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Essentiality of internal control in Audit process

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Abstract

Internal control in the audit process gains much attraction from the last few decades. One basic needs to understand the audit process is to understand the internal control of business organizations. Auditors cannot express and present their true opinion unless they do not understand the mechanism and system of internal control. The need to understand the system of internal control develops when audited financial statements used more for decision making for stakeholders.

The main objective of this paper is to emphasize the concept of internal control and its significance to comprehend the audit process. Further, the history of internal control with the auditing framework is also in discussion. This paper is based on the theoretical approach where the concept of internal control discussed the external audit process. This paper does not cover internal audits in the discussion, the discussion and concepts are limited to external auditing.

Analysis of internal control in the audit process is an important concern for auditors to express their opinion and provide assurance services. Good and strong internal controls are essential to assuring the accomplishments of goals and objectives. They provide reliable financial reporting for management decision making. They ensure compliance with applicable laws and regulations to avoid the risk of public scandals. Poor or excessive internal controls reduce productivity, increase the complexity of the transaction and finally add no value to certain activities. Good internal controls help ensure efficient operations and protect organization image.

This paper concluded the essentiality of the internal control system in the audit process as well as its urgency for meeting organization goals and objectives. It is recommended that internal controls should be proactive, and value-added. It plays a significant role in the auditing process and the report of external auditors based on the understanding of the internal control mechanism. The report of external auditors' further guides to stakeholders in their decision-making process. If it does not depict the true picture, then it damages the integrity of financial reporting.

Keywords: Internal Control, auditing, COSO framework

Introduction

Nowadays businesses operate in more competitive and challenging environment. Their success is based on the ability to adapt to the environmental changes and manage risks as the business structure evolves every day. At the

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beginning of 2000's corporate and accounting scandals resulted in collapses of companies like Enron and WorldCom (Lakis and Giriunas, 2012, p.146) [1]. This resulted in to tighten rules and many regulations in the form of Sarbanes-Oxley Act of 2002 and many other legislations. The purpose of all these laws and regulations is to assure shareholders and to minimise those risks which increased due to weak internal control or due to unclear internal control in audit process.

"Internal control is recognized as a key corporate governance mechanism and disclosure of information about internal control systems is viewed as a significant component in the process of restoring public trust in corporate probity in the wake of financial scandal". (Spira & Gowthorpe, 2008, p.5) [2]. "Internal Audit's objectivity, perspective, and skills can assist stakeholders and provide valuable insight". (McDonnell, Kinsella and Healy, 2017, p.1) [3].

Internal control is an essential part of the audit process in both public and private sectors. Internal controls are a companywide system of policies and procedures that provide some assurance services that the company is operating effectively and compliance to all applicable laws. Internal control system is the indication of company reporting process. Internal control includes planning of administration functions and filing a complete and accurate annual report. Because errors and fraud can do occur, it is important to establish safeguards to ensure adequate fulfil fiduciary responsibilities. For large multinational corporations, the internal control system could involve many layers of other control system, including corporate ethics and corporate governance.

It is easy to conceptualize that what happens when there is no established system of effective internal control. Without controls in place, employees could misuse the assets, assets can be misstated and company could be breaking laws. Effective controls reduce the risk of asset loss and help ensure that plan information is complete and accurate, financial statements are reliable and the plan complies with laws and regulations.

This paper focus on importance of internal control in audit process, here the term audit refers to external audit process only.

Background

The concept of internal control is said to recognise its history back to the beginning of the 20th century in US when audit on financial statements came into being. But its interpretation differs from early days, due to changes in business environment. In the beginning of 20th century the concept of internal control originated when Spanish-American war brought major changes in the business environment of US. The "sample testing" was introduced and system checks are established, which marked the birth of internal control.

In the era 1930 to 1940 the audit of financial statements become mandatory and then the role of auditor is to inspect financial statements to see if they comply with law and principles. As the business become larger and complex then it became impossible to ignore the aspect of business management which is the prerequisite of auditing process. In 1949 American Institute of Certified Public Accountants (AICPA) published a special report on "Internal Control", which signifies the importance of 'safeguarding of assets' and 'ensuring the reliability and accuracy of financial data'. This report however wider the scope of management function and auditor responsibility.

In 1977 after the scandal of Watergate and Lockheed, the internal control became mandatory for the first time by Foreign Corrupt Practices Act (FCPA). At this stage the idea of internal control has become extended and it is considered as a basic tool of audit process. In 1980, AICPA Treadway Commission and issued a report 'Fraudulent Financial Reporting', which emphasizes the importance of internal control and its necessity.

Finally, in 1992 the COSO framework (Committee of Sponsoring Organizations of the Treadway Commission) was established and issued its first publication, which cited three objectives of internal control; 'the effectiveness & efficiency of business', 'the reliability of financial report' and 'the compliance with applicable laws'. COSO framework broadened the scope and perspective of internal control. The COSO framework of internal control provided five components; 'control environment', 'risk assessment', 'control activities', 'information and communication' and 'monitoring'. Sarbanes-Oxley Act (SOX Act) was established in 2002 demise of Enron and WorldCom. SOX Act

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requires company management to assess the effectiveness of internal controls and disclose evidence documents. In 2010, due to developments and improvements in business environment the COSO updated its first version with PriceWaterhouseCoopers.

In Japan the concept of 'internal control' comes in use first time in 1945 and onwards. In 1950 the auditing standards were published which emphasized the importance of internal control system for businesses. In 1970, Japan Accounting Association issued a report titles 'Study of Internal Control Organizations in Auditing Financial Statements' which comprises into three categories; 'asset management', 'accounting management', and operation management'. From 1990 onwards, internal control become legal and COSO framework has been applied. Furthermore, in 2004, due to various cases of false financial reports by listed companies the 'J-SOX' was introduced, it was formulated in consideration of events that occurred after US-SOX Act. U.S. SOX Act is focused on "control activities" whereas J-SOX appears to be weighted more on "control environment.

From the history of internal control, it can be concluded that internal control was originally an accounting term, but the definition kept broadening with the growth of economy and businesses. Currently internal control system not only prevent and detect frauds and errors but also a system and procedure of management to achieve objectives of corporate management.

Internal Control

Internal control is a process, effected by an entity's board of directors, management, and other personnel, designed to provide reasonable assurance regarding the achievement of objectives relating to operations, reporting, and compliance (COSO Report,2013). COSO's Internal Control-Integrated Framework is widely recognized internationally, and part of its recommendations was used in Sarbanes-Oxley Act in 2002. The primary responsibility for internal control rests with management. The governing body is ultimately responsible for ensuring that management fulfils that responsibility.

Plan's policies, procedures, organization design and physical security all are part of the internal control process. There are many definitions of internal control. Lakis and Giurinas (2008, p.146) [1] write that the concept of the word "control" itself holds many definitions and meanings. They entail different goals, values, and achievements that will be implemented in organizations. Therefore, it can be expected that the concept of internal control can be defined in various ways. It can be understood differently each time depending on situation.

In 2008, Hightower (p. 27) [4] defined internal controls as "program of activities established to catch and monitor a potential exposure that could result in a significant error, omission, misstatement, or a fraud".

The most inclusive view on the role of the internal control in organization or enterprise is presented by the internal control framework. It connects definition and main components of internal control. In this research, the role of internal control is represented by the Internal Control Framework developed by COSO. COSO Framework is the most widely recognized and implemented. Moreover, it is also well developed, being published already in the year 1992 and recently updated in 2013. Therefore, it gives comprehensive knowledge on the subject.

As mentioned earlier COSO framework has five essential components of internal control, control environment, risk assessment, control activities, information and communication and monitoring. It is depicted in the form of cube which represents that all five components have impact on each other, and these are connected.

First component 'control environment' indicates the internal beliefs, ethics and values about control system, specifically the management behaviours towards control system which they communicate with organization. Second component 'risk assessment' specifies the management efforts to assess the risk and highlight the areas where greater risks can be existing. Third component 'control activities' refers to control system, which consist of separation of duties from authority. Fourth component 'information and communication' stipulates internal and external ways of communication and how they organization exchange the information. The fifth component 'Monitoring' raises management monitoring of control system and ensures that problem is communicated, and solutions are found.

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It also assesses the quality of internal control performance over time (Whittington, 2001, pp247-253) [6]. Internal control over financial reporting consist of preventive controls, detective control and corrective controls. The main purpose of preventive control is to avoid the occurrence of misstatements in financial statements. Defective controls are designed to discover and finding out the misstatements after they occurred. When detective controls discover a misstatement, a corrective control is commonly needed to remedy the situation.

The role of internal control is to help the organization achieve specific goals and objectives. It is vital that all organizations structure should comply with internal control components. Internal control system brings numerous benefits to organization (Uzun, 2009, pp.46) [5]. Application of standardized procedures, rule and regulations will be probable. Internal control system provides security on assets, reliable financial reporting, element of corporate governance and desired for effective audit process.

Internal Control in Audit Process

Performing an audit on internal control system is an important component in audit process. It helps the auditors to provide maximum assurance services regarding the preparation and reporting of financial statements for stakeholders. An audit of internal control over financial reporting is integrated with an audit of financial statements.

There are different steps under which the external auditor passes on to perform audit process on organization. Internal control is more closely and directly connected to these steps. Auditors obtain an understanding of the client and its environment, including internal control as well as perform different audit procedures. The auditors use risk assessment procedures and obtain other evidence, which allows them to assess the risk of material misstatement.

It is responsibility of auditor to understand the environment of business and its management structure, also obtain sufficient information about management’s attitude, action and behaviour concerning the control environment. The auditors should obtain an understanding of the client’s process for identifying and responding to business risks. This enables auditors to identify the risk of material misstatement. Auditors’ should need to actively scan the environment to identify different changes in organization structure, which may lead manipulation of information.

While obtaining an understanding of the other control components the auditors should obtain knowledge about client and understanding of documents. This can be done when auditor perform different tests of control. Auditor should familiar and understand accounting terminologies, transaction cycles, payroll cycles and acquisition process. Finally, auditors should obtain a sufficient understanding of the entity’s monitoring methods relating to financial reporting to understand how those procedures are used to initiate actions to address inadequate performance. Internal control is a basic tool of corporate governance as well. Corporate governance is the system by which the companies are controlled and directed. Corporate governance is therefor about what the board of a company does and how it sets the values of the company. Recent changes in business and accounting environment highlighted the critical role of corporate governance in effectively managing internal control system. Board of directors are closely monitored and engaged with the internal control system and the achievement of corporate governance based on superlative internal control system.

Ideal internal control system can be developed with the extensive segregation of duties and responsibilities, where no one person will deal or handle a single transaction from the beginning till end. However, in large businesses, it is considered easy to achieve effective internal control system but at the same time difficult to find the faulty areas. Whereas in small organization, where two or more than two employees are working and each employee is responsible for entire transaction, can be difficult to identify the misstatement. In small organization internal control tends to be weaker due to lack of staff, so the duties and responsibilities cannot be divided sufficiently. However, if proper records are mentioned and the business record all transactions then internal control can be stronger even in small organization with few numbers of employees.

Summary & Conclusions

From the above discussion it can be concluded that strong internal control is the key to business success and essential for healthy profits. External audit process mostly based on internal control system, if the organization has

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clear delegation and segregation of duties then it will be quite clear and easier for auditors to form their opinions and provide assurance services.

Auditors perform different type procedures and try to accumulate information about company performance including internal control system. Recent issues in auditing has call an urgency on the need of effective control system. Stakeholders are relying on auditor's financial statements which put pressure on auditors to provide their report with clear determination.

COSO framework is also considered a major development specifically in the field of auditing the internal control system. It provides guidelines and principles to auditors to understand the procedures of auditing and assess different aspects of business where they can form their opinion about the internal control and then further provide assurance services.

This paper focuses on significance of internal control in audit process and particularly in the light of COSO framework. For future research purposes, the scope can be expanded when we combine internal audit with external audit, also with other aspects of management activities. However, this paper currently provides the generic view on the essentiality of internal control system, whereas the details of transactions cycle and other aspects of business transaction are not considered and considered as limitation of this paper.

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