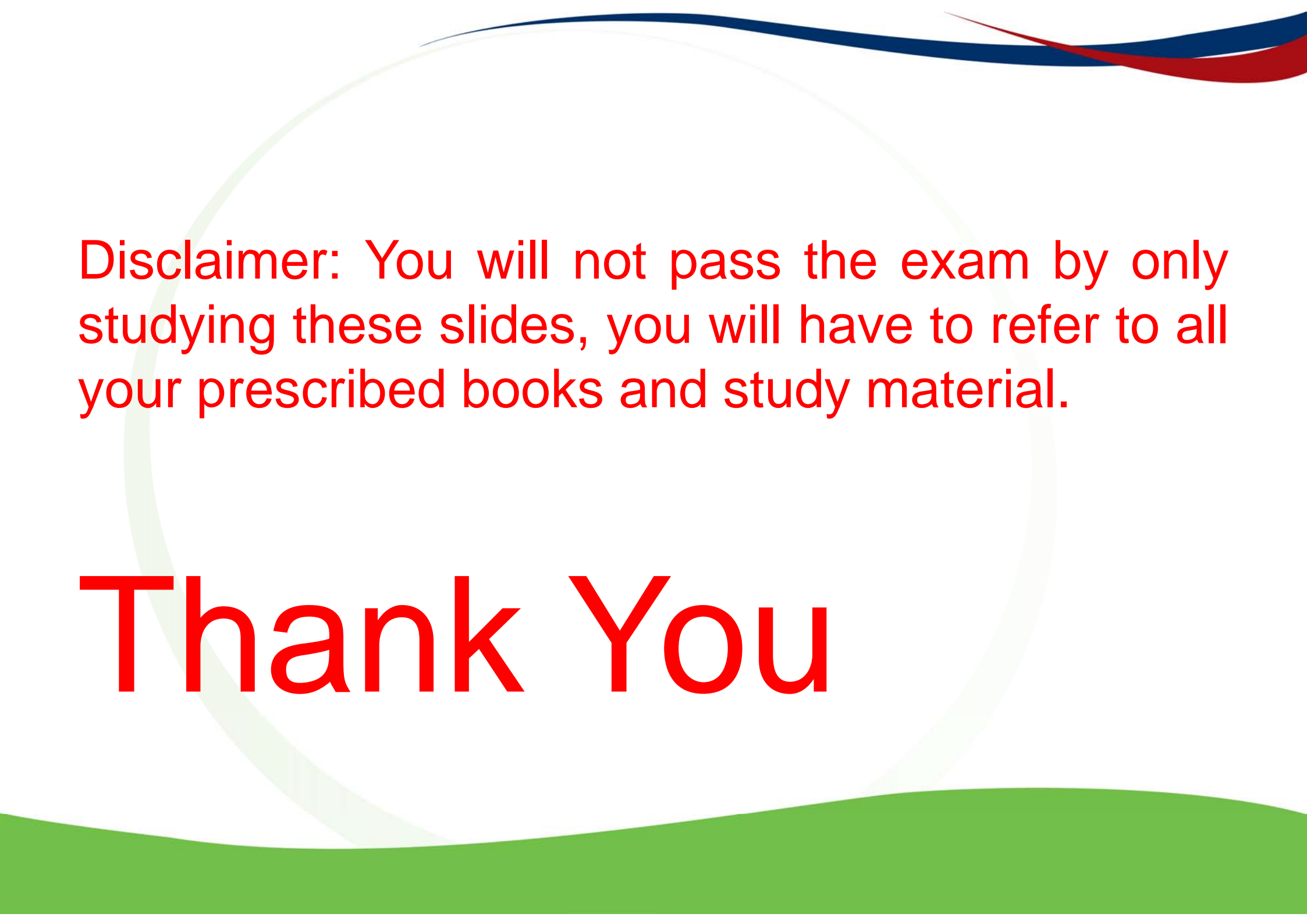
EXAM TECHNIQUE

- When doing the activities, tutorial 102 questions, assignments and past examination papers, take note of how the information is given in the scenario, as well as how the solution is presented.

Old exam paper question

- Do questions 1.3 and 1.4 of May 2017 exam paper
- Do questions 1.5 and 2.1 of May 2018 exam paper
- Do questions 1.4 and 1.5 of October 2018 exam

Disclaimer: You will not pass the exam by only studying these slides, you will have to refer to all your prescribed books and study material.

Thank You