While I often wonder if an auditor understands what is required when s/he performs the internal control procedures contained in audit programs, I am also confident that most auditors question the benefit of completing the procedures. In spite of the fact that there is little perceived benefit, auditors continue to complete all the steps on the “canned” audit programs because they don’t question the efficacy of the forms as it relates to the client.

Auditing “military style”…..doing what you are told without question, may work in the military but not in the audit. A fundamental component of the audit itself is to ask questions, something one of my mentors in my early years coached everyone to do. Yes, his words to “just ask questions” will make you a better auditor.

Without asking questions to gain a better understanding and simply following the forms leads to the auditor’s perception of “so much time for so little benefit.” Instead, by asking questions to gain a better understanding will help you determine if there is a better and more efficient way. This article focuses on several important questions and offers ideas to help auditors develop a better and more efficient way to understand the client’s internal control.
WHY DOES THE AUDITOR NEED TO CONSIDER INTERNAL CONTROL AS A PART OF THE AUDIT?

All audit standards are designed to assist the auditor in minimizing audit risk. Since audit risk (the risk of issuing a clean opinion when the financial statements contain a material error) exists on every audit, the auditor is expected to focus audit effort in the areas where they believe there could be a risk of material misstatement (RMM).

When the Audit Standards Board (ASB) issued the risk based standards in 2006, they eliminated the ability for the auditor to “opt out” of completing any internal control procedures by assessing internal control risk at the maximum. The ASB believed that when an account carried potential for the risk of material misstatement, the auditor should make a determination if internal control over that account had the ability to mitigate that risk. As such, the standards require the auditor to determine if the design of controls at the client has the ability to prevent or detect a material misstatement. If the design is deemed to be sufficient, the auditor is then required to determine if the design has been implemented by performing a walkthrough.

DO I NEED TO DETERMINE THE DESIGN OF INTERNAL CONTROL FOR ALL ACCOUNTS OR CLASSES OF TRANSACTIONS?

No. This is one area where the auditor spends unnecessary time. Many auditors dive into completing all the internal control forms without first determining which accounts or classes of transactions contain the potential of RMM. The auditor is required to understand the design of internal control for only the RMM accounts or classes of transactions. If you currently document the design of internal control on non-RMM accounts, make a note for next year to have the audit team focus only on the RMM accounts.

DO I NEED TO DETERMINE EVERY CONTROL THAT EXISTS FOR THE ACCOUNT OR CLASS OF TRANSACTIONS?

No. The standards ask the auditor to determine the key control or controls that would have the ability to prevent or detect a material misstatement. The standards do not ask the auditor to determine all controls. Many auditors spend a significant amount of time determining all of the controls rather than determining a key control or controls. It is important to remember that these requirements are all about helping the auditor design better the substantive audit procedures in areas of the greatest risk. Gaining an understanding of a key control helps the auditor determine the audit plan. Identifying all controls, on the other hand, in an unnecessary use of time and doesn’t add any additional value to the audit process.

IF I DON’T HAVE TO LOOK AT ALL ACCOUNTS OR ALL CONTROLS, WHY DO THE “CANNED” AUDIT PROGRAMS HAVE EVERY ACCOUNT AND ALL CONTROLS FOR THE AUDITOR TO CONSIDER?

The “canned” programs that many firms use generally will cover all areas and all controls. The developers of these programs attempt to provide the auditor with virtually every potential scenario so nothing is missed. The developers cannot prepare a generic set of forms and procedures that assumes a low level of client complexity or make assumptions about RMM. As such, these packages assume a high level of audit complexity and that all accounts or classes of transactions contain RMM. It is the expectation that the auditor will focus and refine their level of effort based upon the nature of their client. This is something only the auditor, who, by asking questions, can answer.

THOSE “CANNED” FORMS SEEM SO COMPLEX. HOW WOULD I GO ABOUT MODIFYING THEM TO MATCH THE COMPLEXITY OF MY CLIENT SITUATION?

The forms in the audit package are merely tools and not requirements. The method of documentation the auditor chooses is always a matter of professional judgment. The methods of documentation include flowcharts, narratives, questionnaires and client-prepared manuals. In many situations, it may be far more efficient to develop your own streamlined documentation methodology based in the client and/or the client’s industry. Creating your own streamlined approach allows you to focus on only the RMM accounts and key control(s) rather than all accounts and all controls.

HOW CAN I BEST DETERMINE A KEY CONTROL OR KEY CONTROLS?

The auditor needs to first understand the two types of internal controls that can be in place in an organization; namely preventive and detective. A preventive control is a control that is designed to prevent a material misstatement from ever being recorded in the records of the client. An example of a preventive control is the advance approval of a purchase order. Generally, preventive controls are placed at the transaction level and occur every time a transaction takes place.
Detective controls are controls that are designed to identify a misstatement after it has been recorded in the books and records of the client. A typical detective control is the preparation of account reconciliation. Detective controls generally occur at month end as the books and records are being closed for the month.

I generally recommend that the auditor look first for detective controls related to a RMM account or class of transactions. They are easier to identify and since they are mainly month-end controls they occur only twelve times a year and many are looked at as a part of your year-end audit procedures.

Most internal control documentation packages, however, typically identify preventive controls first and then move to detective controls. This happens because the forms follow the typical approach to process flow in an organization. They start with initiation of a transaction, move to the processing of the transaction which then leads to the recording of the transaction in the general ledger which ultimately ends up being reported in the financial statements of the client.

In summary, the key process flow terms are:
- Initiation
- Processing
- Recording
- Reporting

Documenting internal control following the above process flow generally results in excess documentation and the identification of most if not all controls. Both types of controls work to manage the risk of material misstatement, and it is the auditor's challenge to determine which control or controls can be considered a key control.

I recommend reversing the order when looking for a key control or controls in an RMM account or class of transactions. Start by looking for a detective control first at the reporting level, then move to recording if you cannot determine a key control at the financial reporting level. In most companies, you will be able to identify sufficient detective controls in place within those two levels to satisfy your audit needs.

WHAT AM I EXPECTED TO DO WHEN MY CLIENT DOESN'T HAVE DECENT INTERNAL CONTROLS?

In many smaller organizations, it is very possible that there may not be any internal controls in place to prevent or detect a material misstatement. Again, the purpose of the audit standard is to identify a key control or controls that could potentially mitigate the risk of material misstatement. If no controls exist, you can only conclude that there are no controls in place to mitigate the risk of material misstatement and adjust the audit procedures accordingly.

In situations such as this, document your conclusion that controls are not in place for the RMM account or class of transactions, adjust substantive audit procedures and consider the SAS 155 implications to communicate this material weakness to your client.

IN SUMMARY

Performing internal control procedures should not be as time consuming as they tend to be. The auditor can be far more efficient if s/he considers the following key points:

1) Identify the RMM accounts and classes of transactions
2) Identify a key control or controls not all controls
3) Focus on detective controls rather than preventive controls
4) Find the key control or controls by considering reporting and recording steps first
5) When no controls exist, document your conclusion and move to SAS 115 communication

A word on walkthroughs – When the above suggestions are considered, the time that is taken to complete a walkthrough is reduced as well. The auditor will only need to walkthrough one or a few controls rather than all controls. In addition, when the focus is on detective controls, which tend to be month-end controls, you are likely looking at many of those controls during your normal audit procedures and will not need to make the walkthrough a separate step. It can be included at a part of your normal audit process.

CLICK HERE TO REGISTER FOR THIS SELF-STUDY SESSION
“INTERNAL CONTROLS:
SO MUCH TIME FOR SO LITTLE BENEFIT”

DESCRIPTION: Through the eyes of the client, internal control may be just another time-consuming exercise the auditor performs as part of the audit process. In reality, internal control may be one of the most beneficial aspects of the audit. Internal control is management’s responsibilities, yet the audit process can bring to the forefront areas of weakness that can help the client more than imagined.

COURSE TYPE: Self-study

CPE HOURS: 2

DESIGNED FOR: Audit partners, managers and staff who want to provide high quality client service while streamlining and making their audit process more cost effective.

OBJECTIVE: This session will help you and your audit team, design, build, inspect and deliver an efficient audit that has more meaning for your client.

PREREQUISITES: Experience as a member of an audit team.

ADVANCED PREP: None.