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The CPA Ireland Skillnet provides excellent value CPE (continual Professional Education) in accountancy, law, tax and strategic personal development to accountants working both in practice and in industry. However our attendees are not limited to the accountancy field as we welcome all interested parties to our events.



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#### Trainee Accountant Webinar

December 2016

### P1 Auditing Controls and Controls Testing

Presented by Paul Lydon

## Controls and Controls Testing

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

## Why are Controls So 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

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## Why are Controls So Important?

- 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

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## Why are Controls so Important?

### Controls and the Auditor

#### The auditor uses the 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.

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## Why are Controls so Important?

### 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.

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## What Stages 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 effective)

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## What Stages are Involved in Reviewing Controls?

### High level types of controls

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

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**Remember the Financial Statements Assertions:**

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- Identify Principal Business Activities
- Determine the flow of documents
- Identify extent of controls relative to each risk & financial statement objective / assertion
- Perform a walkthrough to validate your understanding

OC	<b>Organizational Controls (Entity Level Controls)</b>
SOD	<b>Segregation of Duties</b>
PC	<b>Physical Controls</b>
R&A	<b>Reviews &amp; Authorisations</b>
SC	<b>System Controls</b>
R	<b>Reconciliations</b> <small>Auditline Webinar December 2016</small>

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## What Stages are Involved in Reviewing Controls?

Stage Three - Assess the Systems and Internal Controls

### To Test or not to Test ...That is the Question

- 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.
- i.e. 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 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

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## What Stages are Involved in Reviewing Controls?

Stage 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
- Representative sample of transactions
- Likely to cover larger number of items than a walkthrough

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## Controls & the Revenue and the Receivables Cycle

STAGE ONE	Transaction Class Audit Objective	Account Balance Audit Objectives
	<b>Sales</b>	<b>Debtors / Receivables</b>
<b>Existence or Occurrence</b>	Recorded revenue transactions represent goods shipped / cash received / authorised deductions	Debtors balances represent amounts owed by customers at the balance sheet date
<b>Completeness</b>	All sales, cash receipts and sales adjustment transactions that occurred have been recorded	Debtors include all claims on customers at the balance sheet date
<b>Rights and Obligations</b>	The entity has rights to the debtor's balance and cash resulting from recorded sales transactions.	Debtors at the balance sheet date represent legal claims of the entity on customers for payment
<b>Accuracy classification and valuation</b>	All sales, cash receipts and sales adjustment transactions are correctly journalised, summarised and posted to the correct accounts.	Debtors represent gross claims on customers at the balance sheet date and agree with the sum of the sales subsidiary ledger
<b>Cut-off</b>	All sales, cash receipts and sales adjustment transactions are recorded in the correct accounting period	The provision for bad debts represents a reasonable estimate of the difference between gross debtors and their NRV.
<b>Presentation and Disclosure</b>	The details revenue transactions support their presentation in FS including their classification and related disclosures	Debtors are properly identified and classified in the balances sheet. Appropriate disclosures

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## Controls & the Revenue & Receivables Cycle

Stage 2 [See "A Typical Revenue and Receivable Cycle Within an Automated System"]

- Ordering & Granting of Credit
- Despatch & Invoicing
- Accounting

- Special Consideration
- Cash Sales

### Key Documents

- New Customer Request Form
- Sales Order
- Goods Despatch Note
- Sales Invoice
- Credit Notes
- Bad Debt Write off forms
- Customer Statements
- Aged Trial Balance
- Remittance Advices

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## Controls & the Revenue & Receivables Cycle

Stage 3 - Assess Systems & Internal Controls

- Revenue & Receivables (R&R) are normally a material figures in the Financial statements and are normally supported by a large volume of transactions which make it time consuming to test at the substantive stage and so the controls approach is normally preferred.

Some areas can be excluded from controls testing and instead a focused approach taken – such areas can include

- Receivables recovery – if risk existed in the past or if concerns exist regarding management's estimates made in the past.
- Cut off – if any concerns then will usually test substantively
- Complexity of business – difficult revenue recognition process
- Scope for fraud activity (although this can support both the control and substantive approach!)

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## Controls & the Revenue & Receivables Cycle

Stage 4 - Test the System of Internal Control [See text book]

Below we look at a principal business activity (PBA) within the R&R cycle and we ask ourselves what could go wrong within this PBA. Once we know the risk, we can ascertain the type of control that would address the risk. Finally we design the test to that will ensure this control activity is operational. Remember we are concerned with control activities that address risks and FS objectives (assertions).

Principal Business Activity	Risk (what could go wrong?)	Control Activities	Control Tests
Ordering and Granting of Credit	Customers with poor credit rating may get deliveries of inventory increasing the risk of bad debts	All new customers must be processed by the credit controller who performs a credit check and assigns a credit limit before permitting them to be set up on the system.	Obtain a list of customers set up in the period. Select a sample from the list and ensure all have been authorised for set up by the credit controller and have a credit limit assigned.

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## Controls and the Purchases and Payables and Payroll Cycle

- Stage One – Identify Risks and Objectives within each Financial Cycle

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## Controls & the Purchases & Payables Cycle

### Stage 2 Ascertain System and Internal Controls

#### Purchasing

- Ordering
- Receipt of Goods & Invoicing
- Accounting

- Purchase Requisition
- Purchase Order
- Goods Received Note
- Purchase Invoice
- Debit Note
- Aged Payables Listing
- Payment Summary / Proposal

#### Payroll

- Hiring Employees
- Authorising Payroll Changes
- Basis of Payroll Calculation
- Payment of Wages & Salaries

- Timesheet
- Payslip
- Gross to Net
- Exception & Control Total Report

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## Controls & the Purchases & Payables Cycle

### Stage 3 – Assess Systems & Internal Controls

- Purchases & Payables are normally material figures in the Financial statements and are normally supported by a large volume of transactions which make it time consuming to test at the substantive stage and so the controls approach is normally preferred. Payroll figures may or may not be material. Testing controls around payroll will depend on the variables / complexity within the payroll environment as if there are not too many variables payroll can be tested using Analytical Procedures

Some areas can be excluded from controls testing and instead a focused approach taken – such areas can include

- Accruals – if risk around unrecorded liabilities is deemed high or due to past experience

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## Controls & the Purchases & Payables Cycle

### Stage 4 - Test the System and Internal Controls

Below we look at a principal business activity (PBA) within the P&P cycle and we ask ourselves what could go wrong within this PBA. Once we know the risk, we can ascertain the type of control that would address the risk. Finally we design the test that will ensure this control activity is operational. Remember we are concerned with control activities that address risks and FS objectives (assertions).

Principal Business Activity	Risk (what could go wrong?)	Control Activities	Control Tests
Receipt of Goods and invoicing	Invoices are received for goods or services not received or for goods and services not authorised for purchase	All invoices received are matched against a valid goods receipt note. All goods receipt notes must be matched to approved POs	Obtain a list of invoices posted to the system during the period under review. Select a sample and trace to goods receipt note and related PO.

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## Other areas to consider in regards to controls

- Controls over **Bank & Cash** (The Cash Cycle)
- Controls and the **Inventory** Cycle
- Controls and the **Investment** Cycle

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## Relevant Questions

- Purchases and payables control system
  - Q1 August 2015 Part (a) and (b)
- Sales/Revenue and Trade Receivables
  - Q1 August 2016 Part (a) and (b)

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