

Chapter

3

Review and the audit process

3.1 The process of review and audit of internal control systems

The board of directors are responsible for the review and maintenance of internal controls.

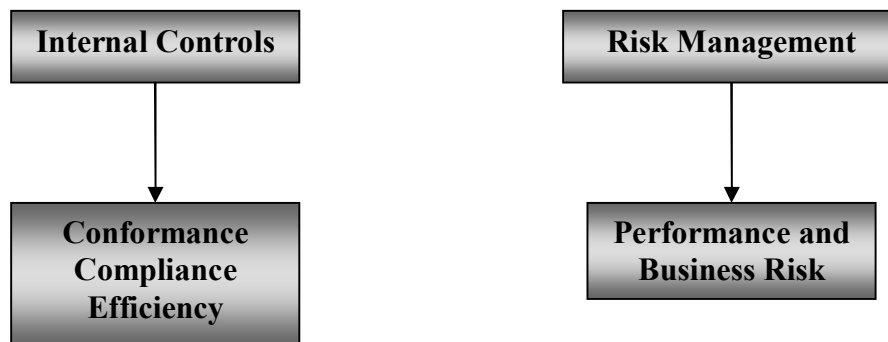
The management of the company are responsible for the devising and implementing these controls.

The Turnbull Report (1999) which has also become part of the Combined Code focuses on the review of internal controls.

Key points in the Turnbull Report:

- Have a **defined process** for the review of effectiveness of internal control.
- **Review** regular reports on internal control.
- Consider **key risks** and how they have been managed.
- Check the **adequacy of action** taken to remedy weaknesses and incidents.
- Consider the **adequacy of monitoring**.
- Conduct an **annual assessment** of risks and the effectiveness of internal control.
- Make a **statement on this process** in the annual report.

Internal audit is used to help directors achieve these objectives.



Conformance, compliance and efficiency

This is focussed on the “administration of decisions”.

Processes and procedures should be regularly reviewed.

This would ensure that decisions are made on results of the company that are timely, accurate and relevant.

Audit programmes and procedures should be drawn up ensuring effective coverage of financial, management, operational and compliance issues. For example, reporting standards, regulations, health and safety, security and competition.

Performance and business risk

This is focussed on the “quality of decisions”.

The comparison of an organisations performance with that of the others is an important part of performance measurement, identifying organisations (not necessarily in the same industry as a yard stick) for which performance can be compared to. The board must identify the key risk areas and key performance indicators of the business and continually monitor and compare these to improve the business processes and help safeguard against any impact by competitors. Management make detailed reports on these benchmarks to the board to help them carry out this monitoring process.

Benchmarking

“A continuous, systematic process for evaluating the products, services and work processes of an organisation that are recognised as representing best practice, for the purpose of organisational improvement.”
(Michael Spendolini)

Four types of benchmarking

A hospital is used to illustrate the following types of benchmarking:

1. **Internal.** Compare an internal function to the best internally within the same organisation e.g. different methods of cleaning used by hospital wards within the same hospital.
2. **Best practice or functional.** Compare an internal function to the best but not necessarily an organisation in the same industry e.g. compare administration activities or cleaning methods to other hospitals or other organisations other than a hospital not involved in healthcare.
3. **Competitive.** Hospital or healthcare services are compared to that of rival competitors in the same industry e.g. methods of patient care and levels of service compared and contrasted with other hospitals.
4. **Strategic.** Comparison in terms of an organisations strategic choices made to the most successful market leader e.g. review organisational structure, culture, mission statement and goals of other hospitals higher in quality league tables. Strategic choices could include outsourcing or decisions about the closure of expensive wards even though unpopular.

Companies to be the very best must

- Establish where customers perceive differences
- Set the very best standards to exceed
- Establish what the competition is doing
- Encourage staff, manage knowledge, ideas and innovate to exceed

A process for benchmarking

1. Gain senior management commitment to establish benchmarking as a process within the organisation and educate staff and stakeholders about the benefits. Participate and consult with staff and stakeholders.
2. Consider the benefits against the cost for each activity to be benchmarked to ensure economic or financial justification.
3. Assign responsibilities to a team of staff e.g. set goals; establish BM processes and systems, checklists and documentation.
4. Identify potential partners and known leaders.
5. Undertake the process of benchmarking e.g. test, measure, observe, experiment or investigate.
6. Gather, analyse and summarise information collected and documented.
7. Gap analysis undertaken for deficiencies identified e.g. standard v actual.
8. Implement improvement e.g. new programmes, processes and procedures. Education and participation encouraged by those affected, avoid being over critical for weaknesses identified. Set objectives and manage change.
9. Monitor and repeat regularly to discourage complacency, follow up improvements implemented to ensure the expected benefits are realised.

Benefits of benchmarking

- ✓ Better understanding of the business, competition and customers.
- ✓ Improves business performance and discourages complacency.
- ✓ Good way of comparing competitive strategies to reposition products.
- ✓ You can learn from other organisations mistakes.
- ✓ You don't need to re-invent the wheel for innovation and creativity e.g. learn from other organisations and a source of new ideas.
- ✓ Advance warning for deteriorating competitive performance e.g. faster awareness of industry innovation and other competitor decisions.
- ✓ Fewer complaints, product returns, and warranty claims e.g. quality improves.
- ✓ Leaner and more cost efficient organisation.
- ✓ Customer satisfaction and brand loyalty increases.
- ✓ Sales and profitability will improve in the long-term.

Drawbacks of benchmarking

- ✗ Benchmarking systems and programmes can be costly and time consuming
- ✗ The diversity and complexity of information can overload management e.g. so much information; management cannot see the wood through the trees.
- ✗ Obtaining information to actually undertake a BM exercise can be a problem e.g. absent, historical or out of date.
- ✗ Confidential information could be leaked or compromised when shared
- ✗ Deciding who the best in a class is?
- ✗ Keeping staff motivated e.g. staff can be criticised and once they exceed standards the standard is normally raised

The board should set clear lines of accountability and assignment of responsibility to the appropriate managers through the company.

Management should report to the board their review and implementation of internal controls and risk management systems.

The board should review the performance of management in dealing with internal controls and risk management systems. They normally have assistance in this area from internal audit.

Internal audit is an appraisal or monitoring activity established by the board for the **review of the accounting and internal control systems** as a service to the entity. It functions by, amongst other things, examining, evaluating and **reporting to** the board on the adequacy and effectiveness of components of the accounting and internal control systems created by management.

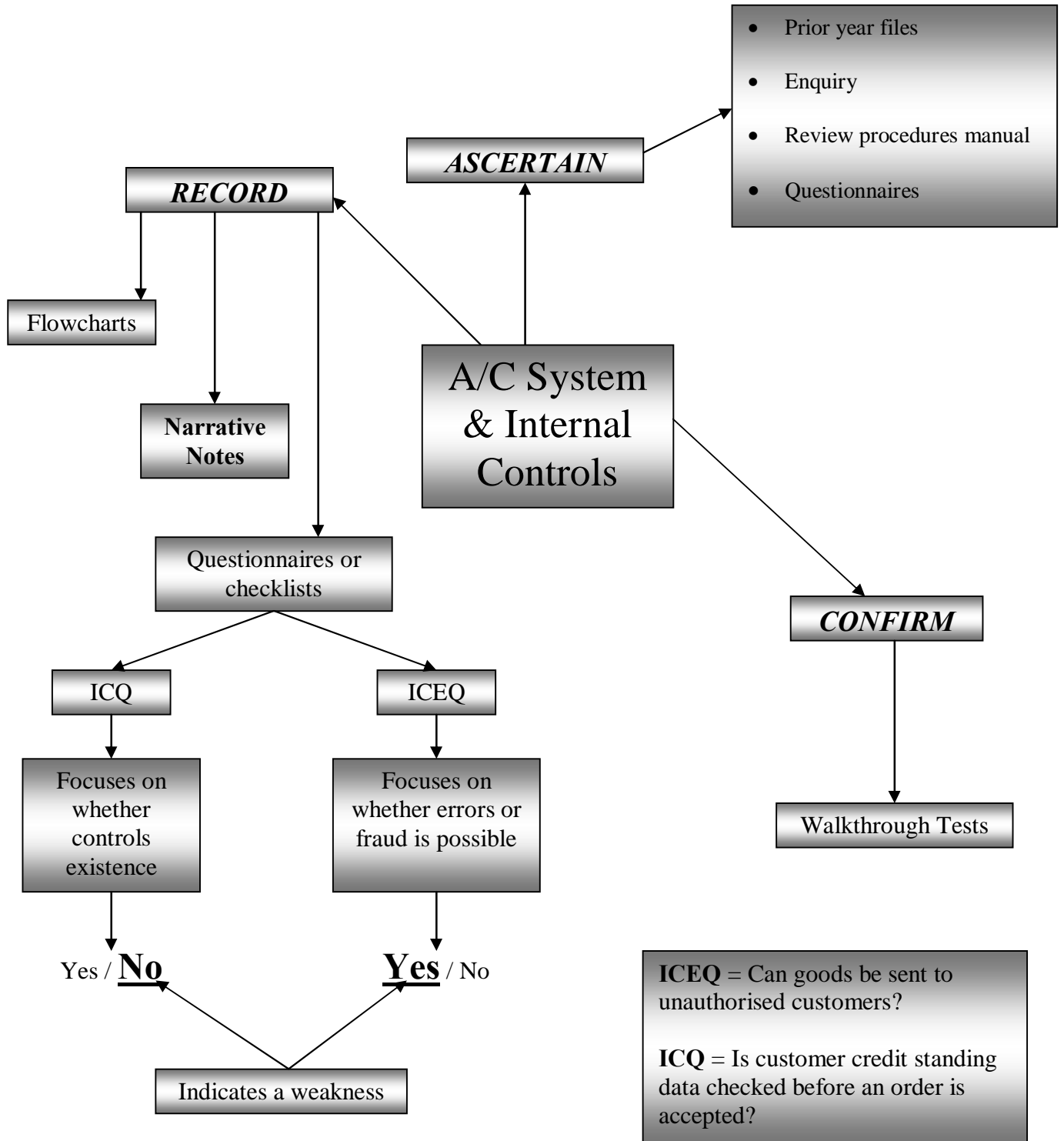
Internal audit is seen as independent from management who are devising and implementing the internal controls, and should be able to provide advice on internal controls both to management and the board. Internal audit being independent from management can also review and advise on the audit the risk management process used by management to systematically identify the risk impacting the business.

The board should encourage a strong control culture. Manager's bonus should not only be linked to company profits but also linked to internal control procedures being adhered to. There should be a specific manager who is responsible and accountable for internal control procedures for each division and who understands the details of that division.

Example 3.1 – (CIMA P3 May 05)

Compare and contrast the roles played by internal audit and risk management in organisations. Discuss the likely nature of the interaction between these two activities.

3.2 Overview



ICQ = Internal Control Questionnaire
ICEQ = Internal Control Evaluation Questionnaire

3.3 Internal controls

Comprises the control environment and control procedures. It includes all the policies and procedures (internal controls) adopted by the management of an entity to assist in achieving management's objective of ensuring, as far as practicable,

- *the orderly and efficient conduct of its business,*
- *including adherence to management policies,*
- *the safeguarding of assets,*
- *the prevention and detection of fraud and error,*
- *the accuracy and completeness of the accounting records and*
- *the timely preparation of reliable information.*

Internal controls may be incorporated within computerised accounting systems. However, the internal control system extends beyond those matters which relate directly to the accounting system.

Example 3.2 – (CIMA P3 May 05)

Explain what an internal control system is, how it relates to the control environment and its likely costs, benefits and limitations.

Specific control procedures should be in place which include:

- O** Organisational structure (clear lines of responsibility and authority)
- A** Authorisation (approval of transactions or limits)
- P** Personnel (recruitment of trustworthy individuals and the right training)
- S** Supervision (discourages fraud and improves quality data entry when the work is complex)
- P** Physical (physical barriers to prevent theft)
- A** Accounting (reconciliation, trial balances and input controls)
- S** Segregation of duties (separate responsibilities between those that record, process and initiate, such as the receipt, recording and banking of cash)
- M** Management (internal audit, regular review of management accounts and exception reporting)

Example 3.3 – (CIMA P3 May 05)

AL and Co. is a London-based building contractor, with an annual turnover of almost £15 million. The company employs 50 people, the majority of whom are skilled tradesmen or apprentices in the areas of plumbing, electrical work, plastering, carpentry, glazing and hard landscaping. AL and Co. specialises in renovation work for private clients by offering a fast 'call service' facility that suits busy professional people seeking to renovate properties either for their own occupation or for investment purposes. As a result of the property boom, turnover has grown by over 30% in the last two years.

Day-to-day management of the business is shared by two executive directors, one of whom manages the financial and legal aspects of the business (Director X), while the other is responsible for operational activities including work scheduling, agreeing quotes with the sales staff, and all procurement (Director Y). The two directors have a mutual respect and trust for one another and therefore do not check or verify each other's work.

As a medium sized company, AL and Co. is subject to an annual external audit, but it has no internal audit function and both its internal control and management accounting systems are very basic. Management accounting procedures record the costs of materials associated with all contracts via a job costing system, but other costs are not charged to individual contracts. The system is thus unable to identify whether any specific contract is profitable, and can only compute aggregate profit. One consequence of this system is that the company profitability depends on there being a close match between the actual time taken to complete jobs and the sales team's estimate of the times required: however, the time variances are neither calculated nor monitored.

The systems have never been questioned or refined because, to date, an average gross markup of 25% has always been achieved. This margin has ensured that both directors earn high salaries which have risen year on year, and there has therefore been little incentive to improve controls and manage costs.

Two staff are employed to issue written quotes in response to customer enquiries, with prices being calculated on the basis of estimated labour and material costs plus 25%. The quotes are reviewed by Director Y before they are sent to customers. All payments are due on completion of the work. In drafting the work schedules Director Y has full knowledge of which quotes are accepted by customers. Additionally, given his role of supervising procurement, he regularly gives administrative staff the names of new suppliers for inclusion in the accounting system.

Six months ago, Director Y found himself over-committed financially, and devised a way of diverting company funds from AL and Co. for his own personal use. He began adding 10% to the figures quoted for all jobs requiring the use of more than three separate services plastering, electrical etc, thereby raising the gross markup to 37.5% in such cases. The intention was to fraudulently redirect the additional income for his personal use. This was achieved by the submission to AL and Co., on the completion of a job, of an invoice (for the 10% additional charge) in the name of a fictitious supplier of small tools and consumables.

Director Y would code the associated costs as variable overhead in the accounting system. The timing of the invoices could easily be matched to the job completion dates in view of his knowledge of work schedules, and he set up a separate bank account in the fictitious name to receive these payments.

You are an accountant in AL and Co. and have been assigned responsibility for liaison with the external auditors. You find that you are unable to resolve their concerns about the escalation in variable overhead expenses over the course of the last year, most of which have been charged to a non-local supplier's account. You are having difficulty clarifying the precise nature of the expenses incurred because telephone calls to the business number always request that a message be left but no calls are ever returned. All other aspects of the audit are satisfactory.

Required:

Detail the inadequacies of the current 'internal control' system within the company and possible changes that could be made to improve the system.

Example 3.4 – (CIMA P3 Nov 07)

VWS is a company manufacturing and selling a wide range of industrial products to a large number of businesses throughout the country. VWS is a significant local employer, with 2,500 people working out of several locations around the region, all linked by a networked computer system.

VWS purchases numerous components from 750 local and regional suppliers, receiving these components into a central warehouse. The company carries about 10,000 different inventory items, placing 25,000 orders with its suppliers each year.

The Accounts Payable Department of VWS has six staff who process all supplier invoices through the company's computer system and make payment to suppliers by cheque or electronic remittance.

Required:

Discuss the purposes and value of an internal control system for Accounts Payable to a company like VWS.

Example 3.5 – (CIMA P3 Nov 07)

EWC is a large company in an unregulated sector of the telecommunications industry. It has ambitious plans for sales growth and increased profitability. In support of these goals, senior management has established a flat management structure. Budget targets place employees under considerable pressure but success in achieving and surpassing sales and profitability targets is rewarded by bonuses and share options. Employees who do not achieve their targets do not remain with the company for long.

Performance targets exist for expanding EWC's customer base, sales value and profitability per customer, and geographic and product-based expansion. EWC zealously pursues cost reduction with continual efforts to drive down suppliers' prices. The company aims to eliminate any wasteful practices in management and administration. EWC considers any expenditure that does not lead directly to sales growth to be wasteful and the company minimises its corporate policies and procedures. As a result, EWC has tended to overlook unscrupulous practices in its employees' dealings with customers, competitors and suppliers in the pursuit of its goals. The company is unlisted and reports its profits to shareholders once per year.

Required:

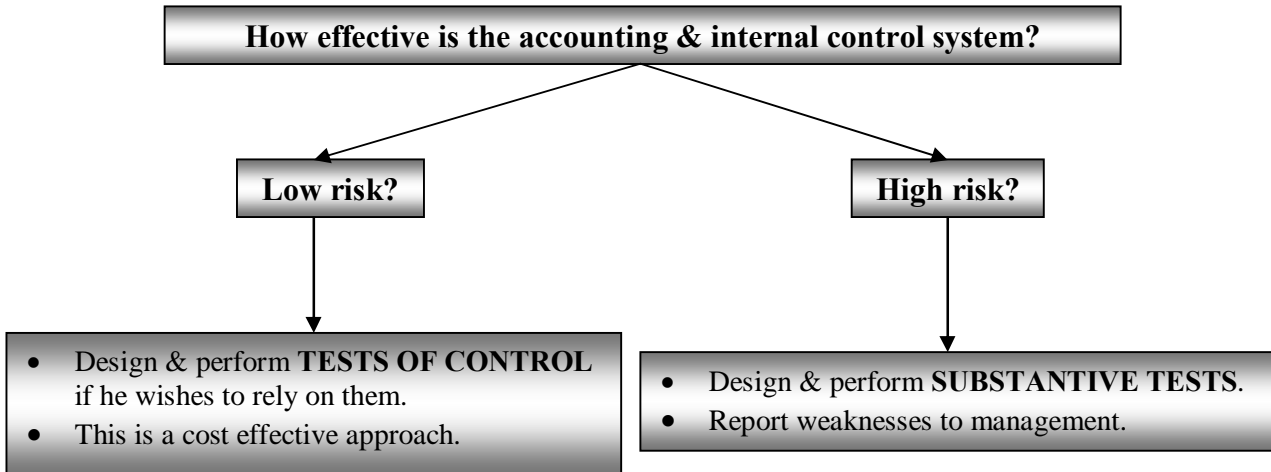
Explain the significance of the control environment in EWC.

Nick Leeson and Barings

Leeson was the trader that managed to bring about the collapse of Barings Bank in 1995. The main reason he was able to do this was because there was a fundamental weakness in the bank's internal controls being a lack of segregation of duties. Leeson was responsible for the entire Singapore office (trading, back office and management) and was able to hide huge trading losses in the accounts whilst reporting healthy profits to his superiors in London. Other weaknesses in the controls lied with his superiors in London who did not properly interrogate and review the accounts and simply just accepted them for what they showed, and even gave Leeson bonuses for falsified profits in the accounts. In addition the auditors failed to bring to light these basic weaknesses in internal controls.

3.4 Types of audit

Audit objective: *Assess the adequacy of a system as a basis for the preparation of accounts.*



Tests of control or systems based auditing

Tests to obtain audit evidence about the effective operation of the accounting and internal control systems. It is not concerned about the detailed underlying transactions but interested in the controls that are in place which manage the information.

It is testing that the control is:

- Properly designed.
- Exists.
- Has operated throughout the period.

Deviations should be recorded and investigated regardless of the amount involved and then assess whether deviations are isolated departures or indicate existence of errors in accounting records.

If replies are unsatisfactory then the preliminary assessment of control risk is not supported. The auditors must modify the nature, timing and extent of their planned substantive procedures.

Systems based audit is useful as it will help identify risks within the processes in an organisation and review how adequate the controls are which mitigate these risks. This will help in achieving the businesses main objectives as processes will be inline to operate effectively and efficiently after such an audit.

Examples of tests of controls:

- Check bank reconciliation has been reconciled as approved by chief accountant.
- Observe buyer checking the goods received note and invoice before authorising cheque for payment.

Tests of controls may include:

- **Enquiries and observations** corroborating internal control functions.
- **Inspection of documents** evidencing operation of an internal control, for example a transaction has been authorised.
- **Examination of evidence** of management reviews, for example minutes of management meetings at which financial results are reviewed and corrective action decided on.
- **Reperformance** of control procedures, for example reconciliation of bank accounts, to ensure they were correctly performed by the entity.
- **Testing of the internal controls** operating on specific computerised applications or over the overall IT function, for example access or program change controls.

Alternative summarised version of tests of controls

- **D**ocumentation (written evidence)
- **S**egregation of duty (i.e. staff records are separate from wages department)
- **A**uthorisation (by senior personnel)
- **R**evue (by senior personnel of other staff work)

Remember no control is fool proof. Humans are careless, distracted easily, misunderstand and make mistakes. Collusion can always happen to over ride controls and responsibility given could always be abused.

Substantive tests or transactions based auditing

Tests to obtain audit evidence to detect material misstatements in the financial statements. Using analytical procedures and other substantive tests to review the accuracy of the accounting information, for example testing transactions and balances, review of minutes of directors meeting and enquiry.

Examples of substantive tests:

- Agree a sample of wages payments to the existence of these individuals and personnel records.
- Agree a sample of cashbook payments to the bank statements.
- Agree a sample of quantities on purchase invoices to goods received notes.

Risk-based auditing

A risk based audit would be reviewing the risk management process and considering the main risks of the organisation as a whole.

Risk management procedures are used to assess what risks will impact on the business. These are not only within the organisation but much wider and look outside the business externally into its environment. If these risks are not mitigated then the business maybe severely effected resulting in the business not continuing in the future. Examples are competition, latest business developments, the state of the economy and social trends.

Example 3.6 – (CIMA P3 Nov 05)

Critically discuss the role of systems based internal auditing in relation to the assessment of risk management procedures in any organisation.

3.4 Planning

Internal auditors should plan the audit work so as to perform the audit in an effective manner. There should be adequate audit programmes in existence which set out the purpose and the aim of the audit. Three main types of audit plans

Strategic ó this the long term forward looking audit, it continually gets updated and identifies areas of audit importance.

Tactical ó this looks at plans for the coming year, timetabling resource allocating and identifying the main audit objectives taken from the strategic plan.

Operational ó detailed audit programme for each and every specific audit.

Planning the work

- Determine the scope and objective of the audit (to verify assets, to check adequacy of internal controls etcí).
- Ensuring appropriate attention is devoted to the different areas of the audit (risk based audit).
- Changes in business environment (new systems, changes in key personnel, competitorø reactions, innovations in the market, consumer preferences, legislation, board decisions etcí)
- Consider external auditors work already done.
- Review previous accounts, internal audit reports and past testing (analytical review and previous problems highlighted).
- Ensuring that potential problems are identified.
- Facilitating review.
- Ensure audit work is assigned and co-ordinated properly (select team, book hotels, communicate, brief and allocate work schedules).
- Economic service within an appropriate time scale.

Audit plan contents

1. Report requirements and terms of reference.
2. A review of the business and financial position, reviewing why changes had occurred in the current year.
3. Risk areas highlighted including assessment of internal controls.
4. Calculations for levels of materiality.
5. Detailing overall audit approach (substantive or compliance) including timing and deadlines.
6. Staffing levels and request for any specialists i.e. computer based control assurance staff.
7. A budget for time estimated for each staff member.
8. Reviewed and approved by manager.
9. Distribute audit plan to all staff on the audit.

The audit team should be sufficiently familiar and fully briefed by the manager and have knowledge of the business or operation such that to be able to carry out the audit work effectively.

Example 3.7 – (CIMA P3 Nov 06)

BLU is a stock market listed manufacturing company that has historically invested in computer numerical control (CNC) equipment to manufacture a range of electronic components for the telecommunications industry. BLU's strategic objective is to increase shareholder value through an annual increase in sales revenue of 15% and an annual increase in after-tax profits of 17.5%, both of which have been achieved over the past three years. This objective is strongly promoted within BLU and senior management bonuses are linked to the achievement of those targets.

In early 2006, the following financial justification was presented to the Board of Directors of BLU to support a proposal for capital investment in new CNC manufacturing equipment:

Projected cash flows for new equipment

All figures in £000	2007	2008	2009	2010	2011
Additional sales income	12,000	13,000	14,000	15,000	16,000
Additional variable costs	3,600	3,900	4,200	4,500	4,800
Additional fixed costs	1,500	1,500	1,500	1,500	1,500
Additional operating profit	6,900	7,600	8,300	9,000	9,700
Less taxation		2,070	2,280	2,490	2,700
Additional operating cash flow	6,900	5,530	6,020	6,510	7,000
Less additional working capital	1,000	300	400	500	600
Additional cash flow	5,900	5,230	5,620	6,010	6,400
Cost of capital 15%					
Present value of future cash flows	19,398				
Less capital cost of new equipment	17,500				
Net present value	1,898				

It is company policy to evaluate investments over the first five years only.

In March 2006, the Board approved the capital investment as it met its minimum criterion of a positive NPV using a cost of capital of 15%. There was one other project that was competing for funds at that time. This was for a new distribution system. However, this project was rejected by the Board because the NPV was lower than that of the CNC equipment.

Later in 2006, the audit committee asked a firm of consultants to review BLU's capital investment approval process and the information system that informs that process. As part of the first stage of the consultants' review, a draft report has been received by the Board that describes the process but as yet does not make any recommendations. The following are extracts from the consultants' draft report:

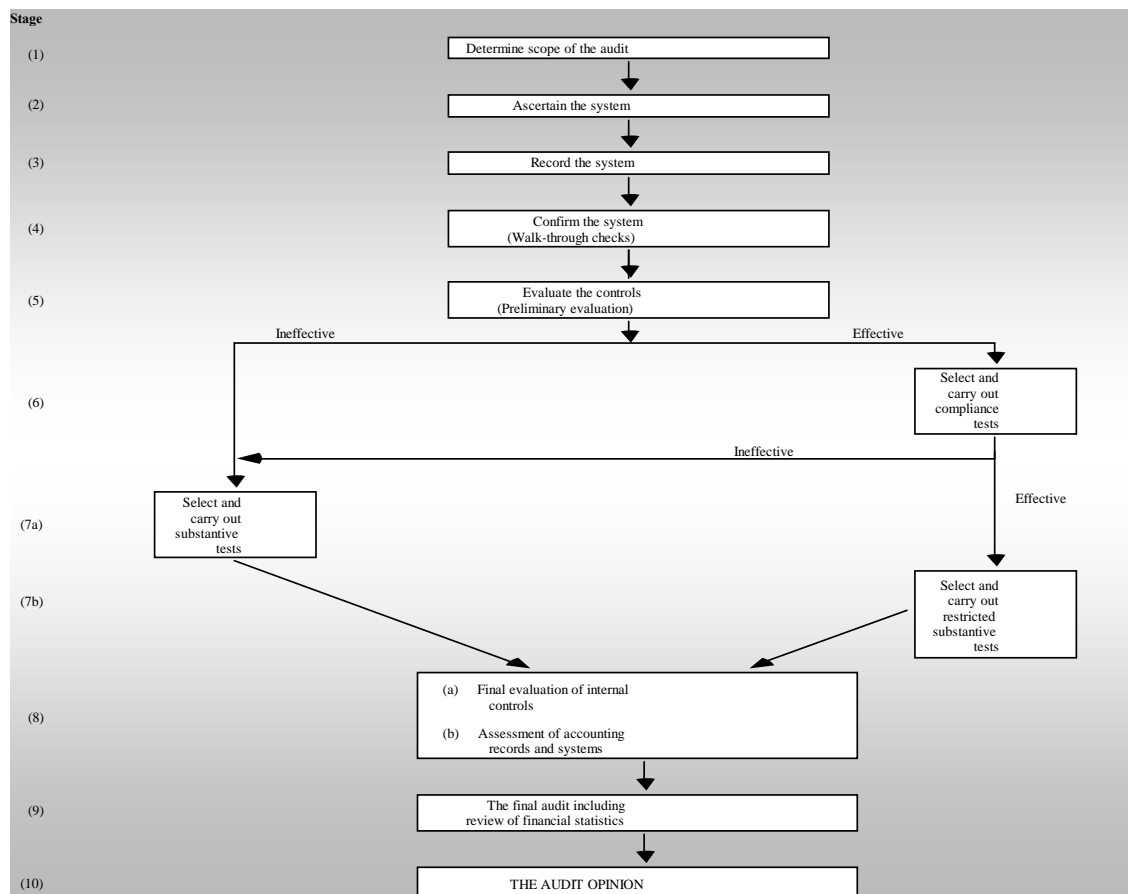
- BLU has a Market Research Department that looks at economic, industry and competitive factors affecting the market demand for its products in order to forecast market growth and likely market share during BLU's strategic planning horizon of five years. As part of its assessment, the Market Research Department asks the Sales Department to liaise with its largest customers to determine their likely requirements. The Sales Department forecasts sales based on its own knowledge of its market, including information from existing customers and its plan to win new customers. Having collated the available information, the Market Research Department provides the Production Department with annually updated forecasts of market demand for the next five years.
- The Production Department compares the Market Research Department's forecasts with its production capacity based on past experience of volumes, product mix, and cycle times. The Production Department then determines the 'capacity gap' over the next five years, which it defines as the difference between the capacity required to satisfy forecasts of market demand and its existing practical capacity.
- Based on the capacity gap, the Production Department conducts a search for new CNC manufacturing equipment that will satisfy projected sales. A range of alternative suppliers is considered and prices for the equipment are compared, after which the Production Department identifies the supplier and the equipment deemed most suitable to bridge the capacity gap. The capital costs of new equipment and the capacity of this new equipment are calculated by the Production Department.
- The Finance Department accepts the forecasts of market demand from the Market Research Department and the cost and capacity information from the Production Department. It then uses historical cost information to update standard costs of labour and materials, with advice from the Human Resources and Purchasing Departments respectively about likely increases in the price of labour and materials. The Finance Department makes its own assessments about the additional working capital requirement.

- The Finance Department then completes a discounted cash flow calculation to assess the investment in new capital equipment, which is then presented to the Board of Directors as part of the annual budget cycle. BLU uses a cost of capital of 15% for the assessment of new capital expenditure proposals. This is the benchmark figure used by the Board, which has been in use for several years. Proposals that show a positive net present value are likely to be approved and where there are competing proposals for limited capital funds, the project with the highest NPV is usually selected. The Board's capital investment approval criteria are well known by BLU's managers.

Required:

Explain how, as an internal auditor, you would plan an audit of BLU's existing capital investment process (and the information system feeding that process), highlighting those elements of the process that you would pay particular attention to under a risk-based approach.

3.5 The audit process



3.6 Understanding the accounting system

The auditor will obtain an understanding of the system using the following methods:

- Walk-through tests – That is tracing one or more transactions through accounting system and observing application of internal controls.
- Review of prior year file and previous experience of reliability of system.
- Enquiry of management and personnel.
- Review of procedures manuals and systems descriptions.
- Examine documents / records produced by systems.
- Observation of the activities and operations, including IT function and the nature of transaction processing.

3.7 Materiality

An item can be considered material if its omission would ***reasonably influence the decisions of an addressee of the report***, a misstatement is material if it would have a similar influence. It can be of value, nature or disclosure. This will always be a matter of judgement for the auditor but should be engaged in seeking 'material' errors, omissions and misstatements.

Material items will have an impact on:

- Audit tests carried out. For example compliance based testing (relying on controls) may not be suitable as they would not be reliable enough to take assurance from, and therefore you may have to resort to detailed substantive tests (account balance level testing).
- Whether adjustments should be made to the accounts.
- Whether the auditor should qualify his report on the accounts.

The calculation of materiality

For example:

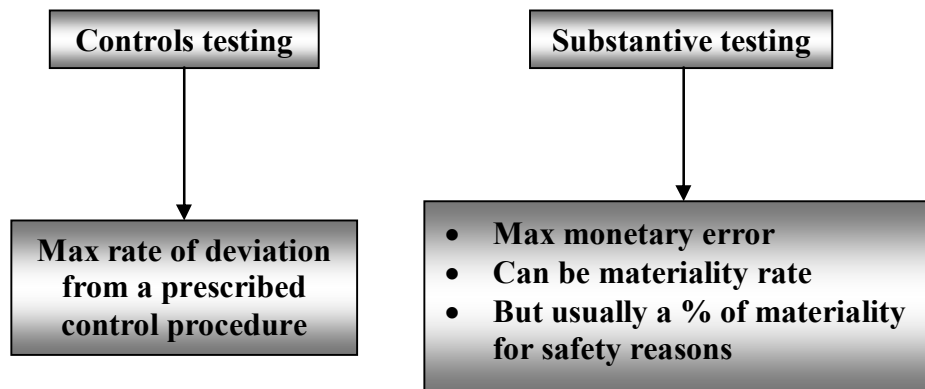
Turnover	1% - 1.5%
Net assets	1% - 2%
Net profit	2% - 6%

Whatever numbers are selected they would be based on the reliability and confidence the auditor places on the

- Department manager's integrity (e.g. motive to maximise profits because bonus linked?)
- The quality of the financial statements (e.g. qualified staff to produce the accounts?)
- Any other factors affecting the auditor's judgement.

In addition to looking at the material differences individually the auditor should list all the differences (material or not) and consider in total whether they are material (list of uncorrected differences) or not.

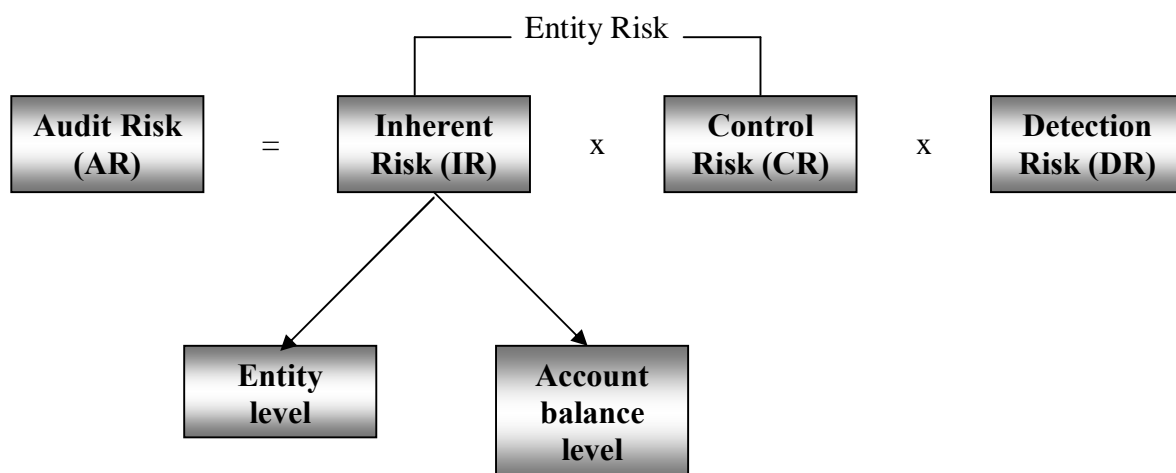
Tolerable error (TE) is the maximum error in the population that the auditors are willing to accept and still conclude that the audit objective has been achieved.



3.8 Audit risk

- Obtain understanding of the accounting and internal control systems
- Sufficient to plan the audit and develop effective audit approach
- Professional judgement to assess the 'audit risk' components
- Design procedures to ensure it is reduced to an acceptable low level

“**Audit risk**” risk that the auditor may give an inappropriate opinion on financial statements. Also known as the ‘ultimate risk’



Inherent risk

The susceptibility of an account balance or class of transactions to material misstatement either individually or when aggregated with misstatement in other balances or classes, irrespective of related internal controls.

The following factors should be considered when assessing the level of inherent risk:

At entity level

- Integrity of management.
- Over reliance on key customers.
- Management's experience and knowledge.
- Unusual pressures on management (e.g. tight reporting deadline).
- Nature of entity's business (e.g. high technology industry).
- Economic conditions.

At account balance / class of transaction level

- Balances susceptible to misstatement.
- History of errors.
- Complexity of transactions.
- Degree of judgement involved in determining account balances.
- Susceptibility of assets to loss or misappropriation.
- The quality of accounting systems.
- Unusual or complex transactions at year end.
- Transactions not subject to normal processing.

Control risk

That material misstatement could occur and not be prevented, or detected on a timely basis, by the accounting and internal control systems.

All audits at their core are substantive. Effective internal controls (i.e. when CR is low) will reduce (not eliminate) substantive work. However must consider cost/benefit of audit approach.

Tests of control should be performed by the auditor at the planning stage. This is to obtain audit evidence about the effective operation of the accounting and internal control system and assess the level of control risk. An appropriate audit plan can be produced based on this assessment.

Detection risk

This is the risk that the auditor's substantive procedures do not detect a material misstatement in an account balance or class of transactions. It is primarily the consequence of the fact that auditors do not, and cannot, examine all available evidence.

Having assessed inherent risk and control risk, detection risk is then the balancing figure set to achieve an acceptable total audit risk.

Example 3.8 – Neo plc

Neo plc is a company that manufactures computer components and assembles computer parts. It has existed for some years and is part of a vertical supply chain for a well-known brand of computer hardware called Matrix plc. Profits are coming under increasing pressure from manufactures in the USA with lower labour costs, and from rising raw material costs. Neo is listed on a stock exchange. There is pressure from institutional investors for better returns in the form of dividends and the main institutional investors are considering selling a proportion of their shares in the company. The directors of Neo plc are considering whether to move into new market areas.

Neo has good accounting and internal control systems. Stock is material to the accounts, and there is a good set of permanent stock records. No year-end stock count is conducted. Operational compliance issues are important to Neo ó many countries have inflexible quality standards and some projects are being held up because of difficulties in obtaining approval from regulators for new components. All staff and directors of Neo are remunerated (at least in part) on a performance-related basis, some with share options. Staff are generally highly qualified and well-paid.

This is your first year as auditors. Your firm has very little experience in this industry. External audit costs are tightly controlled and your firm has agreed to a budget that will allow very little flexibility.

Required

- (a) Describe the risks relating to Neo under the headings of inherent risk, control risk and detection risk.**
- (b) In the light of the risks identified in (a) above, list the matters to which you will pay particular attention during the audit of Neo and explain the work you will perform in relation to them.**

3.9 Documenting the accounting system

There are 3 methods commonly used to document the clients system.

Narrative notes: Written description of the system

Advantages	Disadvantages
<ul style="list-style-type: none">• Comprehensive• Easy to delegate• "Story" approach• Sufficient for small or simple systems	<ul style="list-style-type: none">• Difficult to update if hand written• Difficult to digest if complex system

Flowcharts: Depict in outline the sequence of events in a system showing document flow and the department or function responsible for each event.

Advantages	Disadvantages
<ul style="list-style-type: none">• Easier to read and understand for larger more complex systems• Highlights key features and controls• Standardised• Easy to update and little narrative	<ul style="list-style-type: none">• Requires formal training to understand notation used• Time consuming to prepare• May miss out crucial detail because of little supporting narrative.

Checklists or questionnaires: The audit firm will have a standard list of control questions. The audit staff can quickly ascertain which if any, are in operation by the client. There are two types; the internal control questionnaire (ICQ) and the internal control evaluation questionnaire (ICEQ). ICQs are designed to assess whether a control exists whereas ICEQs are designed to assess whether errors or frauds are possible.

Advantages	Disadvantages
<ul style="list-style-type: none"> • Comprehensive as narrative and should therefore cover all controls • Standard questionnaires with a little tailoring for the specific business • Easy to amend and update • Easy to delegate • Highlights key features and controls • Good for preliminary assessment of controls 	<ul style="list-style-type: none"> • Is not visual or diagram based and not easy to quickly understand • Client are able to mislead on the effectiveness of controls • Controls operated by client may not be identified because of standardised questionnaire. • May contain large number of irrelevant controls

Examples of ICQ's and ICEQ's

ICQ: öDoes an authorised senior person review the purchase invoices before payment is made?ö

ICEQ: öCan payments be made on purchase invoices which have not been approved by an authorised senior person?ö

ICQ's designed to:

- Discover existence of internal controls.
- Identify possible areas of weakness.

Questions are framed in order to highlight situations where:

- **NO** sub-division of duty.
- **NO** controls.
- **NO** control by management supervision.

ICEQ's go further than ICQs

- Discover whether error or fraud is possible.
- Concentrates on the important errors or frauds that might be possible and so only a handful of key control questions needed.
- Describes the nature and extent of the control that is being tested.
- Records tests conclusions and how substantive tests are affected.

3.10 Analytical procedures

Auditors should apply analytical procedures at the planning and overall review stage of the audit.

Analytical procedures include the consideration of comparisons of the entity's financial information with, for example:

- Comparable information for prior periods.
- Anticipated results of the entity, from budgets or forecasts.
- Predictive estimates prepared by the auditors, such as estimation of the depreciation charge for the year end.
- Similar industry information, such as comparison of the entity's ratio of sales to trade debtors with industry averages, or with the ratios relating to other entities of comparable size in the same industry.
- Between financial information and relevant non-financial information, such as the relationship of payroll costs to number of employees.

Auditors should apply analytical procedures at the planning stage to assist in understanding the entity's business, in identifying areas of potential audit risk and in planning the nature, timing and extent of other audit procedures.

When intending to apply analytical review as a substantive procedure, the auditors consider a number of factors such as:

Factor	Impact on use
Plausibility/predictability of relationships	If relationship is strong (e.g. commission on sales) analytical procedure may suffice.
Degree of disaggregation of available information	Procedures are more effective when applied to components.
Availability of financial and non-financial data	Independently prepared non-financial data will allow more effective procedures.

Relevance of information	Budgets based on expectation are more useful than targets.
Comparability of information	Broad industry data (e.g. RPI) may not be relevant to specialised industry.
Knowledge gained previously	Effective procedures are based on recognising unusual/unexpected variations. If knowledge is limited, it is difficult to know what to expect.
Reliability of various forms of data	If data used is unreliable, then any results are equally unreliable therefore procedures less effective.
Nature of enterprise and its operations	Some businesses lend themselves to analytical procedures because steady trends develop therefore easier to know what to expect and spot variations.

When significant fluctuations or unexpected relationships are identified that are inconsistent with other relevant information or that deviate from predicted patterns, auditors should investigate and obtain adequate explanations and appropriate corroborative evidence.

Auditors need to obtain sufficient appropriate audit evidence that the information being used for analytical procedures is reliable.

Common ratios

1 Performance (profitability) – how well has the business done

$$\text{Return On Capital Employed (ROCE)} = \frac{\text{PBIT}}{\text{S/h funds} + \text{LTL (CE)}}$$

$$\text{Margin} = \frac{\text{PBIT}}{\text{Turnover}}$$

$$\text{Asset Turnover} = \frac{\text{Turnover}}{\text{Capital Employed}}$$

$$(\text{Margin} \times \text{Asset t/o} = \text{ROCE})$$

$$\text{Return On Equity (ROE)} = \frac{\text{PAT}}{\text{Capital Employed}}$$

2 Position (liquidity) – Short term standing of the business

$$\text{Current ratio} = \frac{\text{Current Assets}}{\text{Current Liabilities}}$$

$$\text{Quick Ratio} = \frac{\text{Current Assets} - \text{Stock}}{\text{Current Liabilities}}$$

$$\text{Gearing - Equity} = \frac{\text{Debt Capital}}{\text{Shareholders funds}}$$

$$\text{Gearing ó Total} = \frac{\text{Debt Capital}}{\text{Total Capital (shareholder funds} + \text{debt capital)}}$$

$$\text{Interest cover} = \frac{\text{PBIT}}{\text{Interest paid}}$$

$$\text{Creditor days} = \text{Trade creditors} / \text{COS} \times 365$$

$$\text{Stock days} = \text{Stock} / \text{COS} \times 365$$

$$\text{Debtor days} = \text{Trade debtors} / \text{Sales} \times 365$$

3 Potential (investor) – what investors are looking at

Earnings Per Share (EPS) = PAT / No. of Shares

P/E ratio = Share price / EPS

Dividend yield = Div per share / Share price

Dividend cover = EPS / Dividend per share

Example 3.9 – (CIMA P3 May 05)

Recommend how analytic review could be used in the internal audit of sales representatives' expenses.

Example 3.10 – Psycho plc

Psycho plc had 100 employees last year with total wages of £840,000 and 100 employees this year with a wage bill of £950,000, an increase of 13%. The annual pay rise was 6% and the level of business has remained approximately constant.

Required

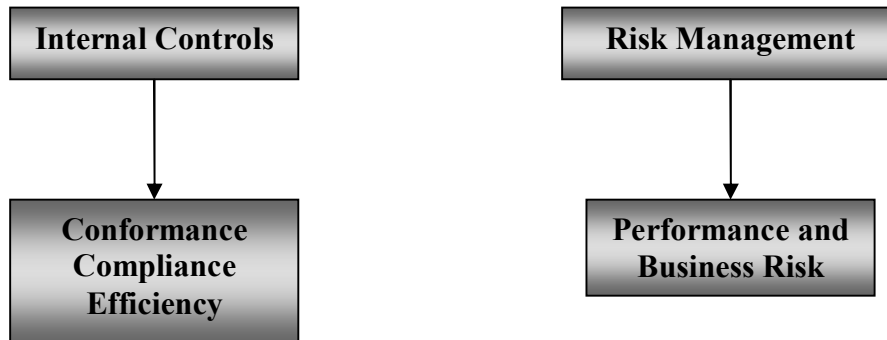
What possible reasons can account for the change in the wages bill for Psycho plc?

Key summary of chapter

Key points in the Turnbull Report:

- Have a **defined process** for the review of effectiveness of internal control.
- **Review** regular reports on internal control.
- Consider **key risks** and how they have been managed.
- Check the **adequacy of action** taken to remedy weaknesses and incidents.
- Consider the **adequacy of monitoring**.
- Conduct an **annual assessment** of risks and the effectiveness of internal control.
- Make a **statement on this process** in the annual report.

Internal audit is used to help directors achieve these objectives.



Performance and business risk

The comparison of an organisations performance with that of the others is an important part of performance measurement, identifying organisations (not necessarily in the same industry as 'yard stick' for which performance can be compared to.

Benchmarking

“A continuous, systematic process for evaluating the products, services and work processes of an organisation that are recognised as representing best practice, for the purpose of organisational improvement.”

Types of benchmarking

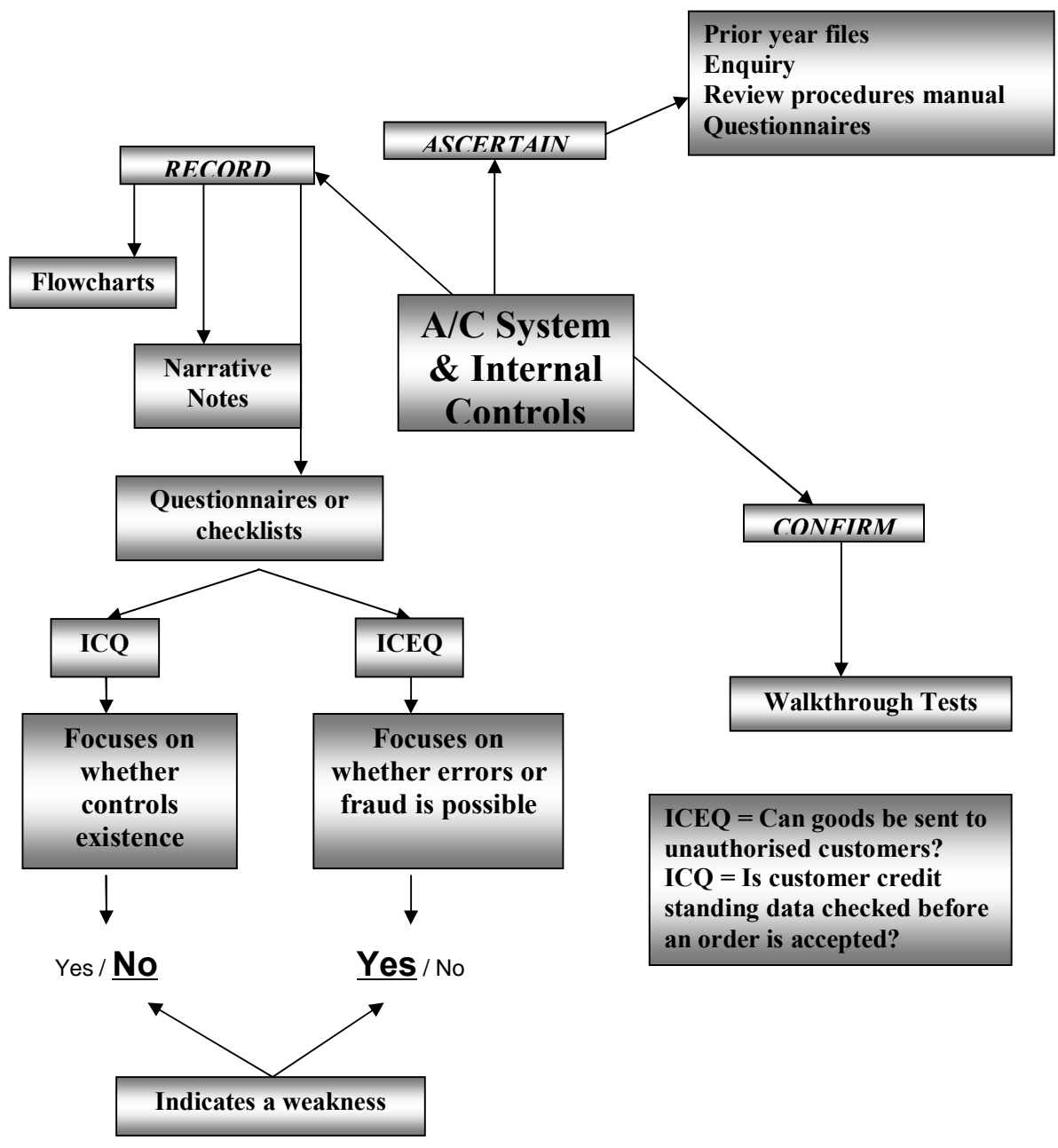
- Internal
- Best practice or functional
- Competitive
- Strategic

The process

- Selecting what you want to benchmark
- Consider benefits against the cost of doing it
- Assign responsibilities to a team
- Identify potential partners/known leaders
- Breakdown processes to complete
- Test and measure e.g. observation, experimentation or investigation/interview
- Gather information
- Gap analysis
- Implement changes/programmes/communicate
- Monitor and control
- Repeat regularly

Internal audit is an appraisal or monitoring activity established by the board for the **review of the accounting and internal control systems** as a service to the entity. It functions by, amongst other things, examining, evaluating and **reporting to** the board on the adequacy and effectiveness of components of the accounting and internal control systems created by management.

Internal audit are seen as independent from management who are devising and implementing the internal controls, should be able to provide advice on internal controls both to management and the board.



ICQ = Internal Control Questionnaire
 ICEQ = Internal Control Evaluation Questionnaire

Internal controls

Comprises the control environment and control procedures. It includes all the policies and procedures (internal controls) adopted by the management of an entity to assist in achieving management's objective of ensuring, as far as practicable,

- *the orderly and efficient conduct of its business,*
- *including adherence to management policies,*
- *the safeguarding of assets,*
- *the prevention and detection of fraud and error,*
- *the accuracy and completeness of the accounting records and*
- *the timely preparation of reliable information.*

Internal controls may be incorporated within computerised accounting systems. However, the internal control system extends beyond those matters which relate directly to the accounting system.

Specific control procedures should be in place which include:

O Organisational structure (clear lines of responsibility and authority)

A Authorisation (approval of transactions or limits)

P Personnel (recruitment of trustworthy individuals and the right training)

S Supervision (discourages fraud and improves quality data entry when the work is complex)

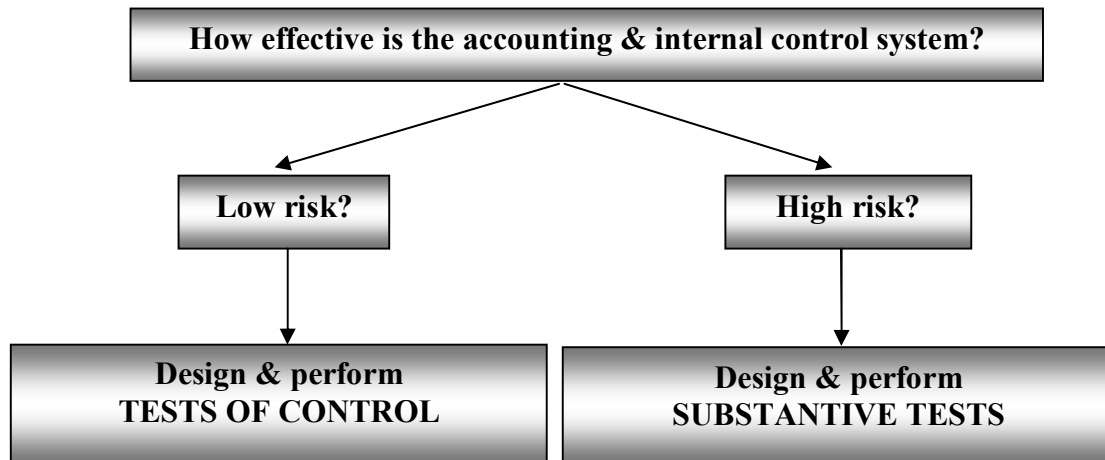
P Physical (physical barriers to prevent theft)

A Accounting (reconciliation, trial balances and input controls)

S Segregation of duties (separate responsibilities between those that record, process and initiate, such as the receipt, recording and banking of cash)

M Management (internal audit, regular review of management accounts and exception reporting)

Audit objective: *Assess the adequacy of a system as a basis for the preparation of accounts.*



Tests of control or systems based auditing

Tests to obtain audit evidence about the effective operation of the accounting and internal control systems.

Substantive tests or transactions auditing

Tests to obtain audit evidence to detect material misstatements in the financial statements.

Risk-based auditing

A risk based audit would be reviewing the risk management process and considering the main risks of the organisation as a whole.

Tests of controls may include:

- **Enquiries** and **observations** corroborating internal control functions.
- **Inspection of documents** evidencing operation of an internal control, for example a transaction has been authorised.
- **Examination of evidence** of management reviews, for example minutes of management meetings at which financial results are reviewed and corrective action decided on.
- **Reperformance** of control procedures, for example reconciliation of bank accounts, to ensure they were correctly performed by the entity.
- **Testing of the internal controls** operating on specific computerised applications or over the overall IT function, for example access or program change controls.

Alternative summarised version of tests of controls

Documentation (written evidence)

Segregation of duty (i.e. staff records are separate from wages department)

Authorisation (by senior personnel)

Review (by senior personnel of other staff work)

Planning

Internal auditors should plan the audit work so as to perform the audit in an effective manner.

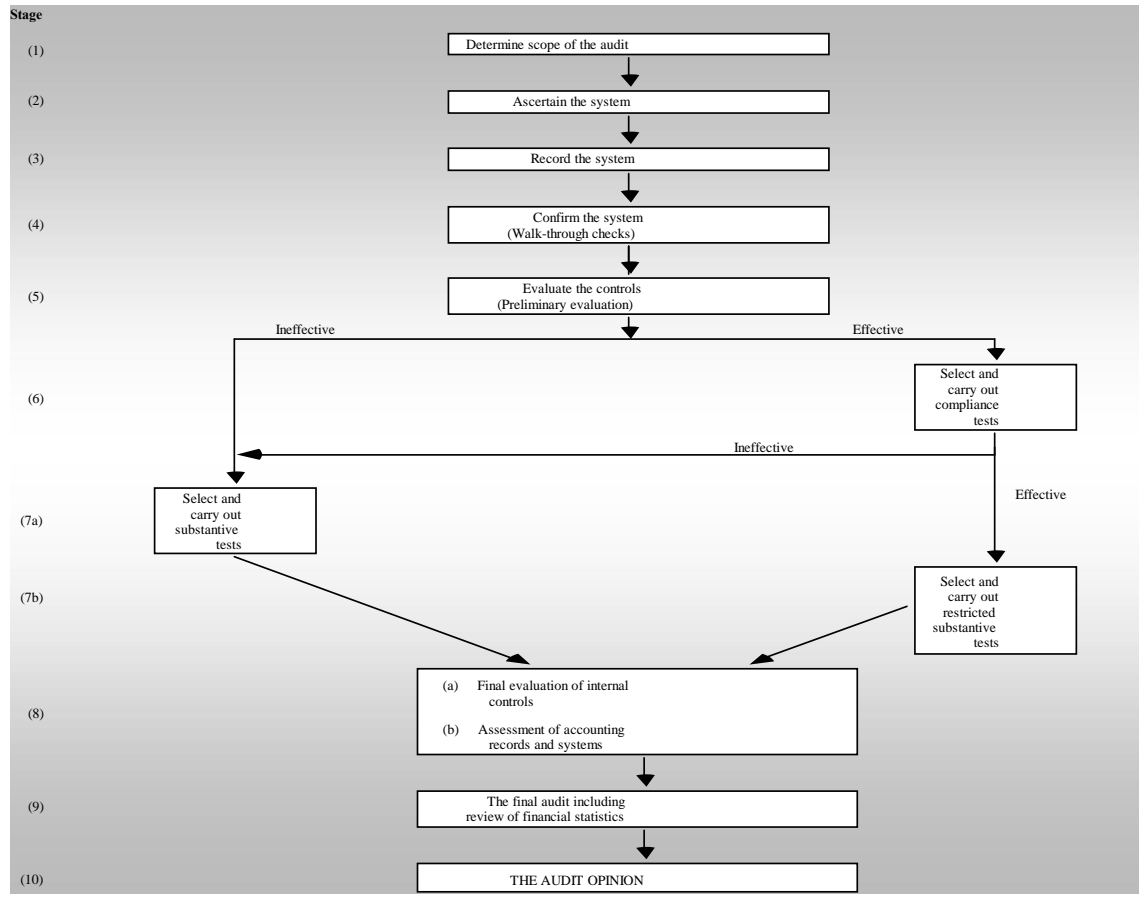
Planning the work

- Determine the scope and objective of the audit (to verify assets, to check adequacy of internal controls etcí).
- Ensuring appropriate attention is devoted to the different areas of the audit (risk based audit).
- Changes in business environment (new systems, changes in key personnel, competitor's reactions, innovations in the market, consumer preferences, legislation, board decisions etcí)
- Consider external auditors work already done.
- Review previous accounts, internal audit reports and past testing (analytical review and previous problems highlighted).
- Ensuring that potential problems are identified.
- Facilitating review.
- Ensure audit work is assigned and co-ordinated properly (select team, book hotels, communicate, brief and allocate work schedules).
- Economic service within an appropriate time scale.

Audit plan contents

- Report requirements and terms of reference.
- A review of the business and financial position, reviewing why changes had occurred in the current year.
- Risk areas highlighted including assessment of internal controls.
- Calculations for levels of materiality.
- Detailing overall audit approach (substantive or compliance) including timing and deadlines.
- Staffing levels and request for any specialists i.e. computer based control assurance staff.
- A budget for time estimated for each staff member.
- Reviewed and approved by manager.
- Distribute audit plan to all staff on the audit.

The audit process



Materiality

An item can be considered material if its omission would *reasonably influence the decisions of an addressee of the report*, a misstatement is material if it would have a similar influence. It can be of value, nature or disclosure. This will always be a matter of judgement for the auditor but should be engaged in seeking "material" errors, omissions and misstatements.

Material items will have an impact:

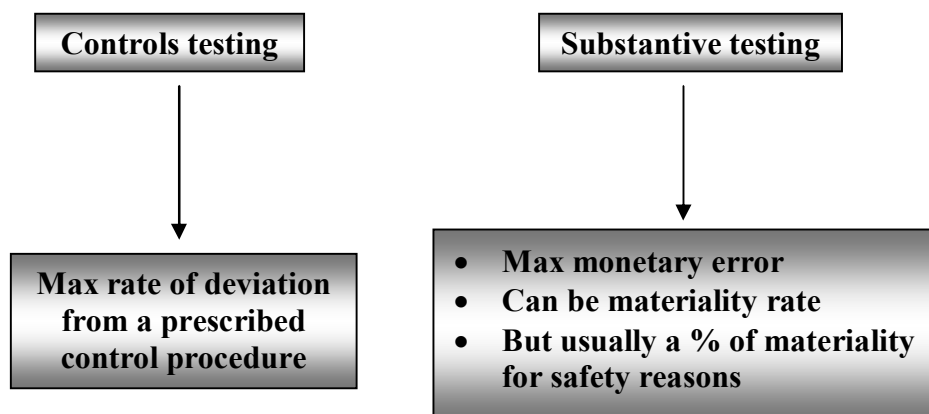
- Audit tests carried out.
- Whether adjustments should be made to the accounts.
- Whether the auditor should qualify his report on the accounts.

The calculation of materiality

For example:

Turnover	1% - 1.5%
Net assets	1% - 2%
Net profit	2% - 6%

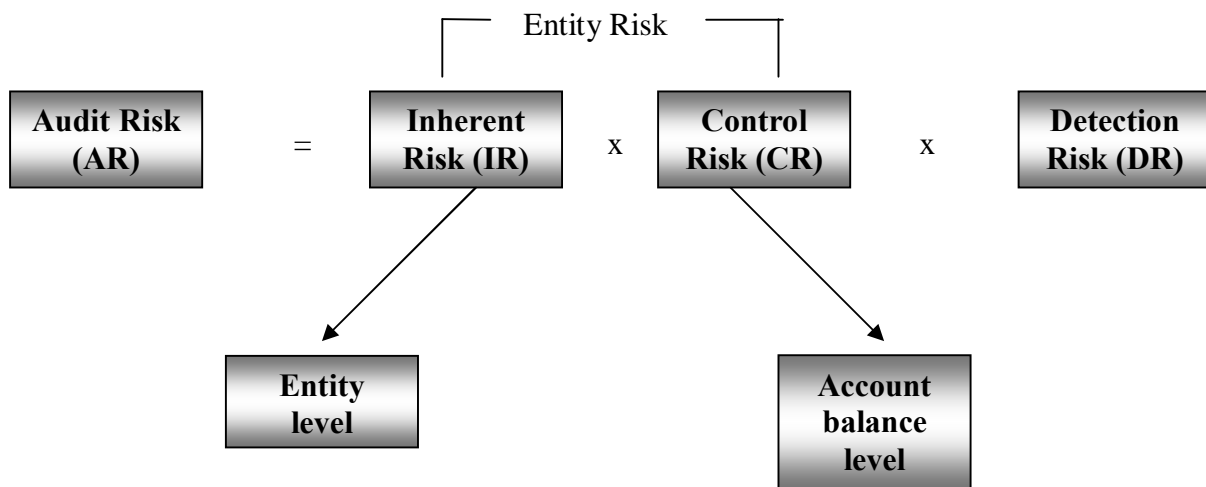
Tolerable error (TE) is the maximum error in the population that the auditors are willing to accept and still conclude that the audit objective has been achieved.



Audit risk

- Obtain understanding of the accounting and internal control systems
- Sufficient to plan the audit and develop effective audit approach
- Professional judgement to assess the "audit risk" components
- Design procedures to ensure it is reduced to an acceptable low level

“**Audit risk**” is the risk that the auditor may give an inappropriate opinion on financial statements. Also known as the “ultimate risk”



Inherent risk

The susceptibility of an account balance or class of transactions to material misstatement either individually or when aggregated with misstatement in other balances or classes, irrespective of related internal controls.

Control risk

That material misstatement could occur and not be prevented, or detected on a timely basis, by the accounting and internal control systems.

Detection risk

This is the risk that the auditor's substantive procedures do not detect a material misstatement in an account balance or class of transactions. It is primarily the consequence of the fact that auditors do not, and cannot, examine all available evidence.

Documenting the accounting system

There are 3 methods commonly used to document the clients system.

Narrative notes: Written description of the system

Advantages

- Comprehensive
- Easy to delegate
- "Story" approach
- Sufficient for small or simple systems

Disadvantages

- Difficult to update if hand written
- Difficult to digest if complex system

Flowcharts: Depict in outline the sequence of events in a system showing document flow and the department or function responsible for each event.

Advantages

- Easier to read and understand for larger more complex systems
- Highlights key features and controls
- Standardised
- Easy to update and little narrative

Disadvantages

- Requires formal training to understand notation used
- Time consuming to prepare
- May miss out crucial detail because of little supporting narrative.

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- Comprehensive as narrative and should therefore cover all controls
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3 Potential (investor) – what investors are looking at

Earnings Per Share (EPS) = PAT / No. of Shares

P/E ratio = Share price / EPS

Dividend yield = Div per share / Share price

Dividend cover = EPS / Dividend per share

Solutions to lecture examples

Chapter 3

Example 3.1 – (CIMA P3 May 05)

Comparison and contrast of internal audit and risk management

Internal audit is an appraisal or monitoring activity established by the board for the review of the accounting and internal control systems as a service to the entity. It functions by, amongst other things, examining, evaluating and reporting to the board on the adequacy and effectiveness of components of the accounting and internal control systems created by management.

Internal audit are seen as independent from management who are devising and implementing the internal controls, and should be able to provide advice on internal controls both to management and the board.

Risk management is to recognise the risks to which the company is exposed to, consider the trade-off between risks and expected returns, and choose an appropriate course of action.

Organisations should have a system to identify risks and this process should be carried out regularly as risks identified in the previous period may not necessarily be the same for the coming period. This process is not designed to eliminate the risks but to identify them and their significance.

Typical examples of methods used are:

- Using external risk consultant experts.
- Discussions with management and supervisors.
- Brainstorming and scenario analysis (constructing a number of possible futures).
- Industry survey reports.
- Discussions with internal audit and reviewing their reports.

Risk identification and management is the responsibility of the directors of the organisation.

The interaction of internal audit and risk management

Internal audit are responsible for devising effective controls to mitigate the risks identified by the risk management team, but in order to do this it is important that internal audit understand the risks. This is why internal audit are also involved in the risk identification and management process as well. Internal auditors would assist the directors in methodically reviewing all the risks impacting on the organisation.

Internal audit would also help determine the high risk areas and so audits can be concentrated on those areas in particular. Internal audit can also audit risk management to ensure that there is an adequate framework being used to identify risks and that the process is regularly reviewed to still be effective.

The findings of internal audit can be used to mitigate weaknesses through effective controls and overall strengthening of the director's function to monitor risks affecting the organisation.

Both disciplines are sometimes merged into one because of the close interaction they have, and most large organisations do not have a distinction between them. Ultimately it is senior management or the directors that are responsible for the risk identification, management and control of risks of an organisation, and delegation to other functions such as internal audit does not diminish this responsibility.

Example 3.2 – (CIMA P3 May 05)

Internal controls

Comprises the control environment and control procedures. It includes all the policies and procedures (internal controls) adopted by the management of an entity to assist in achieving management's objective of ensuring, as far as practicable,

- the orderly and efficient conduct of its business,
- including adherence to management policies,
- the safeguarding of assets,
- the prevention and detection of fraud and error,
- the accuracy and completeness of the accounting records and
- the timely preparation of reliable information.

Internal controls are concerned with not only the financial controls but other controls affecting the whole of the organisation.

Internal controls may be incorporated within computerised accounting systems. However, the internal control system extends beyond those matters which relate directly to the accounting system.

Control environment

This is the attitude, awareness, actions of directors and shows how important and serious internal controls are to the employees of the business. It is the management style, the way the company is organised and corporate culture and values that will dictate the control environment.

Management should devise a process for identifying risks and providing effective internal controls. Internal controls should include ways of quickly reporting weaknesses to appropriate board members as soon as possible

A strong control environment is just as important as strong internal controls, and will undermine internal controls if poor.

Costs

Internal controls are time consuming to create and also will require time of the regional managers to implement them and train staff to adhere to them.

They also are expensive to introduce as there is a need for new information systems and reports. Internal auditors will need to be either employed or used on an adhoc basis from consultancies to help develop, and review the system.

They may restrict creativity, flexibility and responsiveness to customer needs as an order cannot be accepted until all credit vetting processes have been met, for example.

Benefits

Internal controls should greatly improve the efficiency and effectiveness of sales representatives. There should be reduced loss of customer sales, greater recovery of monies from customers and better skilled staff meeting the needs of customers.

Improved information on costs and sales means improved decisions being taken by managers and directors of the business leading to greater profitability. All of this means better resource utilisation, understanding of customer demands, and improved skill set in staff. These would outweigh initial investment costs needed to introduce internal controls over the long-term.

Fraudulent activities would also be greatly reduced or eliminated due to management have a better understanding of costs and sales of the business and any irregularities can be spotted more easily.

Strong internal controls may also reduce the amount of work needed to reach an opinion for the external auditors as they could take a compliance approach, this should lead to a reduction in fees.

Better controls means better comparisons can be made with more reliance between sales representatives on performance and efficiency. We can also look at comparisons between the budget and actual and being able to explain difference with more certainty.

Limitations to internal controls

Internal controls cannot eliminate fraud completely as individuals can always collude to side step controls. Internal controls are also not able to stop poor decisions being made by management or human error; in addition senior management can always override or choose to ignore internal controls.

This however does not mean that we should abandon internal controls because of this, internal controls can still greatly reduce these things and also make it more difficult for fraud to be perpetrated.

Example 3.3 – (CIMA P3 May 05)

Director peer review

Director X manages the financial and legal aspects of the business while director Y is responsible for operational activities, however there is no accountability of the decisions they make and work they do which each other. The 2 directors trust in another and therefore do not check or verify each others work. The potential consequence of this is collusion or fraud being perpetrated by the directors.

Directors should regularly review each others work and hold meetings as a board of directors to give each other an opportunity to ask questions on their work. There should also be involvement of senior staff in finance and internal audit carrying out regular assessment of the work by directors ensuring it is in the interest of the business as a whole.

Management accounting system

The management accounting systems very basic and it is not possible to find out the true profit of any contract as not all costs for the project are charged individually. This may lead to the company producing non-profitable contracts. Sales team estimated time compared to actual time taken is how profits are measured but monitoring of this is not done.

There needs to be a more sophisticated management accounting system, which has the ability to allocate all costs to a contract and understand its profitability. Control accounts should be used to safeguard the reliability of the information in the financial reports. There should also be exception reporting of budgets versus actuals to understand variances and their causes. Full management accounts and cash flow projections should be regularly produced for review by senior staff and the board of directors. Any major differences should be investigated and explained.

Gross mark-up and directors salaries

The contracts all take a total cost plus approach to pricing. There is no attempt to review costs and question why they seem to be increasing each year. In addition it seems that the directors are enjoying increases in their salary each year without any accountability.

The company must consider the market when pricing as they may find that the perpetual price increases may not be accepted by customers over time. The company should review the costs in the business by setting budgets and then compare to actuals and scrutinise the variances, this would highlight the fact that directors' salaries are increasing each year and need to review as to whether the company is getting value for money here. An internal audit department could undertake this analysis and make recommendations to the remuneration board of the company.

Internal audit

There is no internal audit function within the company which means that there are no employees specifically with the task to review the accounting and internal control systems, examining, evaluating and reporting to the board on the adequacy and effectiveness of components of the accounting and internal control systems created by management. Internal audit should be able to provide advice on internal controls both to management and the board.

The company should consider employing an internal auditor or considering the services of a consultancy that provides this service. The company requires an audit and an internal auditor will be able to assist in the creation of strong internal controls and reliable information for the external auditors. In addition more timely, relevant and accurate information can be produced for the board to be able to make effective decisions on.

Customer quotes

Customer quotes are prepared by 2 staff and then reviewed by director Y before they are sent. There is a risk that the quotes could be too high or bogus. It would be reasonable for director X to review the quotes as well before they are sent to customers.

Procurement

Director Y selects the suppliers for procurement of materials and gives details to the admin staff. There is a risk that suppliers selected maybe bogus suppliers used to fraudulently take money out of the business, unreliable in terms of lead time, provide poor quality material, may not be the most cost effective, or have unfavourable payment terms.

Director X should be involved in the selection of suppliers and there should be a criteria used to assess each of these. An internal audit department should be set up and carrying out the initial reviews and provide recommendations to the directors. Director X should also review the costs making up orders and to see that all of these are relevant to the job for the customer, he should compare to previous similar jobs for reasonableness.

Example 3.4 - (CIMA P3 Nov 07)

The internal control system comprises of the control environment and control procedures. It includes all the policies and procedures (internal controls) adopted by the management of an entity to assist in achieving management's objective of ensuring, as far as practicable,

- the orderly and efficient conduct of its business,
- including adherence to management policies,
- the safeguarding of assets,
- the prevention and detection of fraud and error,
- the accuracy and completeness of the accounting records and
- the timely preparation of reliable information.

Internal controls may be incorporated within computerised accounting systems. However, the internal control system extends beyond those matters which relate directly to the accounting system.

Purposes of an internal control system for Accounts Payable

When accounting for purchases internal controls will ensure that they have been correctly accounted for and errors in liabilities cannot occur. All purchases are properly supported by relevant documentation, and the invoice is reviewed for accuracy.

When payments are made internal controls ensure that the accounts are reflected promptly and correctly so there is no risk of double payment, or missing out on worthwhile settlement discounts. Payments will only be made to bona fide suppliers for agreed liabilities which are due, and supplier is made aware of the payment.

Value of an internal control system

Internal controls should greatly improve the efficiency and effectiveness of purchases. There should be reduced loss of excessive purchasing, greater quality and reliability of suppliers and more accurate and prompt payment to suppliers.

Improved information on purchases means improved decisions being taken by managers and directors of the business leading to greater profitability. All of this means better resource utilisation, understanding of goods purchased, and improved skill set in staff. These would outweigh initial investment costs needed to introduce internal controls over the long-term.

Fraudulent activities would also be greatly reduced or eliminated due to management having a better understanding of purchases of the business and any irregularities can be spotted more easily.

Strong internal controls may also reduce the amount of work needed to reach an opinion for the external auditors as they could take a compliance approach, this should lead to a reduction in fees.

Better controls means better comparisons can be made with more reliance on performance and efficiency. We can also look at comparisons between the budget and actual and being able to explain difference with more certainty.

Example 3.5 – (CIMA P3 Nov 07)

Control environment

This is the attitude, awareness, actions of directors and shows how important and serious internal controls are to the employees of the business. It is the management style, the way the company is organised and corporate culture and values that will dictate the control environment.

Management should devise a process for identifying risks and providing effective internal controls. Internal controls should include ways of quickly reporting weaknesses to appropriate board members as soon as possible. Internal controls should be embedded in a strong control environment and culture

A strong control environment is just as important as strong internal controls, and will undermine internal controls if poor.

EWC

The company has a culture of using unscrupulous practices to achieve the key targets of sales growth and profits set by management. Managers lead by example and in addition ignore any unethical or even illegal ways of conducting trade used by employees.

This approach means that there are very few controls in existence to monitor for example bone fide sales or even if there were many controls in place they are being ignored. The reward and bonus system encourages this unethical behaviour to achieve sales and profit by any means necessary. The Board culture at EWC has encouraged this behaviour and has increased reputational, business and reporting risks.

Example 3.6 – (CIMA P3 Nov 05)

Systems based audit looks at whether defined functions or processes are operating effectively and efficiently. It is not concerned about the detailed underlying transactions but interested in the controls that are in place which manage the information.

Risk management procedures are used to assess what risks will impact on the business. These are not only within the organisation but much wider and look externally in its business environment. If these risks are not mitigated then the business may be severely affected resulting in the business not continuing in the future.

Systems based audit is useful as it will help identify risks within the processes in an organisation and review how adequate the controls are which mitigate these risks. This will help in achieving the business's main objectives as processes will be in line to operate effectively and efficiently after such an audit.

Systems based audit however is not focused at what the key risk processes are, instead it looks at all the processes. It also does not look at other risk areas outside the organisation which are crucial to mitigate, such as the competition, latest medical developments and social trends. A risk based audit would be asking what are the main risks of the organisation rather than a systems based audit which asks how effective are the systems and process in the business.

Example 3.7 – (CIMA P3 Nov 06)

Audit procedures for the capital investment process:

- Enquire as to senior management's choice of DCF as an appraisal tool for their capital investment projects. Consider whether alternative methods may be more appropriate such as payback ARR or IRR.
- Review the gearing levels of BLU and compare to industry averages and previous years to consider whether there have been any sharp increases in debt.
- Discuss with management how they arrived at the selection of 15% for discounting capital investment projects, and whether it is a reasonable approximation of the costs of capital for BLU.
- Carry out sensitivity analysis on capital investment projects to assess the level of risk particular to key inputs, and discuss with management how these risks have been mitigated.
- Discuss with management how they reconcile the main strategic objectives of BLU with the selection criteria for capital investment projects.
- Discuss with management if they carry out post-completion audits and how the results are used in the process.

Audit procedures for the information system feeding that process:

- Enquire to management as to how the finance department assess the reliability of the information given to the finance department from the market research department. Consider its reasonableness.
- Enquire of the sales department what procedures they have taken to ensure that the information produced is reliable. Consider its reasonableness.
- Review the sales department figures to be reasonable by comparison to previous years. A similar review should be carried out for the information provided by the production department.
- Enquire of the production department as to the process used to ensure that they have selected the best supplier and equipment for BLU.
- Review the standard costs in comparison to current market data to be reasonable.
- Discuss with management how they are satisfied that they have enough resources in place to complete the project.
- Discuss with management whether the 5 year life of the project is appropriate and whether the life of the machines may have further useful economic life.
- Review the scrap value of the machines at the end of the project by comparing to second hand values and monies received for it in previous projects, this would give an indication if they have been fully utilised in terms of their economic life.

Example 3.8 – Neo plc

(a) **Inherent risks** include:

- The competition from the USA and rising raw material prices. This means that there is pressure on profits and the ability to reward employees and pay dividends to institutional shareholders which increases the pressure to manipulate the financial statements to show good returns.
- The potentially volatile market (computer components) in which new technology can render hardware obsolete in a very short time. This means that there is an ongoing risk to the business as a whole (a potential going concern risk) ó the company must be adaptable.
- The risk that regulators may reject a product which has taken many months or years to develop.
- The pressures for returns from institutional investors which means that there may be a temptation to manipulate the financial statements.
- The inherent risks in diversification into unknown areas (the supply of other customers) ó but these are not current risks.

Control risks: there are apparently very few except for the performance-related payment, including share options, which provides an incentive to produce 'acceptable' figures.

Detection risks: this is the firm's first year as auditors and there are tight controls on audit costs, which may lead to inadequate audit evidence unless the audit is properly directed, supervised and reviewed. This is compounded by the firm's lack of experience in this area. It is important that those with experience are employed on this audit, at least in a review capacity.

(b)

- The good accounting records and internal controls combined with need to keep audit costs down means that a compliance approach, rather than a substantive approach will be necessary wherever possible.
- Audit work will be needed to be directed towards stock (despite the fact that it is well controlled) because it is material to the accounts. There is no year-end stock count, and stock is relatively easy to manipulate. It is likely that there will be a substantial amount of work-in-progress and its valuation will need to be reviewed carefully. It may be possible to rely on any interim or cyclical stock counting.
- The projects on which compliance problems have arisen should be examined carefully as the costs may be significant and there may be a temptation to understate them.
- Overall profits and any unadjusted errors should be examined carefully because of the inherent risks noted above and the performance-related pay.
- The company's going concern status should be reviewed by examining its financial status, financial support and likely future developments in high risk areas (budgets, forecasts, and cash flow projections for feasibility).
- Overall profits and any unadjusted errors should be examined carefully because of the inherent risks noted above and the performance-related pay.
- The company's going concern status should be reviewed by examining its financial status, financial support and likely future developments in high risk areas (budgets, forecasts, and cash flow projections for feasibility).

Example 3.9 – (CIMA P3 May 05)

Examples of analytic review that could be used in the audit of sales representatives' expenses:

- Review expenditure with respect to prior year and historically. Investigate any variances.
- Review the ratio of expenses to sales for the sales team as a whole and compare with prior year and historically. Investigate any variances.
- Review fuel expense claims to be reasonable with respect to clients, for example with overseas clients we would expect to see more air travel costs rather than fuel claim costs.
- Compare by sales representative between new leads and existing business.
- Compare by sales representative percentage conversion of leads into sales.

Example 3.10 – Psycho plc

- Change in number of employees throughout the year, for example the use of temps?
- Have there been any bonuses or retirements?
- Has the mix of employees changed? More skilled expensive labour than cheap unskilled labour?
- A change in the mix of products sold? Does Psycho plc is producing those products which require overtime from a certain group of employees?