

STATEMENT 3.240

AUDITING GUIDELINE

INTERNAL CONTROLS

Introduction

1. Paragraph 6 of the Statement of Auditing Standard No. 3.101 "Audit Approach" states that:

'If the auditor wishes to place reliance on any internal controls, he should ascertain and evaluate those controls and perform compliance tests on their operation.'

This Auditing Guideline, which gives guidance on how that paragraph may be applied, should be read in conjunction with the Explanatory Foreword to Auditing Standards and Guidelines including the Glossary of Terms.

Background

2. At an early stage in his work the auditor will have to decide the extent to which he wishes to place reliance on the internal controls of the entity. As the audit proceeds, that decision will be kept under review and, depending on the results of his examination, he may decide to place more or less reliance on these controls.

Management responsibility for internal control

3. An internal control system is defined as being

'the whole system of controls, financial and otherwise, established by the management in order to carry on the business of the entity in an orderly and efficient manner, ensure adherence to management policies, safeguard the assets and secure as far as possible the completeness and accuracy of the records. The individual components of an internal control system are known as "controls" or "internal controls".'
4. It is a responsibility of management to decide the extent of the internal control system which is appropriate to the entity. The nature and extent of controls will vary between entities and also from one part of an entity to another. The controls used will depend on the nature, size and volume of the transactions, the degree of control which members of management are able to exercise personally, the geographical distribution of the entity and many other factors. The choice of controls may reflect a comparison of the cost of operating individual controls against the benefits expected to be derived from them.

5. The operating procedures and methods of recording and processing transactions used by small entities often differ significantly from those of large entities. Many of the internal controls which would be relevant to the larger entity are not practical, appropriate or necessary in the small entity. Managements of small entities have less need to depend on formal internal controls for the reliability of the records and other information, because of their personal contact with, or involvement in, the operation of the entity itself.

Limitations on the effectiveness of internal controls

6. No internal control system, however elaborate, can by itself guarantee efficient administration and the completeness and accuracy of the records; nor can it be proof against fraudulent collusion, especially on the part of those holding positions of authority or trust. Internal controls depending on segregation of duties can be avoided by collusion. Authorisation controls can be abused by the person in whom the authority is vested. Management is frequently in a position to override controls which it has itself set up. Whilst the competence and integrity of the personnel operating the controls may be ensured by selection and training, these qualities may alter due to pressure exerted both within and without the entity. Human error due to errors of judgement or interpretation, to misunderstanding, carelessness, fatigue or distraction may undermine the effective operation of internal controls.

The auditor's use of internal controls

7. The auditor's objective in evaluating and testing internal controls is to determine the degree of reliance which he may place on the information contained in the books of account. If he obtains reasonable assurance by means of compliance tests that the internal controls are effective in ensuring the completeness and accuracy of the books of account and the validity of entries therein, he may limit the extent of his substantive testing.
8. Because of the inherent limitations in even the most effective internal control system, it will not be possible for the auditor to rely solely on its operation as a basis for his opinion on the financial statements.
9. In some entities the auditor may be unable to determine whether all the transactions have been reflected in the books of account unless there are effective internal controls.
10. The types of internal controls on which the auditor may seek to rely vary widely. An appendix contains a description of some of the main types of internal controls which the auditor may find and on which he may seek to place some degree of reliance.

Procedures

Audit procedures in relation to internal controls

11. The auditor will need to ascertain and record the internal control system in order to make a preliminary evaluation of the effectiveness of its component controls and to decide the extent of his reliance thereon. This recording will normally be carried out concurrently with the recording of the accounting system. As indicated in the guideline on accounting systems the auditor may find it helpful to trace one or two transactions through the system.
12. The evaluation of internal controls will be assisted by the use of documentation designed to help identify the internal controls on which the auditor may wish to place reliance. Such documentation can take a variety of forms but might be based on questions asking either:
 - a. whether controls exist which meet specified overall control objectives; or
 - b. whether there are controls which prevent or detect particular specified errors or omissions.
13. Where this preliminary evaluation indicates that there are controls which meet the objective which the auditor has identified, he should design and carry out compliance tests if he wishes to rely on them. Where, however, the preliminary evaluation discloses weaknesses in, or the absence of, internal controls, such that material error or omission could arise in the books of account or financial statements, the auditor will move directly to designing and carrying out substantive tests.

Compliance tests

14. The auditor is not entitled to place any reliance on internal controls based solely on his preliminary evaluation. He should carry out compliance tests to obtain reasonable assurance that the controls on which he wishes to rely were functioning both properly and throughout the period. It should be noted that it is the control which is being tested by a compliance test, and not the transaction which may be the medium used for the test. For this reason the auditor should record and investigate all exceptions revealed by his compliance testing, regardless of the amount involved in the particular transaction. (An 'exception' in this context is an occurrence where a control has not been operated correctly whether or not a quantitative error has occurred.)

15. If compliance tests disclose no exceptions the auditor may reasonably place reliance on the effective functioning of the internal controls tested. He can, therefore limit his substantive tests on the relevant information in the books of account.
16. If the compliance tests have disclosed exceptions which indicate that the control being tested was not operating properly in practice, the auditor should determine the reasons for this. He needs to assess whether each exception is only an isolated departure or is representative of others, and whether it indicates the possible existence of errors in the books of account. If the explanation he receives suggests that the exception is only an isolated departure, then he must confirm the validity of the explanation, for example by carrying out further tests. If the explanation or the further tests confirm that the control being tested was not operating properly throughout the period, then he cannot rely on that control. In these circumstances the auditor is unable to restrict his substantive testing unless he can identify an alternative control on which to rely. Before relying on that alternative control he must carry out suitable compliance tests on it.

Timing and scope of the review and testing of internal controls

17. If reliance is to be placed on the operation of controls, the auditor should ensure that there is evidence of the effectiveness of those controls throughout the whole period under review. Compliance tests carried out at an interim date prior to the year end need, therefore, to be supplemented by tests of controls for the remainder of the year; alternatively, the auditor will need to carry out other procedures to enable him to gain adequate assurance as to the reliability of the accounting records during the period which has not been subject to compliance tests. In determining the alternative procedures which are necessary he should consider:
 - a. the results of earlier compliance tests;
 - b. whether, according to enquiries made, controls have remained the same for the remaining period;
 - c. the length of the remaining period;
 - d. the nature and size of the transactions and account items involved; and
 - e. the substantive tests which he will carry out irrespective of the adequacy of controls.

18. Where the internal control system has changed during the accounting period under review, the auditor will have to evaluate and test the internal controls on which he wishes to rely, both before and after the change.

Reliance on internal audit

19. Internal audit is an element of the internal control system set up by management. The extent to which the external auditor is able to take account of the work of the internal auditor will depend on his assessment of the effectiveness of the internal audit function. In making this assessment, the external auditor will be concerned with:
- a. the degree of independence of the internal auditor from those whose responsibilities he is reviewing;
 - b. the number of suitably qualified and experienced staff employed in the internal audit function;
 - c. the scope, extent, direction and timing of the tests made by the internal auditor;
 - d. the evidence available of the work done by the internal auditor and of the review of that work;
 - e. the extent to which management takes action based upon the reports of the internal audit function.
20. Provided that relevant internal audit work has been carried out effectively, the external auditor may be able to reduce the level of his tests.

Reporting to management on internal controls

21. It is important that the auditor should report, as soon as practicable, significant weaknesses in internal controls which come to his attention during the course of an audit to an appropriately senior level of management of the entity. Any such report should indicate that the weaknesses notified are only those which have come to the attention of the auditor during the course of his normal audit work and are not necessarily, therefore, all the weaknesses which may exist.
22. The fact that the auditor reports weaknesses in internal controls to management does not absolve:
- a. management from its responsibility for the maintenance of an adequate internal control system; or
 - b. the auditor from the need to consider the effect of such weaknesses on the extent of his audit work and on his audit opinion.

Appendix

Types of internal controls

The following is a description of some of the types of controls which the auditor may find in many entities and on some or a combination of which he may seek to place some degree of reliance.

1. *Organisation.* Entities should have a plan of their organisation, defining and allocating responsibilities and identifying lines of reporting for all aspects of the entity's operations, including the controls. The delegation of authority and responsibility should be clearly specified.
2. *Segregation of duties.* One of the prime means of control is the separation of those responsibilities or duties which would, if combined, enable one individual to record and process a complete transaction. Segregation of duties reduces the risk of intentional manipulation or error and increases the element of checking. Functions which should be separated include those of authorisation, execution, custody, recording and, in the case of a computer-based accounting system, systems development and daily operations.
3. *Physical.* These are concerned mainly with the custody of assets and involve procedures and security measures designed to ensure that access to assets is limited to authorised personnel. This includes both direct access and indirect access via documentation. These controls assume importance in the case of valuable, portable, exchangeable or desirable assets.
4. *Authorisation and approval.* All transactions should require authorisation or approval by an appropriate responsible person. The limits for these authorisations should be specified.
5. *Arithmetical and accounting.* These are the controls within the recording function which check that the transactions to be recorded and processed have been authorised, that they are all included and that they are correctly recorded and accurately processed. Such controls include checking the arithmetical accuracy of the records, the maintenance and checking of totals, reconciliations, control accounts and trial balances, and accounting for documents.
6. *Personnel.* There should be procedures to ensure that personnel have capabilities commensurate with their responsibilities. Inevitably, the proper functioning of any system depends on the competence and integrity of those operating it. The qualifications,

selection and training as well as the innate personal characteristics of the personnel involved are important features to be considered in setting up any control system.

7. *Supervision.* Any system of internal control should include the supervision by responsible officials of day-to-day transactions and the recording thereof.
8. *Management.* These are the controls exercised by management outside the day-to-day routine of the system. They include the overall supervisory controls exercised by management, the review of management accounts and comparison thereof with budgets, the internal audit function and any other special review procedures.