**Unit-2**

**Internal control**

Internal controls are accounting and auditing processes used in a company's finance department that ensure the integrity of financial reporting and regulatory compliance.

Internal controls help companies to comply with laws and regulations and prevent fraud. They also can help improve operational efficiency by ensuring that budgets are adhered to, policies are followed, capital shortages are identified, and accurate reports are generated for leadership.

Internal audit is a process through which internal auditors evaluate a company [internal controls](https://www.accountinghub-online.com/five-components-of-internal-control/). While internal audit primarily focuses on identifying weaknesses in a company’s internal control systems, it also has other aspects. The requirement for having internal auditors stems from corporate governance, which illustrates how companies should be controlled and directed.

Internal audits seek to ensure a company complies with all relevant laws and regulations. It also helps to ensure the company’s financial records are accurate and present a fair view. On top of that, internal auditors are also responsible for risk management in a company.

### **KEY TAKEAWAYS**

* Internal controls are the mechanisms, rules, and procedures implemented by a company to ensure the integrity of financial and accounting information, promote accountability and prevent fraud.
* Internal controls aid companies in complying with laws and regulations and preventing employees from stealing assets or committing fraud.
* They also can help improve operational efficiency by improving the accuracy and timeliness of financial reporting.
* Internal audits play a critical role in a company’s internal controls and corporate governance.

## **Components of Internal Controls**

A company's internal controls system should include the following components:

**Control environment**: A control environment establishes for all employees the importance of integrity and a commitment to revealing and rooting out improprieties, including fraud. A board of directors and management created this environment and lead by example. Management must put into place the internal systems and personnel to facilitate the goals of internal controls.

**Risk Assessment:** A company must regularly assess and identify the potential for, or existence of, risk or loss. Based on the findings of such assessments, added focus and levels of control might be implemented to ensure the containment of risk or to watch for risk in related areas.

**Monitor:** A company must monitor its system of internal controls for ongoing viability. By doing so, it can ensure, whether through system updates, adding employees, or necessary employee training, the continued ability of internal controls to function as needed.

**Information/Communication:** Solid information and consistent communication are important on two fronts. First, clarity of purpose and roles can set the stage for successful internal controls. Second, facilitating the understanding of and commitment to steps to take can help employees do their job most effectively.

**Control Activities:** These pertain to the processes, policies, and other courses of action that maintain the integrity of internal controls and regulatory compliance. They involve preventative and detective activities.

**Compliance with Laws and Regulations**: An organization's financial activities must adhere to all relevant laws, regulations, and standards. This involves keeping up to date with changes in financial regulations and implementing measures to ensure compliance.

**Separation of Duties**: Distributing responsibilities among different people reduces the risk of error or inappropriate actions. This includes separating authorization, custody, and record-keeping roles to prevent fraud and error.

**Physical Controls**: A business must implement security measures to protect its assets, including cash, inventory, and equipment. This could involve secure storage facilities, access controls, and surveillance systems.

## **Preventative vs. Detective Controls**

Internal controls are typically comprised of control activities like authorization, documentation, reconciliation, security, and separation of duties. They are broadly divided into preventative and detective activities.

**Preventative control** activities aim to deter errors or fraud from happening in the first place and include thorough documentation and authorization practices. Separation of duties, a key part of this process, ensures that no single individual can authorize, record, and be in custody of a financial transaction and the resulting asset. Authorization of invoices and verification of expenses are internal controls.

In addition, preventative internal controls include limiting physical access to equipment, inventory, cash, and other assets.

[**Detective controls**](https://www.investopedia.com/terms/d/detective-control.asp) Backup procedures designed to catch items or events missed by the first line of defense. Here, the most important activity is reconciliation, which is used to compare data sets. Corrective action is taken upon finding material differences. Other detective controls include external audits from accounting firms and internal audits of assets such as inventory.

## **What Are the Objectives of Internal Audit?**

While there are some standards that dictate how auditors should conduct internal audits, the scope depends on each company. Every company may specify the expectations it has from its internal audit function. Based on that, the objectives of an internal audit may differ from one company to another.

However, there are some objectives of internal audit that are common among all companies. Some of these include the following.

### **Evaluating Internal Controls**

The primary function that internal auditors fulfill in any company is to evaluate its financial controls. These controls relate to how a company operates and manages its risks. Internal audits assess controls in various areas, such as operational effectiveness, financial compliance, and security. Based on their analysis, they can also recommend several actions to ensure no further breaches occur.

### **Monitoring Regulatory Compliance**

As a part of risk management, internal auditors also monitor a company’s regulatory compliance. While internal auditors are not responsible for ensuring such compliance, they can identify any lapses. Once they do so, they can report it to the management. This objective also coincides with the objective of external audits.

### **Verifying and Protecting Assets**

Internal auditors also verify a company’s assets. It is a part of their evaluation that they carry out for internal controls. They also ensure that proper maintenance procedures are in place that safeguard these assets. By doing so, internal auditors protect the company’s assets. On top of that, internal auditors also monitor asset acquisitions and disposals to ensure proper valuation occurs.

### **Ensuring Accuracy of Financial Records**

Internal auditors ensure that the financial statements prepared by a company’s management are accurate. This objective is like that of external auditors. Usually, internal auditors also perform similar procedures as external auditors. As mentioned, however, they report any misstatements to the management. In most cases, this objective may not make a primary goal for internal auditors.

### **Making Observations and Recording Findings**

Internal auditors don’t play an executive role in a company. Instead, their job is to identify problems by observing various processes. By doing so, they aim to identify any weaknesses in the company’s internal controls. Once they find such issues, they record their findings. Ultimately, they report these weaknesses to the relevant authorities, who take corrective actions.

### **Mitigating Risks**

Internal auditors also play a substantial role in mitigating risk factors. It is a part of the internal controls that a company employs. Internal auditors not only monitor existing risks but also identify new risks that the company may face. Once they analyze those, they can make recommendations on any mitigating procedures that the company can employ.

## **What is an Evaluation of Internal Controls?**

An evaluation of internal control involves an examination of the [effectiveness](https://www.accountingtools.com/articles/effectiveness) of an organization's system of [internal controls](https://www.accountingtools.com/articles/internal-control.html). By engaging in this evaluation and [auditor](https://www.accountingtools.com/articles/auditor) can determine the extent of other tests that must be performed to arrive at an opinion regarding the fairness of the entities [financial statements](https://www.accountingtools.com/articles/financial-statements). A robust system of internal controls reduces the risk of fraudulent activity, which moderates the need for additional [audit procedures](https://www.accountingtools.com/articles/audit-procedures.html). The examination concentrates on such issues as the [separation of duties](https://www.accountingtools.com/articles/what-is-separation-of-duties.html), checks and balances, safeguarding of records, the training level and competence of employees, and the effectiveness of the entity's [internal audit](https://www.accountingtools.com/articles/internal-audit) function.

The steps involved in this evaluation process include the following:

* Determine the extent and types of controls being used by the client.
* Determine which of these controls the auditor intends to rely upon.
* Based on the first two steps, determine which audit procedures should be expanded or reduced.
* Make recommendations to the client regarding how to improve its system of internal controls.

# **Internal Control Questionnaires**

Businesses rely on internal controls to help ensure the accuracy and integrity of their financial statements, as well as [prevent fraud](https://www.fbi.gov/scams-and-safety/common-scams-and-crimes/business-fraud), waste, and abuse. Given their importance, internal controls are a key area of focus for internal and external auditors. Many auditors use detailed internal control questionnaires to help evaluate the internal control environment — and ensure a comprehensive assessment. Although some audit teams still use paper-based questionnaires, many prefer an electronic format. Here’s an overview of the types of questions that may be included and how the questionnaire may be used during an audit.

## **The Basics of Internal Control Questionnaires**

The contents of internal control questionnaires vary from one audit firm to the next. They also may be customized for a particular industry or business. Most include general questions pertaining to the company’s mission, environment control, and compliance situation. There also may be sections dedicated to mission-critical or fraud-prone elements of the company’s operations, such as:

* Accounts receivable,
* Inventory,
* Property, plant, and equipment,
* Intellectual property (such as patents, copyrights and customer lists),
* Trade payables,
* Related party transactions, and
* Payroll.

Questionnaires usually don’t take long to complete, because most questions are closed-ended, requiring only yes-or-no answers. For example, a question might ask: Is a [physical inventory count](https://sensiba.com/resources/insights/how-to-prepare-for-year-end-physical-inventory-counts/) conducted annually? However, there also may be space for open-ended responses. For instance, a question might ask for a list of controls that limit physical access to the company’s inventory.

## **Three Approaches to Administer Questionnaires**

Internal control questionnaires are generally administered using one of the following three approaches:

### **Completion by Company Personnel**

Here, management completes the questionnaire independently. The audit team might request the company’s organization chart to ensure that the appropriate individuals are selected to participate. Auditors also might conduct preliminary interviews to confirm their selections before assigning the questionnaire.

### **Completion by the Auditor Based on Inquiry**

Under this approach, the auditor meets with company personnel to discuss a particular element of the internal control environment. Then the auditor completes the relevant section of the questionnaire and asks the people who were interviewed to review and validate the responses.

### **Completion by the Auditor After Testing**

Here, the auditor completes the questionnaire after observing and testing the internal control environment. Once auditors complete the questionnaire, they typically ask management to review and validate the responses.

### **Audit Procedures Explained**

Audit Procedures are a series of steps/processes/ methods applied by an auditor to obtain sufficient audit evidence for forming an opinion on financial statements, whether they reflect the true and fair view of the organization’s financial position. It is mainly of two types – **substantive audit procedures** and **analytical audit procedures**.

They involve some specific activities and tests which the auditors need to perform. Through these steps the auditors gather important proof to assess the financial statements and the internal control system of the business. In this way they get [**reasonable assurance**](https://www.wallstreetmojo.com/reasonable-assurance/) that the financial statements are not misstated but are fairly presented as per the accounting framework of the organization.[**ow**](https://www.wallstreetmojo.com/financial-modeling-and-valuation/)

### **Methods**

During the preliminary assessment process, an auditor is required to identify and ascertain the amount of risk involved and accordingly develop an [**audit plan**](https://www.wallstreetmojo.com/audit-plan/). The audit plans should define these steps, which the auditor will apply to obtain [**audit evidence**](https://www.wallstreetmojo.com/audit-evidence/).

They can be divided into two types:

#### **1 – Substantive Audit Procedures**

[**Substantive procedures**](https://www.wallstreetmojo.com/substantive-procedure/) are processes, steps, and tests performed by auditors, which create conclusive evidence regarding accuracy, completeness, existence, disclosure, rights, or valuation of assets/ liability, books of accounts, or [**financial statements**](https://www.wallstreetmojo.com/financial-statements/). For any procedure to be concluded, the auditor should collect enough audit evidence so that another competent auditor makes the same conclusion when applying the same procedure to the same documents. The **substantive audit procedures** can be regarded as complete checking. Auditor usually uses this procedure when he believes the audit area includes a high frequency of risk.

#### **2 – Analytical Audit Procedures**

The **analytical audit procedures** can be defined as tests/studies/ evaluations of [**financial information**](https://www.wallstreetmojo.com/financial-information/) through analysis of plausible relationships among both financial and non-financial data. In simple language, certain checks/tests are conducted by auditors based on study/ knowledge/ previous year figures to check and form an opinion on financial statements. Depending on the audit area, the analytical audit procedure may differ. For example, the auditor may compare two sets of financial statements of the same entity about two different financial years or sometimes may compare two separate entities’ financial data for obtaining audit evidence.

#### **3 – Test Of Control**

In this, the auditor assesses how dependable and strong the internal control system of the company is. They do so by testing the design, process followed and effectiveness of the process. They look for any deviation between plans and achievements to determine whether the control systems is working for the business or not.

#### **4 – Sampling**

The auditors can also collect samples of transactions or balances for testing purposes. These samples provide a good level of assurance and help them to draw a conclusion regarding the entire population.

#### **5 – Physical Inspection**

The auditor physically goes to inspect the assets of the company to look at their condition and existence and then evaluates them.

#### **6 – Inquiry**

They may interview people from the company, who may be from the finance department or not, and obtain the necessary information and explanation regarding any doubt. They may also send requests for information to third parties like banks, customers, etc. to get clarity.

#### **7 – Reconciliation**

The auditors also go through the reconciliation reports and analyse them in details and get reasonable assurance regarding the authenticity of the transactions.

# **What Is Vouching In Auditing?**

# **Definition Of Vouching**

*Vouching is a procedure that auditors use to authorize the credibility of the entries allowed in the books of accounts. In other words, it is the documentation that helps the auditors to check the authentication and the accuracy of the documents that the client has presented.*

## **Types And Sources of Vouching**

Auditors use two types of vouchers during the auditing process. They can either be primary or collateral.

* Primary Vouchers: These are the original copies of the company’s vouchers.
* Collateral Vouchers: Collateral Vouchers are duplicate copies (or photocopies) of the original invoices or bills that auditors use for verification purposes.

As far as sources of vouching are concerned, they can be seen as internal or external.

* Internal Vouchers: Internal Vouchers are available from within the company. Examples of internal vouching include purchase orders received or inter-departmental sales.
* External Vouchers: External vouchers are generated from the company’s external sources. Examples of external vouching include bank statements and invoices generated from banks.

**Audit of Payments**

* Purchase of goods
* Payment of wages and salaries
* Petty
* Directors Remuneration
* Purchase of Assets (Immovable and Movable)
* Assets acquired on hire purchase
* Payment for various expenses
* Payment of taxes
* Customs and Excise duties
* Travelling expenses and allowances
* Loans
* Preliminary expenses
* Bank charges
* Advertisement expenses
* Repairs to assets
* Payment of dividends
* Retirement gratuity to employees

**Audit of Receipts**

* Auditing of cash receipts
* Cash sales
* Receipts from debtors
* Income from interests, dividends
* Rent received
* Sale of investment
* Loans
* Bills receivable
* Commission
* Sale of Assets
* Royalty received
* Insurance Claims

**Audit of Purchase and Sales**

* Audit of purchase of goods
* Audit of purchase return
* Audit of sales
* Sales return
* Audit of purchase ledger or supplier's ledger
* Audit of sales ledger or debtor's ledger

**Audit of Assets**

* Fixed Assets
* Current Assets, loans and advances
* Miscellaneous Expenditure
* Leasehold property
* Free hold property
* Plant and Machinery
* Furniture fixtures and Fittings
* Patents and Trademark
* Sundry Debtors/Book debts
* Stock in hand/Inventory
* Bills Receivables
* Loans and Advances
* Cash in Hand
* Cash at Bank

**Audit of Liabilities**

* Capital (Share & Debentures)
* Reserve and funds
* Loans
* Outstanding expenses
* Amount received in advance
* Bills Payables
* Debentures
* Trade creditors
* Contingent Liabilities