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# Risk assessment and internal controls: continuing challenges for auditors

**INTERNATIONAL AUDITING PERSPECTIVES**

An International Accounting, Auditing & Ethics initiative



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# Introduction



*Risk assessment and internal controls: continuing challenges for auditors* brings together three articles on risk assessment and internal controls, written with extensive input from ICAEW members in practice. The articles deal with practical implementation issues and discuss the continuing challenges highlighted in regulatory reports, and in discussions between auditors, standard-setters and regulators.

Risk assessment issues include the:

- quality of linkages between risk assessment and response;
- need to demonstrate and document how professional judgement was applied; and
- definition, determination and understanding of 'significant risk' under the International Standards on Auditing (ISAs).

We look at the challenges auditors face in balancing the judgemental and quantitative aspects of risk assessment, and how and why standard-setters will be changing the risk ISAs.

On the internal controls front, we examine how auditors taking a substantive approach apply the requirements to understand and document the design and implementation of controls. We also consider the challenges associated with testing controls in smaller audits generally, dealing with deviations from the application of control procedures, revising the control risk assessment and adjusting substantive procedures where necessary based on the results of controls testing.

## WHO WILL BE INTERESTED IN THESE ARTICLES?

The objective of this publication is to clearly articulate some of more intractable issues for auditors, standard-setters and regulators in the areas of risk assessment and internal controls.

**For auditors**, a better understanding of common challenges may help with planning and performing future audits by understanding of how work is sometimes wasted, and of the issues that exercise regulators. Auditors may also find it helpful to understand where standard-setters are likely to be going with the risk ISAs.

**For regulators**, a clearer understanding of the issues faced by auditors, particularly smaller firms, will help in developing practical suggestions for standard-setters, and clearer recommendations in their reports.

**For standard-setters**, we hope that shedding more light on the implementation challenges for auditors will support research work and the development of plans to revise the risk ISAs.

We hope that this publication will raise awareness of risk ISA issues and deepen the level of understanding of them among auditors, regulators and standard-setters. It is intended to promote debate and to contribute to the discussions about the risk ISAs that will take place in the near future. Ultimately, we hope that it will result in plans to deliver practical solutions.

# Overview

*Risk assessment and internal controls: continuing challenges for auditors* brings together three articles on risk assessment and internal control, written with extensive input from ICAEW auditors. The articles discuss some of the issues that auditors of smaller, less complex entities continue to find challenging in these fundamental areas of the audit.

International Standards on Auditing (ISAs) apply to audits of all sizes and they must accommodate the largest and most complex of audits as well as smaller, less complex ones. While ISAs are intended to be scalable and capable of proportionate application, many auditors struggle to apply them efficiently, particularly to smaller, less complex entities audits. There are several reasons for this. One is a lack of understanding of the standards themselves among some auditors. But extensive educational efforts by professional bodies and others for over a decade have not eliminated these problems, some of which seem intractable. Another reason may be the ISAs themselves, and there is a belief in some quarters that International Auditing and Assurance Standards Board's (IAASB) planned modernisation of the risk ISAs should include a review of the fundamental concepts underlying the ISAs, as well as their structure and detailed content.

These articles are intended to stimulate and inform debate. They are not a comprehensive review of issues with ISAs 315 *Identifying and assessing the risks of material misstatement through understanding the entity and its environment* and 330 *The auditor's procedures in response to assessed risks* (the risk ISAs). That major undertaking is for standard-setters and the IAASB now has these ISAs on its agenda. An initial discussion is scheduled for the March 2016 meeting.

The last substantive revision of the risk ISAs was finalised in 2003. While there is general agreement that the clarity project, finalised in 2010, made them somewhat clearer, if not a great deal shorter, no significant substantive changes were made at that time.

IAASB's post-implementation review of the clarified ISAs highlights a number of important areas in the risk ISAs that require investigation, including the need for modernisation. IAASB is drawing heavily on this detailed review as part of its plans to revise the risk ISAs. Regulators are aware that some of these issues pre-date not just clarification, but the last substantive revision in 2003.

The three articles all focus on the audit of smaller, less complex entities, because the requirements of ISAs have a disproportionate effect on such audits, but many of the issues highlighted are equally relevant to larger audits.

The three articles cover:

- aspects of risk assessment and the auditor's response thereto that continue to present challenges to auditors, and issues for standard-setters, including IAASB's plans to address them;
- continuing challenges to auditors arising from required audit work on documenting and testing internal controls; and
- required audit work on the design and implementation of internal control components: this article first appeared in the May 2014 edition of *Audit & Beyond*.



# Risk assessment and the response: continuing challenges for auditors and issues for standard-setters

## DOES EVERYONE AGREE ON WHAT 'RISK ASSESSMENT' MEANS?

Risk assessment has been critical to the conduct of all audits for a long time. 'Risk-based auditing' is a term often bandied about and a sure way to cast aspersions on an auditing standard or methodology is to assert that it is, 'not risk based'. Every time an auditing standard is revised, one of the purported benefits is that the new standard is risk based, implying that the extant standard is not. But the idea of a 'risk-based' approach to auditing has been around for at least 20 years, and it is not a difficult concept: it refers to the focus of the audit process on those areas that are most at risk of material misstatement.<sup>1</sup> Nevertheless, both auditors and regulators report problems in determining what constitutes a 'significant' risk, a 'material' risk and a 'high-risk area'.

The last major revision to the risk ISAs was finalised in 2003.<sup>2</sup> Those revisions precipitated significant adjustments to many firms' methodologies. Firms of all sizes initially struggled to apply the new requirements, and there was general agreement that while there was nothing inherently difficult about the new ISAs, they were unwieldy, not an easy read, and they were particularly hard to apply to smaller, less complex audits.

Despite the 'clarification' process in 2010, some believe that the risk ISAs are still unnecessarily lengthy, still hard to apply to smaller less complex audits and that they may be conceptually flawed, as well as out of date. They must accommodate very large audits in all their complexity, as well as the smallest of audits. While the changes made as a result of clarification in 2010 helped, and firms are now used to the language of the risk ISAs, problems applying them persist, and some problems pre-date all of these changes. For firms auditing smaller, less complex entities, one problem is the work required on internal controls as part of understanding the business, even when a wholly substantive approach is taken. We consider this in *Understanding the design and implementation of controls in smaller audits: why and how*.

## WHICH ASPECTS OF RISK ASSESSMENT ARE CONSIDERED MOST PROBLEMATIC?

Appropriate risk assessments should be efficient in terms of cost and effort. If auditors, using their judgement, assess risk appropriately and make clear links between risk assessments and the procedures they perform, the audit stands a chance of uncovering material misstatements by focusing on the right areas. Corrections can be made to the financial statements if necessary and the audit opinion will be appropriate.

### Linkages and judgement

Regulators note that the links between risk assessment, response and audit opinion might often be stronger.<sup>3</sup> It is not that auditors routinely fail to identify risks altogether, but rather that despite the fact that the risks are there for all to see on the file, their significance may not be understood, or they are not followed up.

Those responsible for audit quality within firms are concerned with risk assessment for several reasons. Firstly, it is fundamental to all audits. Secondly, there are many high-level qualitative terms (such as 'significant') used in ISAs to describe categories of risk and how they are to be dealt with, but it is down to audit firm methodologies to determine how these terms

1 This is not the same as risk management for audit practices which is about how firms manage their own exposure to risk.

2 The IAASB's clarity project made very limited substantive changes.

3 ICAEW's Quality Assurance Department (QAD) reports that weak risk assessment processes can potentially result in significant gaps in audit work, and in inefficiencies through over-auditing in insignificant areas. The QAD also notes that if firms reduce substantive testing based on the assessment of risk as 'low', the assessment must be properly supported with an adequate understanding of the client's business and control environment. The QAD finds that significant risks are not always identified as such and that auditor consideration of fraud risks sometimes appear to be little more than a compliance exercise.

are to be applied. Thirdly, there are natural variations within firms in terms of how audit teams interpret the requirements of ISAs and methodologies when identifying risks and determining the response required. Finally, even where the risk and response are clearly identified at the planning stage, there is sometimes an unwillingness to face up to difficult issues, which may result in auditors auditing 'around' them, because they are too complex, difficult or time consuming to address head on.

Furthermore, at each level, judgement is required. This extensive need for the exercise of judgement and to document it, challenges both audit regulators and those with responsibility for quality control within audit firms. Firms rightly defend the need for professional judgement, while emphasising the importance of consistency in the risk assessment, and the need to link risk to responses. But regulators seem to struggle with the fact that given the same set of criteria, different outcomes are often possible. Provided the different outcomes are within reasonable parameters, this should be acceptable but demarcating the parameters is a judgement in its own right requiring documentation in audit methodologies and on individual audits. Audit regulators, given their mandate, are likely to lean towards narrower parameters than auditors. The already fraught issue of determining acceptable parameters for quantitative measures, such as determining an acceptable range for accounting estimates, seems likely to become even more difficult as fair valuations with extended ranges of acceptable parameters, become more widespread.

### What is a 'significant' risk?

Some difficulties in applying ISA requirements lie in the language used within the ISAs. For example, ISA 330 refers to assessments of risk as 'significant', and also uses terms such as 'high' and 'higher'. It is not clear whether a risk at an account or assertion level can be 'significant' without also being 'high', or vice versa, and variations in approach (at best) seem likely.

The IAASB noted in its post-implementation review of the clarified ISAs<sup>4</sup> (IAASB's review), which will form the starting point for its modernisation of the risk ISAs, that regulators are concerned about inconsistencies in auditor determination of what constitutes a significant risk. This lack of consistency may reflect misunderstandings among auditors or poor quality application of the ISAs, but it is also possible that ISA 315 is still not clear. ISA 315 defines a significant risk as one that, '...in the auditor's judgment, requires special audit consideration', and that in exercising that judgement, auditors take account of:

- whether the risk is of fraud;
- whether the risk relates to recent significant economic, accounting or other developments and therefore requires specific attention;
- the complexity of transactions;
- whether the risk involves significant transactions with related parties;
- unusual transactions including those outside the normal course of business; and
- subjectivity and the degree of measurement uncertainty.

It has been pointed out that while the factors to take into account may be helpful, the definition is both circular (a significant risk is one that needs to be treated as significant), and it focuses on how it is dealt with by auditors, rather than the substantive nature of the risk itself.

4 <https://www.ifac.org/publications-resources/clarified-isas-findings-post-implementation-review>.



## HOW SHOULD AUDITORS BALANCE THE JUDGEMENTAL AND QUANTITATIVE ASPECTS OF RISK ASSESSMENT?

Auditors need to exercise judgement when assessing risk, but the use of judgement means that there will be variations in outcome. Audit regulators encourage standard-setters to develop guidance for auditors where they perceive that the exercise of judgement has led to inconsistencies, but they sometimes treat guidance as if it is mandatory by questioning approaches that deviate from that guidance, while at the same time complaining that guidance intended to help contain the level of variation sometimes becomes a substitute for the exercise of judgement itself. It can be hard to strike a balance here.

ISA 330 says that, '...assessed risks may affect both the types of audit procedures to be performed and their combination. For example, when an assessed risk is high, the auditor may confirm the completeness of the terms of a contract with the counterparty, in addition to inspecting the document.' Judgement is clearly required in applying this requirement and the effect of the assessment on the determination of the types and combination of procedures is highly subjective. But other ISAs suggest a more quantitative approach to risk assessment. For example, ISA 200 states that auditors use 'various approaches' to assessing risks, such as models that express '...the general relationship of the components of audit risk in mathematical terms to arrive at an acceptable level of detection risk'.

In practice, risk assessment always involves more than quantitative assessments. Where quantitative elements are included in firm methodologies, such as the percentages applied in assessing risk as 'high', 'medium' and 'low' for the purposes of sample size calculation, they are often intended as high-level boundaries designed to aid decision-making in borderline cases. They are not meant to be used rigidly or without thought. Quantitative elements in audit firm methodologies are certainly not written in stone (or in ISAs) and firms generally do not want them to be treated as if they were. Unfortunately, they sometimes are applied as if they were 'bright lines' and audit teams may, for a variety of reasons, be distracted by the mechanics of the firm's quantitative guidelines and focus on and document those, rather than the substance of the specific risk in hand.

For example, it is easy for auditors to get bogged down in the mechanical detail of a discounted cash flow exercise rather than taking the time to stand back and question the underlying assumptions and assess whether the cash flow makes sense in the context of the auditor's knowledge about the past performance of the business and in terms of the quantum and timing of returns expected. The mechanics may work, but the growth assumptions may be unreasonably optimistic, or inconsistent with past performance. Similarly, a firm's risk assessment may lead a team to a small sample of items to be tested in a population of, say, expenses, but the team may mechanically test that sample without recognising that there are significant or unusual items in the population which merit attention.

If auditors do not both address and document the substantive, judgemental aspects of the specific risks in hand, as well as the quantitative elements of the firm's methodology, it is very hard to show how the audit procedures chosen address the risks. More seriously, if the nature of a risk is not properly understood or assessed because of an excessive focus on methodology, mechanics or the easily measurable, tests may not be properly designed, or even not designed at all, because teams may think that existing procedures cover the risk.

Reviewers considering the effectiveness of planning and team meetings sometimes find that a team has missed 'the elephant in the room', and has focused on the routine issues and overlooked the truly significant risks. These may be to do with fundamental threats arising from changes in the wider business and economic environment in which the entity

operates, from changes in technology or competition, or they may relate to the way the business is being managed, especially if it is being mismanaged. Auditors may want to avoid appearing to make business judgements because managing the business is not their affair, but business judgements sometimes affect the audit. Effective team planning meetings may involve all participants taking a moment to reflect on these issues, so that they are happy that they are not ignoring something that might well be obvious to a bystander.

## **ARE REGULATORS RIGHT TO BE CONCERNED ABOUT INCONSISTENCIES IN RISK ASSESSMENTS?**

The use of a quantitative framework for risk assessment together with judgemental assessments such as 'high', 'medium' and 'low', are intended to facilitate consistency. The ISAs are also intended to promote consistency but it is equally clear that regulators think that there is a problem. The ISAs themselves may be part of the problem as may their application by auditors, but some concerns may also reflect regulatory distrust of the natural variations in outcome that the use of judgement inevitably entails. Teasing out these issues with a view to improving both real and perceived consistency is not straightforward and it is important that auditors, regulators and standard-setters do not simply make demands of each other to improve the situation.

In the UK, the Financial Reporting Council's (FRC) evaluation of the first year of extended audit reports<sup>5</sup> refers to consistency, as does IAASB's review, which identifies six 'key' themes, seven 'important' themes and a number of 'other' themes. Not surprisingly, these include risk assessment.


The 'key' themes in this area include concerns about inconsistency in the nature and number of significant risks identified in practice and the fact that the requirements to obtain an understanding of internal control can be difficult to apply. An 'important' theme is a concern that IT risks are not sufficiently addressed in the standard. The review notes that:

- inconsistencies in the identification of significant risks have an effect on work effort;
- the requirements to understand internal control and control activities relevant to the audit can be difficult to apply because auditors sometimes fail to link the controls they document to the risks they assess. More guidance on this linkage may be needed.

Some consider that the requirements in ISA 315 are excessive if, as in many smaller and less complex audits, a fully substantive approach to testing is adopted. Audit teams find themselves performing too much work on controls for which they perceive there is little benefit. It is therefore suggested that a better definition is needed of what 'relevant to the audit' means.

Regulators across a number of different jurisdictions, including the International Forum of Independent Regulators (IFIAR) and the FRC in the UK, have observed weaknesses in the way some firms deal with complex IT controls. It remains common for firms to audit around the computer rather than bringing in techniques that might be used to audit the 'box'. IAASB's review notes that this is not helped by the fact that ISA 315 is insufficiently reflective of the complexity of the IT and systems used by many larger entities. Some regulators believe that general IT controls may not be tested sufficiently when reliance is placed on IT-dependent controls because IT risks are not sufficiently emphasised in ISA 315. IAASB notes the critical importance of these systems to the audit, and concludes that the ISAs need modernising to reflect these complexities. This may not be good news for the audit of smaller, less complex entities unless the modernisation also recognises that

<sup>5</sup> <https://frc.org.uk/Extended-auditors-reports.pdf>.



in some such audits, simple distinctions between the control environment and control procedures are all that is necessary, and that to apply the Committee of Sponsoring Organizations of the Treadway Commission (COSO) model to such audits may be inappropriate.

Other themes identified in IAASB's review cover the need for clarification or additional guidance on:

- 'risk assessment at the assertion level';
- 'documentation of risk assessment procedures': on the nature and extent of documentation for understanding the business and on internal controls, particularly for smaller audits;
- 'poor linkages between identified significant risks and the responses thereto', because responses sometimes appear to be generic;
- 'the work effort where risks are assessed as low': to address the excessive work performed in some cases;
- 'the meaning of material classes of transactions and account balances'; and
- 'internal controls generally': to deal with over-reliance on management sign-offs, inadequate testing of general IT controls, general concerns among regulators about how internal control testing is and should be conducted, a lack of appreciation of the benefits of an audit strategy involving controls testing, the limitations of high-level controls in relation to some account assertions, and the work to be performed when controls are tested on a rotational basis; and
- 'management override of controls'.

IAASB notes that complexity in the organisation of ISA 315 also needs to be addressed.

In its Work Plan for 2015/16,<sup>6</sup> IAASB states that 'information-gathering activities to inform future work' will be designed to seek further understanding of the findings above. There will be a staff-led initiative to gather information about the potential scope of a project. The plan suggests that co-ordination with firms and regulators will be necessary and that the way forward could include 'specific enhancements' to ISA 315, additional guidance or 'a more fundamental consideration of the implications', which may be shorthand for a complete re-write. There is to be an initial discussion at the IAASB's March 2016 meeting.

<sup>6</sup> <https://www.ifac.org/publications-resources/iaasb-work-plan-2015-2016>.



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# Documenting and testing internal controls: issues that continue to challenge auditors

## WHY ARE ISA REQUIREMENTS ON INTERNAL CONTROLS SO HARD TO APPLY?

Dealing with internal controls is, and always has been, an 'issue' in audits of all sizes for a number of reasons.

In smaller, less complex audits, one particularly long-standing issue is the extent of the required work on the design and implementation of controls where a fully substantive approach is taken. The major overhaul of the risk ISAs in 2003 only served to sharpen the focus on this problem. We deal with it in some detail in *Understanding the design and implementation of controls in smaller audits: why and how*. But there are many other issues that auditors struggle with when understanding and testing internal controls in audits of all sizes, including:

- deciding whether to test the operating effectiveness of controls;
- determining what constitutes a deviation and the tolerable deviation rate, and then dealing with deviations;
- revising the control risk assessment, and the effect of a revision on other audit procedures; and
- balancing the results of controls testing with substantive procedures.

Dealing with internal controls in larger, more complex audits is no more straightforward than dealing with them in smaller audits, but the issues are different. The IFIAR 2014 Survey of Inspection Findings<sup>7</sup> (the survey) reports the highest number of audit inspection deficiencies in three areas: internal control testing (24%), fair value measurements (20%) and revenue recognition (14%). The survey cites problem areas as including the audit of general IT controls, a lack of specialist IT expertise, and excessive reliance on 'tests of one'.<sup>8</sup> The survey does note improvements, but the area seems to be increasingly important, exacerbated by a lack of detailed guidance on the approach to application controls and how they relate to risk and the effectiveness of IT general controls. The survey notes that the use of IT specialists on complex audits is sometimes limited to testing IT general controls, and that testing IT application controls is often undertaken by audit teams who need more support.

The UK's FRC notes in its Audit Quality Inspections Annual Report 2014/15 (the report) that the work performed during the year as part of its Thematic Review of the Audit of Loans Loss Provisioning<sup>9</sup> (the review), showed deficiencies in the testing of the operational effectiveness of IT controls in a number of bank, building society and other audits. The report notes that significant improvement was required in the audit of IT controls. Common issues highlighted by the review included limited consideration of the impact of IT general control weaknesses and insufficient IT general control roll-forward procedures. The review also highlighted over-simplification of application control testing with excessive reliance on untested system-generated information, and on 'tests of one' in the absence of consideration of control attributes.

<sup>7</sup> <https://www.frc.org.uk/Our-Work/Publications/IFIAR/IFIAR-2014-Survey-of-Inspection-Findings.pdf>.

<sup>8</sup> 'Tests of one' involve situations in which auditors believe that systems have not changed and a control is automated. The argument is that if the control works at all, it works every time, so testing it once should be enough. However, controls may have flaws that only give rise to an error in specific circumstances. For example, with a June period-end, if a bespoke accounting system automatically treats bookings as deferred income rather than income if they relate to months 7–12 in any year, bookings made for December of year 1 would be treated correctly as deferred, but those relating to the following January would be treated as current income.

<sup>9</sup> <https://frc.org.uk/News-and-Events/FRC-Press/Press/2014/December/FRC-publishes-review-of-audit-of-banks-loan-loss.aspx>.

Some audit regulators are now recruiting IT specialists. Standard-setters, such as the IAASB, have recognised that auditing standards need to be modernised and firms are putting more resource into this area, as well as developing their data analytics capabilities.

At the other end of the spectrum, *Understanding the design and implementation of controls in smaller audits: why and how* discusses the need for auditors of smaller and less complex entities to document their understanding of the design and implementation of internal controls when they take a fully substantive approach to the audit. That article was authored by two individuals with extensive experience of UK smaller audits, Hugh Morgan of Baker Tilly and Michele Rose of BDO and ICAEW staff member Katharine Bagshaw. It involved wide consultation with auditors who serve on ICAEW's ISA Implementation Sub-group. Arriving at a consensus was exceptionally difficult because it seems that firms in different jurisdictions have very different approaches to the requirements of the risk ISAs in this area. Some take the view that there is little point in spending a great deal of time considering controls in smaller audits because they are not that relevant to the risk assessment process or the wider audit. But others take the view that ISAs require work on the design and implementation of controls relevant to the audit on all audits, not least in order to understand the business properly. Numerous examples of the types of controls typically found in smaller entities and their relevance to the audit are provided in the article.

In the light of these observations, it would not be unreasonable to infer that work on the design and implementation of controls in smaller, less complex audits may sometimes be inadequate. However, members of UK training consortia report that such work is sometimes excessive. All that is needed is sufficient work to enable auditors to understand the system, assess risk and design audit tests. It seems that too much work on important operational controls is sometimes performed, despite the fact that they are not relevant to financial reporting. Within a hotel group booking system, for example, technology has enabled hoteliers to fine tune changes to pricing on an hourly basis, based on algorithms applied to large amounts of data about competitor prices. Auditors do not generally need to understand how prices are set – fascinating though it may be – but they do need to understand the controls that ensure that the right price (ie, one extracted from the correct file subject to various parameter checks) is being charged, because this information will be used in substantive testing.

IAASB may wish to consider whether when modernising the risk ISAs, it should recognise that in smaller, less complex audits, simple distinctions between the control environment and control procedures are all that is necessary and that to apply the COSO model to such audits may be inappropriate.

### **WHY DOES UNDERSTANDING AND DOCUMENTING CONTROLS WITHIN SYSTEMS SEEM TO BE SUCH A PROBLEM?**

The requirement to understand and document system processes and controls involves procedures such as talking to the client, internal control and internal control evaluation questionnaires, narrative notes and flowcharts. On larger, more complex audits some combination of these approaches is likely. For smaller, less complex audits with simpler controls, the extent of documentation and what is most appropriate in the circumstances are both important. Budgets are sometimes cited as a reason for spending less time and effort on documentation in such cases but efficiently prepared, comprehensive and up-to-date documentation probably costs less in the long run than out of date and incomplete documentation, because of the long-term effects on the efficiency of the audit approach, and in terms of regulatory consequences.





In very general terms, smaller, less complex audits tend to involve narrative systems notes. Documentation of systems generally tends to be underdone rather than overdone on all audits. Keeping it up to date – a housekeeping exercise – is often regarded as a chore rather than something with any intrinsic audit value, particularly where only minor changes are made. Provided the audit team does not change, this does not necessarily create problems on a day-to-day basis. However, incremental minor changes stack up and when the team does change, there is rarely any budget for a catching-up exercise. When a catch-up becomes unavoidable, it is not uncommon to uncover aspects of the system that are poorly understood with consequential inefficiencies, in terms of under or over-auditing.

Common failings in narrative systems notes include incomplete records of certain relevant control activities, such as how management accounts are prepared, how the budgeting system works, how journals are processed, how related parties and transactions are identified and approved, how supplier accounts are set up, the use of credit limits and the approval of expenses.

While narrative notes are usually sufficient to understand how a transaction is recorded in the general ledger, they can only be adequate for the purposes of identifying controls to prevent misstatements or manipulation if they are up-to-date, and if the preparer has given active consideration to the issue. Flowcharts may help, but well thought out and up-to-date narrative notes should suffice in most cases.

### **IN SMALLER, LESS COMPLEX AUDITS, DO AUDITORS REALLY NEED TO THINK ABOUT WHETHER TO TEST THE OPERATIONAL EFFECTIVENESS OF CONTROLS?**

In smaller, less complex audits, there is often a theoretical decision to be made regarding whether to test the operating effectiveness of controls. It is very common in smaller audits for a fully substantive approach to be taken even though there are controls that could be tested, because it is quicker and easier. Sometimes though, this is simply a legacy of past practice and it may be worth reviewing the approach from time to time. Work to update and document the auditor's understanding of the design and implementation of controls has to be performed annually regardless, and that work can be leveraged if controls are tested.

In smaller, less complex audits, auditors may be reluctant to consider changing a fully substantive approach, despite the presence of functioning controls, because budgets may not accommodate such changes, for example, even though this may lead to long-term inefficiencies. Other reasons for sticking with the existing approach regardless of what has changed at the client include a fear of doing things differently, unfamiliarity with tests of controls or how to deal with deviations, or a more generalised unwillingness to invest in the future.

Situations in which a move from substantive to controls testing might be worth considering, and factors to take into account include:

- the implementation of extensive changes recommended in a management letter, combined with improved operating effectiveness in transaction cycles;
- significant other improvements to controls, such as the financial statement closing process;

- improvements in the technology available or the recruitment of more IT literate staff;
- the development of knowledge or skills within the audit firm through training or recruitment, bringing with it the confidence to try a change in approach;
- the formalisation and documentation of new controls by the client as a result of expansion, for example, which makes testing of those controls more feasible. However, the size of the entity is not the only factor to take into account and where larger audits remain less complex, a substantive approach may still be perfectly reasonable.

### **IS DEALING WITH DEVIATIONS FROM THE APPLICATION OF CONTROL PROCEDURES A REAL PROBLEM IN SMALLER, LESS COMPLEX AUDITS?**


In performing controls testing, methodologies must help auditors determine what constitutes a deviation and the tolerable deviation rate. Statistical methods can be used when dealing with lower-level tests of controls. For higher-level controls, more judgement is required. It is the level of judgement required in dealing with deviations that gives rise to many of the problems in controls testing, particularly in some smaller, less complex audits.

For example, in not-for-profit organisations, a control over donations received by mail often involves the mail being opened by two persons. There is no real 'fully substantive' alternative to testing this type of control if this is the principal control that serves to ensure the completeness of income and the absence of fraud. If it is not effective, it can be difficult to obtain any other evidence to support the assertion. Testing the operational effectiveness of such controls is sometimes essential. Auditor observation of this procedure and a review of documentation evidencing the presence of two persons are two common tests of control. The opening of the mail by one person might constitute a deviation. How many times does this have to happen before the control ceases to be effective? Anything happening on a systematic basis is likely to be a cause for concern. The discovery that for half of the year it has happened once a week because one person has to visit a hospitalised relative might be an example. Other cases may not be so straightforward. If a review of a sample of documentation involves looking at one set of signatures of the two persons at random every other month, for example, what constitutes a tolerable level of deviation in this case? Less than 5% (when extrapolated) might be tolerable but even when that is unlikely to be exceeded, a considerable amount of additional work is probably required to show that errors are isolated, as ISA 330 does not permit auditors to assume that deviations are isolated, and effectively requires auditors to prove that they are not.

The tolerable level of deviation within automated systems is likely to be zero in many cases, but the tolerable level of deviation in the application of controls that require more human intervention is not, and requires more judgement.

### **REALISTICALLY, WHEN SHOULD AUDITORS REVISE THE CONTROL RISK ASSESSMENT? WHAT HAPPENS WHEN THEY DO?**

When extrapolation of deviations from the application of a control procedure across the population exceeds the tolerable level, and/or further testing fails to provide evidence that supports an alternative conclusion that can be reconciled to the original evidence, auditors must conclude that the control is not operating effectively. This affects the control risk assessment, other tests of controls in the same area (there may be compensating controls), and subsequent substantive procedures. Substantively testing information from poorly controlled systems is an increasingly important issue in larger, more complex audits, as well as smaller audits.



Having to revise the control risk assessment upwards, particularly if it happens after the first year, causes problems because there is rarely, if ever, any contingency in the budget for the additional work required. The need for revisions would ordinarily become apparent during work on the design and implementation of controls during the first audit. If it does not, work on the design and implementation of controls may need to be improved.

### **WHAT DO AUDITORS NEED TO CONSIDER WHEN ADJUSTING SUBSTANTIVE PROCEDURES TO REFLECT THE RESULTS OF CONTROLS TESTING?**

Some auditors struggle with the difference between tests to check that the auditors' recording of the design and implementation of controls is accurate, tests of the operational effectiveness of controls and related substantive procedures. This is partly because audit firm terminology sometimes uses terms such as 'walk-through tests', to describe any or all of these procedures, and partly because a single test can perform multiple functions. It is important to understand the nature of any particular test, however described, and especially its limitations. The tendency to overstate, rather than understate the various conclusions that can be drawn from a single test is almost universal.

Some firms put a lot of time and effort into work on the design, implementation and testing of controls in the first year, in the knowledge that this work should pay off in subsequent years, particularly if the firm decides to take advantage of the 'three-year' rule and rotate the testing of controls over this period. Applying the 'three-year' rule, however, is not always straightforward. ISAs do not permit it to be applied in areas of significant risk, and a 'proportion' of other controls must be tested each year, using a rotational approach.

The results of substantive analytical procedures are important in providing audit evidence to address the assessed risks, and in determining sample sizes. However, it is important to distinguish between substantive analytical procedures and analytical procedures performed for planning or review purposes, the performance of which are often erroneously taken to permit a reduction in sample sizes. Base-line sample sizes of 60, 90 or 120 items within some firm methodologies encourage the use of substantive analytical procedures to reduce those numbers. High base-line numbers such as these have arisen partly from regulatory pressure after the financial crisis and partly from a perceived over-reliance on judgement sampling.

The reduction in base-line sample sizes for substantive procedures when tests of controls show that controls are operating effectively typically range from 30% to 50%. Factors to take into account in deciding how much of a reduction can be made include the overall audit approach, the circumstances of the entity, the balance between substantive analytical procedures and other substantive procedures, and the nature of the associated risks.

All firms change their methodologies over time, including base-line sample sizes for both tests of controls and substantive procedures. The FRC is currently conducting a Thematic Review of sampling among larger firms. Changes in sample sizes are linked to changes to the balance of audit evidence sought from:

- tests of controls and substantive procedures;
- tests of high-level general controls and tests of more detailed control activities over transactions and balances; and
- substantive analytical procedures and detailed tests of transactions and balances.

Firms may also seek to make more use of substantive analytical procedures in an attempt to reduce the level of detailed testing of transactions and balances. Some firms have recently sought to improve efficiency by making better use of work on high-level general controls to reduce the level of testing on both lower-level controls, and the extent of substantive procedures.

Testing the operational effectiveness of high-level controls general such as controls over budgeting and management accounts, including the entity's own review processes, requires some thought. Evidence is needed to show that such processes can actually prevent, detect and correct specific material misstatements. This may not be straightforward, and the resulting reduction in substantive work undertaken may be fairly modest.

All of these trends are sometimes checked when it becomes clear that either the quality, extent and depth of evidence obtained from work on high-level general controls is insufficient to warrant extensive reductions in other types of testing, or when it becomes clear that, for whatever reasons, substantive analytical procedures are not being performed to a sufficiently high standard to warrant the hoped for reductions in detailed tests of transactions and balances. Firms seem currently more inclined to perform detailed tests of transactions and balances than to rely on substantive analytical procedures.

### **IS DATA ANALYTICS REALLY SOMETHING NEW AND IS IT REALLY GOING TO CHANGE THE WAY AUDITS ARE PERFORMED?**

It is clear that the technology that permits auditors to test and manipulate large amounts of client data is being refined and is now being used on more audits. There will be increasing demand among firms and regulators for more IT-literate staff who are sufficiently confident to test controls over computers rather than working around them. Standard-setters are also under pressure to update auditing standards in line with these developments. The technology involved in data analytics is by any measure a step change from the computer-assisted audit techniques (CAATs) of yesteryear and the capabilities currently being developed by large firms do call into question a perceived assumption in the risk ISAs that not all of the transactions in a population will be tested.

All of the larger firms have made it clear that they are developing predictive analytic technologies. Some of these technologies were originally developed within the firms for forensic accounting purposes, including data mining software. Some involve the development of proprietary digital platforms. Some technologies are being developed in partnership with third parties. It seems that many are intended to apply to both advisory and audit services.<sup>10</sup>

<sup>10</sup> The accountancy press has reported details of how the large firms are approaching data analytics. There are references to significant investments in automation, analytics and technological innovation, and to new technology being a core driver of innovation in audit. Some technologies were originally developed by forensics practices to help sift through unstructured data such as emails. By melding this with well-controlled 'structured data', firms are building up a more comprehensive picture of business operations to unearth anomalies. Some firms claim that social media have also created pools of data that could be relevant to an audit.

# Understanding the design and implementation of controls in smaller audits: why and how

Risk assessment is key to an ISA-compliant audit, as highlighted in recent ICAEW Quality Assurance Department (QAD) monitoring reports. They recognise that firms often obtain sufficient evidence to address the risks, even though the risk assessment process itself may not meet all the requirements. The risk assessment process is important though, because without it, there is a danger that significant issues may be overlooked and the response to the risk assessment might not make sense. Standard work programmes help ensure that nothing is missed but they are much more likely to work if the risk assessment process that supports them is sound.

Consideration of internal control and of the risk of fraud are both areas in which auditors often need to improve their risk assessment processes. In particular, auditors need to remember that internal controls are still relevant where a fully substantive audit approach is adopted, and to be more sceptical about the risk of fraud at long-standing clients.

Understanding internal control and documenting that understanding is a challenge for all audits, irrespective of the client's size or complexity. In smaller, less complex entities controls are typically informal and undocumented, and potentially compromised by a lack of segregation of duties. However, the involvement of the owner-manager in the day-to-day running of the business can have a positive and a negative effect on the evaluation of risk.

The QAD has three tips for work on understanding controls as part of the risk assessment, and suggests that, even where auditors adopt a fully substantive approach, they should ask themselves whether they have:

- identified those controls that are relevant to the audit, such as those relating to the key transaction streams;
- checked whether those controls are designed appropriately to achieve their objectives; and
- obtained evidence that these controls have been implemented, by walkthrough tests, for example.

## **WHY IS WORK ON INTERNAL CONTROL NECESSARY WHEN AUDITORS TAKE A SUBSTANTIVE APPROACH?**

Some auditors question the value of the work ISAs require on evaluating the design and implementation of controls. The purpose of this work is to help auditors properly understand the business and, very specifically, to deal with any risks arising from poor internal controls.

Performing the same substantive procedures, regardless of whether controls are designed, implemented and operated properly, poorly or not at all, ignores the following:

- ISAs require substantive procedures to be tailored to the assessed risks;
- a substantive approach often involves analytical procedures and if auditors ignore controls, they risk placing undue reliance on the information on which they perform the procedures, if it is produced by a poorly-controlled system;
- auditors may well miss something important in a key area if they do not understand that the controls over them are poor, and they may not be auditing in the most efficient manner possible if they do not understand that controls are good; and
- ISAs require auditors to obtain an understanding of the internal controls relevant to the audit by evaluating the design and implementation of those controls irrespective of the size and complexity of the client and regardless of the audit strategy.

## WHICH CONTROLS DO AUDITORS NEED TO UNDERSTAND?

Auditors are only required to obtain an understanding of controls relevant to the audit. Controls relevant to the audit are typically controls over financial reporting. That is not to say that all controls over financial reporting are relevant to the audit. The only controls that auditors need concern themselves with are those that auditors believe may prevent, detect or correct a material misstatement. It is a matter of professional judgement whether a control individually, or in combination with others, is relevant to the audit. To be able to make this judgement, auditors need to understand the system within which the controls operate.

Internal controls in smaller and less complex entities are likely to be informal, but this does not mean that there will be no controls relevant to the audit or that if there are, they will never be good enough for auditors to test their operating effectiveness.

If auditors do not understand the system and assume that there are no controls relevant to the audit without further consideration, they write off the potential value of this work before they start.

Operational and financial controls are often tightly integrated and interdependent. In a theatre ticketing system, for example, controls over the issue of tickets are often linked with controls over the receipt of funds or the issue of invoices. This means that operational controls may sometimes be relevant to the audit and auditors need to think carefully about that and whether it is therefore necessary to assess their design and implementation. One way of determining this might be to ask whether the absence of the control might render the system inoperative, or vulnerable to the failure of a single control, or constitute a significant deficiency, for example.

## CONTROL COMPONENTS

ISA 315 *Understanding the entity and its environment and assessing the risks of material misstatement* lists five internal control components:

1. the control environment;
2. risk assessment;
3. information system;
4. control activities; and
5. monitoring of controls.

The risk ISAs were introduced in 2003 using the five component classification of the US COSO framework. This framework has been widely used since 1992 and has stood the test of time. It was revised in June 2013, but the five basic components remain the same. ISA 315 does not require auditors to use it, provided that all of the components are covered, but many if not most firms and the providers of proprietary software systems find this a convenient framework to use.

## CONTROL RISK ASSESSMENT

It is fair to assume that entities that are not dormant have some controls in place, however rudimentary. These controls need not be formal or formally documented; they just need to be appropriate for the entity concerned.

Auditors are required to perform some work to evaluate the design and implementation of controls in order to assess control risk. However, auditors cannot allow an expectation that controls are operating effectively to have any effect on the nature, timing and extent of substantive procedures unless the operational effectiveness of the controls is tested.



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Auditors may believe that controls are, or may be, operationally effective but choose to assume that they are not, and take a purely substantive approach. This may not be the most efficient approach but it is not prohibited. Nevertheless, ISA 315 requires auditors to substantiate the assessment of control risk in all cases and auditors cannot make any unsubstantiated assumptions about control risk simply because the entity is small. Even if auditors have decided to take a substantive approach, regardless of the quality of controls, and the control risk assessment has no effect of the nature or extent of procedures performed, ISA 315 still requires the control risk assessment to be performed.

## KEY ISSUES FOR SMALLER ENTITIES

A lack of segregation of duties and the potential for management override are particularly important considerations for auditors of smaller, less complex entities, particularly those that are owner-managed. While the owner-manager's ability to closely supervise and oversee the business is potentially a strong control, in some situations this dominance can lead to the override of controls and the manipulation of financial data and business assets for personal objectives. Personal tax matters are usually important to owner-managers and provide the motive for bias in or manipulation of the financial statements. Auditors need to assess risks relating to the completeness of recorded assets and income in such cases.

Auditors need to understand the dynamics in place and the motivation of management to fully appreciate the nature and extent of potential risks of material misstatement. If auditors do not properly understand the design and implementation of its internal controls how can they properly understand the business, and if they do not properly understand the business, how can they design and perform the necessary further audit procedures?

## OBTAINING AN UNDERSTANDING OF THE DESIGN AND IMPLEMENTATION OF INTERNAL CONTROL COMPONENTS: EXAMPLES

CONTROL COMPONENT	CONSIDERATIONS FOR SMALLER, LESS COMPLEX ENTITIES	EXAMPLES OF WORK ON CONTROL DESIGN AND IMPLEMENTATION
<p><b>1. The control environment</b></p> <p>As part of obtaining an understanding of the control environment, auditors are required to evaluate whether:</p> <ul style="list-style-type: none"> <li>management, with the oversight of those charged with governance, has <b>created and maintained a culture of honesty and ethical behaviour</b>; and</li> <li>the strengths in the control environment elements collectively provide an appropriate foundation for the other components of internal control, and whether those other components are undermined by deficiencies in the control environment, such as the risk of management override.</li> </ul>	<p>The control environment is all about setting the tone at the top of an organisation, and influencing the control consciousness of its people. In many smaller entities, management and those charged with governance are likely to be the same – either the board of directors or the owner-manager, and may not include independent or outside members. However, with not-for-profit organisations the position is different because those charged with governance, such as trustees are often not involved in the day-to-day management of the business. The tone at the top can sometimes involve mixed messages and poor messages tend to have more impact than the good ones.</p>	<p>Auditors may obtain an understanding of the control environment in a smaller entity by <b>inquiry</b> of management or the owner-manager, by considering management's attitudes and motives based on prior experience and by <b>observing management's actions</b> during the audit.</p> <p>inquiry is an essential part of understanding an entity of any size but ISA 315 does not permit auditors to base their understanding of the design and implementation of controls on inquiries alone. Evidence from inspection, observation and walk-throughs is also required. Walk-through tests are particularly important in understanding implementation.</p>





CONTROL COMPONENT	CONSIDERATIONS FOR SMALLER, LESS COMPLEX ENTITIES	EXAMPLES OF WORK ON CONTROL DESIGN AND IMPLEMENTATION
<b>1. The control environment continued</b>	<p>Formalised policies such as a written code of conduct may be present in some smaller not-for-profit organisations but are less likely in other smaller entities. Even so, <b>a culture of ethical behaviour can be established through oral communication and leading by example.</b></p> <p>If the tone at the top is good, <b>the owner-manager may exercise effective control over transactions which otherwise might be achieved through extensive segregation of duties</b> in a larger entity. However, if the tone at the top is poor, management override can easily occur and even the very best transactional controls over processes, such as purchases and revenue, can be overridden.</p>	<p>It is important to remember that understanding the design and implementation of controls is not the same as tests of the operational effectiveness of controls, although such tests are sometimes performed at the same time as work on design and implementation. It is often not possible to perform tests on the operational effectiveness of the control environment, but obtaining an understanding of the design and implementation of the control environment (and of all of the other control components) is critical to the control risk assessment.</p> <p>The tone at the top of a small, simple owner-managed business may be reflected in the extent to which the owner manager <b>segregates personal assets and transactions from those of the business.</b> Owner-managers who make a clear distinction demonstrate a good tone at the top.</p>
<b>2. Risk assessment</b>  Auditors are required to obtain an understanding of the <b>entity's risk assessment process</b> , which is designed to <ul style="list-style-type: none"> <li>• identify business risks relevant to financial reporting objectives;</li> <li>• estimate the significance of those risks;</li> <li>• assess the likelihood of the risks occurring; and</li> <li>• decide on actions to address those risks.</li> </ul>	<p>In a smaller, less complex entity, it is <b>unlikely that such a formal risk assessment process will be in place.</b> It is more likely that management will identify risks through their direct personal involvement in the business. If this is the case, or there is an ad hoc process, auditors may <b>discuss with management whether business risks relevant to financial reporting objectives have been identified and how they have been addressed.</b></p> <p>Owner-managers are generally very aware of the risks facing their business. They simply see no need to write them down – but this does not mean that they have not thought about the risks to their business and made changes if they consider them necessary.</p>	<p>Auditors discuss business risks with management as part of the planning process and <b>conclude on whether the risk assessment process in place is appropriate given the size and complexity of the entity.</b> The risk assessment process need not be formal or documented.</p> <p>It is unlikely that when auditors ask a smaller, less complex client about their risk assessment process that they will get a positive response. However, using more common terminology may result in a different answer. For example, instead of asking about business risks, auditors could consider asking the following:</p> <ul style="list-style-type: none"> <li>• what are the current threats to profits?</li> <li>• is the entity experiencing increasing costs?</li> </ul>

CONTROL COMPONENT	CONSIDERATIONS FOR SMALLER, LESS COMPLEX ENTITIES	EXAMPLES OF WORK ON CONTROL DESIGN AND IMPLEMENTATION
<b>2. Risk assessment continued</b>		<ul style="list-style-type: none"> <li>• how is the business performing against its competitors?</li> <li>• what impact has the current economic environment had on the business?</li> </ul> <p>Depending on the answers received, auditors will then need to ask how these issues have been addressed. Has the business cut costs, sought new suppliers, reduced their workforce, found new customers, or investigated new markets/territories, for example?</p>
<b>3. Information system</b>  Auditors are required to obtain an <b>understanding of the information system, including the related business processes, relevant to financial reporting</b> , including the following areas: <ul style="list-style-type: none"> <li>• the <b>classes of transactions</b> in the entity's operations that are significant to the financial statements;</li> <li>• the <b>procedures, within both IT and manual systems</b>, by which transactions are initiated, recorded, processed, corrected, transferred to the general ledger and reported in the financial statements;</li> <li>• the related <b>accounting records</b>, supporting information and specific accounts in the financial statements;</li> <li>• <b>how the information system captures events and conditions</b>, other than transactions that are significant to the financial statements; and</li> <li>• the <b>financial reporting process</b> used in preparing the entity's financial statements, including controls over significant accounting estimates and disclosures.</li> </ul>	<p>Information systems and related business processes relevant to financial reporting in a smaller entity are likely to be much simpler than in larger entities, but no less important.</p> <p>Typically, the bookkeeping procedures and accounting records will be simple with no documented descriptions of accounting policies or procedures. Smaller entities generally use <b>off-the-shelf, accounting packages</b> with no modifications to produce their accounts. <b>Properly tailored good quality off-the-shelf packages operated by appropriately trained staff may well constitute a good quality control over information systems and accounting records.</b></p> <p>For a smaller, less complex entity, <b>management and those charged with governance are likely to be the same body or person. Communication is likely to be informal and easily achieved</b> due to fewer levels of responsibility and management's greater direct involvement with the entity.</p>	<p>Understanding systems and processes may be easier in an audit of small entities. Auditors can gain a good level of their understanding of the information systems through <b>inquiry of management</b> and other relevant personnel and are less dependent on formal documentation such as client pre-prepared system notes. As before though, the understanding the design and implementation of systems should not be based on inquiry alone, and needs to be corroborated by reference to inspection of documentation, client staff observations on the operation of systems, and walk-throughs to ensure that systems have been implemented, and operates as prescribed, in accordance with the auditors' understanding.</p> <p><b>Gaining an understanding of the accounting package, of the extent of staff competence and training, and of how well its security and other features are used also helps auditors assess risk.</b></p> <p>Understanding obtained in prior audits and other audits of entities that use the same package can help auditors identify areas of risk that arise from the information system.</p>



CONTROL COMPONENT	CONSIDERATIONS FOR SMALLER, LESS COMPLEX ENTITIES	EXAMPLES OF WORK ON CONTROL DESIGN AND IMPLEMENTATION
<p><b>3. Information system continued</b></p> <ul style="list-style-type: none"> <li>controls over journal entries, including non-standard journal entries used to record non-recurring and unusual transactions or adjustments are adequate.</li> </ul> <p>ISA 315 also requires auditors to obtain an understanding of how the entity <b>communicates financial reporting roles and responsibilities and significant matters relating to financial reporting</b>, including communications between management and those charged with governance and external communications, such as those with regulatory authorities.</p>		<p>An understanding of the communication processes will be most easily obtained through <b>discussion with management</b> supported by documentary evidence.</p>
<p><b>4. Control activities</b></p> <p>Auditors are required to obtain an understanding of <b>control activities relevant to the audit</b>, ie, those activities auditors judge it necessary to understand in order to assess the risks of material misstatement at the assertion level and to design further audit procedures responsive to assessed risks.</p>	<p>The concept of control activities is universal, irrespective of the size and complexity of an entity.</p> <p>Control activities are likely to be limited to the main transaction cycles such as revenue, purchases and payroll.</p> <p>Management's greater direct involvement in the day-to-day operations of smaller entities means that control activities are <b>likely to be less formal</b> than in a larger entity and rely more on <b>reviewing daily, weekly and monthly reports</b> on revenue, purchases and payroll, for example.</p> <p><b>Automated controls within computer packages may provide some comfort on completeness and accuracy in the main transaction cycles</b> but they must be tested like any other control.</p> <p>Management's direct involvement in key decision-making is often an important feature of the management of any smaller entity.</p>	<p>Understanding control activities can be obtained <b>through discussion</b> with management and other staff, observation of their activities and inspection of documented controls, such as authorisations.</p> <p>Audit work might focus on <b>understanding how, for each of the main transaction cycles, a transaction is initiated, processed and recorded in the accounting system and reported in the financial statements</b>.</p> <p>Any lack of control activities, inappropriate design or failure to implement control activities will have an effect on the assessed level of control risk.</p> <p>It is more likely in this area than in any other, that tests of the operational effectiveness of controls will be performed. If such tests show that control activities are not operationally effective, the control risk assessment needs to be revisited.</p>

CONTROL COMPONENT	CONSIDERATIONS FOR SMALLER, LESS COMPLEX ENTITIES	EXAMPLES OF WORK ON CONTROL DESIGN AND IMPLEMENTATION
4. Control activities continued		<p>Where management makes key decisions and has the ability to intervene at any time to ensure an appropriate response to changing circumstances, auditors may decide that this control is sufficient to prevent or detect and correct material misstatements. There would be no need to consider more detailed control activities as part of the risk assessment process in such cases.</p> <p>For example:</p> <ul style="list-style-type: none"> <li>• if management has sole authority for granting credit to customers and approving significant purchases, it might constitute a strong control over important account balances. Auditors might consider that these two controls are sufficient and would not seek to identify further control activities in these areas; and</li> <li>• for a company holding a single leased asset with no indicators of impairment, management might use the lease contract as evidence of the assertions underlying the disclosure of the asset in the financial statements. There may be no specific controls relating to the asset other than management's knowledge and use of the lease contract. Auditor documentation of the use of the contract as the control over that asset may be sufficient for risk assessment purposes. It may not be necessary to investigate more detailed control activities in this area.</li> </ul>



CONTROL COMPONENT	CONSIDERATIONS FOR SMALLER, LESS COMPLEX ENTITIES	EXAMPLES OF WORK ON CONTROL DESIGN AND IMPLEMENTATION
<p><b>5. Monitoring of controls</b></p> <p>Auditors are required to obtain an understanding of the major activities the entity uses to <b>monitor internal control over financial reporting</b>, including monitoring of relevant control activities. They are also required to understand how the entity initiates <b>remedial actions</b> to correct deficiencies in its controls.</p>	<p>In a smaller entity, management's monitoring of controls may be through <b>management's own close involvement with the operations of the entity</b>. This may be through a review of:</p> <ul style="list-style-type: none"><li>• <b>any management accounts</b> and significant variances;</li><li>• <b>key performance indicators</b> set by management; and</li><li>• <b>errors</b> in financial data leading to remedial action.</li></ul> <p>It is important to recognise that in very small entities, where control is achieved through management's day-to-day involvement in the running of the business, it may not be possible for management to monitor controls because it would be effectively monitoring itself.</p>	<p>Auditors can obtain their understanding of management's monitoring of controls by <b>inquiry of management and inspection of items monitored</b> such as completed bank reconciliations. Evidence of changes made in prior years as a result of monitoring may also be relevant.</p> <p>The absence of effective monitoring controls is not necessarily fatal as other controls may be sufficient to reduce control risk to an acceptable level.</p>







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