# INTERNAL CONTROLS

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# TOPICS

- Introduction to Internal Controls
- Components of Internal Control
- Risk Assessment and Internal Controls in Auditing
- Testing of Controls and Auditor’s Response
- Common Internal Control Weaknesses and How to Address Them
- Reporting on Internal Controls
- Q&A

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# Introduction to Internal Controls

*What is internal control?*

According to the Committee of Sponsoring Organizations (COSO):

*Internal control is a process, effected by an entity's board of directors and other personnel, designed to provide reasonable assurance regarding the achievement of objectives related to operations, reporting, and compliance.*

# Introduction to Internal Controls

<u>*What is internal control?*</u>

Series of actions; involves steps

It is the responsibility of the management

According to the Committee of Sponsoring Organizations (COSO):

*Internal control is a process, effected by an entity's board of directors and other personnel, designed to provide reasonable assurance regarding the achievement of objectives related to operations, reporting, and compliance.*

High (but not absolute) level of confidence

**Operations** – effectiveness and efficiency
**Reporting** – reliability of financial reporting
**Compliance** – compliance with applicable laws and regulations

# Introduction to Internal Controls

*What is internal control?*

Under ISA 315 (Revised)

*The process designed, implemented, and maintained by those charged with governance, management, and other personnel to provide reasonable assurance about the achievement of the entity's objectives.*

# Introduction to Internal Controls

*<u>Why are internal controls important?</u>*

- Auditors may plan to rely on internal controls, which may affect the nature, timing, and extent of substantive procedures

- **Impact on Audit Approach:**
  - Strong internal controls – reliance approach; reduced SP
  - Weak internal controls – no reliance approach; more SP
- **Fraud Prevention and Detection**
- **Regulatory & Compliance Requirements**

# POLL QUESTION # 1

# POLL QUESTION # 2

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# Components of IC

1) Control Environment
2) Risk Assessment Process
3) Information System and Communication
4) Control Activities
5) Monitoring Controls

# Components of IC

*Control Environment*

- Foundation of an effective internal control system
- “Tone at the top”
- Influences the overall control consciousness of the organization

**Elements:**

- Integrity and Ethical Values
- Governance and Oversight
- Organizational Structure
- Commitment to Competence
- Accountability

# Components of IC

<u>*Risk Assessment Process*</u>

- Process of identifying, analyzing, and managing risks

**Considerations**

- Identify risks (internal and external)
- Assess likelihood and impact
- Mitigation strategies and controls to address risks

# Components of IC

*Information System and Communication*

- Processes to initiate, record, process, and report

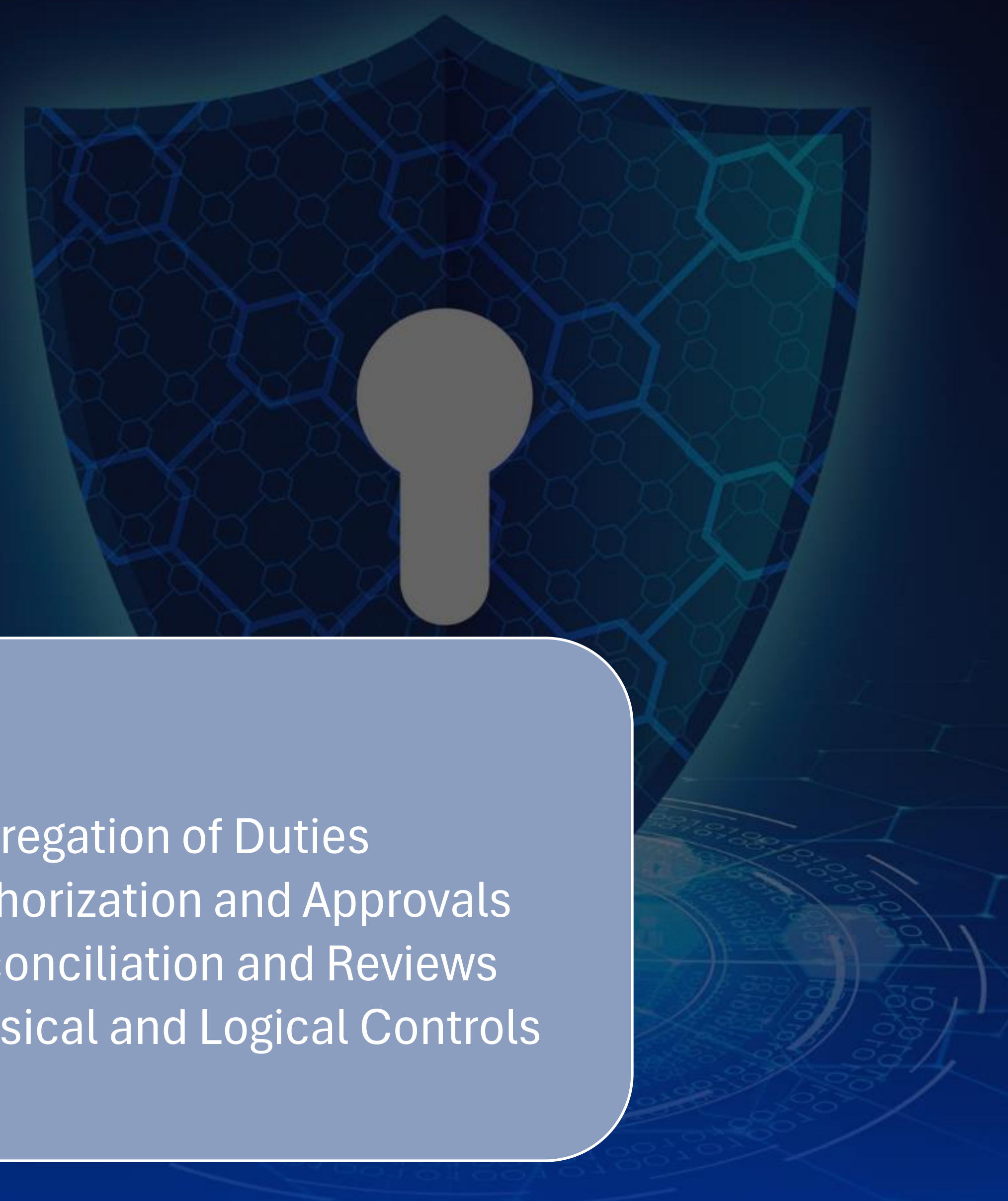
**Key Elements**

- Transaction Processing
- Financial Reporting Processes
- Communication of Responsibilities

# Components of IC

*Control Activities*

- Policies and procedures that are carried out



**Types**

- Segregation of Duties
- Authorization and Approvals
- Reconciliation and Reviews
- Physical and Logical Controls

# Components of IC

*Monitoring Controls*

- Ongoing and periodic assessments

**Key Aspects**

- Ongoing monitoring
- Separate evaluations
- Reporting deficiencies

# POLL QUESTION # 3

# POLL QUESTION # 4

# POLL QUESTION # 5

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# Risk Assessment and Internal Controls

*What is Risk Assessment in an audit?*

Auditors perform risk assessment to identify areas where material misstatements are most likely to occur.

**Key Steps:**

1. Understanding the entity and its environment
2. Understanding the entity's internal controls
3. Identifying ROMM
4. Assessing inherent risk and control risk

# Risk Assessment and Internal Controls

*<u>What are the auditor's approaches to evaluate controls?</u>*

- Inquiry
- Observation
- Inspection
- Reperformance

# Risk Assessment and Internal Controls

*Fraud Risk Factors*

- Opportunities
- Incentives/Pressures
- Rationalization

**Common Fraud Risk Areas:**

- Revenue recognition
- Inventory manipulation
- Expense understatement

# POLL QUESTION # 6

# POLL QUESTION # 7

# POLL QUESTION # 8

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# Testing of Controls; Auditor’s Response

*<u>What is testing of controls?</u>*

Testing of controls involves evaluating whether an entity’s internal controls are effectively designed and implemented and whether they operate as intended.

# Testing of Controls; Auditor's Response

*Why the need?*

- Assess effectiveness of controls
- Identify potential deficiencies
- Determine reliability of controls

*When do we test?*

- If we plan to rely on controls

**Methods:**

- Inquiry
- Observation
- Inspection
- Reperformance

# Testing of Controls; Auditor's Response

**Control Effectiveness Classifications**

- **Effective** – the control *operates consistently as designed*
- **Deficient** – the control *exists* but is *not properly designed* or *does not function as intended*
- **Absent** – the control *does not exist* at all

**Types of Deficiencies:**

- Control deficiency – control is missing or is not designed effectively
- Significant deficiency – control issue that requires attention, but is not severe enough to be material
- Material weakness – deficiency that creates reasonable possibility of material misstatement

# Testing of Controls; Auditor's Response

**Auditor's Response:**

- **Controls are effective –** reliance on control; less substantive testing
  - **Nature** - less strict substantive procedures
  - **Timing** - interim testing to decrease year-end substantive procedures
  - **Extent** – less sample size
- **Controls are weak or ineffective –** no reliance on control; extensive substantive procedures
  - **Nature** - stricter substantive procedures, which may include additional analytical procedures
  - **Timing** - extended year-end procedures
  - **Extent** – more sample size

# Testing of Controls; Auditor's Response

**Communication of Control Deficiencies:**

- **Significant deficiencies and material weaknesses –** must be in writing
- **Minor deficiencies –** may be communicated verbally

**Inclusions in the report:**

- Description
- Potential impact
- Recommendations

# POLL QUESTION # 9

# POLL QUESTION # 10

# POLL QUESTION # 11

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# Common Internal Control Weaknesses

*<u>What are internal control weaknesses?</u>*

Internal control weaknesses occur when control mechanisms are missing, poorly designed, or not functioning as intended.

**Categories:**

- Control design deficiencies
- Control implementation deficiencies
- Control monitoring deficiencies

# Common Internal Control Weaknesses

**Common Internal Control Weaknesses and their Risks**

*Lack of Segregation of Duties*

- **Weakness**: One person has control over multiple aspects of a transaction (e.g., recording transactions and approving payments).
- **Risk**: Increased risk of fraud, errors, and unauthorized transactions.
- **Solution**: Assign different employees to authorization, recordkeeping, and reconciliation duties.

# Common Internal Control Weaknesses

**Common Internal Control Weaknesses and their Risks**

*Weak Authorization and Approval Processes*

- **Weakness**: Transactions (e.g., purchases, payments) are processed without proper approval.
- **Risk**: Unauthorized transactions, fraudulent activities, and budget overruns.
- **Solution**: Implement formal approval levels with documented authorization policies.

# Common Internal Control Weaknesses

**Common Internal Control Weaknesses and their Risks**

*Insufficient Documentation & Record-keeping*

- **Weakness**: Missing invoices, contracts, or receipts for financial transactions.
- **Risk**: Difficulty in verifying transactions, leading to misstatements or fraud.
- **Solution**: Implement policies for document retention and require supporting evidence for all transactions.

# Common Internal Control Weaknesses

**Common Internal Control Weaknesses and their Risks**

*Inadequate IT and Cybersecurity Controls*

- **Weakness**: Weak passwords, lack of access controls, and outdated security systems.
- **Risk**: Unauthorized access, data breaches, and financial fraud.
- **Solution**: Enforce multi-factor authentication, regular system updates, and user access reviews.

# Common Internal Control Weaknesses

**Common Internal Control Weaknesses and their Risks**

*Poor Inventory Management Controls*

- **Weakness**: Lack of physical inventory counts or reconciliation with accounting records.
- **Risk**: Theft, inventory shrinkage, or misstated financials.
- **Solution**: Implement periodic inventory counts, system tracking, and reconciliation procedures.

# Common Internal Control Weaknesses

**Steps to Identify Weaknesses**

1. Perform risk assessments
2. Review audit findings
3. Conduct control testing
4. Monitor Key Performance Indicators (KPIs)

# Common Internal Control Weaknesses

**How to Address Control Weaknesses**

1. Redesign controls
2. Strengthen supervision and monitoring
3. Enhance training and awareness
4. Use technology and automation

# Common Internal Control Weaknesses

**Sample Scenario:**
A mid-sized company identified a significant control deficiency: bank reconciliations were not being performed regularly.

*Issues identified:*

- Unidentified transactions that are potentially fraudulent
- Discrepancies between cash balances and financial records
- No oversight or review process in place

# Common Internal Control Weaknesses

**Sample Scenario:**
A mid-sized company identified a significant control deficiency: bank reconciliations were not being performed regularly.

<u>*Issues identified:*</u>
- Unidentified transactions that are potentially fraudulent
- Discrepancies between cash balances and financial records
- No oversight or review process in place

**Steps taken:**
- Implemented a monthly bank recon process to be completed with 5 days after month-end
- Assigned a specific employee for reconciliation (with managerial review)
- Required supporting documentation for all cash transactions

# POLL QUESTION # 12

# POLL QUESTION # 13

# POLL QUESTION # 14

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# Reporting on Internal Controls

**Purpose:**
 - provide transparency regarding weaknesses that could impact financial reporting and compliance

**Importance:**

- Assists **management** in identifying and addressing control weaknesses
- Assists **regulators** and investors in assessing financial reporting reliability
- Enables **auditors** to comply with ISA

# Reporting on Internal Controls

**Auditor's Responsibilities in Reporting Internal Controls**
- ISA 265: auditors must report significant deficiencies and material weaknesses

**Key Reporting Responsibilities under ISA 265:**
1. Identify control deficiencies during the audit.
2. Evaluate the severity of deficiencies (control deficiency, significant deficiency, or material weakness).
3. Communicate findings to management and those charged with governance.
4. Recommend corrective actions where applicable.

# Reporting on Internal Controls

*When is it required?*

- When significant deficiencies or material weaknesses are identified.
- If control weaknesses impact the financial statement audit.
- When requested by regulatory bodies or governance committees.

# Reporting on Internal Controls

**Impact of Internal Control Weaknesses on the Audit Report:**

- **No Impact**: If controls are weak but substantive procedures provide sufficient appropriate evidence, an unmodified opinion may still be issued.
- **Qualified Opinion**: If weaknesses prevent auditors from obtaining sufficient audit evidence.
- **Adverse Opinion**: If material weaknesses lead to financial misstatements that make the financial statements unreliable.
- **Disclaimer of Opinion**: If control weaknesses prevent the auditor from conducting the audit effectively.

# Reporting on Internal Controls

**Best Practices for Internal Control Reporting:**

- Use clear and concise language
- Prioritize significant issues
- Provide actionable recommendations
- Follow-up on implementation

# Reporting on Internal Controls

**Best Practices for Internal Control Reporting:**

- **Use clear and concise language**
- Prioritize significant issues
- Provide actionable recommendations
- Follow-up on implementation

**"Controls over cash handling are weak"**

**VS**

**"Cash deposits are not reconciled daily, increasing the risk of misappropriation. We recommend implementing a daily reconciliation process with management oversight."**

# Reporting on Internal Controls

**Best Practices for Internal Control Reporting:**

- Use clear and concise language
- **Prioritize significant issues**
- Provide actionable recommendations
- Follow-up on implementation

An auditor identifies multiple control weaknesses in a company's purchasing process, including:

- **Minor**: Purchase orders sometimes lack detailed descriptions.
- **Major**: Large purchases are processed without required approvals.
- **Critical**: Payments were made to fictitious vendors, indicating fraud.

# Reporting on Internal Controls

**Best Practices for Internal Control Reporting:**

- Use clear and concise language
- Prioritize significant issues
- **Provide actionable recommendations**
- Follow-up on implementation

**Weak Recommendation:**
*The company should improve its inventory controls to reduce shrinkage.*

**Strong Recommendation:**
*To reduce inventory shrinkage, the company should:*

1. *Conduct surprise stock counts quarterly.*
2. *Restrict system access so only authorized personnel can modify inventory records.*
3. *Install surveillance cameras in storage areas to monitor movements.*

# Reporting on Internal Controls

**Best Practices for Internal Control Reporting:**

- Use clear and concise language
- Prioritize significant issues
- Provide actionable recommendations
- **Follow-up on implementation**

**Sample Follow-Up Process (on recommending performance of monthly bank recon):**
Initial Report (Quarter 1): Identified issue and recommended monthly reconciliations.

1. Follow-Up (Quarter 2): Checked whether reconciliations were performed as recommended.
2. Outcome: Found that reconciliations were now done but not reviewed by a supervisor.
3. Next Steps: Recommend management review and sign off on all reconciliations.

# POLL QUESTION # 15

# POLL QUESTION # 16

# POLL QUESTION # 17

# POLL QUESTION # 18

# POLL QUESTION # 19

# POLL QUESTION # 20

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# THANK YOU!