MODULE 4

Topic 1 – Testing internal controls

In this Topic

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4. Do we test every transaction or just some? Understanding sampling
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6. Evaluating the evidence – so what?
7. What sort of controls do we expect to see?

Context

1.1 When and why do we need to test internal controls

When do auditors test internal controls?

- Only when CR = low or medium
- Why don't we test controls when CR = high?
- Why test internal controls?
  - Testing the protective layer
  - Efficiency / saving time
  - Tests of controls are audit procedures which evaluate the operating effectiveness of controls in preventing, detecting and correcting material misstatements (i.e. working) at the assertion level.

At what point during the audit do we do this?

3 – 4 months prior to the EOFY

- Preliminary planning
- Understanding the client
- Understanding the transactions and business processes
- Testing internal controls for first 9 months of the year
- Gathering substantive evidence on transactions for first 9 months of the year

EOFY

- Obtain the Trial Balance
- Gather any evidence that can only be collected around the EOFY

1-2 months after EOFY

- Testing internal controls for the last 3 months of the year
- Gathering substantive evidence for the last 3 months of the year
- Gathering evidence on balance sheet accounts

Reporting date

- Evaluate going concern
- Evaluate subsequent events
- Finalise the audit opinion
- Sign the audit opinion

Remember we also want to know when the controls are NOT operating

- We cannot rely on the controls to protect the accounting data – they do not help reduce the ROMM.
- We will search for any other controls – compensating controls.
- If there is/are no compensating control/s, the auditor will have to revise the CR assessment, change DR and adjust the audit strategy

1.2 How do we identify which controls to test?

Identifying the key controls

- A company will have many controls in a business process
- Match your controls to the assertions
- Test one or two controls that best ensures data meets the assertion in question
- It doesn't matter whether it is an IT-based or manual control – we evaluate and test both.

An example

1.3 Designing audit procedures to test internal controls

What does an audit procedure need to do?

- Gather sufficient and appropriate evidence
- Sufficient =
- Appropriate =
- Auditors must DESIGN their procedures

What if I asked you to draw a bird?

- Would you feel confident in drawing a bird?

Instead – let's try drawing a squiggle

- Your squiggle here

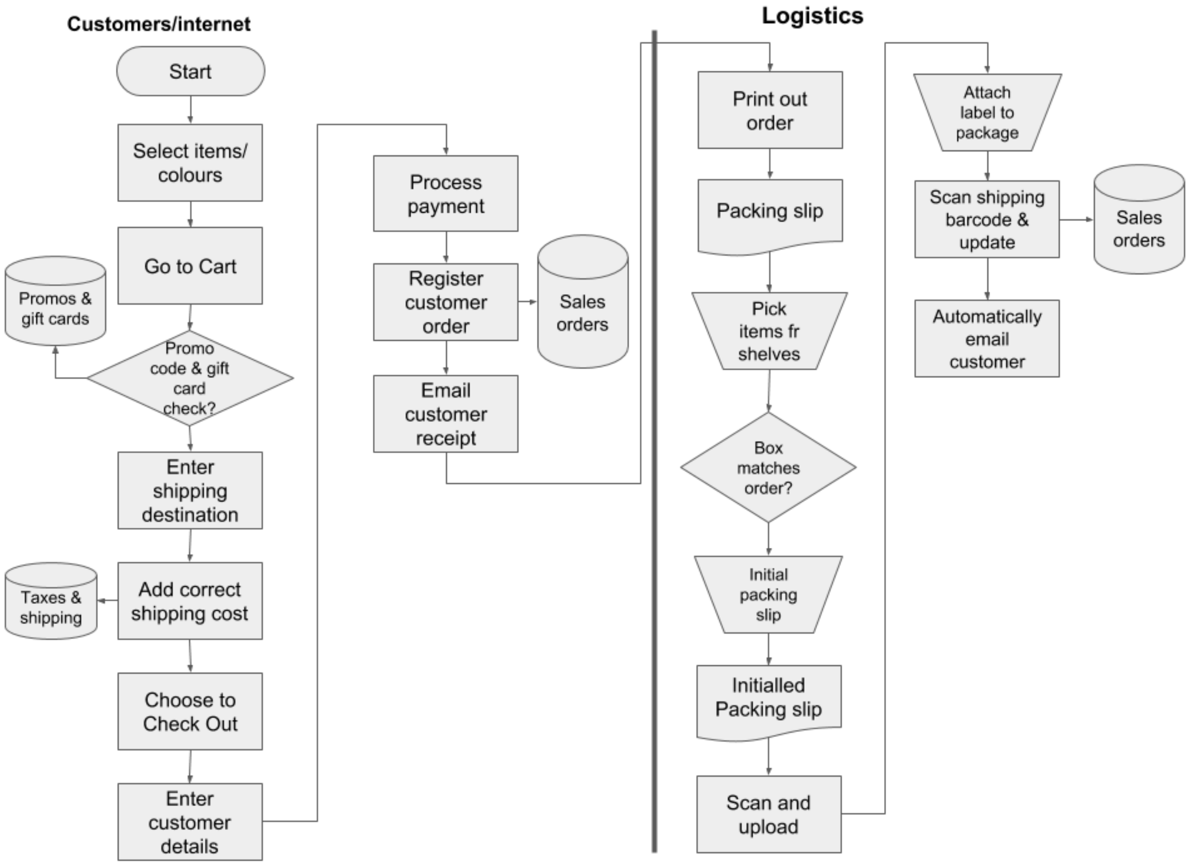
- How can you turn it into a bird?

The sample principle applies for designing audit procedures

- Amanda’s 4 rules for designing audit procedures

1. Use **audit specific terminology** when starting to build your procedure
2. Use **client specific terminology**
3. **Be specific** – instructions should be detailed enough for someone else to follow
4. Make sure your procedure is **fit for purpose**

Let’s try an example – sales process



Control	Procedure to test operating effectiveness	Sampling method

1.4 Do we test every transaction or just some? Understanding sampling

How many times does a control execute or run?

In the past – why haven't tested every time a control runs

- Expensive – manually collecting evidence and checking whether the control is operating correctly requires human effort
- Evaluated monitoring control reports
- Controls are often IT-based – once we can prove it works at specific points in time over the year – we can assume it worked over the entire year.
- With more modern data analytics tools - there is potential for more testing

What does sampling mean?

Definitions

5. For the purposes of the Australian Auditing Standards, the following terms have the meanings attributed below:

   (a) Audit sampling (sampling) means the application of audit procedures to less than 100% of items within a population of audit relevance such that all sampling units have a chance of selection in order to provide the auditor with a reasonable basis on which to draw conclusions about the entire population.

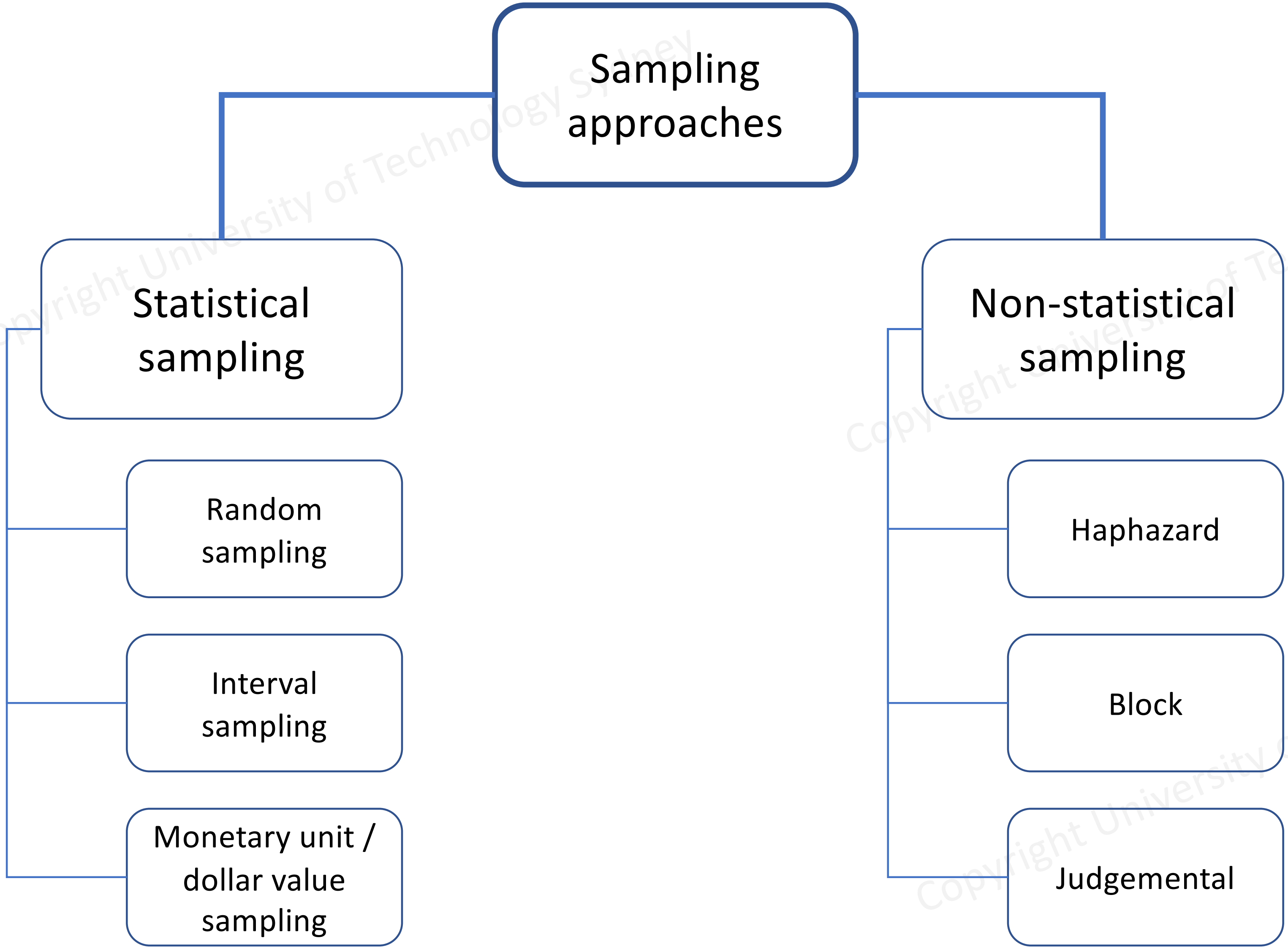
   (b) Population means the entire set of data from which a sample is selected and about which the auditor wishes to draw conclusions.

But could things go wrong?

- Sampling risk
  - "the risk that the auditor's conclusion based on a sample may be different from the conclusion if the entire population were subjected to the same audit procedure" ASA500.5(c)
- What does that mean?
  - Conclusion that controls are working correctly, when they aren't effective
  - Does this result in an overstatement or understatement of Control Risk?
- Non-sampling risk
  - That the auditor makes an inappropriate judgement

How do we respond to sampling risk?

- We need to select a sample that is “representative”
- How do we do that?
  - Statistical analysis of the population
  - Using technology tools to help us with sampling



Sampling approaches
Statistical sampling
Random sampling
Interval sampling
Monetary unit / dollar value sampling
Non-statistical sampling
Haphazard
Block
Judgemental

Steps for audit sampling

1. Design the test
2. Identify the population you need to select your sample from
3. Do you need to stratify?
4. Select the sample

Selecting the population

- It all comes down to understanding the audit procedure.
- What document do you start with?
- This choice doesn't limit what other evidence you gather

1.5 Executing tests of internal controls

The physical how to

- Remember you are looking for proof of the internal control

Make sure you attend the workshop for the follow along exercise

1.6 Evaluating the evidence – so what?

What are we looking for?

- Searching for deviations in internal controls
  - AKA when a control does not work
- How many control deviations are acceptable?
  - Audit manager or supervisor will provide you with a tolerable level or rate of deviations
  - Calculate the actual rate $= \frac{Number\ of\ deviations}{Total\ control\ activities\ tested}$
- Investigate the cause of the deviations – why?

Are controls operating effectively?

How often to do we need to test controls?

- The standards recommend at least every 3 financial periods (assuming nothing in the internal control system changes)
- So the reality is a bit different!

1.7 What sort of controls do you expect to see?

Sales and cash receipts process

- Who are the customers?
- How are prices set?
- How are discounts organised?
- How are sales on credit processed?
- How do they chase up late payments?
- How are payments received from customers?
- How is cash handled?

Purchasing and accounts payable process

- Multi-step process for purchasing items
  - Segregation of duties – request, approve, process, receive items, receive invoice and process payment
- 3 way match process for payments – purchase order, receiving report, invoice
- How are payments processed? Who accesses the bank account?

Try brain storming controls for any account or process in a typical company

- How would payroll be processed at a large retail store?
- What should the process be for purchasing new property plant and equipment?