MODULE 4

AUDIT EXECUTION: INTERNAL CONTROL, ASSESSING CONTROL RISK AND TEST OF CONTROLS

OUTLINE

- Entity's control environment and control procedures, objectives, limitations and attributes
- Auditor's and management respective responsibilities
- Internal control description and internal control assessments
- Board approach to internal controls and components of internal controls
- Limitation of internal controls
- Assessing the risk of material misstatement, internal controls assessment and test of controls of the following major systems; sales, purchases, payroll and inventory
- Audit programmes for tests of control
- Final assessment of control risk
- Management letter reporting and assessment of impact on audit strategy

Entity’s control environment and control procedures

- Control environment is the overall attitude, awareness and actions of directors and management regarding internal controls and procedures and their importance in the entity. While
- Control procedures are those policies and procedures in addition to the control environment which management has established to achieve the entity’s specific objectives.
- Control procedures are those policies and procedures in addition to the control environment which are established to achieve the entity.s specific objectives. They include, in particular procedures designed to prevent or to detect and correct errors. The latter may be a particular focus of high level controls in small or owner-managed entities. Specific control procedures include:

  (a) Approval and control of documents;

  (b) Controls over computerized system and the information technology environment;

  (c) Checking the arithmetical accuracy of the records;

  (d) Maintaining and reviewing control accounts and trial balances;

  (e) Reconciliations;

  (f) Comparing the results of cash, security and stock counts with accounting records;

  (g) Comparing internal data with external sources of information; and

  (h) Limiting direct physical access to assets and records.

- In order to assess the likely effectiveness of control procedures, the auditor must have an understanding of the control environment. A strong control environment, for example, one with strong budgetary controls and an effective internal audit function, increases the effectiveness of control procedures.
- A small entity's control environment may be strengthened by the close involvement of the directors, including their review of financial information. Based on their understanding of the accounting system and control environment:
- (i) Auditors can make a preliminary assessment of the adequacy of the system as a basis for the preparation of the financial statements; and
- (ii) The likely mix of tests of control and substantive procedures.

- An auditor must obtain an understanding of the accounting system, control environment and control procedures (i.e. the systems) as one exercise. However, in order to design and select the appropriate audit tests, it may be necessary for them to undertake additional work to obtain a more detailed understanding of specific control procedures.

Auditor's and management respective responsibilities

Responsibilities of the management

It is the responsibility of the management:

(a) To take appropriate steps to provide reasonable assurance that the entity complies with law and regulations applicable to its activities;

(b) To establish arrangements for preventing any non-compliance with law or regulations and detecting any that occurs; and

(c) To prepare financial statements that give a true and fair view of the state of affairs of a company and its profit or loss for the financial year.

The assignment of particular responsibilities to management or the audit process does not relieve the directors of these fundamental responsibilities.

In addition, directors and officers of companies have responsibility to provide information required by the auditors, to which they have a legal right of access under the Companies and Allied Matters Act, Cap. C 20 LFN 2004.

Responsibilities of the Auditors

Prevention

APB SAS 120 on Consideration of law and regulations states that: .it is not the auditors' function to prevent non-compliance with law or regulations. The fact that an audit is carried out may, however, act as a deterrent..

Detection

The auditors plan, perform and evaluate their audit work in order to have a reasonable expectation of detecting material misstatements in the financial statements of the entity audited. When doing so, they recognise that material misstatements may arise from non-compliance with law or regulations.

APB SAS 120 requires the auditors to .obtain sufficient appropriate audit evidence about compliance with those laws and regulations which relate directly to the preparation of, or the inclusion or disclosure of specific items in the financial statements..

Internal control description and internal control assessments

- In accounting and auditing, internal control is defined as a process effected by an organization's structure, work and authority flows, people and management information systems, designed to assist the organization to accomplish specific goals or objectives. The COSO report further states that internal control is a means whereby an entity's board or senior management obtains reasonable assurance of the achievements of the set objectives. COSO maintains that the strength or weakness of an entity's internal control environment rests on what is called the foundations of the internal control, namely; integrity, ethical values and the competence on the part of the personnel. The availability of the logistics stated above are described as the invisible control environment.
- Essentially, internal controls are process and people-driven and the people's 'mind-set' could make or mar its effectiveness.

- COSO states that ‘internal control. has five components, just as in IT environment, listed as follows:

  (a) Control Environment - sets the tone for the organization, influencing the control consciousness of its people. It is the foundation for all other components of internal control.

  (b) Risk Assessment - the identification and analysis of relevant risks to the achievement of objectives, forming a basis for how the risks should be managed.

  (c) Information and Communication - systems or processes that support the identification, capture, and exchange of information in a form and time frame that enable people to carry out their responsibilities.

  (d) Control Activities - the policies and procedures that help ensure management directives are carried out.

  (e) Monitoring - processes used to assess the quality of internal control performance over time.

Board approach to internal controls and components of internal controls

- Internal control system comprises the control environment and control procedures. It includes all the policies and procedures (internal controls) adopted by the directors and management of an entity to assist in achieving their objective of ensuring, as far as practicable, the orderly and efficient conduct of its business, including adherence to internal policies, the safeguarding of assets, the prevention and detection of fraud and error, the accuracy and completeness of the accounting records, and timely preparation of reliable financial information. Internal controls may be incorporated within computerized accounting systems.
- However, the internal control system extends beyond those matters which relate directly to the accounting system.
- Control environment means the overall attitude, awareness and actions of directors and management regarding internal controls and their importance in the entity.

- Control procedures are those policies and procedures in addition to the control environment which are established to achieve the entity's specific objectives. They include, in particular procedures designed to prevent or to detect and correct errors. The latter may be a particular focus of high level controls in small or owner-managed entities. Specific control procedures include:

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- Internal controls established by the directors relating to the accounting system are concerned with achieving objectives such as:
- (a) Transactions are executed in accordance with proper, general or specific authorisation;
- (b) All transactions and other events are promptly recorded at the correct amount, in the appropriate accounts and in the proper accounting period, so as to permit preparation of financial statements in accordance with the applicable reporting framework (e.g. relevant legislation and applicable accounting standards);
- (c) Access to assets is permitted only in accordance with proper authorisation; and
- (d) Recorded assets are compared with the existing assets at reasonable intervals and appropriate action is taken with regard to any differences.

Limitations of Internal control

- Internal controls are essential features of any organization that is expected to be managed effectively and efficiently, However, it is noteworthy to realize that internal controls have inherent limitations, which include:
- a. The possibility of circumvention of controls either done through collision with parties outside or inside the entity.
- b. Abuse of responsibility
- c. Fraud
- d. Management override of controls
- e. Changes in environment making controls inadequate
- f. Human cleverness or ingenuity
- G. Potential human error caused by stress of work loud, alcohol, carelessness, distraction, mistakes of judgment, and the misunderstanding of instructions.
- h. Internal controls tend lend to be directed at routine transactions. The one off or unusual transaction tends not to be the subject of internal control.
- i. A requirement that the cost of an internal control is not disproportionate to the potential loss which may result from its absence.
- j. Poor remuneration system
- k. Poor working conditions.

Assessing the Risk of material misstatement

- In evaluating whether the financial statements give a true and fair view, auditors should assess the materiality of the aggregate of uncorrected misstatements.

  The following constitute aggregate of uncorrected mis-statements:

  (a) Specific mis-statements identified by the auditor, including uncorrected mis-statements identified during the audit of the previous period if they affect the current period's financial statements; and

  (b) Auditors. best estimate of other mis-statements which cannot be quantified specifically (for example projected errors).

  The auditor must consider whether the aggregate of uncorrected mis-statements is material. If the auditor concludes that the mis-statements may be material, the auditor should consider reducing audit risk by extending audit procedures or requesting the directors to adjust the financial statements. If the directors refuse to adjust the financial statements and the results of extended audit procedures do not enable the auditor to conclude that the aggregate of uncorrected mis-statements is not material, the auditor should consider the implications in the preparation of his or her report.

Test of Control

- Tests of control are performed to obtain audit evidence about the effective operation of the accounting and internal control systems - that is, that properly designed controls identified in the preliminary assessment exist in fact and have operated effectively throughout the relevant period. They include tests of elements of the control environment where strengths in the control environment are used by auditors to reduce control risk assessments.

- In the process of obtaining the understanding of the accounting and internal control systems, some tests of control on one assertion may provide audit evidence about the effectiveness of the operation of internal controls relevant to another assertion and, consequently, serve as tests of control for the other assertion. For example, .in obtaining the understanding of the accounting and internal control systems pertaining to cash, auditors may obtain audit evidence about the effectiveness of the bank reconciliation process, through enquiry and observation.

- In these circumstances, when auditors conclude that procedures performed to obtain the understanding of the accounting and internal control systems also provide audit evidence about the operating effectiveness of policies and procedures relevant to a particular financial statement assertion, they may use that evidence, on its own or (if not in itself sufficient) with other appropriate audit evidence, to support a control risk assessment at less than high.

- Tests of control may include:

  (a) Corroborative enquiries about, and observation of, internal control functions;

  (b) Inspection of documents supporting controls or events to gain audit evidence that internal controls have operated properly, for example, verifying that a transaction has been authorized or a reconciliation approved;

  (c) Examination of evidence of management reviews, for example minutes of management meetings at which financial results are reviewed and corrective action taken;

  (d) Re-performance of control procedures, for example reconciliation of bank accounts, to ensure they were correctly performed by the entity; and

  (e) Testing of the internal controls operating on specific computerized applications or over the overall information technology function, for example access or program change controls

Final Assessment of Control Risk

- Having undertaken tests of control, auditors should evaluate whether the preliminary assessment of control risk is supported.

  Whenever deviations are detected:

  (a) Auditors make specific enquiries in order to consider their implications;

  or

  (b) It may be that, in the circumstances, they can obtain sufficient

  appropriate audit evidence to conclude that, despite those deviations, their preliminary assessment is supported. On the other hand, if they conclude that the deviation rate is such that the preliminary assessment is not supported, they amend their assessment of control risk, unless audit evidence obtained from other tests of control supports that assessment.

- If the evaluation of deviations results in auditors concluding that the assessed level of control risk needs to be revised, they should modify the nature, timing and extent of their planned substantive procedures.

Management Letter Reporting

Management Letter

This is a letter written by the auditor of an enterprise to the management of that enterprise in which .the auditor set out the weakness discovered by him during the course of his audit work.

- **Purpose of the management letter**

a. To inform management of any significant weakness in the accounting and internal control system.
b. To serve as evidence that management is aware of all the weakness in the system
c. To serve as evidence in ease of litigation
d. To recommends any improvement to the system, which the auditor considers necessary.

Contents of the Management Letter

a. Details of all major weakness discovered in (he internal control and accounting systems.
b. Implication of those weakness on the financial statement
c. Additional work that was carried out as a result of the weakness
d. Recommendation for improvement
e. Previous recommendation not acted upon

Review Questions

1) Highlight the specific control procedures.
2) Discuss the responsibilities of management as it relates to financial report
3) Highlight the limitations of internal control
4) Enumerate the content of a management letter

References

- Adebisi .J.F (2009), Auditing, Investigation and Assurance Services, Bee Printing & Publishing Co, Abuja Nigeria.
- ANAN Study Pack