Section 404 Audits of Internal Control and Control Risk

I. Introduction

Preparation Questions: Which of the GAAS fieldwork standards requires and understanding of internal controls?

What is the difference between getting an understanding of internal controls for public versus private companies?

What is the definition of internal controls?

Which of the COSO objectives (reliability of financial reporting, effectiveness and efficiency of operations, and compliance with applicable laws and regulations) is/are of primary concern to auditors?

Preparation Question: Complete the following table with one example for each objective assuming that transactions involving the payroll cycle are under examination. Recognize that there will be a wide variety of appropriate answers for this question.

<table>
<thead>
<tr>
<th>Transaction Related Audit Objectives</th>
<th>Potential Misstatement (Error or Fraud)</th>
<th>Internal Control to Prevent Misstatement</th>
</tr>
</thead>
<tbody>
<tr>
<td>Occurrence</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Completeness</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Accuracy</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Classification</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Timing</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Posting and Summarizing</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
II. Responsibilities
A. Management → Design, implementation, and maintenance
   1. Provide reasonable assurance (remote likelihood that material misstatement will not be detected on a timely basis)
   2. Inherent limitations (lack of competence and dependability, management override, or collusion)

B. Management → Section 404 Report
   1. State management’s responsibility
   2. Assess effectiveness of:
      o Design of controls
      o Operation
   3. Material weaknesses must be disclosed

C. Auditor
   1. GAAS Fieldwork Standard #2, quality of internal controls affects the nature, timing and extent of substantive tests.
      o Reliability of financial reporting (financial statements)
      o Classes of transactions (inputs and processing)
   2. SOX Sec. 404
      o Attest and issue report on management’s assessment of the company’s internal control.

III. Components of Internal Control Systems

A. Control Environment – what is management’s and owners’ level of commitment?
   * Integrity and ethical values
   * Commitment to competence
   * Board of Directors and audit committee participation (PCAOB Std. 5 – auditor must evaluate effectiveness of audit committee; privately held – “those charged with governance” – strategic direction and accountability)
   * Philosophy and operating style
   * Organizational structure
   * Human resource policies and practices
B. Risk Assessment
* Identify factors affecting risks
* Assess significance of risks and likelihood of occurrence
* Determine actions necessary to manage risks
* Plan and design adequate controls in light of management assertions.

C. Control Activities
1. Adequate separation of duties
   * custody from accounting
   * authorization of transactions from custody of asset
   * operational responsibilities from record keeping
   * separation of IT duties from users

   * Assumption about the players:
     * controller – accounting
     * treasurer – cash receipts and disbursements

   Example: Problem 10-36

<p>| | | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

2. Proper authorization of transactions and activities
   * general
   * specific
   * authorization (policy decision) vs. approval (implementation)

3. Adequate documents and records
   * pre-numbered and accounted for
   * timing
   * multiple-use
   * easy to use (hard to mess up)
   * chart of accounts
   * systems manuals

4. Physical control over assets and records
   * physical safeguards
   * computer equipment
accountability
access controls
backup and recovery procedures

5. Independent checks on performance
almost anyone can do.
anytime data entered or manipulated.
SAS 109 requires understanding of reconciliation process

D. Information and communication – initiate, record, process and report transactions and maintaining accountability.

E. Monitoring
- Internal auditing – independence different, but still important
- AU 322 – using information provided by the internal auditors.
- PCAOB Standard 5 – using internal auditors when do Section 404 work

**Preparation question:** What is the greatest (or maybe scariest) limitation of any internal control system?

IV. Understand Internal Controls (Design and implementation)

SAS 109 and PCAOB Std. 5 require obtain and document understanding.

Purpose of Understanding Internal Controls
- Identifying type of potential misstatements.
- Recognizing likelihood of misstatements occurring.
- Determining the nature, timing, and extent of tests to be performed.
- Considering audibility of financial statements.
  ➔ If records not auditable, must disclaim or withdraw.

A. Evidence of Understanding
1. Update and evaluate previous experience with client
2. Make inquiries of client
3. Examine documents, records, reports, and prior year working papers.
4. Observe control related activities
5. Perform walkthroughs (reperformance)

B. Documentation
1. Narrative – written, detailed, step-by-step ➔ what documents (original and copies), who does what to document (original or copy), what control procedures proscribed.
2. Flowchart – overview of the workings of the internal control structure, easier to follow, broader
3. Questionnaire – checklist reminder of many different types of controls
   
   Advantages:
   * Complete and quick
   * Easy to do (yes/no)

   Disadvantages
   * Narrow/single area
   * Many items N/A
   * Mechanized fashion / don’t think

   Conclusion/summary – How are the internal controls intended to operate? Have minimal knowledge of effectiveness.

V. Assess Control Risk based on understanding and assumes controls followed.

A. Identifying Internal Control Weaknesses (misstatement could occur)
   1. Complete a control risk matrix:
      a. Identify TRAO that applies to type of transaction.
      b. Identify specific controls (key controls) that client has for TRAO under consideration.
      c. Identify weaknesses.
      d. What key controls are missing which assure the TRAOs being fulfilled?
      e. What’s the potential misstatement?
      f. Consider compensating controls.

   2. Evaluating absence of internal controls
      a. control (design or operational) deficiency – design or operation does not permit company personnel to prevent or detect misstatements on a timely basis.
      b. significant deficiency (more than remote likelihood and more than inconsequential)
      c. material weakness (more than remote likelihood of material misstatement – focus on degree of likelihood and significance of amount)
      d. Must communicate b or c in writing immediately to those charged with governance (audit committee and management). Due no later than 60 days after audit report release.
      e. Letter to management – not required by the auditor, but very typically done

   3. Decide on an initial estimate of control risk (CR).

B. Initial choices for CR level for privately held company (CR set by segment)
   1. Never zero → inherently human, collusion always possible
   2. 100% → go straight to substantive testing
      a. Policies and procedures do not apply
      b. Internal controls not effective, implemented, enforced
      c. Evaluating internal controls inefficient
3. Reduce CR based on current evidence of understanding, which reduces substantive testing (typically CR = M).

4. Foresee further reduction of CR (move CR to L) through additional testing.
   a. must have additional evidence available
   b. additional testing must be cost effective

5. If choose 3 or 4 above do Tests of Controls.
   Three potential results of additional control testing:
   - reduce CR further (set at L), therefore further reduce substantive testing.
   - CR choice supported (less than 100%, probably M) – see 3.
   - raise CR (= H), if controls not effective, circumvented, ignored, etc. In other words, increase substantive testing.

C. Publicly-traded – assume low CR, with intent to support through tests of controls.

VI. Test of Controls – examines effectiveness of internal control system

A. Types of procedures (timing and sample sizes)
   1. Make inquiries
   2. Examine documents, records, reports
   3. Observe control related activities
   4. Reperform client procedures

B. Extent of procedures
   1. Prior year audit evidence – SAS 110 rotation testing (3 years), test controls that have changed
   2. Test (a lot) controls related to significant risks
   3. Less than entire audit period – okay, unless change in controls.

Use results of tests of controls to determine final level for Control Risk – this decision has a major influence on the timing, extent, and type of substantive tests.

VII. Reporting on Internal Controls

Public auditor and SEC 404
A. What
   1. Opinion on management’s assessment
   2. Opinion on effectiveness of Internal Controls

B. Types
   1. Unqualified
      a. No Identified material weaknesses
      b. No restriction on scope
   2. Adverse – material weakness exists
   3. Qualified or disclaimer – scope limited

Non-public – no audit of internal controls required (SAS 112 requires written report to those charged with governance)
Preparation Questions:
1. What is the difference between the execution of the A and B audit?

2. In which audit was the auditor wrong about her/his initial belief about the quality of the client’s internal control system?

3. In which audit was the understanding done simultaneously with the tests of controls?

4. Which audit was not executed in a cost effective manner?

5. In which audit did the auditor likely not complete tests of controls?

6. Which audit plan(s) is/are relying primarily on tests of details of balances for achieving a high level of assurance?

7. Which audit plan(s) is/are relying primarily on tests of controls for achieving a high level of assurance?

<table>
<thead>
<tr>
<th>Audit</th>
<th>A</th>
<th>B</th>
<th>C</th>
<th>D</th>
<th>E</th>
</tr>
</thead>
<tbody>
<tr>
<td>Control Risk after obtaining an understanding of internal controls</td>
<td>70%</td>
<td>90%</td>
<td>100%</td>
<td>50%</td>
<td>70%</td>
</tr>
<tr>
<td>Control risk after completing test of controls</td>
<td>40%</td>
<td>40%</td>
<td>100%</td>
<td>50%</td>
<td>100%</td>
</tr>
</tbody>
</table>

If time permits: Do Case 10-42 as an example.
Timeline View of the Audit Process
Potential Client: Medium Sized Private Company

Communication initiated. Making a bid or offer:
- Interview key personnel
- Financial Statements
- Prior audit reports
- Journals/ledgers
- Minutes
- Contracts
- Organizational chart, etc.
- Previous auditor?

Understanding:
- Flow charts
- Narrative
- Questionnaire
Tests of controls
Substantive tests of transactions
Preliminary Analytical Procedures

Potentially:
- Tests of Controls
- Substantive Tests of Transactions
- Analytical Procedures

Definitely:
- Tests of Details of Balances
- Other final stuff (AP)

Fiscal year end 12/31/03

Fiscal year end 12/31/04

January - March

Engagement Letter

Firm Policy Issue Report