

\*Sample only – parts are extracted from random parts of the full version

## Topic 7 Internal control & Fraud

### Internal Control

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. Reliability of financial reporting

- Management has both a legal and a professional responsibility to be sure that the information is fairly prepared in accordance with reporting requirements such as accounting standards

#### 2. Compliance with applicable laws and regulations

- Organisations are required to follow many laws and regulations

#### 3. Effectiveness and efficiency of operations

- Controls within an organisation are meant to encourage efficient and effective use of its resources, including personnel, to optimise the company's goals

### Components of internal control

#### 1 Control environment

- Actions, policies and procedures that reflect the overall attitudes of top management, directors and owners of an entity towards internal control and its importance to the entity

#### 2. Integrity & ethical values

- To enforce & communicate ethical values:
- Management actions to remove incentives that prompt a person to behave improperly

#### 3. Commitment to competence

- Commitment to competence includes management's consideration of the competence levels for specific jobs and how those levels translate into requisite skills and knowledge
- If people aren't qualified → more likely to make mistakes → CR increase

#### 4. Participation by those charged with governance

- Board delegates responsibility for internal control to management and is charged with regular independent assessments of management-established internal control

#### 5. Management's philosophy and operating style

- Management provides clear signals to employees about the importance of internal control

#### 6. Organizational structure

- By understanding the client's organisational structure, the auditor can learn the management and functional elements of the business and perceive how controls are implemented

#### 7. HR policies and practices

- if employees are honest and trustworthy, other controls can be absent and financial statements will still be reliable – if they make a mistake, they are most likely to admit mistake

## Topic 9 Audit Testing & Substantive Procedures: Sampling

### Why do we need sampling?

- Not practical to test every transaction – time / resources constraints.
- Sampling increases efficiency
- Select a sample representative of the population we want to examine to collect sufficient and appropriate evidence
- If the sample tests OK, then we can extrapolate the results to the entire population of items  
Eg. All credit sales in the sample were correctly authorised, therefore, we may assume that credit sales in general are correctly authorised

### Representative Sample

A representative sample is where the characteristics of the sample are approximately the same as those of the population

Two things cause a sample to be non representative:

#### a) Sampling risk

- The risk that the auditor's conclusions based on a sample may be different from the conclusion if the entire population were subjected to the same audit procedure
- May lead to 2 types of wrong conclusions
  - 1) **Wrongly conclude that**
    - (a) internal controls are more effective than they actually are (Risk of **over-reliance**)
    - (b) there are no material misstatements (Risk of incorrect acceptance) → Ineffective audit (more likely to result in an inappropriate audit opinion)
  - 2) **Wrongly conclude that**
    - (a) internal controls are less effective than they actually are (Risk of **under-reliance**)
    - (b) there are material misstatements (Risk of incorrect rejection) → Inefficient audit (additional work)

### To reduce sampling risk:

- Adjusting the sample size
- Larger sample, lower sampling risk
- Using an appropriate method of sample selection

#### b) Non-sampling risk

- The risk that the auditor reaches an erroneous conclusion for any reason not related to sampling risk

### Examples:

- Failure to detect a material misstatement due to human error / incompetence
- Inappropriate audit procedures

### To minimise non-sampling risk:

- Careful design of audit procedures
- Proper instruction / supervision / review