Key Issues facing auditors when assessing and testing Internal Controls

Audit Training-of-Trainers Workshop
6-8 February 2013, Vienna

Henri Fortin and Jan Tyl, CFRR, February 2013
Where are we in the audit process?

Activity | Purpose | Documentation
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Perform preliminary engagement activities | Decide whether to accept engagement | Listing of risk factors
|  |  | Independence
|  |  | Engagement letter

Plan the audit | Develop an overall audit strategy and audit plan | Materiality
| Audit team discussions | Overall audit strategy | Business & fraud risks including significant risks

Perform risk assessment procedures | Identify/assess RMM through understanding the entity | Design/implementation of relevant internal controls

Assessed RMM at:
- E/S level
- Assertion level
Auditors are making too many mistakes in their audit of internal control over financial reporting, prompting a new warning from the Public Company Accounting Oversight Board to pay closer attention to auditing standards and the firms' own audit methodologies.

US PCAOB, December 10, 2012
In 46 of the 309 integrated audit engagements (15%) that were inspected in 2010, Inspections staff found that the firm, at the time it issued its audit report, had **failed to obtain sufficient audit evidence to support its audit opinion on the effectiveness of internal control** due to one or more deficiencies identified by the Inspections staff.

In 39 of those, the firm also failed to obtain sufficient audit evidence to support the financial statement audit opinion.

In addition, in another 50 audits, Inspections staff identified **deficiencies in the auditing of internal control** that did not involve findings of such significance that they indicated a failure to support the firm's internal control opinion. These deficiencies, however, did evidence deficiencies in some firms' systems of quality control of such significance that in the Board's view they require remediation.
Weaknesses in internal control

» Identify and sufficiently test controls that are intended to address the risks of material misstatement

» Sufficiently test the design and operating effectiveness of management review controls that are used to monitor the results of operations, such as: (1) monthly comparisons of budget and actual results to forecasts for revenues and expenses; (2) comparisons of other metrics, such as profit margins and certain expenses as a percentage of sales; and (3) quarterly balance sheet reviews

» Obtain sufficient evidence to update the results of testing of controls from an interim date to the company's year end (i.e., the roll-forward period)

» Sufficiently test the system-generated data and reports that support important controls

» Sufficiently perform procedures regarding the use of the work of others; and

» Sufficiently evaluate identified control deficiencies and consider their effect on both the financial statement audit and on the audit of internal control.

PCAOB – Observations from 2010 inspections
The audit approach for the largest listed entities, large retailers and financial institutions generally includes some independent testing of the effectiveness of internal controls as sufficient audit evidence cannot be obtained on a timely basis from substantive testing alone.

At all firms, however, the audit approach for other entities is generally focused on substantive audit procedures with only limited testing, if any, of the effectiveness of internal controls.

We believe that there is scope for firms to improve the efficiency and effectiveness of their audit approaches by reviewing the extent to which audit evidence is obtained through their testing of the effectiveness of internal controls.
The audit file … often contains (insufficient) documentation on the client’s internal controls. In general, … firms are not documenting the understanding of internal controls in accordance with ISA 315 … and do not evaluate the design and implementation of controls relevant to the audit.

In several cases, the auditor made a conclusion regarding the evaluation of the internal control system and control risk, but the documentation did not include (sufficient appropriate) audit evidence to support the conclusion (walkthrough tests, description of key cycles and identified relevant controls.)
Relevant controls – controls over financial reporting:

- Control environment
- Assertion-related controls

Key cycles:

- Revenues (sales), receivables, receipts
- Purchases, payables, payments
- Payroll
- Conversion

Auditor should understand and document:

- The cycle
- Controls relevant to the audit
- Adequate testing
- Conclusions
For larger companies, the key cycles may have to be divided into processes

Following slides include the description of a process relevant to both SRR and PPP cycles, the cash reconciliation process

For each step:
- Identify possible controls
- Determine whether the control would be relevant to the audit
- Devise a test of the control (to verify effectiveness)
Narrative Description: XYZ Ltd.
Process: Cash Reconciliation

Objective:
To ensure proper controls exist over cash accounts, bank accounts are reconciled and reviewed by staff independent of the cash receipt and disbursement function.

Process:
Step 1: The Senior Accountant (SA) accesses the bank account using a unique name and password to download the monthly statement for current and payroll accounts which list all cleared account transactions. The bank mails hard copy of the statements to SA as backup monthly.
Step 2: SA obtains copy of the “Cash Management” spreadsheet prepared by the Accounting Manager. The spreadsheet contains information on current account activity. The types of data included in the worksheet are account transfers, card payments and wire transfers.
Narrative Description: XYZ Ltd.  Cash Reconciliation (cont.)

Step 2 (cont.): SA obtains copies of the following reports from accounting staff for use in performing the monthly cash reconciliation:

- “Payment Register” and “Credit Card Statement” provided by the Senior Accounts Payable Clerk. The reports provide information of all withdrawals made from the accounts for vendor payments and payments made by the credit card.
- Payroll register provided by the Payroll Accountant.

Step 3: SA also creates a “Payroll Reconciliation” spreadsheet that reconciles the Payroll register to the bank account statement.

Step 4: All reports identified above are used to create a ‘Monthly Bank Reconciliation’ spreadsheet by transaction type. This spreadsheet is used to reconcile the cash balances in the reconciliation reports to the bank statement balances.

Step 5: As a part of the process, outstanding transactions are identified and recorded by SA and journal entry vouchers are created if needed.
Narrative Description: XYZ Ltd. (cont.)

Process (cont.):

Step 6: The “Monthly Bank Reconciliation” spreadsheet and journal entry vouchers are reviewed for accuracy and are approved by the Controller. A copy of the spreadsheet is maintained in the SA’s office. The Controller ensures that outstanding reconciling items are resolved in a timely manner.

Step 7: Journal entry vouchers are given to the Accounting Manager (AM) for entry into the general ledger.

Step 8: AM verifies that the correct cutoff date is used for all cash receipts and disbursements transactions. Accounts Payable closes the last working day of the month. Accounts Receivable closes the first working day of the month or once the cash is posted for the last working day of the month.
Key tool: flowcharts

4 types (groups) of flowcharting symbols:
1. Input/output symbols
2. Processing symbols
3. Storage symbols
4. Flow and miscellaneous symbols
Key tool: flowcharts
» Help auditor **identify relevant control procedures** by focusing on specific areas where control procedures should be in place

» Certain control procedures, in addition to achieving management’s objectives, relate to financial statement assertions

» For example, using pre-numbered sales invoices and reviewing the sequence of invoice numbers recorded in the sales journal ensures that all sales are recorded and that sales invoices are not recorded twice.
Inventory purchase orders

- Are purchases of goods and services properly authorized?
- Are pre-numbered purchase orders prepared and approved according to general or specific management policies regarding the vendor selected, the goods ordered, and prices?
- Are all major purchases made on the basis of competitive bids to ensure that the company obtains the best price?
Receipt of goods

- Are pre-numbered receiving reports used for all receipts of goods?
- Do receiving personnel count the goods when they are received and record the count on the receiving document?
Recording the receipt of goods

- Are purchase orders prepared by someone who does not also:
  - prepare supporting documents required for payment?
  - make payment to the vendor?

- Are purchase orders, receiving reports, and vendor invoices matched before recording the purchase?

- Are quantities on the receiving document and prices on the purchase order compared to the vendor invoice to ensure that the billed amount is correct?
Internal control description, flowchart or template questionnaire should be filed in continuing/permanent audit file and updated on each audit.

On SME audit engagements, the questionnaire may be more efficient / practical than detailed descriptions and flowcharting.

Documenting not an end in itself but essential to
- Demonstrate that members of the audit engagement team have fulfilled their roles
- Ensure continuity in the audit engagement over years
- Provide needed evidence during quality assurance reviews/inspections
Documentation is the major issue highlighted in PCAOB inspections summary and first QA cycle summary in FYROM

An audit is not in accordance with ISA if the auditor does not obtain understanding of the design and effectiveness of internal control system even in those circumstances where the controls are not relied on and substantive approach is selected.

To document understanding, the auditor must have prepared either description, flowchart, or questionnaire (or combination thereof).
What are the most common deficiencies in internal control encountered in your country (e.g., concentration of control on the top, lack of segregation of duties)?

What are the most common limitations to appropriate emphasis on assessment of internal controls among audit practitioners in your country?

- Lack of awareness / understanding
- Scarcity of tools/resources
- Low fees
- Insufficient “culture” of internal control
- Other
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