

INTERNAL CONTROLS EVALUATION

- **Planning an Internal Controls Evaluation Project**
- **Internal Control Documentation**
- **Internal Control Testing**
- **Evaluation of Internal Control Deficiency**
- **Reporting**

Internal Control Definition

Internal control is broadly defined as a process, effected by an entity's board of directors, management and other personnel, designed to provide reasonable assurance regarding the achievement of objectives in the following categories:

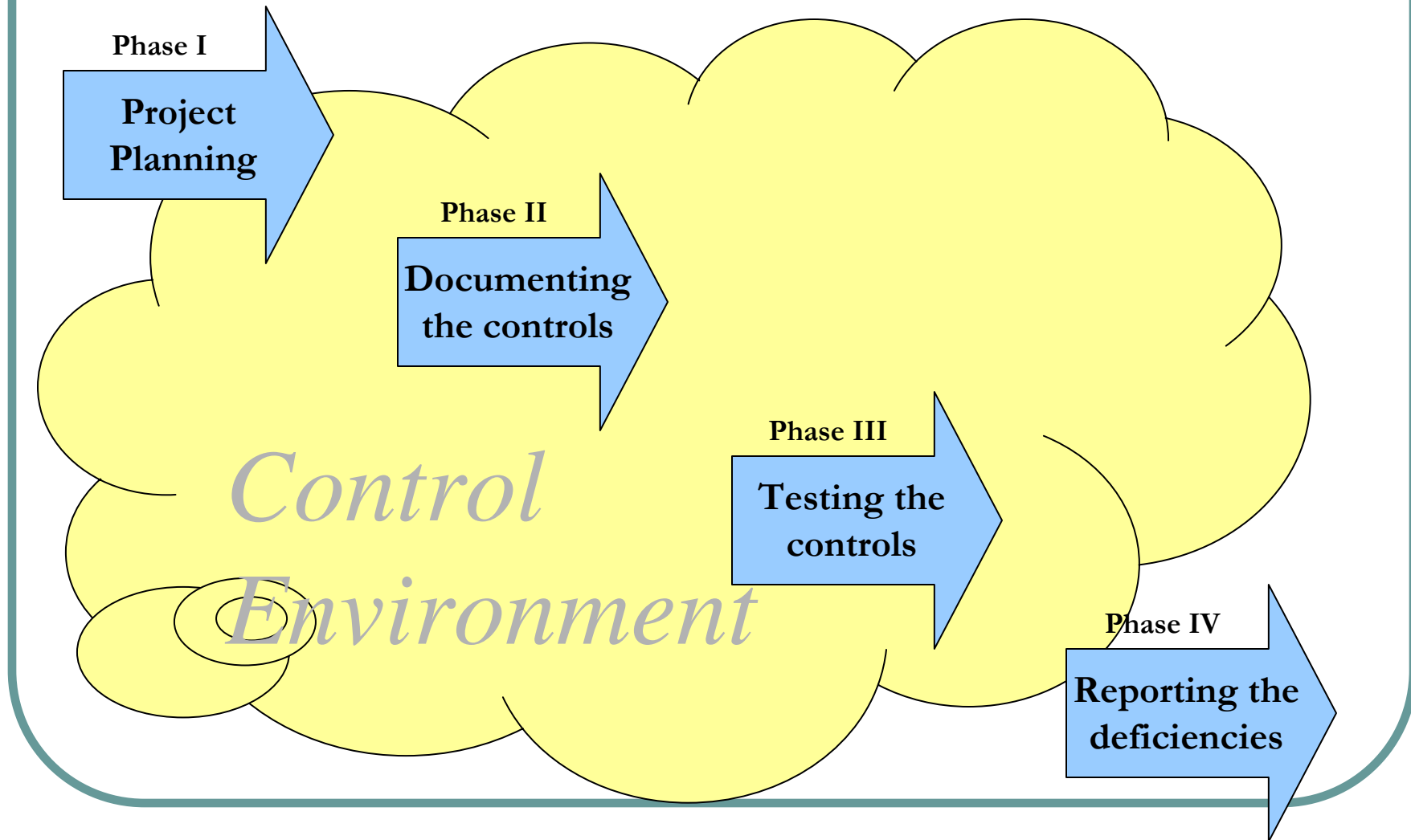
1. Effectiveness and efficiency of operations.
2. Reliability of financial reporting.
3. Compliance with applicable laws and regulations.

(www.coso.org)

Why Internal Controls Evaluation?

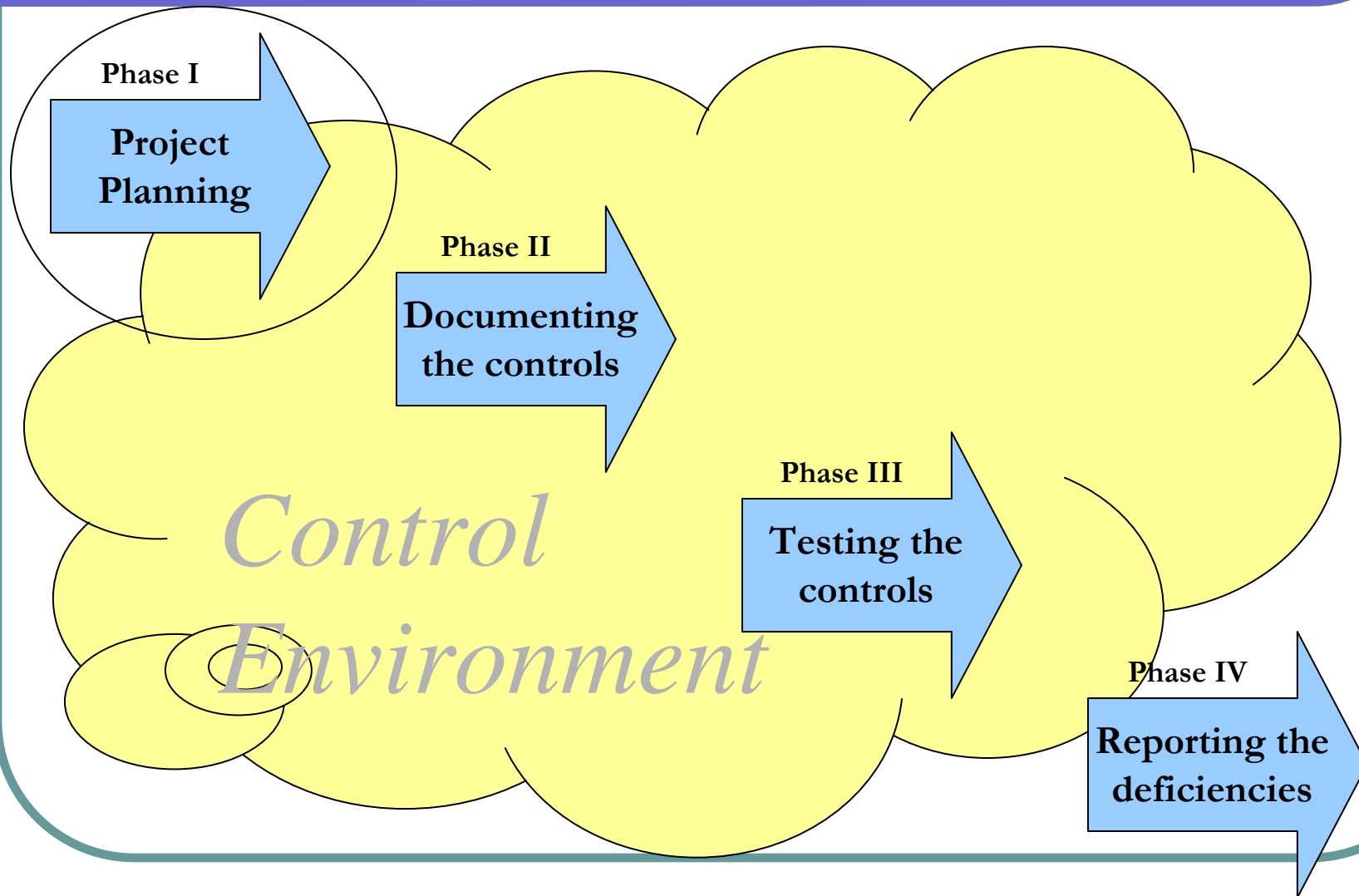
- Enhanced investors' confidence
- Risk mitigation
- Improved business processes
- Better control over operations
- Reduced losses
- Regulatory compliance
- The best practices

Internal Controls Evaluation Project



Phase I: Project Planning

Internal Controls Evaluation Project



Getting Started / Project Initiation

- Identify the Project Sponsor and get support from Audit Committee and Top Management
- Establish a cross-functional team
- Appoint the Team Leader, ideally he must be one of Chief Audit Officer, Chief Financial Officer or Chief Risk Officer.
- Determine the project scope
- Arrange logistics for the project team

Planning an Internal Control Evaluation

- Finalize the project scope
- Get an understanding of the business
- Identify key business processes e.g. Sales & AR, Purchases & AP etc. and their sub-processes
- Identify the company locations where the assessment will be performed
- Perform a risk assessment for the business processes

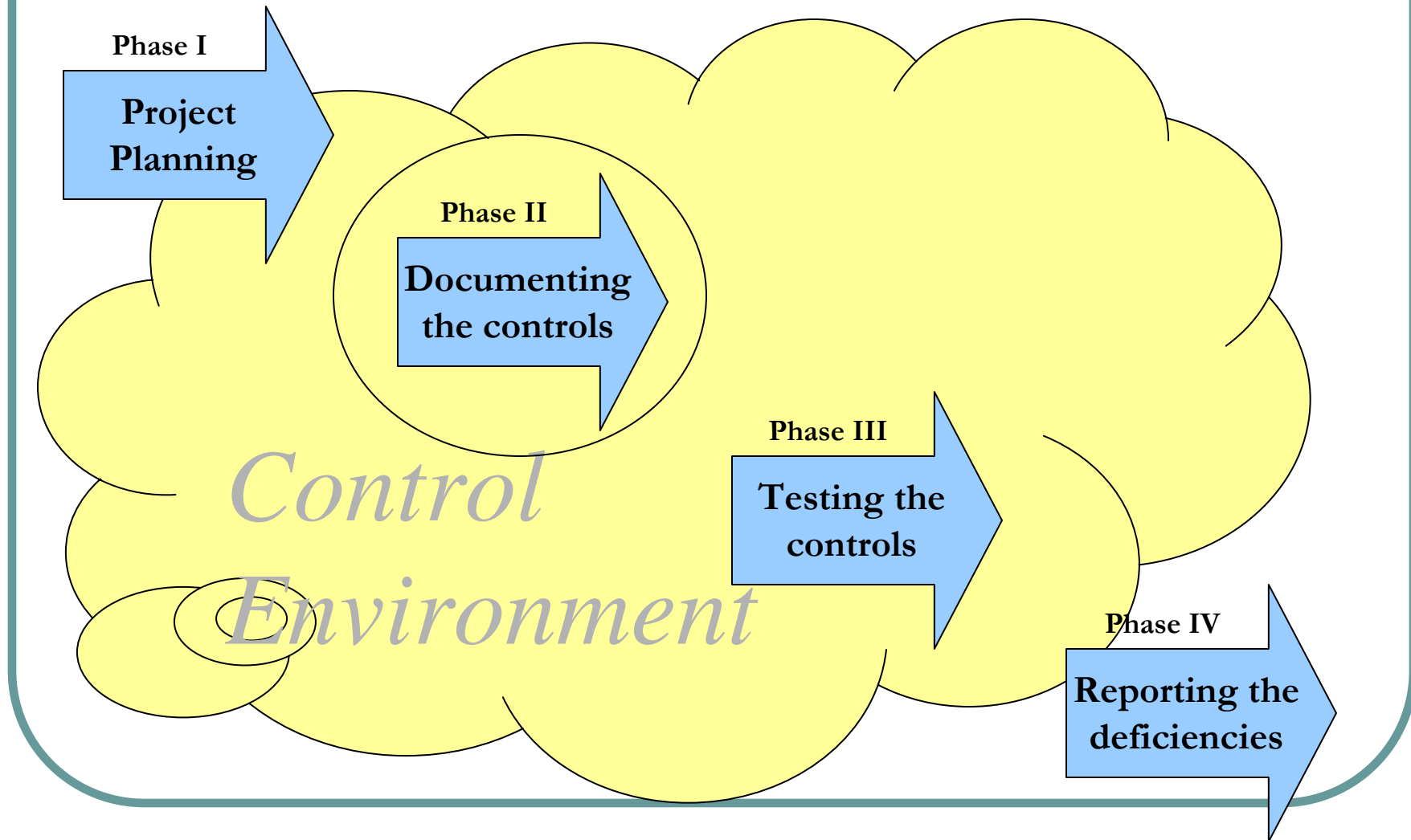
Key Considerations in Risk Assessment

- Materiality of transactions for each business process
- Susceptibility of errors or frauds
- Nature of the process (for example, reconciliation of suspense accounts generally warrant greater attention)
- Accounting and reporting complexities associated with the account
- Exposure to losses represented by the process (for example, loss arising due to cash transactions)
- Likelihood (or possibility) of significant contingent liabilities arising from the activities represented by the process
- Existence of related-party transactions in the process
- Changes in the processes attributes since the previous period (for example, new complexities, subjectivity, or types of transactions)



**Phase II:
Internal Control Documentation**

Internal Controls Evaluation Project



Process of Documenting Internal Controls

- Identify key business processes
- Develop the system flow charts
- Identify key controls
- Develop the “Risk & Control Matrix”.

Sample Business Processes

Revenues

- Customer master file maintenance
- Pricing and order processing
- Invoicing
- Credit and collections
- Returns
- Cash application and receipts processing
- Revenue recognition
- Incentive programs
- Reconciliation & Write offs

Sample Business Processes

Purchasing

- Vendor master file maintenance
- Requisitions
- Purchase orders
- Goods receiving
- Invoice processing
- Cash disbursements
- Reconciliation

Sample Business Processes

Inventory and Production

- Inventory master file maintenance
- Inventory quantity control
- Obsolete and slow-moving inventory control
- Shipping activities
- Production activities
- Receiving activities
- Inventory costing

Sample Business Processes

Payroll and Employee Benefits

- Payroll and employee master file maintenance
- Time and attendance
- Processing payroll
- Pension and post retirement benefits
- Management incentive and stock option programs
- Payroll disbursement
- Payroll reconciliation

Sample Business Processes

Capital Spending and Maintenance

- Capital master file maintenance
- Capital acquisition requests
- Depreciation
- Disposals
- Leases (operating, capital)

Sample Business Processes

Financial Reporting (including period-end reporting)

- Planning, budgeting, and management reporting
- General ledger maintenance
- Consolidation and adjusting, eliminating and consolidating entries
- Accounting policies and procedures
- Account analysis and reconciliations
- Currency translation
- Inter-company accounts
- Adoption of new accounting pronouncements

Sample Business Processes

Treasury and Risk Management

- Debt and related interest
- Cash Management
- Investments and related interest
- Equity
- Hedging and derivatives
- Workers compensation and other self-insurance programs
- Legal exposures
- Environmental exposures
- Guarantees and other commitments

Sample Business Processes

Taxes

- Income taxes (local, state and federal)
 - effective tax rate
 - valuation allowances
 - tax contingency considerations
- Sales taxes
- Property taxes

Sample Business Processes

Information Systems

- Control environment
- Program development
- Program changes
- Access to programs and data (security access)
- Computer operations
- Network Security
- Physical Security

Sample Business Processes

Others / Miscellaneous

- Restructurings and impairments
- Prepaid and other miscellaneous assets
- Other miscellaneous liabilities and accruals
- Equity method investments
- Miscellaneous other income and expense
- Purchase accounting
- Discontinued operations

Flowcharts

- Keep the main flow of activities and controls in a vertical line down the middle of the flowchart.
- To the left and right of the flowchart, add the main input and output documents and computer files.
- The sequence of activities should flow from top to bottom.
- Each flowchart should take up no more than one printed page. If a flowchart is larger than one page, activities should be grouped into higher-level processes and documented in separate flowcharts.

Flowcharts Levels

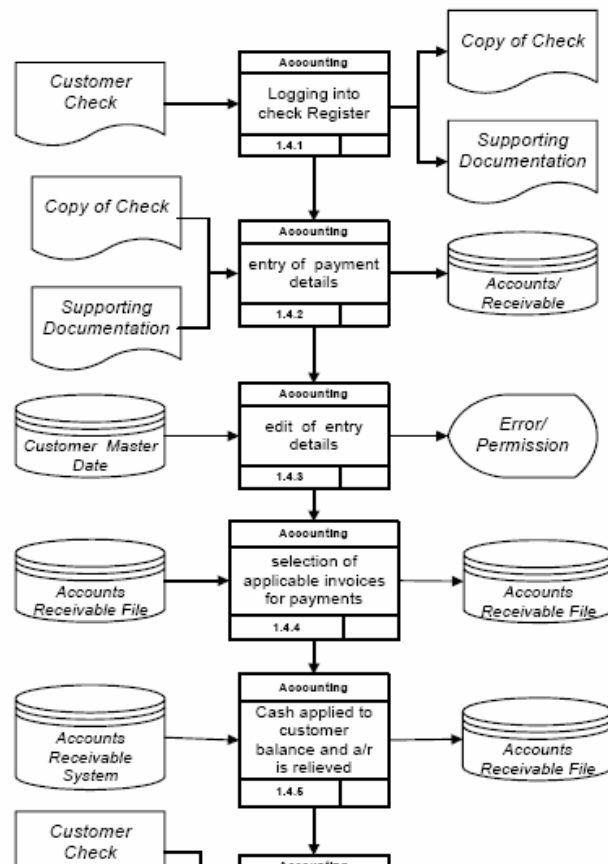
- The detailed operations and controls that are associated with a company's various business processes can be documented in flowcharts, with each main activity in a given process being assigned its own chart. Documentation at each level should contain a meaningful amount of information without providing too much data.
 - Level 1: Overview of the process containing each of the main activities
 - Level 2: Breakdown of the main activities into sub-activities
 - Level 3: More detailed description of the sub-activities
- A set of flowcharts that describes every process in detail become very difficult to read because there is little information on the higher levels.
- A highly complex single-level flowchart may be difficult for the reader to understand.

Sample Flowchart

Process Flow & Controls Map	Description
<pre> graph TD A["Sales Dept. Order 1.1"] --> B["Production Dept. Delivery, Distribution 1.2"] B --> C["Accounting Invoicing 1.3"] C --> D["Accounting Cash Receipt/ Payment 1.4"] </pre>	<p>1.1 Creation of sales order: The creation of sales orders is initiated by a customer's order. The order management functions receive the order and enter all order data into the Sales and Accounts Receivable (SAR) system to create a sales order. The Sales Department creates the sales order in SAR by using a special item category in the sales order that automatically generates a delivery note.</p> <p>1.2 Delivery and Distribution: Goods are picked for distribution within the production department and dispatched to the customer with the delivery note.</p> <p>1.3 Invoicing: Based on the completed delivery and related delivery note, billing to the customer takes place.</p> <p>1.4 Cash Receipt: The cash application process includes both manual and automated procedures. Cash received into the lockbox(s) is automatically applied to customer accounts via a Cash</p>

Sample Flowchart

Process Flow & Controls Map



Description

1.4.1 The checks are forwarded to the Accounting Supervisor who logs them in a Check Register. The information recorded includes date of check, check number, check amount, customer name/number, and invoices that payment relates to. The Accounting Supervisor makes copies of the checks and sends the check copies along with the invoice hard copy supporting documentation to the Cash Application Department.

1.4.2 A representative of the Cash Application Department (representative) enters the customer number into the Cash Application screen within the Accounts Receivable system. The system validates the customer number against the Customer Master (Standing Data) file within the system.

1.4.3 If the system does not find the number, an error message is displayed indicating the number is invalid. The representative has the option of entering the customer last name and first name into a search screen to locate the customer number. If the system locates the customer master record for the customer number entered, a list of open invoices is generated on to the screen.

1.4.4 The next screen is for the first invoice number selected to apply payment to.

1.4.5 The representative is prompted to enter the amount of payment being applied to the invoice on a field at the top of the screen. The amount will typically match the total invoice amount (listed on the bottom of the screen), but

Risk & Control Matrix

Sub-Process	Control Objective	Description and Frequency of Control Activity	Financial Statement Area (1)	Information Processing Objectives (C,A,V, R) (2)	Assertions (CO, EO, RO, VA, PD) – (3)	P or D (4)	A or M (5)
Invoicing	Sales invoices are accurate.	The billing system receives shipped items from the shipping system and compares, line by line, the shipped items to the original order, making changes to the original order to reflect actual quantities shipped. (Multiple times a day)	Sales	C, A, V	CO, EO, VA	P	A
Invoicing	A sales invoice is generated for every shipment or work order.	Before an invoice is processed, shipment information is matched to customer-order information to ensure the information's accuracy and validity. (Multiple times a day)	Sales	A,V	A,C,E/O	P	A
G/L Posting	Sales are recorded in the proper period.	Management monitors sales and margins to ensure that they are aligned with expectations. (Monthly)	Sales	C, A, V	C,E/O	D	M
G/L	Sales are	The finance department	Sales	C, A, V	C,E/O	D	M

Legend

C, A, V, R:
Completeness, accuracy, validity, restricted access

CO, EO, RO, VA, PD:
Completeness, existence or occurrence, rights & obligations, valuation or allocation, presentation & disclosure

P, D, A, M:
Preventive, detective, automated, manual

Risk & Control Matrix

Example "What Can Go Wrong" Questions

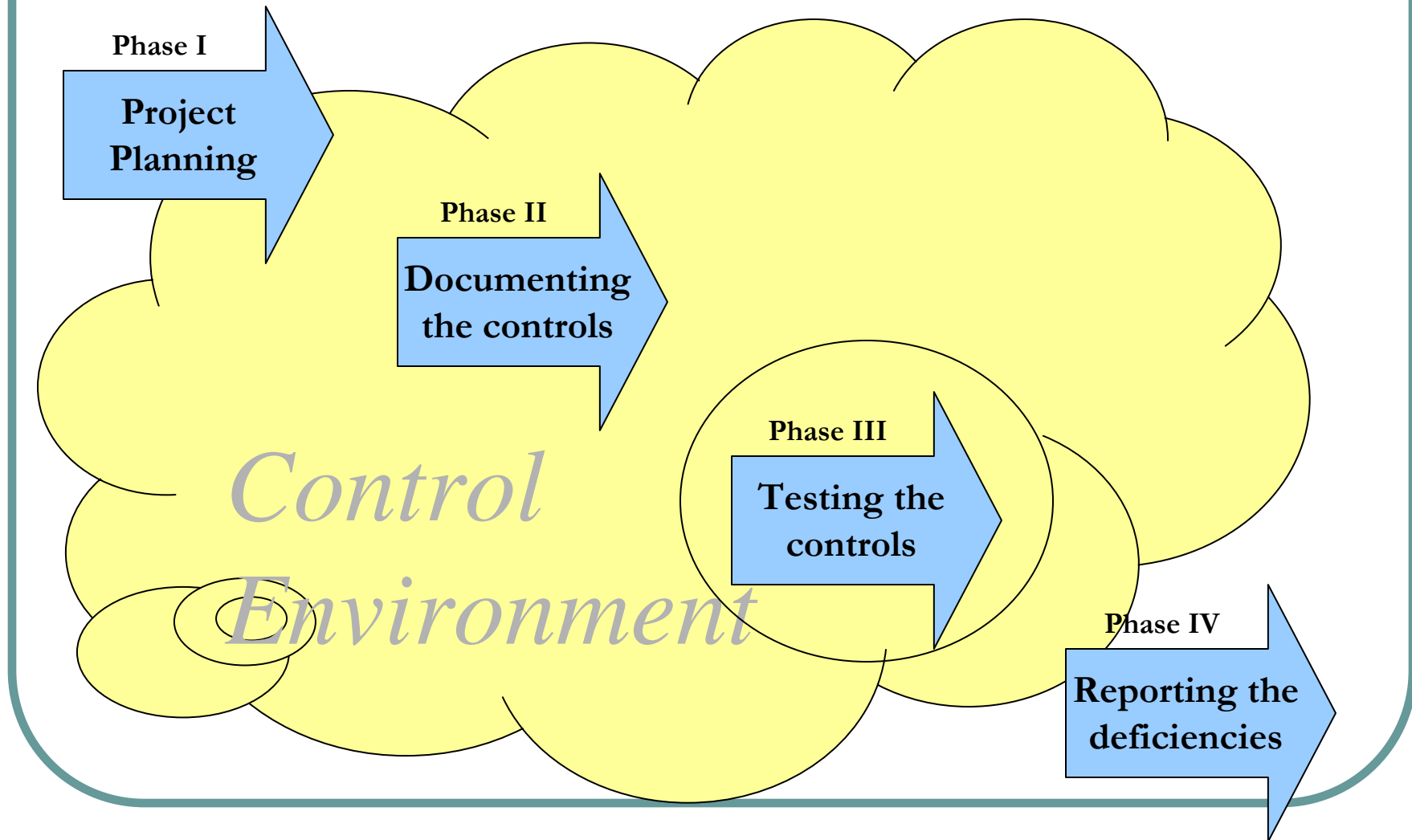
What ensures that coding of purchases is correct?
 What ensures that payables for drop-shipped goods are recorded in a timely manner?
 What ensures that proper cut-off information is generated and used for purchases?

<i>Accounts payable subledger is reconciled to the general ledger.</i>													
<i>Accounts payable subledger/aging is reviewed.</i>													
<i>Accrual for goods received not invoiced is reviewed.</i>													
<i>Advanced bookings are reviewed and approved by management.</i>													
<i>Classification of PP&E versus expense is reviewed.</i>													
<i>Costs by department are reviewed and approved by executive.</i>													
<i>Debit memos are reviewed and approved by executive.</i>													
<i>Debit memos are matched with vendor's invoice and approved by department/division/etc.</i>													
<i>Exceptions to 3-way match (purchase order, invoice) are investigated daily.</i>													
<i>Inventory count crews are supervised.</i>													
<i>Movement of inventories during physical count is controlled.</i>													
<i>Out-of-balance reports are reviewed.</i>													
<i>Significant debit balances in individual vendor accounts are reported, reviewed and authorized.</i>													
IT	IT	IT	IT	IT	IT	IT	IT	P	P	IT			



**Phase III:
Internal Control Testing**

Internal Controls Evaluation Project



Internal Control Testing Process

- Determine the control framework
- Assess the design of controls
- Select the controls to be tested
- Develop test plans
- Assign responsibilities to perform the testing
- Develop and execute the test plans
- Evaluate the test results

The COSO Framework



Control Environment

- Integrity and ethical values
- Commitment to competence and development of people
- Management's philosophy and operating style
- Organizational structure
- Assignment of authority and responsibility
- Human resources policies and procedures
- Participation by those charged with governance (i.e., board of directors, audit committee)

Risk Assessment

	Risk dimension: security	Risk dimension: financial	Risk dimension: legal/compliance
Serial no.	1	2	3
Risk description	Cybercrime, including virus damage, identity theft, spyware, general fraud	Costs associated with online transactions outweigh benefits associated with initiative	Breach of regulations within e-business legislation
Impact	Direct financial loss, reputation damage, equipment damage, system unavailability	Direct financial loss due to increased fees Customer loss due to increased costs	Possible fine and/or legal prosecution
Consequence	Significant	Moderate	Moderate
Likelihood	Likely	Likely	Possible
Level of risk	Extreme	High	Moderate
Risk priority	1	2	3
Treatment options	<ol style="list-style-type: none"> 1. Update anti-virus software and check firewall viability 2. Review requirements to ensure secure online banking 3. Develop and test security policies 4. Develop disaster recovery plan 	Develop business case to identify impact of increased fees	<ol style="list-style-type: none"> 1. Review all legislation 2. Consult solicitor to seek advice 3. Develop and test compliance policies and procedures

Control Activities

- Top level reviews
- Direct functional supervision
- Information processing controls
- Safeguarding of assets / physical controls
- Performance Indicators
- Segregation of Duties

Information & Communication

- Accounting systems
- Policy systems
- Management reports
- Newsletters
- Accounting policy matters
- Technical updates
- Staff meetings
- Training

Monitoring

- On-going monitoring by the management
- Internal audits
- Management reviews
- Audit committee activities
- Disclosure committee activities
- Self-assessment reviews
- Ongoing monitoring
- Special evaluations
- Information systems audit

Assess the design of controls

- The alignment between controls and risks
- Frequency of the control
- Knowledge & experience of people involved in design, implementation and performance of the control
- Level of segregation of duties
- Timeliness in addressing issues and exceptions
- Reliability of information used in performance of control
- Period covered by the control

Assess the design of controls

Less Assurance	Greater Assurance
Manual control	Automated control
Complex control (requires many steps, multiple calculations, etc.)	Simple control (single step, single calculations, etc.)
Control is performed by a junior, inexperienced person	Control is performed by an experienced manager
Detective control (detects a potential problem after a transaction is executed)	Preventive control (prevents a problem)
Single control	Multiple, overlapping controls
High-level control (analytics)	Detailed, transaction-level control
Control uses sampling	Control involves checking all items
Control takes place well after the transaction	Control occurs in real time (i.e., as the transaction takes place)

Selecting Controls for Testing

- Materiality in impact
- Likelihood
- Overall risk rating

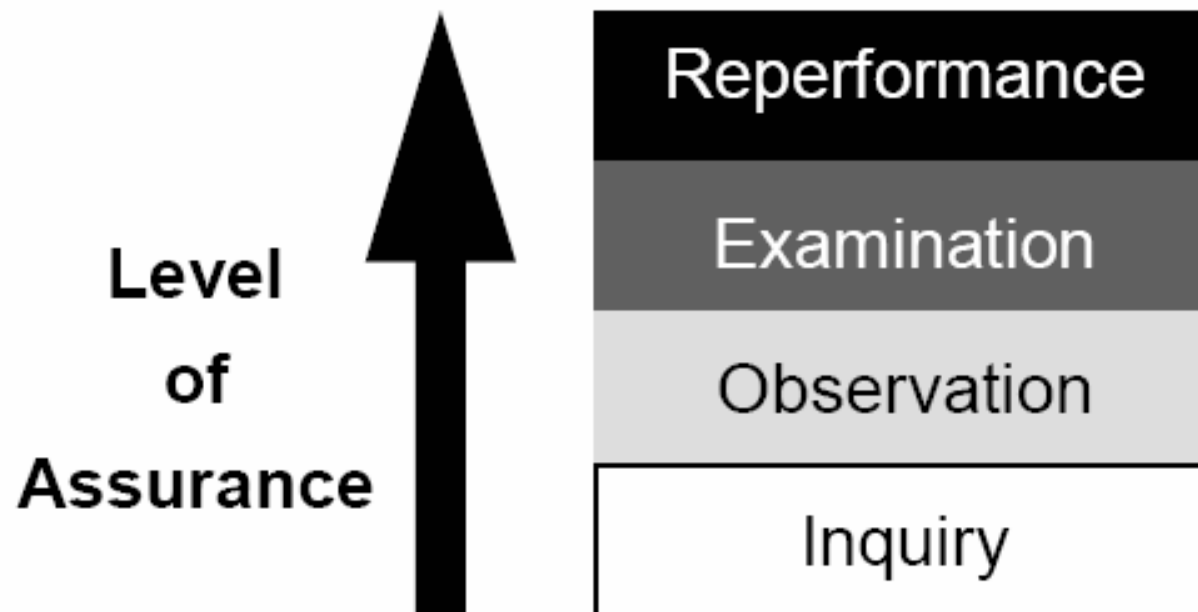
Team for testing the controls

- Experts in Finance, Audit and Operations for manual controls
- Experts in Information Systems, Network, Operating System and Database for automated controls
- Experienced in walkthroughs and controls testing

Develop & execute the test plans

- **Key controls to be tested** – Normally management will summarize the controls to be tested.
- **Nature of tests to be used** – Tests should be categorized as inquiry, observation, examination, or re-performance.
- **Extent of testing** – The plans should specify the number of items that are to be tested and the method and reasons for selecting those items.
- **Timing of procedures** – The plans should specify when the testing should be performed and the time span that the tests cover, including update testing planned from the interim testing date to year-end.
- **Key administrative items** – The plans should identify who will perform the test, when the test will be performed, what evidence will be reviewed, and where the control is performed.
- **Documentation** – The plans should describe the documentation required.
- **Exceptions** – The plans should describe how exceptions will be investigated and addressed and when additional testing should be performed.

Nature of tests



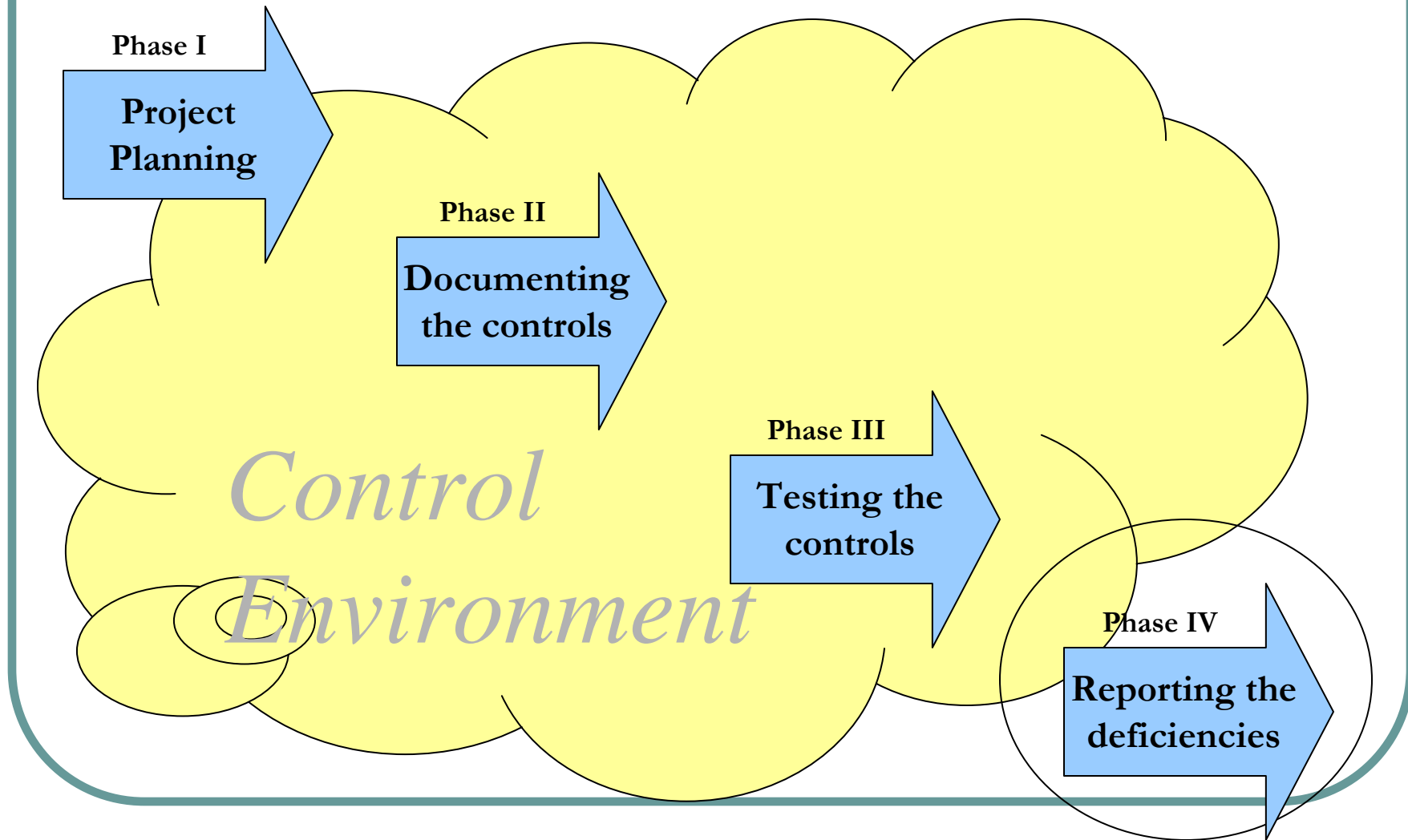
Extent of testing

Frequency of Manual Control's Performance	Typical Number/Range of Times to Test Controls	Factors to Consider When Deciding the Extent of Testing
Annually	1	<ul style="list-style-type: none">■ Complexity of the control■ Significance of judgment in the control operation■ Level of competence necessary to perform the control■ Frequency of operation of the control■ Impact of changes in volume or personnel performing the control■ Importance of the control<ul style="list-style-type: none">● Addresses multiple assertions● Period-end detective control● Only control that covers a particular assertion
Quarterly	2	
Monthly	2 to 5	
Weekly	5 to 15	
Daily	20 to 40	
Multiple Times a Day	25 to 60	



Phase IV: Reporting Deficiencies

Internal Controls Evaluation Project



Evaluation of Internal Control Deficiencies

- Identify the deficiency
- Assess likelihood of potential loss resulting from the deficiency
- Assess magnitude of potential loss resulting from the deficiency
- Identify compensating controls
- Determine the effectiveness and efficiency of compensating controls
- Determine classification of deficiencies
- Assess deficiencies in aggregation with others

Factors affecting evaluation

- Nature of the transaction, financial statement accounts, disclosures, and assertions involved;
- Susceptibility of the related assets or liability to loss or fraud (that is, greater susceptibility increases risk);
- Subjectivity, complexity, or extent of judgment required to determine the amount involved (that is greater subjectivity, complexity, or judgement, like that related to an accounting estimate, increases risk);
- Cause and frequency of known or detected exceptions for the operating effectiveness of a control;
- Interaction or relationship of the control with the other controls (that is, the interdependence or redundancy of the control);
- Interaction of the deficiencies;
- Control environment and motivation for frauds;
- Possible future consequences of the deficiency.

Classification of deficiencies

Deficiencies related to:

- Anti-fraud programs and controls
- Controls over non-routine or non-systematic transactions
- Controls over the period-end financial reporting process and over the selection and application of accounting policies that are in conformity with GAAP
- Information systems controls
- Controls over strategic planning

Reporting the Deficiencies

- Deficiency description
- Likelihood
- Magnitude
- Overall impact
- Risk rating
- Recommendation
- Action plan agreed with the management
- Implementation date of agreed action plan
- Follow-up testing required
- Results of follow-up testing