

# MODULE 3

## Topic 3 – The role of internal controls in preventing/detecting errors

# In this Topic

1. Why do we need to understand internal controls?
2. Systems of Internal Controls (SIC)
3. Gathering evidence of SICs
4. Documenting our understanding of SICs
5. Assessing the design of SICs
6. Preliminary assessment of CR
7. Impact on audit strategy

# Abbreviations

- Systems of Internal Control (SIC)
- Internal Control (IC)

# Context

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# Topic 3.1 - Why do we need to understand the internal controls?

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# Why we need to understand SICs

- ASA 315 tells us we must
- It is part of the audit risk model
- A weakness in the SICs – a gap or poorly operating control – can allow in errors or misstatements
- This increases the ROMMs
- → adjust our audit strategy

# Topic 3.2 – Systems of internal control (SIC)

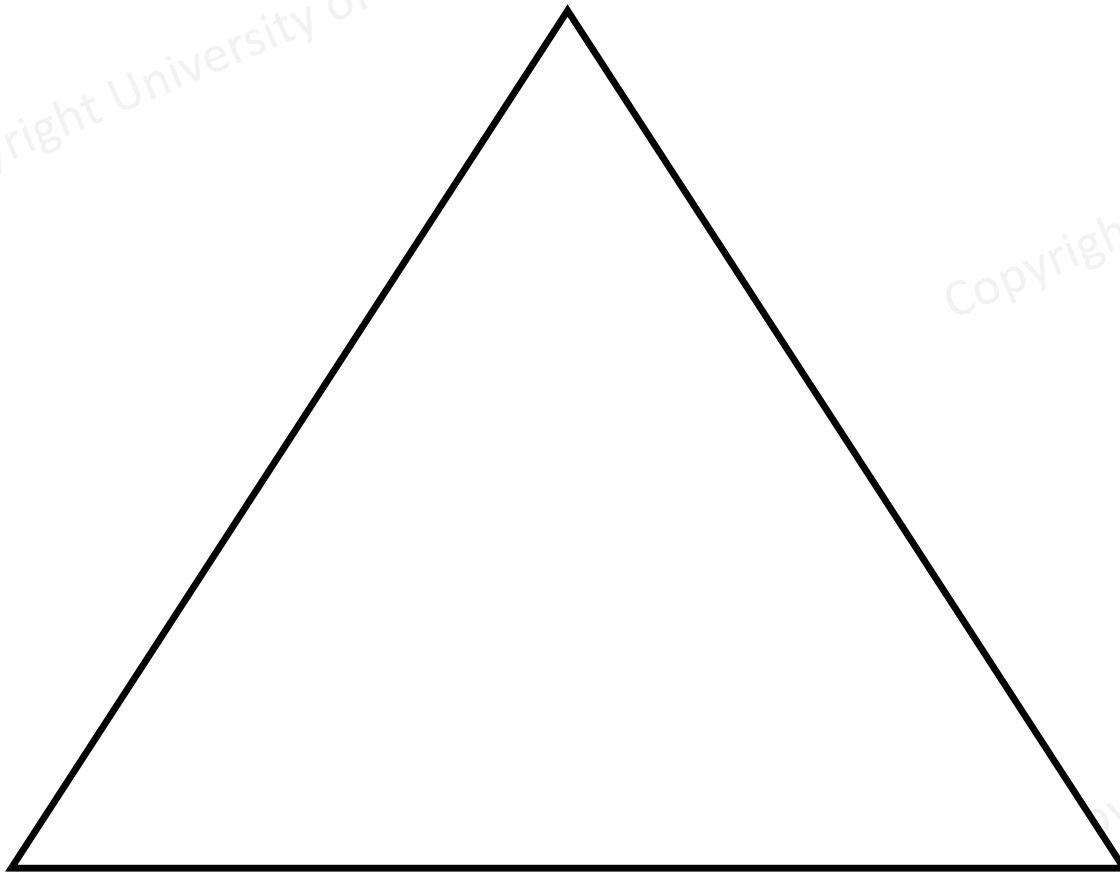


# Are we interested in every internal control?

- ASA315.21 – just the ones related to preparing the financial report
- In reality – this means most internal controls related to every business function

# Reminder of SICs

- Read ASA315.21 to 26



# A note on Control Activities

- Options when you have a risk
  - Prevent the risk from occurring
  - Detect the risk when it does occur
  - Insure against the risk occurring
  - Avoid the risk
  
- Auditors are looking for controls that \_\_\_\_\_ or  
\_\_\_\_\_

# Topic 3.3 - Gathering evidence on systems of internal control

# How do we gather the evidence?

1. Interviewing the client
2. Go for a tour
3. Observe a process flow

# Topic 3.4 - Documenting our understanding of systems of internal control

# Remember ASA 230 requires us to document our work

- 3 main methods to document our understanding of SICs
  - 1. Narrative
  - 2. Flowchart
  - 3. Checklist

# Which method to choose?

	Advantage	Disadvantage
Narrative		
Flowchart		
Checklist		



# Flowcharting – the symbols

Start/end

Process

Manual process

File

Decision

Process

Database (or cloud)

# An example

Felix's Fresh Fruits provides contactless delivery of fresh fruits and vegetables in Sydney. Orders are received when customers place their order and pay on a secure website. Felix prints out the order and prepares the delivery box with the customer's order. At this point, a journal entry is made to recognise unearned revenue. A label is placed on the box and the order is given to the delivery driver. Felix updates the computer system to mark the order as "in transit". Once the driver delivers the item – they use their mobile device to update the system to mark the item as "delivered". This automatically triggers a journal entry to record the sale.

# Topic 3.5 - Assessing the design of the internal controls

Will they prevent or detect misstatements?

# Once we have our flowchart

- What are the internal control activities? Will they prevent or detect misstatements?
- Look for the glaring weaknesses first – gaps or controls that you don't think will work?
- Then work from the assertions for the process
  - Is there a control for each?
  - Could controls be circumvented?
  - If there is a weakness – is there a mitigating control further on in the process?

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# Topic 3.6 - Making the preliminary assessment of Control Risk

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# Low, Medium or High?

- What do each of the ratings mean?
- Strong internal controls, no weaknesses =
- Very poor internal controls, many weaknesses =
- Some internal controls + some weaknesses =

# Topic 3.7 CR, the AR model and audit strategy

# Remember the AR model?

- DR =
- Where there CR is low – is there a lower or higher ROMMs?
- What should our response be on the audit? More work or less?



# Think back to my diagram from earlier

# Things you should be able to do

- Identify the components in the Systems of Internal Controls
- Document a business process
- Identify control activities and control weaknesses
- Make an assessment of CR
- Explain how that will impact your audit strategy