



## **Article: Control Systems and Controls Testing: General Review**

***By: Paul Lydon, BA, CPA, MBS (Hons), PGCLTHE, FHEA Current Examiner in P1 Auditing***

The main duty of auditors is to report to the members on whether, in their opinion, the company's financial statements give a true and fair view. The auditors' report must be made available to every member and be read at the AGM.

To ensure their opinion is based on credible information, it is the auditor's responsibility to ensure that they communicate appropriately to those charged with governance deficiencies in internal control that the auditor has identified in an audit of financial statements.

This article looks at the specific procedure of internal controls, and considers,

- Why are controls so important?
- What stages are involved in reviewing controls?
- Controls in the Revenue and Receivables Cycle,
- Controls in the Purchases and Payables Cycle

### **Why are controls important?**

The internal control system comprises

- the control environment, and
- the control procedures

It includes all the policies and procedures adopted by the directors and management of the entity to assist in achieving their objective of ensuring, as far as practicable, the orderly and efficient conduct of its business

This includes:

- Adherence to internal policies
- The safeguard of assets
- The prevention and detection of fraud and error
- The accuracy and completeness of the accounting records
- The timely preparation of reliable financial information

The auditor uses his/her understanding of internal controls:

- To identify types of potential misstatements
- To consider factors that affect the risks of material misstatement
- To design the nature, timing and extent of further audit procedures

The auditor may choose to test the controls within the entity which will assist in making his overall audit more efficient as it may assist in reducing the level of substantive testing to be performed.

The Components of Internal Control

- The internal control environment – Tone at the Top / Entity level controls.
- The risk assessment process – How does the company manage risk?
- The information systems – The use of information systems in generating financial statements and the controls embedded within it.
- Control activities – Activities put in place to prevent / detect and correct fraud and errors occurring in the financial statements.
- Monitoring of controls – internal audit / identification of ineffective controls and correction of same.

### **What Steps are involved in Reviewing Controls?**

Auditors follow a process to determine whether testing controls will make the overall audit efficient (i.e. will help to reduce substantive testing and results of control testing will show if the controls are operating effectively)

- Step One – Identify Risks and Objectives within each Financial Cycle
- Step Two – Ascertain System and Internal Controls
- Step Three – Assess the Systems and Internal Controls
- Step Four - Test the Systems and Internal Controls (only if they are deemed to be effective)

Step One – Identify Risk and Objectives within the client's business activities  
We must identify the objectives (Financial Statement Assertions) in order to know what we wish the controls to prevent, detect and correct.

## **Remember the Financial Statements Assertions**

### **Assertion / Objective for Transaction Classes**

Existence or Occurrence

Completeness

Rights and obligations

Accuracy

Presentation and disclosure

### **Assertion / Objective for Y/E Balances**

Occurrence

Completeness

Rights and obligations

Valuation

Presentation and disclosure

### **Step Two – Ascertain System and Internal Controls**

- Identify principal business activities
- Determine the flow of documents
- Identify the extent of controls relative to each risk & financial statement objective / assertion
- Perform a walkthrough test to validate your understanding

The control activities will fall into one of the following categories:

#### **Organizational Controls (Entity Level Controls)**

- Generally cover the written policies and procedures regarding hiring and retaining of appropriately qualified personnel and existence of a chart of authority.

#### **Segregation of Duties**

- This is the separation of staff responsible for different tasks. For example, in the purchasing the individuals responsible for ordering goods should not be able to approve payments.

#### **Physical Controls**

- Should ensure the safeguarding of documentation, inventory, and access to physical locations and computer systems. This can be in the form of access cards for entry to different areas or locations.

#### **Reviews & Authorisations**

- Double checking of tasks performed and approval for transactions. For example, the stock chosen in the warehouse to fulfil a sales order should be checked by someone independent of the picker prior to despatch, to ensure no errors have been made and the order picked equals the order taken. Authorisation should be given for certain transactions such as returned stock or bad debt write offs.

### System Controls (IT Systems)

- This involves system configuration to prevent invalid recordings. For example, during order entry, the system should prevent the order entry clerk from taking an order that will result in a customer exceeding their credit limit or ordering items which are currently out of stock.

### Reconciliations

- i.e. performance of reconciliations between two independent sources of data carried out by a person other than the person who recorded the data.

### Step Three – Assess the Systems and Internal Controls

#### When to test?

- If the auditor tests the controls and results prove that the company controls are effective, it will allow the auditor to reduce his substantive testing, e.g. if controls connected to the completeness assertion of sales prove to be effective then the substantive testing connected to the completeness assertion of the revenue figure and the debtors balance will be reduced.
- If the auditor however makes an incorrect assessment of the internal controls and deems ineffective controls effective or vice versa, this will impact on the efficiency of his audit.
- In deciding whether or not to test controls, the auditor will also take into consideration how much substantive testing can be reduced by an effective control assessment. However while substantive testing can be reduced, it cannot be eliminated completely.

### Step Four – Test the System of Internal Controls

#### Tests of Controls are:

- Concerned only with those areas subject to effective controls
- Concerned only with those controls mitigating risks and supporting objectives
- Must consist of a representative sample of transactions
- Likely to cover larger number of items than a walkthrough

### Examination

It is common in practice and in exam questions to identify and explain deficiencies in internal control systems. A good example is Question 1 (a) of May 2014 exam, where deficiencies in the tangible non-current asset control system of a company were examined.

A brief outline of a possible approach to answering any questions on control systems is to consider the key assertions.

**An approach to a purchases system is outlined below where one considers the assertions. A similar approach could equally be applied to other control systems such as sales/revenue or wages system etc.**

## **Assertion / Objective for Transaction Classes i.e. purchases on credit**

### **Existence or Occurrence:**

- Authorisation of purchase orders/purchase invoices in order to mitigate the risk of unnecessary or fraudulent purchases it is common for only a small number of experienced staff to have the authority to raise purchase orders. In addition, the value of purchases which a staff member can authorise often varies depending on their seniority and level of experience.
- That all the recorded purchase transactions i.e. purchases or expenses on credit, actually took place. Ensure each purchase invoice should only be recorded if there is an authorized goods received note (GRN).
- Therefore all purchase invoices recorded should have a supporting goods received note. This should prove that the organization received the goods or services invoiced.

The types of control procedures to achieve this are:

- e.g. goods can only be received if there is a valid authorised purchase order.
- Goods can only be accepted once inspected and recorded on a GRN.
- The purchase order number should be recorded on the GRN to maintain the audit trail i.e. the ability to trace a transaction from where it was initiated, the "cradle"; to where it is recorded in the financial statements, the "grave".

### **Completeness:**

- That all the goods or services bought and received on credits are recorded in the financial records. So we would expect a system whereby all goods and expenses bought on credit are recorded on a goods received note (GRN).
- Someone - other than the person who wrote the GRN i.e. segregation of duties - should check that all GRNs have been matched to purchase invoices and, that any GRNs that have not been matched, should be checked to establish where the purchase invoice is.

### **Rights and obligations;**

- that the company is entitled to the goods or services that are included on the invoice.
- the company's entitlement should be supported by a valid GRN and an authorised purchase order, both of which are in the company's name.

### **Accuracy**

- that all purchase invoices are recorded accurately in the financial records i.e. the correct amounts are recorded and the figures are posted to the correct nominal ledger and payables ledger accounts.

The types of controls to achieve this are:

- As part of the review and authorisation procedures check invoice details to ensure accuracy of input, establish segregation of duties by ensuring that individuals responsible for processing payments are autonomous of those posting the entries to the supplier accounts, etc.
- the payables ledger is reconciled to the payable statements on a regular basis by someone not involved with the recording of payables

### **Presentation and disclosure:**

- that the payables are disclosed correctly re accounting notes and properly classified between current and noncurrent payables.

### **Another examinable area is to ask students to design appropriate tests of control**

A possible approach is to consider the stages in the system and the systems objectives at various stages. E.g. if we consider a sales system this and could be structured as follows:

#### **Control objectives**

<b>Stage</b>	<b>Possible System Objectives</b>
Ordering and granting of credit	<ul style="list-style-type: none"><li>• Goods and services are only supplied to customers with good credit ratings</li><li>• Customers are encouraged to pay promptly</li><li>• Etc</li></ul>
Dispatch and Invoicing	<ul style="list-style-type: none"><li>• All dispatches of goods are recorded</li><li>• All goods and services sold are correctly invoiced</li><li>• Etc</li></ul>
Recording, accounting and credit control	<ul style="list-style-type: none"><li>• All credit notes that have been issued are recorded in the general and sales ledgers</li><li>• All entries in the sales ledger are made to the correct sales ledger accounts</li><li>• Etc</li></ul>

#### **Controls**

<b>Stage</b>	<b>Possible Controls</b>
Ordering and credit approval process	<ul style="list-style-type: none"><li>• Orders only accepted from customers who have no credit problems</li><li>• Sequential numbering of blank pre-printed order documents</li><li>• Etc</li></ul>
Dispatches and invoice preparation	<ul style="list-style-type: none"><li>• Examination of goods outwards as to quantity, quality and condition</li><li>• Recording of goods outwards</li><li>• Etc</li></ul>
Recording and credit problems	<ul style="list-style-type: none"><li>• Segregation of duties: recording sales, maintaining customer accounts and preparing statements</li><li>• Recording of sales invoices sequence and control over spoilt invoices</li><li>• Etc</li></ul>

## Tests of Controls

Stage	Possible Test of controls
Ordering and granting of credit	<ul style="list-style-type: none"> <li>• Review all new customer files for references</li> <li>• Review sales ledger for new customers to confirm authorisation by senior staff</li> <li>• Etc</li> </ul>
Dispatches and invoice	<ul style="list-style-type: none"> <li>• Test numerical sequence of dispatch notes and enquire into missing numbers</li> <li>• Test numerical sequence of Invoices and credit notes, enquire into missing numbers and of those cancelled</li> <li>• Etc</li> </ul>
Recording of and accounting for sales	<p>Sales day book</p> <ul style="list-style-type: none"> <li>• Agree with invoices and credit notes respectively</li> <li>• Reperform additions and cross casts</li> <li>• Etc</li> </ul> <p>Sales ledger</p> <ul style="list-style-type: none"> <li>• Agree entries in a sample of accounts to sales day book</li> <li>• Reperform additions and balances carried down</li> <li>• Etc</li> </ul>

This article has attempted to introduce a general review of control systems and controls testing; in the areas of tangible non-current asset, purchases system and sales system. However, other areas in related to control systems and controls testing which have not been discussed in any depth in this article and where students should be able to answer examination questions on include:

- Bank and cash
- Inventory cycle