Chapter 1: Auditing and Internal Control

Auditing, Hall, 4e

Learning Objectives

- Know the difference between attest services and advisory services and be able to explain the relationship between the two.
- Understand the structure of an audit and have a firm grasp of the conceptual elements of the audit process.
- Understand internal control categories presented in the COSO framework.
- Be familiar with the key features of Section 302 an 404 of the Sarbanes-Oxley Act.
- Understand the relationship between general controls, application control, and financial data integrity.

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Auditing

- **Information technology (IT)** developments have had tremendous impact on **auditing**.
- Business organizations undergo different types of audits for different purposes.
- Most common are external (financial) audits, internal audits and fraud audits.

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External (Financial) Audits

- Independent attestation performed by an expert (i.e., CPA) who expresses an opinion regarding the fair presentation of financial statements.
- Required by Securities and Exchange Commission for all public companies.
- Key concept is independence:
  - Similar to a trial by judge.
  - Auditor collects evidence and renders opinion.
  - Basis of public confidence in financial statements.
- Strict rules must be followed.
  - Defined by SEC, FASB (Financial , AICPA and SOX.

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FINANCIAL STATEMENTS

- Statement of financial position
- Statement of profit or loss (Statement of profit or loss and other comprehensive income)
- Statement of cash flows
- Notes

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Attest Service vs. Advisory Services

- Requirements of attestation services:
  - Written assertions and practitioner's written report.
  - Formal establishment of measurement criteria.
  - Limited to examination, review, and application of agreed-upon procedures.
- Advisory services are offered to improve client's operational effectiveness and efficiency.
- SOX greatly restricts the types of non-audit services auditors may render to audit clients.
  - Unlawful to provide many accounting, financial, internal audit, management, human resource or legal services unrelated to the audit.

Internal Audits

- **Internal auditing** is an independent appraisal function to examine and evaluate activities within, and as a service to, an organization.
- Internal auditors perform a wide variety of activities including financial, operational, compliance and fraud audits.
- Auditors may work for the organization or task may be outsourced.
  - Independence is self-imposed, but auditors represent the interests of the organization.

External vs. Internal Auditors

- External auditors represent outsiders while internal auditors represent organization's interests.
- Internal auditors often cooperate with and assist external auditors in some aspects of financial audits.
  - Extent of cooperation depends upon the independence and competence of the internal audit staff.
- External auditors can rely in part on evidence gathered by internal audit departments that are organizationally independent and report to the board of directors' audit committee.

Fraud Audits

- Recent increase in popularity as a corporate governance tool.
- Objective to investigate anomalies and gather evidence of fraud that may lead to criminal convictions.
- May be initiated by management who suspect employee fraud or the board of directors who suspect executive fraud.

Role of Audit Committee

- Subcommittee of the board of directors
  - Usually three members who are outsiders.
  - SOX (Sarbanes – Oxley Act) requires at least one member must be a "financial expert".
- Serves as independent "check and balance" for the internal audit function.
- SOX mandates that external auditors report to the audit committee:
  - Committee hires and fires auditors and resolve disputes.

Auditing Standards

- Three classes of auditing standards: general qualification, field work, and reporting.
- Specific guidance provided by AICPA Statements on Auditing Standards (SASs) as authoritative interpretations of GAAS or ISA
- Conducing an audit is a systematic and logical process that applies to all forms of information systems.

Generally Accepted Auditing Standards

General Standards	Standards of Field Work	Reporting Standards
1. The auditor must have adequate technical training and proficiency.	1. Audit work must be adequately planned.	1. The auditor must state in the report whether financial statements were prepared in accordance with generally accepted accounting principles.
2. The auditor must have independence of mental attitude.	2. The auditor must gain a sufficient understanding of the internal control structure.	2. The report must identify those circumstances in which generally accepted accounting principles were not applied.
3. The auditor must exercise due professional care in the performance of the audit and the preparation of the report.	3. The auditor must obtain sufficient, competent evidence.	3. The report must identify any items that do not have adequate informative disclosures.
		4. The report shall contain an expression of the auditor's opinion on the financial statements as a whole.

Auditing Standards

- Management assertions and audit objectives:
  - Existence or Occurrence; Completeness; Rights and Obligations; Valuation or Allocation; Presentation and Disclosure.
  - Auditors develop audit objectives and design **audit procedures** based on these assertions.
- Auditors seek evidential matter that corroborates assertions.
- Auditor must determine whether internal control weaknesses and misstatements are material.
- Auditors must communicate the results of their tests, including an **audit opinion.**

Audit Objectives and Audit Procedures Based on Management Assertions

Management Assertions	Audit Objectives	Audit Procedure
Existence or occurrence	Inventories listed on the statement of financial position exist.	Observe the counting of physical inventory.
Completeness	Accounts payable include all obligations to vendors for the period.	Compare receiving reports, supplier invoices, purchase orders, and journal entries for the period and the beginning of the next period.
Rights and obligations	Plant and equipment listed in the statement of financial position are owned by the entity.	Review purchase agreements, insurance policies, and related documents.
Valuation or allocation	Accounts receivable are stated at net realizable value.	Review entity's aging of accounts and evaluate the adequacy of the allowance for uncorrectable accounts.
Presentation and disclosure	Contingencies not reported in financial accounts are properly disclosed in footnotes.	Obtain information from entity lawyers about the status of litigation and estimates of potential loss.

Audit Risk

- Probability that auditor will render unqualified (clean) opinion on financial statements that are, in fact, materially misstated.
- **Inherent risk (IR)** is associated with unique characteristics of client's business or industry.
- **Control risk (CR)** is the likelihood the control structure is flawed because controls are either absent or inadequate to prevent or detect errors.
- **Detection risk (DR)** is the risk auditors are willing to take that errors not detected or prevented by the control structure will not be detected by the auditor.

Audit Risk

- Audit risk components in a model used to determine the scope, nature and timing of substantive tests:
- Audit risk model: AR = IR x CR x DR
  - If acceptable audit risk is 5%, the planned detection risk will depend upon the control structure.
- The stronger the internal control structure, the lower the control risk and the less substantive testing the auditor must do.
  - Substantive tests are labor intensive and time consuming, which drives up audit costs and cause disruption.
  - Management's best interests are served by a strong internal control structure.

AUDIT RISK

Both inherent risk and control risk increase the level of audit procedures required in order to reduce the detection risk to an acceptable level. Because audit risk is comprised of all three elements, if both control risk and inherent risk are high, detection risk will need to be minimized through increased audit procedures. If inherent risk and control risk are both low, the level of audit procedures required will be lower.

Acceptable Audit Risk	Inherent Risk	Control Risk	Planned Detection Risk	Audit Procedures / Evidence Required
High	Low	Low	High	Low
Medium	Medium	Medium	Medium	Medium
Low	Low	Low	Medium	Medium
Low	High	High	Low	High

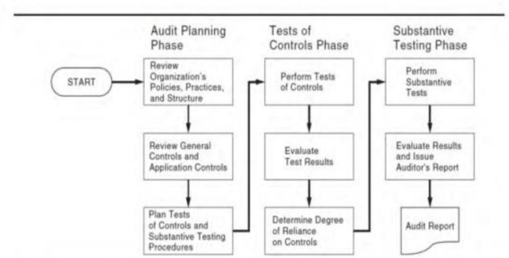
IT AUDIT

IT auditing can be defined as the *formal, independent, and objective examination of an organization's IT infrastructure to determine whether the activities (e.g., procedures, controls, etc.) involved in gathering, processing, storing, distributing, and using information comply with guidelines, safeguard assets, maintain data integrity, and operate effectively and efficiently to achieve the organization's objectives*.

IT auditing

- evaluate the adequacy of application systems to meet processing needs
- evaluate the adequacy of internal controls
- ensure that assets controlled by those systems are adequately safeguard

The IT Audit



The IT Audit

- First step is **audit planning** which includes the analysis of audit risk.
  - Techniques for gathering evidence include questionnaires, management interviews, reviewing system documentation and observing activities.
- Objective of **tests of controls** is to determine if adequate controls are in place and functioning.
- Third phase focuses on financial data and a detailed investigation of specific account balances and transactions through **substantive tests.**
  - Files may be extracted using **Computer-Assisted-Audit Tools and Techniques (CAATTs)** software.

Classification of Audit Procedures

A. Risk Assessment Procedures
  1. Inquiries of Management
  2. Analytical Procedures
  3. Observation and Inspection

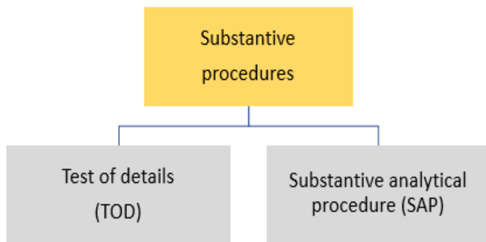
1. Further Audit Procedures
  1. Tests of Controls
  2. Substantive Procedure
     i. Substantive Analytical Procedures
     ii. Tests of Details of Classes of Transactions
     iii. Tests of Details Account Balances
     iv. Test of Details of Disclosures

TEST OF CONTROL

TEST OF CONTROL

Tests of control can be grouped into:
Enquiry and confirmation. For example, ask the credit controller about the way in which customers are encouraged to pay and ask how these customers are identified and how often they are followed up. This is a relatively weak source of evidence because the credit controller might exaggerate his or her efforts.
Inspection. For example, the credit references or notes made by the credit controller of conversations.
Recalculation and re-performance. For example, ensuring that the aged receivables analysis seems to be accurate.

SUBSTANTIVE PROCEDURES



SUBSTANTIVE PROCEDURES

- **A**nalytical (compare the item with other things, such as prior year, industry average)
- **E**nquiry and conformation (ask directors, or better a 3[rd] Party, to confirm information in writing)
- **I**nspection (look at a document, or asset, or the ledgers/books of prime entry)
- **O**bservation (of an asset in use)
- **R**ecalc**U**lation (e.g. of depreciation)

TEST OF DETAIL

Tests of detail would include:
•Writing to customers asking them to *confirm* the amount owed (existence and ownership).
•Tracing, by *inspection*, some sales invoices to the Dr side of customers' accounts (existence and ownership).
•*Observation/inspection* of amounts received after year end. This gives evidence about valuation because if a payment is received subsequently the debt was obviously not bad.
•*Recalculation* of bad debt provisions.

Internal Control

- Management required by law to establish and maintain adequate system of internal controls.
- Brief history of internal control legislation:
  - SEC Acts of 1933 and 1934.
  - Copyright Law of 1976.
  - Foreign Corrupt Practices (FCPA) of 1977 requires companies registered with the SEC to:
    - Keep records that fairly and reasonably reflect firm's transactions and financial position.
    - Maintain a system of internal control that provides reasonable assurance that organization objectives are met.
  - Committee of Sponsoring Organizations - 1992

Internal Control

- Sarbanes-Oxley Act of 2002 (SOX) requires management of public companies to implement adequate internal control system over their financial reporting process. Under Section 302:
  - Managers must certify organization's internal controls quarterly and annually.
  - External auditors must perform certain procedures quarterly to identify any material control modifications that may impact financial reporting.
- Section 404 requires management of public companies to access the effectiveness of their internal controls in an annual report.

Internal Control System

- **Internal control system** comprises policies, practices, and procedures to achieve four broad objectives:
  - Safeguard assets of the firm.
  - Ensure accuracy and reliability of accounting records and information.
  - Promote efficiency in the firm's operations.
  - Measure compliance with management's prescribed policies and procedures.

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Modifying Principles

- Management responsibility made law by SOX.
- Objectives should be achieved regardless of the **data processing** method used.
- Every system has **limitations** on its effectiveness including: possibility of error, circumvention, management override and changing conditions.
- System should provide **reasonable assurance** that broad objectives are met.
  - Cost to achieve improved control should not outweigh benefits.
  - Cost of correcting material weaknesses is offset by benefits.

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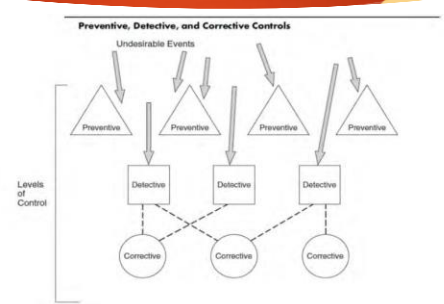
The PDC Model



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The PDC Model

- **Preventive controls** are passive techniques designed to reduce frequency of undesirable events occurring.
  - More cost effective than detecting and correcting problems after they occur.
- **Detective controls** are devices, techniques and procedures to identify and expose undesirable events that eluded the preventive controls.
- **Corrective controls** fix the identified problem.

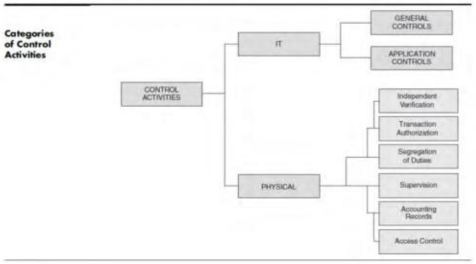
COSO Internal Control Framework

- The **control environment** is the foundation for the other four control components and includes:
  - Management integrity and ethical values, organizational structure, board of director participation and management's philosophy and operating style.
- A **risk assessment** must be performed to identify, analyze and manage financial reporting risks.
- An effective accounting information system will:
- Identify and record all valid financial transactions, provide timely information and adequately measure and record transactions.

COSO Internal Control Framework

- **Monitoring** is the process by which the quality of internal control design and operation can be assessed.
- **Control activities** are policies and procedures to ensure actions to deal with identified risk.
  - Physical controls relate primarily to human activities employed in accounting systems.
  - Information technology controls.

COSO Internal Control Framework



Physical Controls

- **Transaction authorization** is to ensure all processed transactions are valid.
  - May be general (sales only to authorized customer) or specific (extending the credit limit of a customer).
- **Segregation of duties** is designed to:
  - Separate transaction authorization from processing.
  - Separate asset custody from recordkeeping.
  - Ensure a successful fraud requires collusion between individuals with incompatible responsibilities.
- **Supervision** is a compensating control for small organizations that cannot achieve adequate segregation of duties.

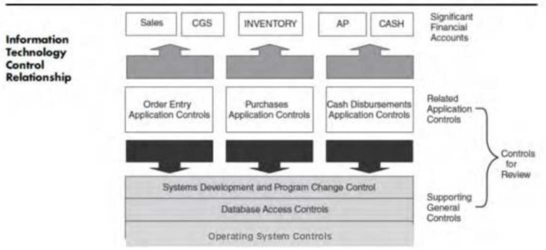
Physical Controls

- **Accounting records** are source documents, journals and ledgers that provide an audit trail.
  - Information needed for day to day operations and essential in the financial audit process.
- **Access controls** ensure only authorized personnel have assess to firm's assets.
- **Verification procedures** are independent checks to identify errors and misrepresentations in the accounting system.
  - Management can assess the performance of individuals, the integrity of the transaction processing system, and data correctness.

IT Controls

- **Application controls** ensure validity, completeness, and accuracy of financial transactions.
  - Includes check digits, batch balancing and payroll limits.
- **General controls** apply to all systems and include:
  - IT governance, IT infrastructure, security and access to operating systems and databases, application acquisition and development and program change procedures.
- General controls needed to support functioning of application controls. Both needed to ensure accurate financial reporting.

IT Controls



Audit Implications of SOX

- Expanded role of auditors:
  - Must attest to quality of client organization's internal controls with a separate audit opinion.
  - Possible to render a qualified opinion on controls and an unqualified opinion on financial statements.
- PCAOB Standard No. 5 requires auditors to understand:
  - Transaction flows including controls pertaining to how transactions are initiated, authorized, recorded, and reported.
- Auditors responsible for detecting fraudulent activity.