
CHAPTER 5

MAKING TENTATIVE INTERNAL CONTROL ASSESSMENTS

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A SUMMARY OF THE PLANNING AND APPROACH

In Chapter 2, “Planning the Assessment,” the idea that the work of evaluating and assessing internal controls over financial reporting could be integrated with other internal audit, control, and/or enterprise risk management activities was presented. Identifying the operation of work processes was described in Chapter 3, “Mapping the Organization.” The need to make tentative evaluations of risk was discussed in Chapter 4, “Tentative Risk Assessments.” Because planning and conducting the assessment of internal control over financial reporting is an iterative or circular process, it is important to keep a grip on the way that these various activities fit together. The following provides a step-by-step overview of the overall task of making management’s assessment of internal control over financial reporting.

Preliminary Assessment of the Organization

The highest level of management responsible for assessing internal controls over financial reporting begins by making a preliminary assessment of the organization at the highest level. With the aid of Exhibit 2-1, “Preliminary Assessment Planning Questionnaire/Checklist—Company Organization and Resources,” and Exhibit 2-2, “Preliminary Assessment Planning—Preliminary Procedures Assignments,” or similar tools, management at this level considers its preferred approaches, which will include making preliminary determinations about what portions of the assessment activities

will be delegated to lower levels of management and what portions will be performed at the top level; who at the lower levels of management will be assigned responsibility for the activities delegated downstream; and what other internal audit, control, and/or enterprise risk management activities should be performed while also performing the internal control over financial reporting assessment activities.

Identification of General Processes

The high-level management above, with the aid of Exhibit 3-1, “Questionnaire/Checklist for Identifying General Processes” or a similar tool, will more specifically identify those general processes (i.e., sets of activities) that should most appropriately be analyzed at the highest level. This should include the specific identification of those sets of activities (referred to as “routes” in Chapter 3) that directly relate to, and are to be analyzed at, the highest level and a general identification of all other sets of activities by group. At this point, the “routes” or sets of activities may not all have been specifically identified; however, high-level management should in some manner group them for more detailed analysis downstream. Exhibit 3-1, Items I–V, is constructed in a manner that helps management at the highest level identify the “routes” or sets of activities that relate to the highest levels of the organization. Those “routes” or sets of activities that directly relate to the highest levels of the organization may be processes that accumulate financial statement information from any of the three perspectives discussed in Chapter 2 (i.e., the Organizational, the Business Transaction Process, or the Financial Statement Element).

Risk Analysis

Following the preliminary determinations made in Step 1, above, and the identification of specific high-level “routes” or sets of activities and groups of routes, made in Step 2, above, management at the highest level begins the risk analysis. Using the results of the process identifications made in Step 2, high-level management may make preliminary determinations about whether the specific high-level “routes” or sets of activities and groups of routes have the potential to cause a material misstatement in the financial statements. Exhibit 4-2, “Evaluation of Significant/Potential Materiality of Financial Reporting Processes,” or a similar tool may be used on a preliminary basis for each of the specific high-level “routes” or sets of activities and each group of such routes, as identified above by using Exhibit 3-1. The potential quantitative financial statement effect of each route or group of

routes may be listed on Exhibit 4-3, "Tentative Analysis of Financial Reporting Processes Having No Significant Risk," or a similar schedule for the purpose of determining whether any such route or group of routes may be tentatively eliminated from further consideration based on the raw assessment that it does not have the potential to produce a material misstatement in the financial statements. All routes or groups of routes tentatively eliminated should be entered on Exhibit 4-3 and summarized. If the resulting summarized quantitative effect of the routes or group of routes tentatively eliminated is material, then some of the tentatively eliminated routes or groups of routes should be analyzed rather than eliminated from consideration.

Final Determinations

After performing Steps 1, 2, and 3 above, high-level management should make its final determinations about what portions of the assessment activities will be delegated to lower levels of management and what portions will be performed at the top level; who at the lower levels of management will be assigned responsibility for the activities delegated downstream; what other internal audit, control, and/or enterprise risk management activities should be performed while also performing the internal control over financial reporting assessment activities.

Top-Level Management Analysis of Specific Activities

After the high-level delegation of responsibilities is decided upon, top-level management should proceed with the analysis of those specific sets of activities that it has assigned to itself for analysis. Each such specific set of activities should be analyzed in detail, using Exhibit 3-2, "Questionnaire/Checklist for Analyzing General Processes," or a similar tool, to determine the precise flow of individual activities, manual or IT, within the set; the nature of each such individual activity; and the input and output documentation related to each such individual activity.

Identification of Basic and Underlying Risks

Risk analysis should proceed for each set of activities analyzed in detail, using Exhibit 3-2 or a similar tool. Exhibit 4-1, "Questionnaire/Checklist for Identifying Basic and Underlying Process Risks," or a similar tool may be used to identify the basic and underlying risks that create the potential for error. Exhibit 4-1 is designed to be applied to each of the individual activities, manual

or IT, within any given route or set of activities analyzed in detail using Exhibit 3-2 or a similar tool. Each condition identified by Exhibit 4-1 as having a reasonable potential to cause an error should be listed on Exhibit 4-4, "Tentative Considerations for Improvement to Internal Controls," with an explanation about the precise nature of the perceived risk and its perceived potential for harm.

Input of Next-to-Highest Level of Management

The next-to-highest level of management that has been assigned responsibility for assessing internal controls over financial reporting for a particular set of activities should proceed in the same manner as outlined for its area of responsibility. The lower levels of management may use Exhibits 2-1, 2-2, 3-1, 3-2, 4-1, 4-2, and 4-4 in the same way, but apply the Exhibits to their specific areas of responsibility. Delegation downstream should continue until all sets of activities (i.e., "routes") have been analyzed. Any set of activities that is tentatively eliminated from consideration because it is not believed to have a significant potential effect on the financial statements as a whole should be listed on the top-level analysis of such items (i.e., the top-level Exhibit 4-3 or its equivalent). Top-level management should monitor all the items listed on Exhibit 4-3 or its equivalent to ensure that the organization is analyzing a sufficient portion of its total financial reporting activities.

INTERNAL CONTROL DESIGN ANALYSIS

The following sections address a company's internal control design analysis, which, under SEC Regulations, is a required part of management's assessment of internal control over financial reporting. To that end, the evaluation of internal control design analysis is performed in terms of the five COSO components of internal control. After the design analysis is performed in terms of the COSO components, the likelihood that a misstatement of the financial statements will occur must be evaluated.



PRACTICE POINTER: Very small companies, which have relatively simple systems of accounting and financial reporting, should be able to perform a more streamlined internal control design analysis. The practice pointers in succeeding pages are designed to simplify the consideration of internal control design analysis with respect to each COSO component of internal control.

CONDENSED SUMMARY OF COSO 2009 GUIDANCE ON MONITORING INTERNAL CONTROL SYSTEMS

Consulting the COSO 2009 Guidance on Monitoring Internal Control Systems could be extremely beneficial. This guidance, an executive summary of which is available for free from www.coso.org, proceeds to describe a model for monitoring in the following fashion:

1. **Establish a Foundation** (tone at the top, organizational structure and baseline understanding of internal control effectiveness)
2. **Design and Execute** (prioritize risks, identify controls, identify persuasive information about controls, implement monitoring procedures)
3. **Assess and Report** (prioritize findings, report results to appropriate level, follow up on corrective action)

Such a systematic approach to engaging in monitoring activities is expected to lead to supported conclusions regarding control effectiveness for any organization.

A condensed summary of the model for monitoring referred to above is now furnished.

First, with respect to *establish a foundation* for monitoring, we recognize that the board of directors and management set the proper tone at the top in showing a commitment to maintaining a set of effective internal controls (that is reviewed periodically for operating effectiveness throughout the process of monitoring). Management's tone influences how employees conduct and react to monitoring; similarly, the board's oversight influences management's conduct and commitment to maintaining effective internal control systems.

Second, in terms of organizational structure, although management has the primary responsibility with respect to maintaining effective internal control systems, the board's role is one of governance, guidance, and oversight. Specifically, the board is aware of circumstances in which management may not be able to objectively monitor certain controls, as well as the risk of management override of key internal controls. Hence, the Board must assume overall responsibility for ensuring that monitoring is being conducted by competent and objective evaluators in the context of a particular organization.

Third, it is important to understand that a starting point for monitoring involves establishing a *control baseline* (a supported understanding of the internal control system's design and operation), identifying changes through ongoing monitoring or separate evaluation, a change management process that involves making

necessary modifications to come up with a new control baseline, and periodically revalidating control operations.

With regard to the design and execution of monitoring procedures, a four-step process is envisaged:

- **Prioritize Risks:** Understand and prioritize risks to organizational objectives
- **Identify Controls:** Identify the *key controls* across the internal control system that address the prioritized risks
- **Identify Information:** Identify information that will *persuasively* indicate whether the internal control system is operating effectively, and
- **Implement Monitoring:** Develop and implement cost-effective procedures to evaluate that *persuasive* information.

Key controls are those that have one or both of the following characteristics:

- Their failure could materially affect the objectives for which the evaluator is responsible, but might not be detected in a timely manner by other controls and/or
- Their operation might prevent other control failures or detect such failures before they have an opportunity to become material to the organization's objectives.

Persuasive information possesses attributes of suitability (i.e., it is relevant, reliable and timely) as well as sufficiency (i.e., it is available in sufficient quantity to justify the drawing of reliable inferences and conclusions).

One important aspect of persuasive information is its nature: whether it constitutes *direct* or *indirect* information about the operating effectiveness of controls.

Direct information is obtained by observing controls in operation, reperforming them, or otherwise evaluating their operation directly. Indirect information is all other information that may indicate a change or failure in the operation of controls. It can include, but is not limited to: (1) operating statistics, (2) key risk indicators, (3) key performance indicators, and (4) comparative industry metrics. Although indirect information is limited as to the level of support (i.e., persuasiveness) it can provide on its own, especially over a long period of time, its value depends on numerous considerations such as: the level of precision, degree of variability in the outcomes, the adequacy of follow-up procedures, and the length of time since the operation of the underlying controls was last validated through persuasive direct information. Obviously, a judicious combination of direct and indirect information would be maximally effective in obtaining persuasive information for monitoring purposes.

With the risks prioritized, key controls selected, and available persuasive information identified, the organization implements monitoring procedures to evaluate internal control effectiveness over time.

Monitoring typically involves both ongoing monitoring procedures and/or separate evaluation. The COSO 1992 Internal Control Integrated Framework makes an important point: “An entity that perceives a need for frequent separate evaluations should focus on ways to enhance its ongoing monitoring activities, and, thereby, to emphasize ‘building in’ versus ‘adding on’ controls.”

Separate evaluations can employ the same techniques as ongoing monitoring, but they are designed to evaluate controls periodically and are not ingrained in the routine operations of the organization. They do, however, play an important role in monitoring in that they often:

- Provide an objective analysis of control effectiveness when performed by personnel who are not involved in the operation of the control, and
- Provide periodic feedback regarding the effectiveness of ongoing monitoring procedures.

In the final stage, the results of monitoring either confirm previously established expectations about the effectiveness of internal control or highlight identified deficiencies for possible corrective action.

Identifying and prioritizing potential control deficiencies allows organizations to determine (1) the levels to which the potential deficiencies should be reported, and (2) the corrective action, if any, that should be taken. Several factors may influence an organization’s prioritization of identified deficiencies, including:

- The likelihood that the deficiency will materially affect the achievement of an organizational objective.
- The effectiveness of compensating controls, and
- The aggregate effect of multiple control deficiencies.

Reporting protocols vary depending on the purpose for which the monitoring is conducted and the severity of the deficiencies noted, and such reporting can be done internally or externally (especially where external assertions or certifications are called for). Most external reporting requirements (e.g., SOX 404) are developed to address risks that are already contemplated by properly designed and executed monitoring procedures. Effective monitoring procedures generally provide substantial support for such assertions. In some circumstances, however, modifications to the monitoring program may be warranted or beneficial to the organization when external reporting is required.

Control Activities

As the term implies, one aspect of Internal Control Design refers to the manner by which Control Activities are supposed to operate to ensure that material misstatements to the financial statements do not occur. Internal Control Design Analysis involves identifying the controls that are in place to provide this assurance. In the COSO Framework, Control Activities are described as ordinarily involving policies that establish what should be done and procedures to carry out the policies. The COSO Framework also points out the need to integrate control activities with risk assessment (i.e., the need to have control activities that effectively address risks). Thus, the integration of control activities with risk assessment that is discussed in Chapter 4 of the COSO Framework directly overlaps with the need to consider how risks should be managed, which is discussed in Chapter 3 of the COSO Framework. The COSO Framework discusses types of control activities and provides a list, which is not all-inclusive, of some of the general types:

- Top-Level Reviews
- Direct Functional or Activity Management
- Information Processing
- Physical Controls
- Performance Indicators
- Segregation of Duties

With all of this in mind, management can build on the identification of the activities involved in the preparation of financial statements and the identification of the risks associated with those activities. Just as the identification of the activities involved in the preparation of financial statements (as discussed in Chapter 3, “Mapping the Organization”) lead to the identifications of the risks associated with those activities (as discussed in Chapter 4, “Tentative Risk Assessments”), the identification of the risks leads to the identification of control activities in place to mitigate the risks.

As discussed in Chapter 4 of this book, because some risk is always present with any activity, each of the Basic and Underlying Risks (as shown in Exhibit 4-1 and also discussed in that chapter), when applied to any identified activity involved in the preparation of financial statements, will either be present or will not apply to the activity. Thus, the completion of Exhibit 4-1, “Questionnaire/Checklist for Identifying Basic and Underlying Process Risks,” or a similar tool will help identify the presence of risk so that management may identify where control activities are needed. For each activity, each of the line items on Exhibit 4-1 that has a “Yes” answer should be followed by a response that documents a mitigating control activity.

If no control activity can be identified, then the company is at risk for error that would not be detected in the normal course of the preparation of financial statements. Exhibit 5-1, "Control Activities Related to Identified Individual Activity Risk," flows directly from Exhibit 4-1 to provide a documentation trail that leads directly from (a) the identification of all the activities in the financial reporting process, to (b) the identification of the risks for errors or misstatements associated with them, to (c) the identification of the control activity in place that is designed to mitigate the identified risks. Frequently mitigating control activities may apply to an entire route (i.e., activity set) or even to a group of routes. If so, an analysis of the entire route or group of routes may help to identify control activities applicable to individual activities. Exhibit 5-2, "Detailed Identification/Analysis of Control Activities," is a supplemental tool for that purpose.

To provide this documentation trail, Exhibit 5-2 elicits information about existing management control activities related to a route (i.e., activity set), such as:

- Whether there are clear budget, profit, other financial and operating management goals or objectives for the activity or activities and whether such objectives are understandable, actively communicated and monitored.
- Whether there are planning and reporting systems in place for the activity or activities that adequately identify and communicate performance variances for management action.
- Whether management over the activity or activities investigates variances and responds appropriately.
- Whether management has put in place procedures to prevent unauthorized access to, or destruction of, documents, records, and assets related to the activity or activities.
- Whether management has established policies for controlling access to programs and data files related to the activity or activities.
- Whether management adequately monitors the policies in place related to the activity or activities.
- Whether amounts recorded in the accounting system are periodically compared with physical assets.
- Whether control and subsidiary accounts are reconciled and discrepancies reported to appropriate management.
- Whether the performance of critical control functions, such as reconciling accounts, is properly documented.
- Whether the activities produce journal entries that should be approved by a responsible person not involved with their origination.

- Whether knowledgeable and responsible personnel make accounting estimates and judgments.
- Whether the activities contribute information needed to prepare financial statements and related disclosures in a timely manner.
- Whether competent, knowledgeable people review the output from activities.

Responses to these matters permit a matching of control activities with basic and underlying risks. Thus, if it is found that the identified control activities do not address or inadequately address those risks, a control deficiency is tentatively indicated.

Conflicting Duties and Errors

Errors may occur intentionally or unintentionally; therefore, control activities should be designed to address the intentional as well as the unintentional to the extent that is feasible. Conflicting duties occur when, in performing one duty, an individual has the opportunity to make an intentional error for the purpose of gaining some kind of benefit and when, in performing another duty, that same individual has the opportunity to hide his intentional error. Intentional errors may be made both when there are conflicting duties and when there are not. For example, a payroll clerk with no other duties could intentionally compute his pay at a higher-than-authorized rate. Without a control activity in place, that intentional error could go undetected. Such an error would be detected, however, with an effective control activity. Effective control activities also can address the risk of intentional error even where conflicting duties exist—if there are control activities that address the commission of errors, they, by default, address the commission of intentional errors.

Nevertheless, one of the best ways to address the problem of conflicting duties is to keep them to a minimum. Unfortunately, there is no end to the variety of ways that people might devise to commit and cover up an intentional error. Therefore, the problem of conflicting duties is best addressed by identifying those areas in the financial reporting process that are most susceptible to improprieties that could be disguised by people who have conflicting duties. Companies can develop a matrix to identify potential conflicting duties from the activity analyses that were developed to map the system of financial reporting, as discussed in Chapter 3, “Mapping the Organization.” In general, if an individual with duties that affect the accounting for any asset, liability, equity, revenue, or expense item through one set of activities also has duties that affect the accounting for the same asset, liability, equity, revenue, or expense

item through another set of activities, then he or she *might* have conflicting duties.



PRACTICE POINTER: An individual with duties at the “initiating level” refers to a person who has involvement with the accounting for or accumulation of information at a non-supervisory or developmental-type level. Such a person would (a) develop initial information for entry into the accounts or (b) take initially developed information and further refine it by adding to it and/or performing some form of computation or summarization. Such an individual engages in “pre-control activity activities.” Those are activities that are an integral part of the accounting or financial reporting process, as opposed to a control activity. Such a person could be a member of management, but the activity performed could still be at the pre-control activity stage. This is an important point to keep in mind when identifying potentially conflicting duties because conflicting duties can exist and can be mitigated by control activities. People in supervisory or managerial positions may still have duties at the initiating level and, in analyzing the design of a system of internal controls, the need for control activities at any level in an organization should be considered. In addition, a conflicting duty situation could exist if someone in a supervisory or managerial position engages in a control activity over one activity which conflicts with another “pre-control activity activity” or in two or more conflicting control activities.

More precisely, if an individual has the ability to cause a false debit or credit to an accounting item or to prevent a valid debit or credit to an accounting item through one set of activities, the individual also has the ability to cause a false debit or credit to that same accounting item or prevent a valid debit or credit that same accounting item through another set of activities, then he or she has a potential conflict. An error committed in the course of performing one duty could be offset by another error committed in the course of performing another duty.

Exhibit 5-3, “Sample of Level 1 Conflict of Duties Matrix,” uses the “routes” described in the case study in Chapter 3, adding Persons A, B, C, D, E, F, G, and H to routes. Route or activity set A1 involves Persons A, B, and C. Route or activity set A2 involves Persons D, E, and F. Route or activity set A3 involves Persons A, G, and H. A potential conflict of duties is indicated where Person A is involved with both routes A1 and A3. Upon identifying such potential conflicts, further analysis can be made to determine if an actual conflict of duties exists. When using Exhibit 5-3 in practice, both axes of the matrix would be set up to include all the routes (i.e., sets of activities) and each person having duties within each set of activities. When a match is made for the same person under different activity sets, a potential conflict is identified for further study. Each match will

appear twice because of the configuration of the matrix. Exhibit 5-3 is set up as an Excel spreadsheet. To start easy operation of the matrix, a person code assigned to each individual would be entered in the entire column where the person is listed on the horizontal axis. The "Find" tool of Excel may be used to search for person codes down the vertical axis of the matrix. Each time the person code is found on the vertical axis, the corresponding horizontal row may be scrolled for matches, which would indicate situations involving potentially conflicting duties. Illustration 5-1, "Level 1 Conflict of Duties Matrix," demonstrates the operation of the matrix.

Further analysis is necessary after individuals with potentially conflicting duties are identified. The matrix provided in Exhibit 5-3 will identify persons involved with two or more sets of activities in the accounting process. The first step after that is to see whether involvement with those different sets of activities causes the individual to have duties that conflict with one another from an internal control perspective. Making such a determination should begin with an analysis of the accounts or accounting items that are affected by each of the different sets of activities with which the individual is involved. A simple list of the matters that each of the different sets of activities has the possibility to affect should be prepared and matched against each other. That information should be available from the "mapping" of the work flows as discussed in Chapter 3, "Mapping the Organization."

Exhibit 3-1 identifies the various accounting/financial reporting processes involved in the financial reporting system. Keeping in mind the various perspectives from which accounting information may be accumulated (i.e., the organizational, the business transaction process, and the financial statement element), such a comparison can be made to further refine the potential conflicts that have been identified and weed out those situations that do not conflict with each other. The existence of potentially conflicting duties is more precisely pinpointed when the same individual is found to have involvement with the same organization and the same business transaction process or financial statement element. Further refining of the conflict of duties matrix can help with this procedure. If an individual is found to be involved with only two different activity sets, then it is relatively easy to compare the organization, business processes, and financial statement elements affected by each activity set to further refine the identification of conflicting duties.

The analysis becomes more complex, however, when the individual is involved with three or more sets of activities because the number of comparisons multiplies. That is, if Person A is only involved with route or activity set A1 and A3, then it is easy to match the organization, business processes, and financial statement elements affected by those two sets of activities. However, if Person B is found to be involved with activity sets A1, A2, and A3, then A1 must be compared to A2 and A3, A2 must be compared to A1 and

Illustration 5-1: Level 1 Conflict of Duties Matrix

Insert Route and Person Codes (PCs) in the boxes below

Route x	Person	Person	Person	Route y	Person	Person	Person	Route z	Person	Person	Person	Route	Route
---------	--------	--------	--------	---------	--------	--------	--------	---------	--------	--------	--------	-------	-------

(For each Person above, insert the Person Code in all boxes in the column)
(x axis)

Insert Route and Person Codes in the boxes to the right

		(Use the Find tool on the column to the left to find each Person Code (PC) entered in the columns below the x axis and then scroll across the row to find Person Code Matches (PCM(s))																	
		(y axis)																	
Route x										PC	PC	PC					PC	PC	PC
Person										PC	PC	PC					PCM	PC	PC
Person										PC	PC	PC					PC	PC	PC
Person										PC	PC	PC					PC	PC	PC
Route y										PC	PC	PC					PC	PC	PC
Person		PC	PC	PC													PC	PC	PC
Person		PC	PC	PC													PC	PC	PC
Person		PC	PC	PC													PC	PC	PC
Route z		PC	PC	PC						PC	PC	PC							
Person		PCM	PC	PC						PC	PC	PC							
Person		PC	PC	PC						PC	PC	PC							
Person		PC	PC	PC						PC	PC	PC							
Route		PC	PC	PC						PC	PC	PC							
Route		PC	PC	PC						PC	PC	PC					PC	PC	PC

A3, and A3 must be compared to A1 and A2. Exhibit 5-4 presents a conflict of duties matrix at this more refined level.

Again using the case study from Chapter 3, in Exhibit 5-4, Person Y is involved with the Unit B Inventory Accounting System, the Unit C and Unit B Inventory Accounting System, and the payroll system supporting Units B and C. The potential conflicts are indicated in the matrix.

For easy operation of the Exhibit 5-4 matrix, a code is assigned to each organization, transaction process, or account related to the activity sets the individual is involved with. That code would be entered in the entire column where the organization, transaction process, or account is listed on the horizontal axis. The "Find" tool of Excel may be used to search for organization, transaction process, or account codes down the vertical axis of the matrix. Each time the organization, transaction process, or account code is found on the vertical axis, the corresponding horizontal row may be scrolled for matches, which would indicate the more refined level of

conflicting duties. Exhibit 3-2 is a tool to document the work flows for each set of activities. It contains descriptions of tasks and the persons performing those tasks. The task descriptions provide the information necessary to determine just how an individual's duties can affect the accounting for particular asset, liability, equity, revenue, or expense items. A determination about whether an actual conflict of duties exists may be made by comparing the ways that an individual's duties can affect different asset, liability, equity, revenue, or expense items through the various sets of activities with which the individual has involvement and which have been identified as being potentially conflicting leads to a determination. In a generic sense, it can be useful to look at broad possibilities for conflicting duties. Table 5-1 provides such a look.

Table 5-1: Conflicting Duties Analysis

<i>Note</i>	<i>Tasks Affecting</i>	<i>Possibly Conflict with Tasks Affecting</i>
a.	Cash	Cash and most other accounts involving or related to cash receipts or cash disbursements
b.	Investments (include Special Purpose Entities)	Cash receipts or cash disbursements, other income, other expense
c.	Trade accounts receivable	Cash receipts, revenues
d.	Miscellaneous accounts receivable	Cash receipts, other income
e.	Inventories	Cash disbursements, accounts payable, payroll liabilities, cost of sales
f.	Prepaid expenses and other current assets	Cash disbursements, accounts payable, operating expenses
g.	Property, plant, and equipment	Cash disbursements, accounts payable (A/P), payroll liabilities, cost of sales, operating expenses, other income, other expense
h.	Deferred charges, other assets, and intangibles	Cash disbursements, accounts payable, operating expenses
i.	Accounts payable	Cash disbursements, inventories, property, plant, and equipment, operating expenses, other expense
j.	Payroll liabilities	Cash disbursements, inventories, property, plant, and equipment, operating expenses, other expense

<u>Note</u>	<u>Tasks Affecting</u>	<u>Possibly Conflict with Tasks Affecting</u>
k.	Other current liabilities	Cash disbursements, operating expenses, other expense
l.	Long-term debt and obligations	Cash receipts and disbursements, commitments and contingent liabilities, deferred charges, other expense
m.	Commitments and contingent liabilities	Inventories, property, plant, and equipment, long-term debt and obligations, operating expenses, other expense
n.	Equity	Cash receipts and disbursements, commitments and contingent liabilities, operating expenses, other expense
o.	Income taxes	Cash disbursements, commitments and contingent liabilities, operating expenses, other expense
p.	Revenues	Cash receipts, trade accounts receivable, miscellaneous accounts receivable, cost of sales
q.	Cost of sales	Cash disbursements, inventories, accounts payable, payroll liabilities, revenues
r.	Operating expenses	Cash disbursements, prepaid expenses and other current assets, property, plant, and equipment, deferred charges, other assets, intangibles, accounts payable, payroll liabilities
s.	Other income	Cash receipts, investments, miscellaneous accounts receivable, property, plant, and equipment
t.	Other expense	Cash disbursements, investments, prepaid expenses and other current assets, property, plant, and equipment, deferred charges, other assets, intangibles, accounts payable, payroll liabilities, other current liabilities

Notes to Table 5-1

- a. Duties affecting cash can conflict with other duties affecting cash, and with duties affecting anything else involving the receipt or disbursement of cash, because the performance of the other duties can make misstatements in cash balances, cash receipts, or cash disbursements possible. Because of the nature of double-entry bookkeeping, misstatements to cash resulting from such other duties can be detected by duties affecting cash. If the person who performs the duties that are possible sources of errors or misstatements also performs the duties

- affecting cash that might detect those errors or misstatements, a conflict-of-duties situation exists.
- b. Duties affecting investments can conflict with other duties affecting investments, such as duties affecting investment income or expenses, and with duties affecting investments or the disposal of them. If the person who performs the duties that are possible sources of errors or misstatements also performs the duties affecting investments, or investment-related items that might detect those errors or misstatements, a conflict-of-duties situation exists.
 - c. Duties affecting trade accounts receivable can conflict with other duties affecting trade accounts receivable, such as duties affecting invoicing or collections. If the person who performs the duties affecting trade accounts receivable, revenues, collections, discounts, special credits, or other receivable related items that are possible sources of errors or misstatements also performs duties that might detect those errors or misstatements, a conflict-of-duties situation exists.
 - d. Duties affecting miscellaneous accounts receivable can conflict with other duties affecting miscellaneous accounts receivable, such as duties affecting the cause or source of the receivable or the collection of the receivable. If the person who performs the duties affecting miscellaneous accounts receivable, other income, miscellaneous collections, or other miscellaneous receivable-related items that are possible sources of errors or misstatements also performs duties that might detect those errors or misstatements, a conflict-of-duties situation exists.
 - e. Duties affecting inventories can conflict with other duties affecting inventories, such as duties affecting the acquisition or production of the inventory or the sale or disposal of it. If the person who performs the duties affecting inventory, purchases, payroll, production expenses, or other miscellaneous inventory related items that are possible sources of errors or misstatements also performs duties that might detect those errors or misstatements, a conflict-of-duties situation exists.
 - f. Duties affecting prepaid expenses and other current assets can conflict with other duties affecting prepaid expenses and other current assets, such as duties affecting their acquisition, amortization, or other write-down. If the person who performs the duties affecting prepaid expenses and other current assets, and related matters that are possible sources of errors or misstatements also performs duties that might detect those errors or misstatements, a conflict-of-duties situation exists.
 - g. Duties affecting property, plant, and equipment can conflict with other duties affecting property, plant, and equipment, such as duties affecting the acquisition or construction/installation of the property, plant, and equipment or the sale or disposal of it. If the person who performs the duties affecting property, plant, and equipment, purchases, payroll,

construction costs or commitments, retirements, disposals, or other miscellaneous property, plant, and equipment related items that are possible sources of errors or misstatements also performs duties that might detect those errors or misstatements, a conflict-of-duties situation exists.

- h. Duties affecting deferred charges, other assets, and intangibles can conflict with other duties affecting deferred charges, other assets, and intangibles, such as duties affecting their acquisition, amortization, or other write-down. If the person who performs the duties affecting deferred charges, other assets, and intangibles, and related matters that are possible sources of errors or misstatements also performs duties that might detect those errors or misstatements, a conflict-of-duties situation exists.
- i. Duties affecting accounts payable can conflict with other duties affecting accounts payable, such as duties affecting cash disbursements, purchases of inventory, property, plant and equipment, and expenditures for other assets and expenses. If the person who performs the duties affecting accounts payable and related matters that are possible sources of errors or misstatements also performs duties that might detect those errors or misstatements, a conflict-of-duties situation exists.
- j. Duties affecting payroll liabilities can conflict with other duties affecting payroll liabilities, such as duties affecting cash disbursements, inventory production, construction/installation of property, plant and equipment, operating expenses and other expenses. If the person who performs the duties affecting payroll liabilities and related matters that are possible sources of errors or misstatements also performs duties that might detect those errors or misstatements, a conflict-of-duties situation exists.
- k. Duties affecting other current liabilities can conflict with other duties affecting other current liabilities, such as duties affecting cash disbursements, operating expenses for items such as property taxes and other expenses. If the person who performs the duties affecting other current liabilities and related matters that are possible sources of errors or misstatements also performs duties that might detect those errors or misstatements, a conflict-of-duties situation exists.
- l. Duties affecting long-term debt and obligations can conflict with other duties affecting long-term debt and obligations, such as duties affecting cash receipts and disbursements, debt compliance commitments, issuance costs, interest expense, and other debt expenses. If the person who performs the duties affecting long-term debt and obligations and related matters that are possible sources of errors or misstatements also performs duties that might detect those errors or misstatements, a conflict-of-duties situation exists.
- m. Duties affecting commitments and contingent liabilities can conflict with other duties affecting commitments and contingent liabilities, such as

duties affecting cash receipts and disbursements, inventory purchase commitments, commitments to construct property, plant, and equipment, debt compliance commitments, and other contractual obligations and their related expenses. If the person who performs the duties affecting commitments and contingent liabilities and related matters that are possible sources of errors or misstatements also performs duties that might detect those errors or misstatements, a conflict-of-duties situation exists.

- n. Duties affecting equity can conflict with other duties affecting equity, such as duties affecting cash receipts and disbursements, issuance costs, dividends, equity-financing compliance commitments, compensation commitments, and expenses related to these items. If the person who performs the duties affecting equity and related matters that are possible sources of errors or misstatements also performs duties that might detect those errors or misstatements, a conflict-of-duties situation exists.
- o. Duties affecting income taxes can conflict with other duties affecting income taxes, such as duties affecting cash disbursements, interpretations of tax requirements, computations of taxes, and matters related to these items. If the person who performs the duties affecting income taxes and related matters that are possible sources of errors or misstatements also performs duties that might detect those errors or misstatements, a conflict-of-duties situation exists.
- p. Duties affecting revenues can conflict with other duties affecting revenues, such as duties affecting invoicing or collections. If the person who performs the duties affecting revenues, trade accounts receivable, miscellaneous accounts receivable, collections, discounts, special credits, or other revenue-related items that are possible sources of errors or misstatements also performs duties that might detect those errors or misstatements, a conflict-of-duties situation exists.
- q. Duties affecting cost of sales can conflict with other duties affecting cost of sales, such as duties affecting cash disbursements, purchases of inventory, accounts payable, payroll, and relief of inventory with revenues. If the person who performs the duties affecting cost of sales and related matters that are possible sources of errors or misstatements also performs duties that might detect those errors or misstatements, a conflict-of-duties situation exists.
- r. Duties affecting operating expenses can conflict with other duties affecting operating expenses, such as duties affecting cash disbursements; the incurrence of prepaid expenses and other current assets and their amortization; depreciation; the incurrence of deferred charges, other assets, intangibles and their amortization; accounts payable; and payroll. If the person who performs duties affecting operating expenses and related matters that are possible sources of errors or misstatements also performs duties that might detect those errors or misstatements, a conflict of duties situation exists.

- s. Duties affecting other income can conflict with other duties affecting other income, such as duties affecting miscellaneous cash receipts, investments, miscellaneous accounts receivable, or property, plant, and equipment. If the person who performs the duties affecting miscellaneous cash receipts, investments, miscellaneous accounts receivable, or property, plant, and equipment, or additional other income-related items that are possible sources of errors or misstatements also performs duties that might detect those errors or misstatements, a conflict-of-duties situation exists.
 - t. Duties affecting other expenses can conflict with other duties affecting other expenses, such as duties affecting cash disbursements; investments; the incurrence of prepaid expenses and other current assets and their amortization; depreciation; the incurrence of deferred charges, other assets, intangibles and their amortization; accounts payable; and payroll. If the person who performs duties affecting other expenses and related matters that are possible sources of errors or misstatements also performs duties that might detect those errors or misstatements, a conflict-of-duties situation exists.
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Exhibit 5-5, “Individual Conflict of Duties Analysis,” provides a format for comparing the tasks that are performed by someone who has been found to have potentially conflicting duties. This Exhibit builds on information indicating potential conflicts, such as the indications developed by using the matrices in Exhibits 5-3 and 5-4. Exhibit 5-5 calls for a specific analysis that addresses whether any errors or misstatements (intentional or unintentional) that might occur while performing one task would ordinarily be detected by properly performing any other tasks performed by the individual. If so, then a conflict exists in the duties of the person. If such a conflict is determined to exist, then the nature of the conflict should be documented, along with an explanation about how errors or misstatements that might occur while performing the conflicting tasks would ordinarily be detected by the proper performance of one or more other tasks by parties other than the person with the conflict. If it is found that no tasks are performed that could be expected to detect errors or misstatements that might occur in the performance of conflicting duties, a control deficiency exists that should be further analyzed.

IT Activities

Internal Control Design Analysis includes identifying the control activities in place that are designed to ensure that software applications function without producing errors and/or material misstatements to the financial statements. Although software applications

do not make errors in the same way that humans do, errors are possible as a result of either inappropriate or inadequate programming. Inappropriate or inadequate programming can be intentional or it can be situational. That is, the software may not be able to accommodate all the situations that are presented to it. Consequently, management should not assume that computer software makes no mistakes simply because it is computer software. Control activities related to activities performed by computer software can be internal to the software, with such things as comparisons of control totals or alternative computations, or external to it. Further, a control activity over one software application may be built into another. Because some risk is present with software applications as well as other activities, software applications should be evaluated with respect to each of the Basic and Underlying Risks discussed in Chapter 4, "Tentative Risk Assessments." The illustration below lists ways in which the conditions precipitating those risks can be applicable to IT applications.

Illustration 5-3: Underlying Activity Level Financial Reporting Risk Identification—IT Applications

Risks

Basic Risk 1—The facts [input] are not correct or complete.

Applicability to Software

The risk of incorrect input applies not equally to tasks performed by software and to manual tasks.

Conditions Precipitating Risk (Underlying Risks)

- | | |
|---------------------------------------------------------------|----------------------------------------------------------------------------------------------------------------------|
| 1. External data is not correct or complete. | The risk of incorrect external data applies equally to tasks performed by software and to manual tasks. |
| 2. Results of preceding process are not correct. | The risk of incorrect preceding task results applies equally to tasks performed by software and to manual tasks. |
| 3. External data or results of preceding process are altered. | The risk of alteration to preceding task results applies equally to tasks performed by software and to manual tasks. |
| 4. Management intervention. | The risk of management intervention applies equally to tasks performed by software and to manual tasks. |

Risks

Applicability to Software

5. Other.

Basic Risk 2—The facts are not correctly interpreted or applied.

There is a risk that software will not be appropriately or adequately programmed to correctly apply input.

Conditions Precipitating Risk (Underlying Risks)

1. Meaning of data is not understood.

Because programmers may not understand the meaning of input data, there is a risk that software will not be appropriately or adequately programmed to correctly apply input.

2. Purpose of activity is not understood.

Because programmers may not understand the purpose of the activity to which the application will be applied, there is a risk that software will not be appropriately or adequately programmed to correctly apply input.

3. Manner of data application is not understood.

Because programmers may not understand the proper way to apply accounting or financial information, there is a risk that software will not be appropriately or adequately programmed to correctly apply input.

4. Management intervention.

The risk of management intervention applies equally to tasks performed by software and to manual tasks.

5. Other.

Basic Risk 3—Specified mathematical operations to be applied to the facts are not appropriate to the circumstances.

There is a risk that software will not be appropriately or adequately programmed to apply the correct mathematical operations.

Conditions Precipitating Risk (Underlying Risks)

1. Purpose of activity is not understood.

Because programmers may not understand the purpose of the activity to which the application will be applied, there is a risk that software will not be appropriately or adequately programmed to apply the correct mathematical operations.

Risks

2. Mathematical operation is not understood.

Applicability to Software

Because programmers may not understand the objectives of mathematical operations for which the application is to be used, there is a risk that software will not be appropriately or adequately programmed to apply the correct mathematical operations.

3. Circumstances are not understood.

Because programmers may not understand the circumstances under which the application is to be used, there is a risk that software will not be appropriately or adequately programmed to apply the correct mathematical operations.

4. Alternatives are not understood.

Because programmers may not understand appropriate alternatives for the circumstances under which the application is to be used, there is a risk that software will not be appropriately or adequately programmed to apply the correct mathematical operations.

5. Management intervention.

The risk of management intervention applies equally to tasks performed by software and to manual tasks.

6. Other.

Basic Risk 4—The accounting principle to be applied is not be appropriate to the circumstances.

There is a risk that software will not be appropriately or adequately programmed to correctly apply the accounting principles appropriate for the circumstances.

Conditions Precipitating Risk (Underlying Risks)

1. Applicability of accounting principle is not known or understood.

Because programmers may not understand the applicability of accounting principles to the circumstances for which the application is to be used, there is a risk that software will not be appropriately or adequately programmed to apply the correct accounting principles.

Risks

2. Required conditions are not understood.

3. Alternatives are not understood.

4. Management intervention.

5. Other.

Basic Risk 5—The accounting principle identified is not correctly applied.

Applicability to Software

Because programmers may not understand the conditions necessary to apply certain accounting principles to the circumstances for which the application is to be used, there is a risk that software will not be appropriately or adequately programmed to apply the correct accounting principles.

Because programmers may not understand the appropriate alternative accounting principles for the circumstances for which the application is to be used, there is a risk that software will not be appropriately or adequately programmed to apply the correct accounting principles.

The risk of management intervention applies equally to tasks performed by software and to manual tasks.

There is a risk that software will not be appropriately or adequately programmed to correctly apply the accounting principles to be used.

Conditions Precipitating Risk (Underlying Risks)

1. Proper manner of application of accounting principle is not known understood.

Because programmers may not understand the proper way to apply the accounting principles to be reflected in the application, there is a risk that software will not be appropriately or adequately programmed to correctly apply accounting principles.

2. Required conditions are not properly applied.

Because programmers may not understand the conditions required for the proper application of certain accounting principles to be reflected in the application, there is a risk that software will not be appropriately or adequately programmed to correctly apply accounting principles.

Risks

Applicability to Software

- | | |
|-------------------------------------------------------------------------------------|---------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| 3. Alternatives are not understood. | Because programmers may not understand the acceptable alternative ways of applying certain accounting principles to be reflected in the application, there is a risk that software will not be appropriately or adequately programmed to correctly apply accounting principles. |
| 4. Management intervention. | The risk-of-management intervention applies equally to tasks performed by software and to manual tasks. |
| 5. Other. | |
| Basic Risk 6 —Specified mathematical operations are not correctly performed. | There is a risk that software will not be appropriately or adequately programmed to correctly perform the mathematical operations to be used. |

Conditions Precipitating Risk (Underlying Risks)

- | | |
|-------------------------------------------------------------------------------------------|-------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| 1. The proper manner of application of mathematical operation is not known or understood. | Because programmers may not understand the proper way to apply specified mathematical operations to be reflected in the application, there is a risk that software will not be appropriately or adequately programmed to correctly apply mathematical operations. |
| 2. Management intervention. | The risk-of-management intervention applies equally to tasks performed by software and to manual tasks. |
| 3. Other. | |

Because the same essential risks apply to IT activities as to human activities, control activities that mitigate the risks of errors produced by IT activities should be identified. Exhibit 5-1, “Control Activities Related to Identified Individual Activity Risk,” may be used for that purpose.

Sufficiency of Controls

Regardless of the existence of conflicting duty situations, companies should have sufficient controls in place to prevent or detect errors or fraud. Therefore, companies must have controls that are designed

effectively and that operate effectively. Controls are effectively designed when the controls, if complied with, can be expected to prevent or detect errors or fraud that could result in misstatements in the financial statements on a timely basis. Controls operate effectively when they (a) are properly designed but do not operate as designed or (b) when the person performing the control does not possess the necessary authority or competence to perform the control effectively. Determining whether a company has the controls to meet the objectives involves:

- Identifying the company's control objectives in each area;
- Identifying the controls that satisfy each objective; and
- Determining whether the controls, if operating properly, can effectively prevent or detect errors or fraud that could result in material misstatements in the financial statements.

Although it is important to pay attention to all five of the COSO components of internal control—Control Environment, Risk Assessment, Control Activities, Information and Communication, and Monitoring—the Control Activities component is often the component that interacts with specific accounting tasks in the most directly observable way. Control Environment, although very important, is an intangible quality related to influences. Risk Assessment, in relation to specific accounting/financial reporting procedures, is the component that management should apply in determining the sufficiency of those procedures and in establishing sufficient Control Activities. Information and Communication is necessary to carry out specific accounting/financial reporting procedures; therefore Control Activities should ensure that proper information is conveyed and that communications are adequate and operating effectively. Monitoring overlaps with Control Activities and Risk Assessment in relation to specific accounting/financial reporting procedures and is necessary, since it is necessary to monitor the effectiveness of specific procedures, evaluate associated control activities, and consider the sufficiency of both.

Up to now, the identification of the specific accounting/financial reporting procedures and the risks and control activities related to them has been discussed. From this work, determinations can be made about whether existing controls can be expected to prevent or detect errors or fraud that could result in material misstatements in the financial statements. Following, or concurrent with, the identification of mitigating control activities associated with each of the basic risks related to each activity in the financial reporting process, a judgment should be made about whether the identified mitigating control activity associated with each task would prevent or detect errors or fraud, and if so, how. The documentation identifying mitigating control activities (such as shown by Exhibit 5-1, "Control

Activities Related to Identified Individual Activity Risk”) for each task may be consolidated into a single document applicable to each set of activities, identified when mapping the system, as in Chapter 3, “Mapping the Organization.” The consolidated document for the activity set may then contain judgments about whether the mitigating control activities should be effective in preventing or detecting errors. After the judgments are made concerning the effects of mitigating control activities, information about how the other four components of internal control affect the activity set should be documented. The documentation concerning the effect of those other four components of internal control should explain how they should operate to prevent or detect errors, along with a judgment about whether they are fulfilling that function.



PRACTICE POINTER: The documentation identifying mitigating control activities at very small companies may be further consolidated to address all activities, not just each set of control activities, because of the small number of activities and the small number of personnel. Thus, the identification of control activities can be performed jointly for all accounting and financial reporting activities (or sets of activities) and for all the types of basic risks. Exhibits 5-14 and 5-15 can assist with the documentation identifying mitigating control activities.

In larger organizations, in order to provide for the efficient analysis of the effects of these components on the various routes or sets of activities, they should be grouped in such a way as to allow for the analysis of the effects of each of these four components of internal control on an entire group of routes or activity sets. For example, as a start, routes or activity sets should be grouped according to the *Control Environment* in which they operate to facilitate a single analysis of the effects of their Control Environment on the prevention or detection of errors. Second, routes or activity sets should also be grouped according to the *Risk Assessment* mechanisms to which they are subject to facilitate a single analysis of the effects of Risk Assessment management on the prevention or detection of errors. Third, routes or activity sets should also be grouped according to the *Information and Communication* lines to which they are subject to facilitate a single analysis of the effects of Information and Communication management on the prevention or detection of errors. Fourth, routes or activity sets should also be grouped according to the *Monitoring* mechanisms to which they are subject to facilitate a single analysis of the effects of Monitoring management on the prevention or detection of errors. Exhibits 5-6, 5-7, 5-8, and 5-9 are practice aids that can be used to analyze the effects of the Control Environment, Risk Assessment, Information and Communication, and Monitoring aspects of Internal Control on the prevention and detection of errors for specific routes (activity sets) or groupings of routes. These Exhibits are designed to provide a direct link between the specific aspects

of internal control as set forth in the COSO Framework and the activities in the accounting/financial reporting process.


*Analysis of the Effects of the Control Environment on Activities
(read in conjunction with the condensed description of the
COSO 2009 Guidance on Monitoring Internal Control
Systems provided earlier in this chapter)*

In developing a link between the Control Environment and the activities in the accounting/financial reporting process, analysis should be made to determine how important aspects of the Control Environment specifically contribute to error prevention and detection. To accomplish this objective, the important aspects of the Control Environment, **as they relate to the specific activities under analysis**, must be scrutinized to determine:

- Whether management adequately emphasizes the importance of integrity.
- Whether an attitude of control-consciousness and a positive “tone at the top” exists to promote the prevention and detection of errors.
- Whether duties are assigned to people that are commensurate with their abilities.
- Whether management’s operating style is effective and appropriate.
- Whether management understands the requirements of pertinent laws and regulations.
- Whether management adequately considers the potential effects of taking unusual business risks.
- Whether there is sufficient review of output by management, the board of directors, the audit committee, or others.
- Whether there is a willingness to correct important weaknesses in the system of internal control that might be identified from time to time.
- Whether up-to-date accounting policies and procedures are maintained and documented to facilitate their understanding.
- Whether there is an adequate chart of accounts maintained which describes the nature of each account to facilitate understanding.
- Whether management periodically reviews insurance coverage.
- Whether reliable accounting estimates are established.
- Whether the turnover of accounting, IT, and key management positions is indicative of difficulties.

- Whether there is adequate staffing to avoid constant crisis.
- Whether there is adequate coordination between accounting and IT departments.
- Whether there is an adequate organization chart sufficiently reflecting the areas of responsibility and lines of reporting.
- Whether there are there formal job descriptions that clearly set out duties and responsibilities.
- Whether there are adequate background and reference checks of applicants for financial, IT, and key management positions.
- Whether personnel policies and employee benefit plans covering employees performing are adequately documented and communicated to the employees.
- Whether there is a formal and/or adequate conflict-of-interest policy or code of conduct for employees.
- Whether employees who handle cash, securities, and other valuable assets are bonded.
- Whether the job assignments of related employees, if any, minimize opportunities for collusion.
- Whether employees are adequately trained to meet their assigned responsibilities.
- Whether there is an adequate rotation of duties enforced by mandatory vacations.
- Whether job performances are periodically evaluated and reviewed with employees in an appropriate manner.
- Whether there are adequate policies and procedures for the development, modification, and use of computer programs and data files.
- Whether the board of directors or audit committee takes an active oversight role in accordance with the entity's policies and practices.
- Whether the board of directors or audit committee approves the appointment of the independent auditors.
- Whether the board of directors or audit committee has sufficient knowledge, experience, and time to serve effectively.
- Whether the board of directors or audit committee constructively challenges management and takes necessary, appropriate actions.
- Whether the board of directors or audit committee meets in a timely manner with the chief accounting officer and the internal and external auditors to discuss the reasonableness of the performance of the financial reporting process, the system of internal control, and other significant matters.
- Whether the board of directors or audit committee adequately reviews the scope of activities of the external and internal auditors.

- Whether the board of directors or audit committee regularly receives and reviews key information.
- Whether the board of directors or audit committee is informed in a timely manner about sensitive information, investigations, and improper acts (e.g., significant litigation, investigations by regulatory agencies, embezzlement, misuses of corporate assets).
- Whether the board of directors or audit committee appropriately oversees the compensation and benefits of management.
- Whether the board of directors or audit committee is sufficiently involved in establishing and evaluating the effectiveness of the “tone at the top” (e.g., approving the entity’s code of conduct or policy and procedure manual).

 **PRACTICE POINTER:** Very small companies have the same concerns regarding the control environment as larger companies. However, the control environment of very small companies can have a greater effect on internal controls than it does at larger companies because of the close relationship between management and others in small companies. In addition, small companies do not have as many alternatives in designing control activities. (In larger companies, there can be two or more layers of reporting, thus providing multiple control environment layers.) Exhibit 5-16 provides a simplified checklist for analyzing the effects of the control environment.

Analysis of the Effects of Management Risk Assessments on Activities (read in conjunction with the condensed description of the COSO 2009 Guidance on Monitoring Internal Control Systems provided earlier in this chapter)

In a manner analogous to the above, developing a link between Management’s Risk Assessments and the activities in the accounting/financial reporting process, an analysis should be made to determine how important aspects of those Risk Assessments (or lack thereof) specifically contribute to error prevention and detection. To accomplish this objective, the important aspects of Management Risk Assessment, **as it relates to the specific activities under analysis**, must be scrutinized to determine:

- Whether clear objectives are in place that are consistent with its business plans and budgets.
- Whether objectives for key matters that are consistent with and linked to entitywide objectives and strategies have been established.

- Whether the resources and critical factors that are important to achieving objectives (e.g., financing, personnel, facilities, and technology) have been identified.
- Whether there has been adequate consideration of risks arising from external sources (e.g., supply sources, creditors' demands, competitors' actions, regulation, natural events).
- Whether there has been adequate consideration of risks arising from internal sources (e.g., retention of key personnel or changes in their responsibilities, compensation and benefit programs to keep the entity competitive, the adequacy of backup systems in the event of failure of systems that could significantly affect operations).
- Whether significant shifts in the entity's industry (e.g., changes in customer demographics, preferences, or spending patterns) have been adequately identified and monitored
- Whether there has been adequate consultation with legal counsel regarding the implications of any new legislation.
- Whether new employees in key positions are adequately supervised to ensure that they understand and perform in accordance with the entity's policies and procedures.
- Whether there are adequate procedures in place to assess the effects of new or redesigned information systems and monitor new technologies.
- Whether there are adequate procedures in place to handle rapidly increasing volumes of information.
- Whether appropriate consideration is given to major factors such as customer demand, production capabilities, and profitability implications when considering the development of new product lines.
- Whether staff reassignments and reductions in connection with corporate restructurings are appropriately analyzed for their potential effect on operations or on the morale of the remaining employees.
- Whether there is an awareness of the political, regulatory, business, and social culture of areas in which foreign operations exist and whether personnel are made aware of accepted customs and rules.
- Whether there is an awareness of the existence of new accounting or reporting pronouncements and how they may affect the activity or activities and the entity's financial reporting practices.



PRACTICE POINTER: As with the other components of internal control, very small companies have to address the same

matters regarding risk assessment as larger companies. With respect to risk assessment, very small companies are often more likely to take greater risks than larger companies because their business is typically more entrepreneurial, has limited access to capital, is less able to attract qualified people, and generally has fewer resources than larger companies. This business environment can create a “vicious circle” in that access to more resources can make a difference between business success and business failure. Exhibit 5-17 provides a simplified checklist for analyzing the effects of management risk assessment on internal control.

Analysis of the Effects of Information and Communication on Activities (read in conjunction with the condensed description of the COSO 2009 Guidance on Monitoring Internal Control Systems provided earlier in this chapter)

As with the preceding, developing a link between Information and Communication and the activities in the accounting/financial reporting process should involve an analysis to determine how important aspects of Information and Communication in the organization and especially as pertinent to the activities under analysis specifically contribute to error prevention and detection. To accomplish this objective, the important aspects of Information and Communication, **as it relates to the specific activities under analysis**, must be scrutinized to determine:

- Whether there are mechanisms in place to obtain relevant external information (e.g., on market conditions, competitors’ programs, legislative or regulatory developments, and economic changes) and internally generated information critical to the activity or activities and the achievement of related objectives.
- Whether the information necessary to perform the activity or activities is provided to the right people in sufficient detail and on time to enable them to carry out their responsibilities efficiently and effectively.
- Whether information systems related to the activity or activities and to financial reporting are adequate, interrelated with the entity’s overall information systems, and responsive to achieving the entitywide and activity-level objectives.
- Whether the appropriate human and financial resources are committed to develop and serve the necessary financial reporting information systems.
- Whether employees’ duties and control responsibilities are communicated in an effective manner.

- Whether communication channels are established for people to report suspected improprieties.
- Whether communication flows across the organization adequately (e.g., from shipping to accounting) to enable people to discharge their responsibilities effectively.
- Whether timely and appropriate follow-up action is taken on communications received from customers, vendors, regulators, or other external parties.
- Whether parties outside the organization review and follow up on the organization's actions (e.g., an active review of bank loan agreements).



PRACTICE POINTER: Obtaining information that affects a business and its internal controls can be as much of a problem at very small companies as it can be at larger companies. However, dissemination of information at smaller companies is much simpler than it is at larger companies. At both small and large companies, management and others may not recognize the type of information that should be gathered and communicated to company personnel. Larger companies face the task of communicating information to the right people. Smaller companies also face that task, but the communications are simpler. Exhibit 5-18 provides a simplified checklist for analyzing the effects of information and communication on internal control.

Analysis of the Effects of Monitoring on Activities (read in conjunction with the condensed description of the COSO 2009 Guidance on Monitoring Internal Control Systems provided earlier in this chapter)

Developing a link between Monitoring and the activities in the accounting/financial reporting process should also involve an analysis to determine how important aspects of Monitoring in the organization, especially as pertinent to the activities under analysis, specifically contribute to error prevention and detection. To accomplish this objective, the important aspects of Monitoring, **as it relates to the specific activities under analysis**, must be scrutinized to determine:

- Whether operating information used to manage operations is integrated or reconciled with data generated by the accounting/financial reporting activity or activities.
- Whether information from other parts of the financial reporting system is integrated or reconciled with data generated by the accounting/financial reporting activity or activities.

- Whether complaints are investigated and any internal control deficiencies corrected.
- Whether communications from vendors and monthly statements of accounts payable are used as a control monitoring technique.
- Whether internal control recommendations made by external auditors (and internal auditors, if applicable) are implemented.
- Whether feedback from training seminars, planning sessions, and other meetings on whether controls operate effectively is acted upon.
- Whether the organization takes a fresh look at the internal control system from time to time and whether its effectiveness is periodically evaluated.
- Whether any evaluation process includes checklists, questionnaires, or other tools.
- Whether any evaluations made are documented.
- Whether the entity has an adequate internal audit function.
- Whether internal auditors, if any, possess adequate training and experience.
- Whether internal auditors, if any, adhere to applicable professional standards.
- Whether internal audits, if any, have an adequate documentation of the organization's internal control related to the activity or activities.
- Whether internal audits, if any, include tests of controls and substantive tests related to the activity or activities.
- Whether internal audits, if any, have adequate documentation of the work related to the activity or activities.
- Whether internal audit reports on findings about the activity or activities, if any, have been submitted to the board of directors or audit committee.
- Whether internal audit reports, if any, are submitted in a timely manner.
- Whether there has been follow-up on corrective actions taken by management related to any internal audit reports.
- Whether internal auditors, if any, have direct access to the board of directors or audit committee.
- Whether internal auditors, if any, have direct access to records.
- Whether the scope of any internal audit activities is limited.



PRACTICE POINTER: The analysis of the effect of the monitoring component of internal control is less difficult at very small companies. Exhibit 5-19 provides a simplified checklist for analyzing the effects of monitoring on internal control.

Analysis of the Effects of the Control Environment, Risk Assessment, Information and Communication, and Monitoring

The analysis of the effects of the Control Environment, Risk Assessment, Information and Communication, and Monitoring aspects of Internal Control on the prevention and detection of errors for specific routes (activity sets), as described above and demonstrated in Exhibits 5-5 through 5-9, may be combined with the analysis of the effects of Control Activities, as discussed under “Control Activities,” earlier in this chapter and demonstrated in Exhibits 5-1 and 5-2. The combined analysis provides a blueprint of the design of the organization’s internal control and reveals the effect internal controls have on financial reporting process activities relative to the risks identified as being applicable to the activities. Exhibit 5-10, “Analysis of the Effect of Internal Control Components on Routes,” is a practice aid that is designed to pull together all of these internal control considerations relative to the risks identified. With Exhibit 5-10, the risks applicable to an activity set (i.e., route), identified as discussed in Chapter 4, “Tentative Risk Assessments,” are matched against the individual processing tasks in the activity set, identified in the process of “Mapping the Organization” (Chapter 3 of this book). These activities and risks are then matched against mitigating control activities (MCAs), as identified by using Exhibits 5-1 and 5-2 or something similar. Stated mitigating control activities (MCAs) should then be analyzed to determine whether they should be effective in preventing or detecting errors related to the risk indicated that might be made in performing the tasks in the activity set. In addition, the activities and risks are then matched against the effects of the other four components of internal control—Control Environment, Risk Assessment, Information and Communication, and Monitoring—as to how those components should be effective in preventing or detecting errors related to the risk that might be made in performing the tasks in the activity set.

The sufficiency of controls, from an internal control design standpoint, may be judged by making the determinations about whether existing controls should operate to prevent or detect errors, since those judgments should lead to the identification of significant deficiencies or material weaknesses in internal control. The determinations made about the capacity of internal controls to prevent or detect errors leads directly to the identification of control deficiencies. Control deficiencies are indicated in each case where the existing controls are not sufficient to prevent or detect errors. Thus, performance of the foregoing procedures yields a list of control deficiencies. The control deficiencies so identified should then be analyzed to determine their significance.

Likelihood of Misstatement

The significance of control deficiencies is a function of the likelihood that they will cause a misstatement in the financial statements. It does not depend on whether a misstatement actually has occurred, but on the potential for misstatement. Therefore, once control deficiencies have been identified, the probability that they will cause a misstatement must be assessed.

A variety of factors affect the probability that a deficiency, or a combination of deficiencies, could result in a misstatement of an account balance or disclosure. Such factors include:

- The type of transactions and the nature of the financial statement accounts and disclosures involved; for example, the existence of a suspense account indicates some type of unknown or unresolved matter, and engaging in transactions involving complex financial instruments carry a greater risk.
- The degree of susceptibility of an asset or liability to loss or fraud.
- The subjectivity, complexity, or extent of judgment necessary to determine the amount involved; for example, estimating fair values is frequently complex, subjective, and requires a high degree of judgment.
- The frequency of known or detected exceptions to the operating effectiveness of a control.
- The interaction or relationship of one control with another control, that is, the interdependence of controls.
- The interaction of the deficiencies, such as when a combination of two or more deficiencies can affect the same financial statement accounts and assertions.
- Any potential future consequences of the deficiency.

Evaluating the likelihood that a deficiency or combination of deficiencies could result in a misstatement should involve evaluating how controls interact with each other. Some controls depend on other controls, some controls function together as a group of controls, and still other controls overlap or achieve the same objective.

The COSO Framework discussion of the need to assess risk suggests that management should keep these considerations in mind when evaluating the likelihood that control deficiencies will result in misstatements. When control deficiencies are identified based on the way that controls address risks, assessments about the likelihood that control deficiencies will result in misstatements is equivalent to making assessments about the likelihood that the underlying risks may result in misstatements. As previously noted, the COSO Framework also points out that “many risks are indeterminate in size. At best they

can be described as “large,” “moderate” or “small.”” The assessment of likelihood is inherently a subjective matter. Therefore, the author does not believe management should attempt to go to a level of precision beyond “large,” “moderate” or “small” in making its assessments about the likelihood of control deficiencies causing misstatements.



PRACTICE POINTER: The AICPA Guide, *Audit Sampling*, refers to an auditor’s assessed level of control risk in its discussion of sampling to test internal controls. The assessed level of control risk affects the sample sizes an auditor would choose to perform his or her testing. Auditing literature such as this generally does not depict assessed levels of control risk more precisely than “high,” “medium” or “low” or “maximum,” “slightly below maximum,” “moderate” or “low.” From a statistical standpoint, a more refined assessment of the likelihood that controls will or will not prevent or detect errors should be based on objective evidence, which is, by default, more than is possible from management’s subjective determinations.

Management may make judgments about the likelihood that control deficiencies will result in misstatements by making a detailed analysis of the reasons behind the deficiencies and their potential effects. Control deficiencies exist when the combined effects of all of the components of internal control are not judged to be sufficient to prevent or detect errors. Management’s detailed analysis might consider the ways that the risks and the components of internal control relate to the control deficiencies, as follows:

- The Route (Activity Set) (Exhibits 3-1 and 3-2)—The function of the set of activities can have a direct relationship to the possibility for misstatement of the financial statements or the disclosures to the financial statements. Some activities are more likely to cause misstatements because they may be complex or involve information that is difficult to capture.
- The Nature of Control Deficiency—The reason that a control deficiency was identified is related to the possibility that it may cause misstatements. Control deficiencies should be identified because the organization’s application of the components of internal control has been judged as insufficient to prevent or detect potential errors resulting from identified risks. Some risks have a greater potential to produce errors than others, and some aspects of the components of internal control have a direct relationship to specific risks, while others are more influential by nature.
- The Nature of the Risks Related to the Control Deficiency:
 - Risks involving competencies include how well people, or software applications developed by people, are able to perform. Management must consider the intelligence and other

abilities of its people, in the absence of internal controls, when considering the likelihood that misstatements will occur. These could include the basic risks BR2-2, BR3-1, and BR3-3 in Exhibit 5-10. They often will relate to control activities involving performance of activities, control environment matters involving control-consciousness and discipline and structure, risk assessments related to processes used to consider risks, and monitoring and evaluating control design and operation.

- Risks involving knowledge are those that are concerned with whether people, regardless of their intelligence and other abilities, have the knowledge necessary to perform the tasks required of them. These could include the basic risks BR2-1, BR2-3, BR2-5, BR3-2, BR3-4, BR3-6, BR4-1, BR4-2, BR4-3, BR4-5, BR5-1, BR5-2, BR5-3, BR5-5, BR6-1, and BR6-3 in Exhibit 5-10. They often will relate to control environment matters involving awareness of management, risk assessments related to decisions about responses to risks, and monitoring to identify needs for improvement and corrective action.
 - Risks involving security or control include the risks of collusion to perpetrate a fraud, the risk that a single individual with conflicting duties could engage in fraud, the risk that management's activities will not be sufficient to prevent or detect unintentional, as well as intentional, errors. These could include the basic risks BR1-4, BR2-4, BR3-5, BR4-4, BR5-4, and BR6-2 in Exhibit 5-10. They often will relate to control activities involving physical controls and segregation of duties, control environment matters involving attitude of management and actions of management, risk assessments related to estimates about risk significance and assessments about risk probability, information and communication matters that concern the identification of pertinent information, and monitoring for appropriate follow-up procedures.
 - Risks involving information include risks about the availability of correct appropriate information. These could include the basic risks BR1-1, BR1-2, BR1-3, and BR1-5 in Exhibit 5-10. They often will relate to control activities involving information and information and communication matters concerning the obtaining of necessary information and the communicating of information.
- Is the item a control deficiency because there are inadequate control activities? If so, what are the inadequacies of the control activities? Are the inadequacies of the control activities related to:
 - Performance of activities?
 - Information, such as failures to ensure that proper information is provided?

- Physical controls?
- Segregation of duties?

If these items are the cause of the control deficiency, is there a direct relationship to potential misstatements, or are these inadequacies more aptly described as negative influences? Are there compensating controls that make up for the indicated control deficiency?

- Is the item a control deficiency because of inadequacies in the control environment? If so, what are the inadequacies in the control environment? Are the inadequacies of the control environment related to:
 - Control consciousness?
 - Discipline and structure?
 - Attitude of management?
 - Actions of management?
 - Awareness of management?
 - Board oversight of management?

If these items are the cause of the control deficiency, is there a direct relationship to potential misstatements, or are these inadequacies more aptly described as negative influences? Are there compensating controls that make up for the indicated control deficiency?

- Is the item a control deficiency because of inadequate risk assessment? If so, what are the inadequacies of the related risk assessments? Are the inadequacies of the risk assessments related to:
 - Processes used to consider risks?
 - Estimates about risk significance?
 - Assessments about risk probability?
 - Decisions about responses to risks?

If these items are the cause of the control deficiency, is there a direct relationship to potential misstatements, or are these inadequacies more aptly described as negative influences? Are there compensating controls that make up for the indicated control deficiency?

- Is the item a control deficiency because of inadequate information or communication? If so, what are the inadequacies of information or communication related to the activity or activities? The information gathering dimension is intimately related to monitoring with the goal of obtaining persuasive

information. Are the inadequacies concerning information or communication related to:

- Identification of pertinent information?
- Obtaining persuasive information?
- Is the information gathered of the appropriate kind (quality) and is it enough to draw reliable inferences (quantity)? (In other words, is the information relevant, reliable, timely and sufficient, i.e., persuasive)
- Communicating information?

If these items are the cause of the control deficiency, is there a direct relationship to potential misstatements, or are these inadequacies more aptly described as negative influences? Are there compensating controls that make up for the indicated control deficiency?

- Is the item a control deficiency because of inadequate monitoring? If so, what are the inadequacies of the monitoring of the related activity or activities? Are the inadequacies concerning monitoring related to:
 - Scope, nature, frequency, and precision of monitoring activities? (COSO 2009)
 - Use of ongoing monitoring and/or separate evaluations in gathering direct and indirect information, a combination of which may be regarded “persuasive”? (COSO 2009)
 - Evaluating control design and operation? Continued effectiveness of the operation of controls over time?
 - Identifying needs for improvement and corrective action?
 - Follow-up procedures?

If these items are the cause of the control deficiency, is there a direct relationship to potential misstatements, or are these inadequacies more aptly described as negative influences? Are there compensating controls that make up for the indicated control deficiency? How can monitoring effectiveness as well as efficiency be assessed and improved? (COSO 2009)

This specific consideration of the reasons behind control deficiencies and their relationship to the COSO components of internal control provides a basis for support for determinations about each control deficiency’s potential to cause a misstatement. In making judgments about the likelihood that misstatements will be produced, those matters of risk and internal control that have a direct relationship to the potential of an activity to produce a misstatement should be given greater weight than matters that are more influential in nature. When there are numerous influencing factors behind a control deficiency, however, management should give serious consideration

to the possibility that misstatements will result, even if there are no direct connections between a control deficiency and a potential misstatement. In this regard, a direct relationship between a control and the potential of an activity to produce a misstatement may be thought of as a relationship where errors would be prevented or detected if the control were in place and operating properly. An example of such a control might be a supervisor's detailed review of specific calculations. Alternatively, an influencing factor has no such direct relationship to the output of an activity. For example, an employee might be more prone to make mistakes if he perceives that he is not treated fairly or if he perceives a lack of integrity within management. In addition, there will frequently be overlaps in the manner in which the causes for control deficiencies relate to the COSO components of internal control. For example, a company might not perform adequate control activities owing to a lack of control-consciousness or discipline in its control environment. Compensating controls—controls related to other activities that impact the activity set where a control deficiency has been identified—must also be considered.

Management may choose to weight each factor that it identifies as underlying a control deficiency based on whether those underlying factors have a direct or indirect relationship to potential misstatements, the degree of overlap in the underlying factors, and the existence of compensating controls. In making its analysis, management should assess the likelihood that a control deficiency will result in an error and should also assess whether any such error will result in a misstatement.

Exhibits 5-11 and 5-13 are designed as an example of one way to perform these analyses of the likelihood that misstatements will result from control deficiencies. These Exhibits are designed to relate the assessed likelihood for misstatement to assessments of inadequacies associated with the COSO components of internal control. Using the items discussed under the bullet points above, Exhibit 5-11 is designed as a first step for analyzing the potential for misstatement from the standpoint of the COSO components of internal control. For each "Yes" response in column (b), either column (d) or column (e) would be checked depending on whether there is a direct or indirect relationship between the control factor and the potential of the activity to produce a misstatement. "Yes" or "No" would be checked if there are or are not compensating controls to make up for the identified control deficiency. Column (g) would contain management's assessment about the probability (high, medium, or low) that the control deficiency would lead to an error from the activity or set of activities. Based on those high, medium, or low probability assessments, management could compute factors relative to its assessment of the probability that an error resulting from each identified control deficiency will result in a misstatement based on whether there are or are not compensating controls and on whether the control deficiency would or would not *directly* lead to a misstatement. The factors computed that are judged

as root causes for possible misstatements would be weighted based on management's judgment concerning their relative importance. If the sum of the weighted factors amounts to a "more than remote" likelihood for misstatement, a significant deficiency in internal controls would be indicated.

The following table provides an example of one way that management could go about developing likelihood factors for use in determining the likelihood of a misstatement. The example factors appear in the rows and columns of the body of the table:

<i>Assessment of Probability of Error</i>	<u>Relationship to Potential Misstatement^a</u>			
	<u>Indirect Effect</u>		<u>Direct Effect</u>	
	<u>With Comp Controls</u>	<u>W/O Comp Controls</u>	<u>With Comp Controls</u>	<u>W/O Comp Controls</u>
High (67–100%)	21%	42%	62%	83%
Medium (34–66%)	12%	25%	37%	50%
Low (0–33%)	4%	8%	12%	17%

^a These factors were developed as an example only. They were computed by assuming that the mitigating effects on the possibility for misstatement represented by each of the conditions in the four columns are inversely related to the nearness of the relationship between the control deficiency and the possibility for a misstatement caused by it. For purposes of this example, the following assumptions were made:

—Where there is no direct relationship between a control deficiency and a possible misstatement and there are compensating controls, the probability that an error resulting from the control deficiency will result in a misstatement will range from 0–25%. The factors in the corresponding column of the above table are averages assuming 25%.

—Where there is no direct relationship between a control deficiency and a possible misstatement, but there are no compensating controls, the probability that an error resulting from the control deficiency will result in a misstatement will range from 26–50%. The factors in the corresponding column of the above table are averages assuming 50%.

—Where there is a direct relationship between a control deficiency and a possible misstatement, but there are compensating controls, the probability that an error resulting from the control deficiency will result in a misstatement will range from 51–75%. The factors in the corresponding column of the above table are averages assuming 75%.

—Where there is a direct relationship between a control deficiency and a possible misstatement and there are no compensating controls, the probability that an error resulting from the control deficiency will result in a misstatement will range from 76–100%. The factors in the corresponding column of the above table are averages assuming 100%.

Causal factors computed in a manner as described above, based on analysis such as that in Exhibit 5-11 can flow to an analysis such as is

in Exhibit 5-13. There, management would complete its analysis of the significance of control deficiencies by weighting the effects of the causal factors. The weighting of the factors that exist should sum to 100%. Exhibit 5-13 is designed so that the factors from Exhibit 5-11 would be entered in column (a), management's judgments about their relative importance would be entered in column (b), and the weighted factor—the product of column (a) times column (b)—would be placed in column (c). The sum of the weighted factors in column (c) would represent the design assessment of the likelihood for a misstatement. A "material weakness" would be indicated when the assessed likelihood of a misstatement is "reasonably possible." The terminology used with respect to the likelihood for misstatements is from Statement of Financial Accounting Standards No. 5 (FAS-5), *Accounting for Contingencies*, as a basis for that term. Under FAS-5, *remote* is when "the chance of the future events or events occurring is slight." *Probable* is when the future event or events are likely to occur, and *reasonably possible* is when the chance of the future event or events occurring is more than remote but less than likely.



PRACTICE POINTER: "More than remote" can be equated to a relatively low level of probability and can be said to exist whenever the threshold between "remote" and "reasonably possible," as those terms are used in FAS-5, has been crossed. In the preparation of financial statements, that is the threshold used to determine whether or not to disclose a contingency. Compared to the "high," "medium," and "low" referred to in the COSO Framework for analyzing likelihood, the author believes that "remote" implies a lower range of probabilities than "low" and that "reasonably possible" extends into a "low" range of probabilities. Management should take care to document the reasoning used to support the determinations it makes about what is "remote" and what is "reasonably possible."

Management's judgments about the significance of deficiencies include judgments of this nature about the relative importance of causal factors, the likelihood for errors, and the likelihood that errors will result in misstatements. Therefore, management should document the considerations behind its judgments about the likelihood for error and the likelihood that errors will result in misstatements. The SEC rules allow a considerable degree of flexibility for these determinations, but at the same time they demand reasonable support for them. The SEC has stated:

The methods of conducting evaluations of internal control over financial reporting will, and should, vary from company to company. Therefore, the final rules do not specify the method or procedures to be performed in an evaluation. However, in conducting such an evaluation and developing its assessment of the effectiveness of

internal control over financial reporting, a company must maintain evidential matter, including documentation, to provide reasonable support for management's assessment of the effectiveness of the company's internal control over financial reporting. Developing and maintaining such evidential matter is an inherent element of effective internal controls.

The SEC further states:

The assessment of a company's internal control over financial reporting must be based on procedures sufficient both to evaluate its design and to test its operating effectiveness. Controls subject to such assessment include, but are not limited to: controls over initiating, recording, processing and reconciling account balances, classes of transactions and disclosure and related assertions included in the financial statements; controls related to the initiation and processing of non-routine and non-systematic transactions; controls related to the selection and application of appropriate accounting policies; and controls related to the prevention, identification, and detection of fraud. The nature of a company's testing activities will largely depend on the circumstances of the company and the significance of the control. However, inquiry alone generally will not provide an adequate basis for management's assessment.

An assessment of the effectiveness of internal control over financial reporting must be supported by evidential matter, including documentation, regarding both the design of internal controls and the testing processes. This evidential matter should provide reasonable support: for the evaluation of whether the control is designed to prevent or detect material misstatements or omissions; for the conclusion that the tests were appropriately planned and performed; and that the results of the tests were appropriately considered. The public accounting firm that is required to attest to, and report on, management's assessment of the effectiveness of the company's internal control over financial reporting also will require that the company develop and maintain such evidential matter to support management's assessment.

An important point to note from this item is that management's assessment must be supported by both an analysis of internal control design and by the testing of that design. Therefore, assessments made in evaluating the design of internal controls should be borne out by testing the actual operation of those controls.

These requirements point to the need for diligence when making judgments about matters such as the likelihood that control deficiencies will cause misstatements. In addition, because such

judgments—which can aptly be described as the hypotheses of management—are inherently subjective, there is a need to support those hypotheses with empirical evidence. Testing provides that empirical evidence. The need to integrate the management’s design evaluations with its testing of them becomes more apparent with these thoughts. When testing does not support management’s judgments, there comes a need to reconsider those judgments. Any such reconsideration constitutes a revision to management’s design evaluation, which must be tested to provide evidence that the revised design evaluation is accurate. Therefore, it may be said that the initial consideration of control deficiencies and the likelihood that they will cause misstatements produces a *tentative* assessment of internal control design and a *tentative* list of control deficiencies that could be considered “material weaknesses.”

Material Weaknesses in Internal Control

Material weaknesses in internal control, as pointed out in Chapter 1 of this book, are control deficiencies having a “reasonably possible” likelihood of producing a material misstatement in the financial statements. The “Risk and Materiality” section of Chapter 4 discusses making tentative evaluations of the potential for any given set of activities to produce a material misstatement in the financial statements. Exhibit 4-2 is an illustration of an evaluation of the significance/potential materiality related to a general set of activities. Routes (activity sets) *tentatively* identified as containing “significant deficiencies” should be evaluated as discussed in Chapter 4 to determine whether a material misstatement might be produced based on the maximum estimated error to the financial statements that might occur. Caution dictates that the time-honored convention of conservatism be followed because the final SEC rules prevent management from determining that a company’s internal control over financial reporting is effective if it identifies even one material weakness in internal control over financial reporting.



PRACTICE POINTER: The preceding practice pointers related to assessing the effectiveness of internal controls at very small companies allow for the assessment of the effectiveness of internal controls on an overall company basis and by financial statement element. The simplified exhibits—5-14, 5-15, 5-16, 5-17, 5-18, and 5-19—are meant to provide an analysis of whether there is a reasonably possible likelihood that material misstatements in the financial statements will be neither prevented nor detected. After performing an analysis of the control deficiencies in terms of the five COSO components of internal control, the next step in assessing effectiveness is to consider the likelihood that material misstatements will occur; Exhibits 5-20, 5-21, and 5-22 are provided for that purpose.

EXHIBITS

**EXHIBIT 5-1
CONTROL ACTIVITIES RELATED TO
IDENTIFIED INDIVIDUAL ACTIVITY RISK**



Process (Route) _____
[From Exhibit 3-1]

Activity _____
[From Exhibit 3-1] *[From Exhibit 5-2]*

<u>Presence of Risk</u>	<u>Yes</u>	<u>No</u>	<u>Mitigating Control Activities</u>
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Basic Risk 1—The facts [input] are not correct or complete. _____

**Conditions Precipitating Risk
(Underlying Risks)**

1. External data are not correct or complete. _____
2. Results of preceding process are not correct. _____
3. External data or results of preceding process are altered. _____
4. Management intervention. _____
5. Other. _____

Basic Risk 2—The facts are not correctly interpreted or applied. _____

**Conditions Precipitating Risk
(Underlying Risks)**

1. Meaning of data is not understood. _____
2. Purpose of activity is not understood. _____
3. Manner of data application is not understood. _____
4. Management intervention. _____
5. Other. _____

Yes No Mitigating Control Activities

Basic Risk 3—Specified mathematical operations to be applied to the facts are not appropriate to the circumstances.

Conditions Precipitating Risk (Underlying Risks)

1. Purpose of activity is not understood.

2. Mathematical operation is not understood.

3. Circumstances are not understood.

4. Alternatives are not understood.

5. Management intervention.

6. Other.

Basic Risk 4—The accounting principle to be applied is not appropriate to the circumstances.

Conditions Precipitating Risk (Underlying Risks)

1. Applicability of accounting principle is not known or understood.

2. Required conditions are not understood.

3. Alternatives are not understood.

4. Management intervention.

5. Other.

Basic Risk 5—The accounting principle identified is not correctly applied.

Conditions Precipitating Risk (Underlying Risks)

1. Proper manner of application of accounting principle is not known or understood.

2. Required conditions are not properly applied.

	<u>Yes</u>	<u>No</u>	<u>Mitigating Control Activities</u>
3. Alternatives are not understood.	_____	_____	_____
4. Management intervention.	_____	_____	_____
5. Other.	_____	_____	_____
Basic Risk 6 —Specified mathematical operations are not correctly performed.	_____	_____	_____
Conditions Precipitating Risk (Underlying Risks)			
1. Proper manner of application of mathematical operation is not known or understood.	_____	_____	_____
2. Management intervention.	_____	_____	_____
3. Other.	_____	_____	_____

**EXHIBIT 5-2
DETAILED IDENTIFICATION/ANALYSIS
OF CONTROL ACTIVITIES**



Applies to Routes (Activity Sets):

	Yes	No	N/A	If Yes, How?
1. Are there clear management objectives for the activity or activities in terms of budget, profit, and other financial and operating goals? If yes, are such objectives:	_____	_____	_____	_____
a. Clearly written?	_____	_____	_____	_____
b. Actively communicated throughout the entity?	_____	_____	_____	_____
c. Actively monitored?	_____	_____	_____	_____
2. Do the planning and reporting systems in place for the activity or activities:				
a. Adequately identify variances from planned performance?	_____	_____	_____	_____
b. Adequately communicate variances to the appropriate level of management?	_____	_____	_____	_____
3. Does the appropriate level of management over the activity or activities:				
a. Adequately investigate variances?	_____	_____	_____	_____
b. Take appropriate and timely corrective action?	_____	_____	_____	_____
4. Are there procedures to prevent unauthorized access to or destruction of documents, records, and assets related to the activity or activities?	_____	_____	_____	_____
5. Are there policies for controlling access to programs and data files related to the activity or activities?	_____	_____	_____	_____
6. Does management over the activity or activities adequately monitor compliance with such policies?	_____	_____	_____	_____

	<u>Yes</u>	<u>No</u>	<u>N/A</u>	<u>If Yes, How?</u>
7. Are amounts recorded by the activity or activities in the accounting system periodically compared with physical assets?	_____	_____	_____	_____
8. Are control and subsidiary accounts affected by the activity or activities regularly reconciled and are discrepancies reported to appropriate personnel?	_____	_____	_____	_____
9. Are signatures required to evidence the performance of critical control functions, such as reconciling accounts, for the activity or activities?	_____	_____	_____	_____
10. Are general journal entries, other than standard entries, produced by the activity or activities required to be approved by a responsible official not involved with their origination?	_____	_____	_____	_____
11. Are accounting estimates and judgments related to the activity or activities made only by knowledgeable and responsible personnel?	_____	_____	_____	_____
12. Does the activity or do the activities enable the accounting system to provide, in a timely manner, the necessary information for the preparation of financial statements and related disclosures in accordance with generally accepted accounting principles or another comprehensive basis of accounting?	_____	_____	_____	_____
13. Is the output from the activity or activities reviewed by competent personnel who are knowledgeable of the factors affecting the activity or activities?	_____	_____	_____	_____

Notes about control activities for the routes:

Assessment of the effect of the control activities for these routes on preventing and detecting errors:

Very Effective	Moderately Effective	Not Very Effective
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EXHIBIT 5-3 SAMPLE OF LEVEL 1 CONFLICT OF DUTIES MATRIX



Pers Code	Route No.	General Route Function	A1	Person A	Person B	Person C	A2	Person D	Person E	Person F	A3	Person A	Person G	Person H	A4	A5
	A1	- Unit A Inventory System						D	E	F		A	G	H		
A	Person A							D	E	F		A	G	H		
B	Person B							D	E	F		A	G	H		
C	Person C							D	E	F		A	G	H		
	A2	- Unit A Purchases/Accounts Payable System		A	B	C						A	G	H		
D	Person D			A	B	C						A	G	H		
E	Person E			A	B	C						A	G	H		
F	Person F			A	B	C						A	G	H		
	A3	- Unit A Payroll System		A	B	C		D	E	F						
A	Person A			A	B	C		D	E	F						
G	Person G			A	B	C		D	E	F						
H	Person H			A	B	C		D	E	F						
	A4	- Unit A Disbursements System		A	B	C		D	E	F		A	G	H		
	A5	- Unit A Combining/Consolidating Accounting		A	B	C		D	E	F		A	G	H		

**EXHIBIT 5-5
INDIVIDUAL CONFLICT OF DUTIES ANALYSIS**



Individual: _____

	Route Process and Activity/Action [From Exhibit 3-2]	Description of Task [From Exhibit 3-2]	Conflict*	
			Yes	No
1.	_____	_____	_____	_____
2.	_____	_____	_____	_____
3.	_____	_____	_____	_____
4.	_____	_____	_____	_____
5.	_____	_____	_____	_____

*Indicate in the last two columns whether any errors or misstatements (intentional or unintentional) that might occur while performing the task would ordinarily be detected by properly performing any of the other tasks listed. If "Yes," a conflict in the duties of this person exists. Describe the nature of the conflict below and explain how errors or misstatements that might occur while performing the task would ordinarily be detected by the proper performance of one or more of the other tasks listed.

Description of conflict and explanation about detection:

EXHIBIT 5-6
ANALYSIS OF THE EFFECTS OF THE
CONTROL ENVIRONMENT ON ACTIVITIES



Applies to Routes (Activity Sets):

	Yes	No	N/A	Describe Contribution to Error Prevention and Detection
1. Is the message that integrity cannot be compromised adequately conveyed by the management over the activity or activities to promote the prevention and detection of errors?	_____	_____	_____	_____
2. Does a positive control environment exist, whereby there is an attitude of control consciousness through out the portion of the organization where the activity or activities are performed, and a positive “tone at the top” that promotes the prevention and detection of errors related to the activity or activities?	_____	_____	_____	_____
3. Is the competence of the entity’s people performing the activity or activities commensurate with their responsibilities and does it contribute to the prevention and detection of errors?	_____	_____	_____	_____
4. Is management’s operating style—the way it assigns authority and responsibility and organizes and develops its people—appropriate for the prevention and detection of errors from the activity or activities?	_____	_____	_____	_____

	<u>Yes</u>	<u>No</u>	<u>N/A</u>	<u>Describe Contribution to Error Prevention and Detection</u>
5. Does management understand the requirements of laws and regulations pertinent to its business and thus provide for the prevention and detection of errors from the activity or activities?	_____	_____	_____	_____
6. Does management adequately consider the potential effects of taking unusual business risks and so consider the prevention and detection of errors from the activity or activities?	_____	_____	_____	_____
7. Is the output from the activity or activities submitted to and reviewed by management, the board of directors, or the audit committee at regular intervals, so as to contribute to the prevention and detection of errors?	_____	_____	_____	_____
8. Does management demonstrate concern about and willingness to correct important weaknesses in the system of internal control in order to prevent and detect errors from the activity or activities?	_____	_____	_____	_____
9. Does the entity maintain up-to-date accounting policies and a procedures manual to facilitate the prevention and detection of errors from the activity or activities?	_____	_____	_____	_____
10. Is a chart of accounts maintained and does it describe the nature of each account to facilitate the prevention and detection of errors from the activity or activities?	_____	_____	_____	_____

	<u>Yes</u>	<u>No</u>	<u>N/A</u>	<u>Describe Contribution to Error Prevention and Detection</u>
11. Does management periodically review insurance coverage and promote the prevention and detection of errors related to the activity or activities?	_____	_____	_____	_____
12. Does management have a history of establishing reliable accounting estimates related to the activity or activities to facilitate the prevention and detection of errors?	_____	_____	_____	_____
13. Is there a low turnover of accounting, IT, and key management positions related to the activity or activities to facilitate the prevention and detection of errors?	_____	_____	_____	_____
14. Are the activity or activities adequately staffed, therefore avoiding constant crisis and facilitating the prevention and detection of errors?	_____	_____	_____	_____
15. Is there adequate coordination between accounting and IT departments as they relate to the activity or activities, resulting in timely reports and closings and facilitating the prevention and detection of errors?	_____	_____	_____	_____
16. Is there an organization chart encompassing the activity or activities that reflects the areas of responsibility and the line of reporting, which facilitates the prevention and detection of errors?	_____	_____	_____	_____

	<u>Yes</u>	<u>No</u>	<u>N/A</u>	<u>Describe Contribution to Error Prevention and Detection</u>
17. Are there formal job descriptions related to the activity or activities that clearly set out duties and responsibilities and that facilitates the prevention and detection of errors?	_____	_____	_____	_____
18. Are backgrounds and references of applicants for financial, IT, and key management positions related to the activity or activities thoroughly investigated to facilitate the prevention and detection of errors?	_____	_____	_____	_____
19. Are personnel policies and employee benefit plans covering employees performing the activity or activities documented and communicated to those employees to promote the prevention and detection of errors?	_____	_____	_____	_____
20. Is a formal conflict of interest policy or code of conduct for employees performing the activity or activities in effect to promote the prevention and detection of errors?	_____	_____	_____	_____
21. Are employees performing the activity or activities who handle cash, securities, and other valuable assets bonded to promote prevention and the detection of errors?	_____	_____	_____	_____
22. Do related employees, if any, have job assignments that minimize opportunities for collusion related to the performance of the activity or activities?	_____	_____	_____	_____

	<u>Yes</u>	<u>No</u>	<u>N/A</u>	<u>Describe Contribution to Error Prevention and Detection</u>
23. Are employees performing the activity or activities adequately trained to meet their assigned responsibilities in a way that promotes the prevention and detection of errors?	_____	_____	_____	_____
24. Is rotation of duties for the activity or activities enforced by mandatory vacations to promote the prevention and detection of errors?	_____	_____	_____	_____
25. Is the job performance for the activity or activities periodically evaluated and reviewed with employees in a way that promotes the prevention and detection of errors?	_____	_____	_____	_____
26. Has management overseeing the activity or activities established adequate policies and procedures for the development, modification, and use of computer programs and data files in a way that promotes the prevention and detection of errors?	_____	_____	_____	_____
27. Concerning the board of directors and/or audit committee:				
a. Does the board or committee take an active role in overseeing the performance of the activity or activities in accordance with the entity's policies and practices to promote the prevention and detection of errors?	_____	_____	_____	_____

	<u>Yes</u>	<u>No</u>	<u>N/A</u>	<u>Describe Contribution to Error Prevention and Detection</u>
b. Does the board or committee approve the appointment of the entity's independent auditors and is the activity or activities subject to their audits?	_____	_____	_____	_____
c. Does the board or committee have sufficient knowledge, experience, and time to serve effectively and promote proper performance of the activity or activities?	_____	_____	_____	_____
d. Does the board or committee constructively challenge management's planned decisions related to the activity or activities and take appropriate action if necessary (e.g., conducting special investigations) and so promote the prevention and detection of errors?	_____	_____	_____	_____
e. Does the board or committee meet in a timely manner with the chief accounting officer and internal and external auditors to discuss the reasonableness of the performance of the activity or activities within the context of the financial reporting process, the system of internal control, and other significant matters?	_____	_____	_____	_____

	<u>Yes</u>	<u>No</u>	<u>N/A</u>	<u>Describe Contribution to Error Prevention and Detection</u>
f. Does the board or committee review the scope of activities of the external and internal auditors related to the activity or activities at least annually and promote the prevention and detection of errors?	_____	_____	_____	_____
g. Does the board or committee regularly receive and review key information from the activity or activities, such as financial statements, major marketing initiatives, significant contracts, and negotiations?	_____	_____	_____	_____
h. Does a process exist for informing the board or committee in a timely manner of sensitive information, investigation, and improper acts (e.g., significant litigation, investigations by regulatory agencies, embezzlement, misuses of corporate assets) related to the activity or activities?	_____	_____	_____	_____
i. Is there appropriate oversight in determining the compensation and benefits of executive officers overseeing the activity or activities?	_____	_____	_____	_____

	<u>Yes</u>	<u>No</u>	<u>N/A</u>	<u>Describe Contribution to Error Prevention and Detection</u>
j. Is the board or committee sufficiently involved in establishing and evaluating the effectiveness of the “tone at the top” (e.g., approving the entity’s code of conduct or policy and procedure manual) applicable to the activity or activities?				

Additional comments about how the control environment contributes to the prevention and detection of errors for the activity set or group of activity sets:

Assessment of the effect of control environment on preventing and detecting errors:

Very Effective	Moderately Effective	Not Very Effective



EXHIBIT 5-7
ANALYSIS OF THE EFFECTS OF MANAGEMENT
RISK ASSESSMENTS ON ACTIVITIES



Applies to Routes (Activity Sets):

	<u>Yes</u>	<u>No</u>	<u>N/A</u>	<u>Describe Contribution to Error Prevention and Detection</u>
1. Have clear entitywide objectives affecting the activity or activities been established and are they consistent with business plans and budgets?	_____	_____	_____	_____
2. Have objectives for key matters affecting the activity or activities been established and are they consistent with and linked to the entitywide objectives and strategies?	_____	_____	_____	_____
3. Have the resources and critical factors important to achieving its objectives (e.g., financing, personnel, facilities, technology) affecting the activity or activities been identified?	_____	_____	_____	_____
4. Are risks arising from external sources (e.g., supply sources, creditors' demands, competitors' actions, regulation, natural events) affecting the activity or activities adequately considered?	_____	_____	_____	_____
5. Are risks arising from internal sources (e.g., retention of key personnel or changes in their responsibilities, compensation and benefit programs to keep the entity competitive, the adequacy of back-up systems in the event of failure of systems that could significantly affect	_____	_____	_____	_____

	<u>Yes</u>	<u>No</u>	<u>N/A</u>	Describe Contribution to Error Prevention and Detection
operations) affecting the activity or activities adequately considered?	_____	_____	_____	_____
6. Are significant shifts in the entity's industry (e.g., changes in customer demographics, preferences, or spending patterns) affecting the activity or activities adequately identified and monitored?	_____	_____	_____	_____
7. Is legal counsel consulted regarding the implications of any new legislation affecting the activity or activities?	_____	_____	_____	_____
8. Are new employees in key positions related to the activity or activities adequately supervised to ensure that they understand and perform in accordance with the entity's policies and procedures?	_____	_____	_____	_____
9. Are procedures in place to assess the effects of new or redesigned information systems on the activity or activities and to monitor new technologies?	_____	_____	_____	_____
10. Are procedures in place to handle rapidly increasing volumes of information related to the activity or activities?	_____	_____	_____	_____
11. When considering the development of new product lines, does management give appropriate consideration to major factors such as customer demand, production capabilities, and				

	<u>Yes</u>	<u>No</u>	<u>N/A</u>	<u>Describe Contribution to Error Prevention and Detection</u>
profitability implications and the effect on the activity or activities?	_____	_____	_____	_____
12. In connection with corporate restructurings, are staff reassignments and reductions related to the activity or activities appropriately analyzed for their potential effect on operations or on the morale of the remaining employees?	_____	_____	_____	_____
13. Does management keep abreast of the political, regulatory, business, and social culture of areas in which foreign operations exist, and are personnel made aware of accepted customs and rules as they relate to the activity or activities?	_____	_____	_____	_____
14. Is management aware of the existence of new accounting or reporting pronouncements and how they may affect the activity or activities and the entity's financial reporting practices?	_____	_____	_____	_____
Additional comments about how management's risk assessment activities/ procedures contributes to the prevention and detection of errors for the activity set or group of activity sets:				

<i>Assessment of the effect of management's risk assessment activities/ procedures on preventing and detecting errors:</i>				
Very Effective	Moderately Effective		Not Very Effective	

**EXHIBIT 5-8
ANALYSIS OF THE EFFECTS OF INFORMATION
AND COMMUNICATION ON ACTIVITIES**



Applies to Routes (Activity Sets):

	<u>Yes</u>	<u>No</u>	<u>N/A</u>	<u>Describe Contribution to Error Prevention and Detection</u>
--	------------	-----------	------------	----------------------------------------------------------------

Information

1. Does the part of the organization related to the activity or activities have mechanisms in place to obtain relevant external information (e.g., on market conditions, competitors' programs, legislative or regulatory developments, and economic changes) and internally generated information critical to the activity or activities and the achievement of the organization's objectives? _____

2. Is the information necessary to perform the activity or activities provided to the right people in sufficient detail and on time to enable them to carry out their responsibilities efficiently and effectively? _____

3. Is the development or revision of information systems related to the activity or activities and to financial reporting based on a strategic plan and interrelated with the entity's overall information systems and is it responsive to achieving the entitywide and activity level objectives? _____

	Yes	No	N/A	Describe Contribution to Error Prevention and Detection
4. Does top management and management over the activity or activities commit the appropriate human and financial resources to develop the necessary financial reporting information systems?	_____	_____	_____	_____
<i>Communication</i>				
5. Does management over the activity or activities communicate employees' duties and control responsibilities in an effective manner?	_____	_____	_____	_____
6. Are communication channels established for people performing the activity or activities to report suspected improprieties?	_____	_____	_____	_____
7. Does communication flow across the organization adequately (e.g., from shipping to accounting) to enable people performing the activity or activities to discharge their responsibilities effectively?	_____	_____	_____	_____
8. Are there timely and appropriate follow-up actions on communications received from customers, vendors, regulators, or other external parties relating to the activity or activities?	_____	_____	_____	_____
9. Do other parties outside the organization review and follow up on the organization's actions (e.g., an active review of bank loan agreements) as they relate to the activity or activities?	_____	_____	_____	_____

Additional comments about how information and communication contributes to the prevention and detection of errors for the activity set or group of activity sets:

Assessment of the effect of information and communications on preventing and detecting errors:

Very Effective

Moderately Effective

Not Very Effective

EXHIBIT 5-9
ANALYSIS OF THE EFFECTS OF
MONITORING ON ACTIVITIES



Applies to Routes (Activity Sets):

	<u>Yes</u>	<u>No</u>	<u>N/A</u>	<u>Describe Contribution to Error Prevention and Detection</u>
1. Is operating information used to manage operations integrated or reconciled with data generated by the activity or activities? Is information from other parts of the financial reporting system integrated or reconciled with data generated by the activity or activities?	_____	_____	_____	_____
2. Are complaints about the activity or activities investigated and any internal control deficiencies corrected?	_____	_____	_____	_____
3. Are communications from vendors and monthly statements of accounts payable used as a control-monitoring technique over the activity or activities?	_____	_____	_____	_____
4. Are internal control recommendations made by external auditors (and internal auditors, if applicable) related to the activity or activities implemented?	_____	_____	_____	_____
5. Is feedback received from training seminars, planning sessions, and other meetings on whether controls over the activity or activities operate effectively?	_____	_____	_____	_____

	<u>Yes</u>	<u>No</u>	<u>N/A</u>	<u>Describe Contribution to Error Prevention and Detection</u>
6. Does the organization take a fresh look at the internal control system from time to time and evaluate its effectiveness as it relates to the activity or activities? If yes:	_____	_____	_____	_____
a. Does the evaluation process include checklists, questionnaires, or other tools?	_____	_____	_____	_____
b. Are the evaluations documented?	_____	_____	_____	_____
7. Does the entity have an adequate internal audit function that covers the activity or activities? If yes, do the internal auditors:	_____	_____	_____	_____
a. Possess adequate training and experience related to the activity or activities?	_____	_____	_____	_____
b. Adhere to applicable professional standards?	_____	_____	_____	_____
c. Have an adequate documentation of the organization's internal control related to the activity or activities?	_____	_____	_____	_____
d. Perform tests of controls and substantive tests related to the activity or activities?	_____	_____	_____	_____
e. Have adequate documentation of their work related to the activity or activities?	_____	_____	_____	_____
f. Submit reports on their findings about the activity or activities to the board of directors or audit committee in a timely manner?	_____	_____	_____	_____

	Yes	No	N/A	Describe Contribution to Error Prevention and Detection
g. Follow up on corrective actions taken by management related to the activity or activities?	_____	_____	_____	_____
h. Have direct access to the board of directors or audit committee?	_____	_____	_____	_____
i. Have direct access to records, and the scope of their activities is not limited?	_____	_____	_____	_____

Additional comments about how monitoring contributes to the prevention and detection of errors for the activity set or group of activity sets:

Assessment of the effect of monitoring on preventing and detecting errors:

Very Effective

Moderately Effective

Not Very Effective



(a) [From Exhibit 4-1] Risk	(b) [From Exhibits 3-1 & 3-2] Specific Activities					(c) Mitigating Control Activities	(d) MCA Error Control		(e) Effect of Other IC Components	(f) Other Error Control	
	1	2	3	4	5		Y	N		Y	N
	BR4-4	___	___	___	___		___	___		___	___
BR4-5	___	___	___	___	___	___	___	___	___	___	
BR5	___	___	___	___	___	___	___	___	___	___	
BR5-1	___	___	___	___	___	___	___	___	___	___	
BR5-2	___	___	___	___	___	___	___	___	___	___	
BR5-3	___	___	___	___	___	___	___	___	___	___	
BR5-4	___	___	___	___	___	___	___	___	___	___	
BR5-5	___	___	___	___	___	___	___	___	___	___	
BR6	___	___	___	___	___	___	___	___	___	___	
BR6-1	___	___	___	___	___	___	___	___	___	___	
BR6-2	___	___	___	___	___	___	___	___	___	___	
BR6-3	___	___	___	___	___	___	___	___	___	___	

Notes:

- (a) These risks correspond to the risks on Exhibit 4-1. See the risk code key below.
- (b) These are the individual activities in the route (activity set). Insert additional columns as needed and check off next to each risk if that risk has been identified as applicable to the activity.
- (c) Indicate, or explain on an attached page, the mitigating control activities that address the stated risk for the activities in this activity set.
- (d) Indicate, by checking Y or N, whether the stated mitigating control activities (MCAs) should be effective in preventing or detecting errors related to the risk that might be made in performing the tasks in this activity set.
- (e) Indicate, or explain on an attached page, the specific ways that the other four components of internal control address the stated risk for the activities in this activity set.
- (f) Indicate, by checking Y or N, whether the other four components of internal control should be effective in preventing or detecting errors related to the risk that might be made in performing the tasks in this activity set.

Risk Code Key:

- BR1 The facts [input] are not correct or complete.
- BR1-1 External data are not correct or complete.
- BR1-2 Results of preceding process are not correct.
- BR1-3 External data or results of preceding process are altered.
- BR1-4 Management intervenes to change input.

- BR1-5 Other input risks identified in brainstorming.
 - BR2 The facts are not correctly interpreted or applied.
 - BR2-1 Meaning of data is not understood.
 - BR2-2 Purpose of activity is not understood.
 - BR2-3 Manner of data application is not understood.
 - BR2-4 Management intervenes in the interpretation or application.
 - BR2-5 Other interpretation or application risks identified in brainstorming.
 - BR3 Specified mathematical operations to be applied to the facts are not appropriate to the circumstances.
 - BR3-1 Purpose of activity is not understood.
 - BR3-2 Mathematical operation is not understood.
 - BR3-3 Circumstances are not understood.
 - BR3-4 Alternatives are not understood.
 - BR3-5 Management intervenes by specifying mathematical operations.
 - BR3-6 Other mathematical operations identification risks identified in brainstorming.
 - BR4 The accounting principle to be applied is not appropriate to the circumstances.
 - BR4-1 Applicability of accounting principle is not known or understood.
 - BR4-2 Required conditions are not understood.
 - BR4-3 Alternatives are not understood.
 - BR4-4 Management intervenes by specifying accounting principles.
 - BR4-5 Other accounting principles identification risks identified in brainstorming.
 - BR5 The accounting principle identified is not correctly applied.
 - BR5-1 Proper manner of application of accounting principle is not known or understood.
 - BR5-2 Required conditions are not properly applied.
 - BR5-3 Alternatives are not understood.
 - BR5-4 Management intervenes by specifying manner of applying accounting principles.
 - BR5-5 Other accounting principles application risks identified in brainstorming.
 - BR6 Specified mathematical operations are not correctly performed.
 - BR6-1 Proper manner of application of mathematical operation is not known or understood.
 - BR6-2 Management intervenes by specifying how to apply mathematical operations.
 - BR6-3 Other mathematical operations performance risks identified in brainstorming.
-
-

	(a)	(b)	(c)	(d) (e)		(f)		(g)	(h)
				<u>Effect</u>		<u>Comp Controls</u>		<u>Assessed Prob</u>	<u>Exhibit 5-12</u>
				<u>Yes</u>	<u>No</u>	<u>Dir</u>	<u>Ind</u>	<u>Yes</u>	<u>No</u>
5.	Is the item a control deficiency because of inadequate monitoring? If yes, what are the inadequacies of the monitoring of the related activity or activities (from Exhibit 5-9)? Are the inadequacies concerning monitoring related to:								
	a. Evaluating control design and operation?	_____	_____	_____	_____	_____	_____	_____	_____
	b. Identifying needs for improvement and corrective action?	_____	_____	_____	_____	_____	_____	_____	_____
	c. Follow-up procedures?	_____	_____	_____	_____	_____	_____	_____	_____

Notes: Columns (d) and (e) are concerned with whether the control deficiency has a direct or indirect effect on the potential for misstatement. Column (f) addresses whether there are compensating controls that affect the control deficiency and column (g) is to indicate the assessed probability of misstatement—High (H), Medium (M), or Low (L). The probability factor to be entered in column (h) is determined by using Exhibits 5-12 and 5-13 for each item. The percentages entered should be in terms of their decimal equivalents (e.g., 100% = 1).





EXHIBIT 5-12
SAMPLE OF PROBABILITY FACTOR DETERMINATION SPREADSHEET
EXHIBIT 5-11 TABLE

Relationship to Potential Misstatement ^a										
(a)	(b)	(c)	(d)	(e)	(f)	(g)	(h)	(i)	(j)	(k)
Control Deficiency Potential For Error		Probability Assessments	With Compensating Controls		W/O Compensating Controls		With Compensating Controls		W/O Compensating Controls	
			0%	25%	25%	50%	50%	75%	75%	100%
High (66.1–100%)	66%	100%	12.50%	25%	33.30%	50%	54.06%	74.82%	75%	100%
Medium (33.1–66%)	33%	66%	8.25%	20.65%	33.04%	45.43%	12.38%	16.50%	33.04%	45.43%
Low (0–33%)	0%	33%	4.13%	8.25%	12.38%	16.50%	33.04%	45.43%	74.82%	100%

^a These factors were developed as an example only. They were computed by assuming that the mitigating effects on the possibility for misstatement, represented by each of the conditions depicted in the four columns, are inversely related to the nearness of the relationship between the control deficiency and the possibility for a misstatement caused by it. For purposes of this example, the following assumptions were made:

- Where there is no direct relationship between a control deficiency and there are compensating controls, the probability that an error resulting from the control deficiency will result in a misstatement will range from 0–25%. The factors in the corresponding column of the above table are averages assuming the 0–25% range in columns (d) and (e).
 - Where there is no direct relationship between a control deficiency and a possible misstatement, but there are no compensating controls, the probability that an error resulting from the control deficiency will result in a misstatement will range from 26–50%. The factors in the corresponding column of the above table are averages assuming the 25.1–50% range in columns (f) and (g).
 - Where there is a direct relationship between a control deficiency and a possible misstatement, but there are compensating controls, the probability that an error resulting from the control deficiency will result in a misstatement will range from 51–75%. The factors in the corresponding column of the above table are averages assuming the 50.1–75% range in columns (h) and (i).
 - Where there is a direct relationship between a control deficiency and a possible misstatement and there are no compensating controls, the probability that an error resulting from the control deficiency will result in a misstatement will range from 76–100%. The factors in the corresponding column of the above table are averages assuming the 75.1–100% range in columns (j) and (k).
-
-

EXHIBIT 5-13
ASSESSMENT OF THE PROBABILITY OF
MISSTATEMENT FROM CONTROL
DEFICIENCIES: PART B



Process (Route): _____
 [From Exhibit 3-1]
Nature of Control Deficiency: _____

	(a) 5-11 <u>Factor</u>	(b) <u>Weight</u>	(c) <u>Weighted</u> <u>Factor</u>
Related Risks (from Exhibit 5-10) and Cause of Control Deficiency			
What type of risks underlie the control deficiency:	_____	_____	_____
Risks involving competencies (From Exhibit 5-11: Items 1a, 2a, 2b, 3a, & 5a):			
1.a. Performance of activities	_____	_____	_____
2.a. Control consciousness	_____	_____	_____
2.b. Discipline and structure	_____	_____	_____
3.a. Processes used to consider risks	_____	_____	_____
5.a. Evaluating control design and operation	_____	_____	_____
Risks involving knowledge (From Exhibit 5-11: Items 2e, 3d, & 5b):			
2.e. Awareness of management	_____	_____	_____
3.d. Decisions about responses to risks	_____	_____	_____
5.b. Identifying needs for improvement and corrective action	_____	_____	_____
Risks involving security or control (From Exhibit 5-11: Items 1c, 1d, 2c, 2d, 3b, 3c, 4a, & 5c)			
1.c. Physical controls	_____	_____	_____
1.d. Segregation of duties	_____	_____	_____
2.c. Attitude of management	_____	_____	_____
2.d. Actions of management	_____	_____	_____
3.b. Estimates about risk significance	_____	_____	_____
3.c. Assessments about risk probability	_____	_____	_____

	(a) 5-11 <u>Factor</u>	(b) <u>Weight</u>	(c) <u>Weighted</u> <u>Factor</u>
4.a. Identification of pertinent information	_____	_____	_____
5.c. Follow-up procedures	_____	_____	_____
Risks involving information (From Exhibit 5-11: Items 1b, 4b, & 4c)	_____	_____	_____
1.b. Information	_____	_____	_____
4.b. Obtaining necessary information	_____	_____	_____
4.c. Communicating information	_____	_____	_____
Assessed Likelihood of Misstatement = Σ of Weighted Factors			=====

Note: As discussed in the table that appears at the end of the section “Likelihood of Misstatement” earlier in this chapter, the weight assigned in column (b) is management’s assessment of the relative importance of the risk to the financial statement element for the control deficiency identified. The weights assigned by management should be in percentages (or their equivalent decimal amounts) so that all of the weights for the deficiency total 100% (or 1.00 in decimal terms). Column (c) is the product of columns (a) and (b). The sum of column (c) may be used as a percentage assessment of the likelihood of misstatement. If the total assessed likelihood of misstatement is “reasonably possible,” the control deficiency is considered to be a material weakness.



EXHIBIT 5-14
CONTROL ACTIVITIES RELATED TO CONTROL
ACTIVITY RISKS—VERY SMALL COMPANIES



[From Exhibit 5-15]

<u>Risk</u>	<u>Yes</u>	<u>No</u>	<u>Mitigating Control</u> <u>Activities</u>
1. External data are not correct or complete.	_____	_____	_____
2. Results of preceding process are not correct.	_____	_____	_____
3. External data or results of preceding process are altered.	_____	_____	_____
4. Meaning of data is not understood.	_____	_____	_____
5. Purpose of activity is not understood.	_____	_____	_____
6. Manner of data application is not understood.	_____	_____	_____
7. Mathematical operation is not understood.	_____	_____	_____
8. Circumstances are not understood.	_____	_____	_____
9. Applicability of accounting principle is not known or understood.	_____	_____	_____
10. Required conditions are not understood.	_____	_____	_____
11. Proper manner of application of accounting principle is not known or understood.	_____	_____	_____
12. Required conditions are not properly recognized.	_____	_____	_____
13. Alternatives are not understood.	_____	_____	_____
14. Proper manner of application of mathematical operation is not known or understood.	_____	_____	_____
15. Management intervention.	_____	_____	_____
16. Other.	_____	_____	_____

EXHIBIT 5-15
DETAILED IDENTIFICATION/ANALYSIS OF
CONTROL ACTIVITIES—VERY SMALL
COMPANIES



		<u>Yes</u>	<u>No</u>	<u>N/A</u>	<u>If Yes, How?</u>
1.	Are there clear management objectives in terms of budget, profit, and other financial and operating goals? If yes, are such objectives:	_____	_____	_____	_____
	a. Clearly written?	_____	_____	_____	_____
	b. Actively communicated throughout the entity?	_____	_____	_____	_____
	c. Actively monitored?	_____	_____	_____	_____
2.	Do the planning and reporting systems in place:				
	a. Adequately identify variances from planned performance?	_____	_____	_____	_____
	b. Adequately communicate variances to the appropriate level of management?	_____	_____	_____	_____
3.	Does the appropriate level of management:				
	a. Adequately investigate variances?	_____	_____	_____	_____
	b. Take appropriate and timely corrective action?	_____	_____	_____	_____
4.	Are there procedures to prevent unauthorized access to or destruction of documents, records, and assets?	_____	_____	_____	_____
5.	Are there policies for controlling access to programs and data files?	_____	_____	_____	_____
6.	Does management adequately monitor compliance with such policies?	_____	_____	_____	_____
7.	Are amounts recorded in the accounting system periodically compared with physical assets, if applicable?	_____	_____	_____	_____

	<u>Yes</u>	<u>No</u>	<u>N/A</u>	<u>If Yes, How?</u>
8. Are control and subsidiary accounts regularly reconciled and are discrepancies reported to appropriate personnel?	_____	_____	_____	_____
9. Are signatures required to evidence the performance of critical control functions, such as reconciling accounts?	_____	_____	_____	_____
10. Are journal entries required to be approved by a responsible official not involved with their origination?	_____	_____	_____	_____
11. Are accounting estimates and judgments made only by knowledgeable and responsible personnel?	_____	_____	_____	_____
12. Does the accounting system provide, in a timely manner, the necessary information for the preparation of financial statements and related disclosures in accordance with generally accepted accounting principles or another comprehensive basis of accounting?	_____	_____	_____	_____
13. Is the output from the activity or activities reviewed by competent personnel who are knowledgeable of the factors affecting the activity or activities?	_____	_____	_____	_____

Notes about control activities:

Assessment of the effect of the control activities on preventing and detecting errors:

Very Effective

Moderately Effective

Not Very Effective



EXHIBIT 5-16
ANALYSIS OF THE EFFECTS OF THE CONTROL ENVIRONMENT ON ACTIVITIES—VERY SMALL COMPANIES



	<u>Yes</u>	<u>No</u>	<u>N/A</u>	<u>Describe Contribution to Error Prevention and Detection</u>
1. Is the message that integrity cannot be compromised adequately conveyed by the management over the activity or activities to promote the prevention and detection of errors?	_____	_____	_____	_____
2. Does a positive control environment exist, whereby there is an attitude of control consciousness throughout the organization, and a positive “tone at the top” that promotes the prevention and detection of errors?	_____	_____	_____	_____
3. Is the competence of the entity’s people performing activities commensurate with their responsibilities and does it contribute to the prevention and detection of errors?	_____	_____	_____	_____
4. Is management’s operating style—the way it assigns authority and responsibility and organizes and develops its people—appropriate for the prevention and detection of errors?	_____	_____	_____	_____
5. Does management understand the requirements of laws and regulations pertinent to its business and thus provide for the prevention and detection of errors?	_____	_____	_____	_____

	<u>Yes</u>	<u>No</u>	<u>N/A</u>	<u>Describe Contribution to Error Prevention and Detection</u>
6. Does management adequately consider the potential effects of taking unusual business risks and so consider the prevention and detection of errors?	_____	_____	_____	_____
7. Is the output from the various activities submitted to and reviewed by management, the board of directors, or the audit committee at regular intervals so as to contribute to the prevention and detection of errors?	_____	_____	_____	_____
8. Does management demonstrate concern about and willingness to correct important weaknesses in the system of internal control in order to prevent and detect errors?	_____	_____	_____	_____
9. Does the entity maintain up-to-date accounting policies and a procedures manual to facilitate the prevention and detection of errors?	_____	_____	_____	_____
10. Is a chart of accounts maintained and does it describe the nature of each account to facilitate the prevention and detection of errors?	_____	_____	_____	_____
11. Does management periodically review insurance coverage and promote the prevention and detection of errors?	_____	_____	_____	_____
12. Does management have a history of establishing reliable accounting estimates related to the activity or activities to facilitate the prevention and detection of errors?	_____	_____	_____	_____

	Yes	No	N/A	Describe Contribution to Error Prevention and Detection
13. Is there a low turnover of accounting and key management positions to facilitate the prevention and detection of errors?	_____	_____	_____	_____
14. Are activities adequately staffed, therefore avoiding constant crisis and facilitating the prevention and detection of errors?	_____	_____	_____	_____
15. Is there adequate coordination between the accounting and other functions in the company to provide for the ability to achieve timely reports and closings and facilitate the prevention and detection of errors?	_____	_____	_____	_____
16. Is there an organization chart that reflects the areas of responsibility and lines of reporting which facilitates the prevention and detection of errors?	_____	_____	_____	_____
17. Are there formal job descriptions that clearly set out duties and responsibilities and that facilitate the prevention and detection of errors?	_____	_____	_____	_____
18. Are backgrounds and references of applicants for financial and key management positions investigated to facilitate the prevention and detection of errors?	_____	_____	_____	_____
19. Are personnel policies and employee benefit plans documented and communicated to employees to promote the prevention and detection of errors?	_____	_____	_____	_____

	<u>Yes</u>	<u>No</u>	<u>N/A</u>	<u>Describe Contribution to Error Prevention and Detection</u>
20. Is a formal conflict of interest policy or code of conduct for employees in effect to promote the prevention and detection of errors?	_____	_____	_____	_____
21. Are employees performing the activity or activities who handle cash, securities, and other valuable assets bonded to promote the prevention and detection of errors?	_____	_____	_____	_____
22. Do related employees, if any, have job assignments that minimize the likelihood of error?	_____	_____	_____	_____
23. Are employees adequately trained to meet their assigned responsibilities in a way that promotes the prevention and detection of errors?	_____	_____	_____	_____
24. Is rotation of duties enforced by mandatory vacations to promote the prevention and detection of errors?	_____	_____	_____	_____
25. Is job performance periodically evaluated and reviewed with employees in a way that promotes the prevention and detection of errors?	_____	_____	_____	_____
26. Has management established adequate policies and procedures for the development, modification, and use of computer programs and data files in a way that promotes the prevention and detection of errors?	_____	_____	_____	_____

	<u>Yes</u>	<u>No</u>	<u>N/A</u>	<u>Describe Contribution to Error Prevention and Detection</u>
27. Concerning the board of directors and/or audit committee:				
a. Does the board or committee take an active role in overseeing the performance of activities in accordance with the entity's policies and practices to promote the prevention and detection of errors?	_____	_____	_____	_____
b. Does the board or committee approve the appointment of the entity's independent auditors and is the activity or activities subject to their audits?	_____	_____	_____	_____
c. Does the board or committee have sufficient knowledge, experience, and time to serve effectively and promote proper performance of the activity or activities?	_____	_____	_____	_____
d. Does the board or committee constructively challenge management's decisions and take appropriate action if necessary (e.g., by conducting special investigations) and so promote the prevention and detection of errors?	_____	_____	_____	_____

	<u>Yes</u>	<u>No</u>	<u>N/A</u>	<u>Describe Contribution to Error Prevention and Detection</u>
e. Does the board or committee meet in a timely manner with the chief accounting officer and external auditors to discuss the reasonableness of the performance of activities within the context of the financial reporting process, the system of internal control, and other significant matters?	_____	_____	_____	_____
f. Does the board or committee review the scope of activities of the external auditors at least annually and promote the prevention and detection of errors?	_____	_____	_____	_____
g. Does the board or committee regularly receive and review key information, such as financial statements, major marketing initiatives, significant contracts, and negotiations?	_____	_____	_____	_____
h. Does a process exist for informing the board or committee in a timely manner of sensitive information, investigations, and improper acts (e.g., significant litigation, investigations by regulatory agencies, embezzlement, misuse of corporate assets)?	_____	_____	_____	_____

	Yes	No	N/A	Describe Contribution to Error Prevention and Detection
i. Is there appropriate oversight in determining the compensation and benefits of executive officers?	_____	_____	_____	_____
j. Is the board or committee sufficiently involved in establishing and evaluating the effectiveness of the "tone at the top" (e.g., approving the entity's code of conduct or policy and procedure manual)?	_____	_____	_____	_____

Additional comments about how the control environment contributes to the prevention and detection of errors:

Assessment of the effect of control environment on preventing and detecting errors:

Very Effective	Moderately Effective	Not Very Effective
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EXHIBIT 5-17
ANALYSIS OF THE EFFECTS OF
MANAGEMENT RISK ASSESSMENTS ON
ACTIVITIES—VERY SMALL COMPANIES



	yes	No	N/A	Describe Contribution to Error Prevention and Detection
1. Have clear company objectives been established and are they consistent with business resources and budgets?	_____	_____	_____	_____
2. Have the resources and critical factors important to achieving its objectives (e.g., financing, personnel, facilities, technology) affecting internal controls been identified?	_____	_____	_____	_____
3. Are risks arising from external sources (e.g., supply sources, creditors' demands, competitors' actions, regulation, natural events) adequately considered?	_____	_____	_____	_____
4. Are risks arising from internal sources (e.g., retention of key personnel or changes in their responsibilities, compensation and benefit programs to keep the entity competitive, adequacy of back-up systems in the event of failure of systems that could significantly affect operations) adequately considered?	_____	_____	_____	_____

	yes	No	N/A	Describe Contribution to Error Prevention and Detection
5. Are significant shifts in the entity's industry (e.g., changes in customer demographics, preferences, or spending patterns) adequately identified and monitored?	_____	_____	_____	_____
6. Is legal counsel consulted regarding the implications of any new legislation?	_____	_____	_____	_____
7. Are new employees in key positions related to the activity or activities adequately supervised to ensure that they understand and perform in accordance with the entity's policies and procedures?	_____	_____	_____	_____
8. Are procedures in place to handle rapidly increasing volumes of information?	_____	_____	_____	_____
9. When considering the development of new product lines, does management give appropriate consideration to major factors such as customer demand, production capabilities, and profitability implications and their effect on internal controls?	_____	_____	_____	_____
10. In connection with corporate restructurings, are staff reassignments and reductions appropriately analyzed for their potential effect on operations or on the morale of the remaining employees?	_____	_____	_____	_____

	yes	No	N/A	Describe Contribution to Error Prevention and Detection
11. Does management keep abreast of the political, regulatory, business, and social environments as they might affect the company's business?	_____	_____	_____	_____
12. Is management aware of the existence of new accounting or reporting pronouncements and how they may affect the activity or activities and the entity's financial reporting practices?	_____	_____	_____	_____

Additional comments about how management's risk assessment activities/procedures contributes to the prevention and detection of errors:

Assessment of the effect of management's risk assessment activities/procedures on preventing and detecting errors

Very Effective Moderately Effective Not Very Effective



EXHIBIT 5-18
ANALYSIS OF THE EFFECTS OF INFORMATION
AND COMMUNICATION ON ACTIVITIES—VERY
SMALL COMPANIES



	<u>Yes</u>	<u>No</u>	<u>N/A</u>	<u>Describe Contribution to Error Prevention and Detection</u>
<i>Information</i>				
1. Does the company have mechanisms in place to obtain relevant external information (e.g., on market conditions, competitors' programs, legislative or regulatory developments, and economic changes) and internally generated information important to achieving the company's objectives?	_____	_____	_____	_____
2. Is the information necessary to perform activities provided to the right people in sufficient detail and on time to enable them to carry out their responsibilities efficiently and effectively?	_____	_____	_____	_____
3. Is the development or revision of information systems related to financial reporting based on a strategic plan and interrelated with the company's overall information needs and is it responsive to achieving the company objectives?	_____	_____	_____	_____
4. Does top management commit the appropriate human and financial resources to develop the necessary financial reporting information systems?	_____	_____	_____	_____

	<u>Yes</u>	<u>No</u>	<u>N/A</u>	<u>Describe Contribution to Error Prevention and Detection</u>
<i>Communication</i>				
5. Does management communicate employees' duties and control responsibilities effectively?	_____	_____	_____	_____
6. Are communication channels established for people to report suspected improprieties?	_____	_____	_____	_____
7. Does communication adequately flow across the company (e.g., from shipping to accounting) to enable people to discharge their responsibilities effectively?	_____	_____	_____	_____
8. Are there timely and appropriate follow-up actions on communications received from customers, vendors, regulators, or other external parties?	_____	_____	_____	_____
9. Do parties outside the company review and follow up on the company's actions (e.g., an active review of bank loan agreements)?	_____	_____	_____	_____

Additional comments about how information and communication contributes to the prevention and detection of errors:

Assessment of the effect of information and communication on preventing and detecting errors:

Very Effective Moderately Effective Not Very Effective



	<u>Yes</u>	<u>No</u>	<u>N/A</u>	<u>Describe Contribution to Error Prevention and Detection</u>
b. Are the evaluations documented?	_____	_____	_____	_____
7. Does the company have an adequate accounting and financial reporting review function? If yes, does it:	_____	_____	_____	_____
a. Provide for reviews by persons having the appropriate competence, knowledge, and experience?	_____	_____	_____	_____
b. Conform with regulatory requirements?	_____	_____	_____	_____
c. Adequately document the company's internal controls related to accounting and financial reporting?	_____	_____	_____	_____
d. Include substantive tests and tests of controls?	_____	_____	_____	_____
e. Adequately document the work?	_____	_____	_____	_____
f. Require that reports on findings be submitted to the board of directors or audit committee in a timely manner?	_____	_____	_____	_____
g. Follow up on corrective actions taken by management to address findings?	_____	_____	_____	_____
h. Have direct access to the board of directors or audit committee?	_____	_____	_____	_____
i. Provide direct access to records without limitations on the scope of review activities?	_____	_____	_____	_____

<u>Yes</u>	<u>No</u>	<u>N/A</u>	<u>Describe Contribution to Error Prevention and Detection</u>
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Additional comments about how monitoring contributes to the prevention and detection of errors:

Assessment of the effect of monitoring on preventing and detecting errors:

Very Effective

Moderately Effective

Not Very Effective



EXHIBIT 5-20
ANALYSIS OF THE EFFECTS OF INTERNAL CONTROL COMPONENTS ON ACCOUNTING
PROCESSES—VERY SMALL COMPANIES

Financial Statement Element _____
 [From Exhibit 3-3]

Risks that are not mitigated by a control are control deficiencies to be evaluated on Exhibits 5-21 and 5-22

	[From Exhibits 5-14 and 5-15] (b)	[From Exhibits 5-16, 5-17, 5-18, and 5-19] (c)	[From Brainstorming] (d)
(a)	Risk Mitigated by Control Activities	Risk Mitigated by Other IC Components	Risk Mitigated by Other Error Control
[From Exhibit 5-14]	Yes No	Yes No	Yes No

Risk

External data are not correct or complete. _____

Results of preceding process are not correct. _____

External data or results of preceding process are altered. _____

Meaning of data is not understood. _____

Purpose of activity is not understood. _____

Manner of data application is not understood. _____

Mathematical operation is not understood. _____

Circumstances are not understood. _____

(See Notes Below) _____

Applicability of accounting principle is not known or understood. _____

(a) [From Exhibit 5-14] Risk	[From Exhibits 5-14 and 5-15] (b)		[From Exhibits 5-16, 5-17, 5-18, and 5-19] (c)		[From Brainstorming] (d)	
	Risk Mitigated by Control Activities		Risk Mitigated by Other IC Components		Risk Mitigated by Other Error Control	
	Yes	No	Yes	No	Yes	No
Required conditions are not understood.						
Proper manner of application of accounting principle is not known or understood.						
Required conditions are not properly recognized.						
Alternatives are not understood.						
Proper manner of application of mathematical operation is not known or understood.						
Management intervention.						
Other.						
(See Notes Below)						
Notes:						
(a)	These risks correspond to the risks on Exhibit 5-14.					
(b)	Indicate by checking Y or N whether mitigating control activities should be effective in preventing or detecting errors related to the risk. Explain on an attached page the mitigating control activities that address the stated risk for each of the financial statement elements on Exhibit 3-3.					
(c)	Indicate by checking Y or N whether any of the other internal control components (control environment, risk assessment, information and communication, or monitoring) should be effective in preventing or detecting errors related to the risk. Explain on an attached page the mitigating factor that addresses the stated risk for each of the financial statement elements on Exhibit 3-3 and the specific ways that the mitigating factor addresses that risk.					
(d)	Indicate by checking Y or N any other matters identified by brainstorming or otherwise that should be effective in preventing or detecting errors related to the risk. Explain on an attached page the mitigating factor that addresses the stated risk for each of the financial statement elements on Exhibit 3-3 and the specific ways that the mitigating factor addresses that risk.					

(a)	(b)	(c)	(d) (e)		(f)		(g)	(h)
			Effect		Comp Controls		Assessed Prob	
			Yes	No	Dir	Ind	Yes	
b. Identifying needs for improvement and corrective action?	_____	_____	_____	_____	_____	_____	_____	_____
c. Follow-up procedures?	_____	_____	_____	_____	_____	_____	_____	_____

See Notes Below

Notes:

Columns (d) and (e) are concerned with whether the control deficiency has a direct or indirect effect on the potential for misstatement. Column (f) addresses whether there are compensating controls that affect the control deficiency and column (g) is to indicate the assessed probability of misstatement—High (H), Medium (M), or Low (L). The probability factor to be entered in column (h) is from Exhibit 5-12.



EXHIBIT 5-22
ASSESSMENT OF THE PROBABILITY OF
MISSTATEMENT FROM CONTROL
DEFICIENCIES: PART B—VERY SMALL
COMPANIES



Financial Statement Element _____
[From Exhibit 3-3]

Nature of Control Deficiency: _____ *[From Exhibit 5-20]*

	(a) 5-21 <u>Factor</u>	(b) <u>Weight*</u>	(c) <u>Weighted</u> <u>Factor</u>
Related Risks (from Exhibit 5-20) and Cause of Control Deficiency What type of risks underlie the control deficiency:			
Risks involving competen- cies (From Exhibit 5-21: Items 1a, 2a, 2b, 3a, and 5a):			
1.a. Performance of activities	_____	_____	_____
2.a. Control consciousness	_____	_____	_____
2.b. Discipline and structure	_____	_____	_____
3.a. Processes used to con- sider risks	_____	_____	_____
5.a. Evaluating control design and operation	_____	_____	_____
Risks involving knowledge (From Exhibit 5-21: Items 2e, 3d, and 5b):			
2.e. Awareness of management	_____	_____	_____
3.d. Decisions about responses to risks	_____	_____	_____
5.b. Identifying needs for improvement and corrective action	_____	_____	_____
Risks involving security or control (From Exhibit 5-21: Items 1c, 1d, 2c, 2d, 3b, 3c, 4a, and 5c):			
1.c. Physical controls	_____	_____	_____
1.d. Segregation of duties	_____	_____	_____

	(a) 5-21 <u>Factor</u>	(b) <u>Weight</u>	(c) <u>Weighted</u> <u>Factor</u>
2.c. Attitude of management	_____	_____	_____
2.d. Actions of management	_____	_____	_____
3.b. Estimates about risk significance	_____	_____	_____
3.c. Assessments about risk probability	_____	_____	_____
4.a. Identification of pertinent information	_____	_____	_____
5.c. Follow-up procedures	_____	_____	_____
Risks involving information (From Exhibit 5-21: Items 1b, 4b, and 4c):			
4.b. Obtaining necessary information	_____	_____	_____
4.c. Communicating information	_____	_____	_____

Assessed Likelihood of Misstatement = Σ of Weighted Factors _____

Note: As discussed in the table that appears at the end of the section “Likelihood of Misstatement” earlier in this chapter, the weight assigned in column (b) is management’s assessment of the relative importance of the risk to the financial statement element for the control deficiency identified. The weights assigned by management should be in percentages (or their equivalent decimal amounts) so that all of the weights for the deficiency total 100% (or 1.00 in decimal terms). Column (c) is the product of columns (a) and (b). The sum of column (c) may be used as a percentage assessment of the likelihood of misstatement. If the total assessed likelihood of misstatement is “reasonably possible,” the control deficiency is a material weakness.

