Accounting and Internal Control Systems Evaluation and Audit Quality

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ABSTRACT: This study is on the evaluation of accounting and internal controls systems of an organization and its effect on quality audit. The evaluation is to serve as a basis upon which the external auditor is to obtain basic knowledge of the systems and to decide whether or not to rely on them and to what extent of such reliance so as to ensure quality audit. Descriptive research design was employed to describe the basic processes involved in evaluating the systems. The outcome revealed a basic knowledge that the management is responsible for the establishment and maintenance of an effective Accounting and Internal control system, but it is the duty of the external auditors to evaluate and ascertain the effectiveness of these systems in order to decide whether or not to place reliance on the existing systems and to what extent would be such reliance. The basic processes involved in the evaluation of the systems as well as the methods (Narrative Notes, Flowcharts, and Questionnaires) that could be employed were highlighted. Communication of the outcome of the evaluation to the appropriate authority were also described and a conclusion drawn.

Keywords: Accounting System, External Auditor, Flowcharts, Internal Control System, Narrative Notes, Questionnaires and Reliance

I. INTRODUCTION

The establishment as well as the maintenance of accounting and internal control systems that is effective is the responsibility of Management while the audit committee is to oversee these systems and to review them in order to ascertain their effectiveness. The external auditor on the other hand, is to review and assess these systems to enable them to both have an understanding of the systems and to decide the level of reliance to be placed on it so as to produce a reliable audit report (26). The provision of reasonable assurance that can guarantee that all aspects as it affects policies, processes, tasks and behaviors of an organization, taken together, facilitate its effective and efficient operation is provided by an effective internal control system and it helps to ensure that the quality of internal and external reporting is maintained in accordance with the relevant and subsisting laws.

The ability of an auditor to rely on the accounting statements and other reports produced by its clients depends greatly on the adequacy of the recording and processing of the transactions of the accounting system of the firm as well as the internal controls that are in place in such an organization. Recently, the importance that is attached to financial statements together with the purpose of these financial statements is on the rise as the day go by not leaving out the users thereof. A lot of decisions are made using these financial statements and this to a very large extent could result to a level of manipulations and cooking of books by the managers or those saddled with the responsibility of preparing and presenting these financial statements. 6 opined that the speed with which data and accounting figures are manipulated has increased thereby making the objectives of reviewing the financial statements to verify the credibility and values contained in the financial reports for the shareholders to be reassured very essential.

37 opined that scandals like the Waste Management of 1998, Enron of 2001, WorldCom of 2002, AIG of 2005, Cadbury Nigeria of 2006 and BHS of 2016 are a few among revealed situations showing that companies are engaging in practices that are unethical through the omission of important information or by doctoring the financial information to hide fraudulent activities that have occurred. Requiring that auditors of a necessity need to evaluate both the accounting and the internal control systems of their clients to ensure that they are good enough to be relied on. The extent to which an auditor will rely on the internal control system and the entire accounting and recording system will be a function of the outcome of walk-through-test of the firm’s recording, accounting and internal control systems.
Auditors generally desire that internal controls existing in a firm is reliable enough so as to reduce the level of substantive testing to be carried out during an audit process and this leads the auditor to attempt to evaluate the client’s system that is, the accounting and internal control systems to have an understanding of these systems and to verify their reliability. Auditing is the independent examination of financial statements of an organization by a certified accountant. It is a process of diligent examination of financial records or documents prepared by responsible officer, so as to give an opinion on the truth and fairness of the prepared account (34). It is therefore necessary for the auditor reaffirm the efficiency of the system that produced the financial systems that they are to examine. This paper therefore, attempts to describe the various tools that are available at the disposal of the auditors to enable them evaluate a given accounting and internal control system.

II. REVIEW OF EXTANT LITERATURES

2.1 Conceptual Review

2.1.1 Accounting System

Companies adopt various methods of recording and reporting their accounting transactions known as accounting system which is generally required by law that companies need to providesome financial and management reports to the stakeholders as these reports are important business tools for decision making (34). Furthermore, 35 defined accounting system as the manner in which the accounting transactions and records are organized and used within an organization. For a desirable and effective audit to be carried out, the auditor will need to have an understanding of the accounting system of the client as well as its effectiveness and this is done by tracking and ascertaining the recording system so as to assess whether it is adequate for the preparation of the financial statements and reliable for audit process.

The extent to which the auditor is to record the client’s transactions and the method to be used would depend on the complexity and nature of the system and the degree of reliance the auditor plans to place on the existing controls. To be able to understand the accounting and control systems of the client, auditors often embark on a walk-through-test. 16are of the opinion that external and internal auditors use available information to come up with opinions about how fair and reliable the financial statements are. Again, the planning process of audit involves audit programs preparation by assessing the internal control and confirming that it is efficient enough to be relied on for quality audit (30).

2.1.2 Walk-Through Test

Walk-through test as the name implies is the test of correctness and understanding of description of the system which is achieved by taking a few of the transactions of each and check through them. Walk-through test means tracing a particular transaction from the point of initiation through all the possible stages to the final entry in the books of accounts of an entity and it involves carefully looking at all documents and records that were produced, the manner with which they were prepared and the internal controls applied too (2). It is a situation where an auditor picks up a transaction and monitors it through the system to see if all the controls that they expected to be in place are really existing and in operation with regard to that transaction.

It is at this point that the auditor picks up a particular transaction and traces it through the system to see if all the controls that are expected to be in existence were both existing and in operation as it affects that particular item of transaction (3). Walkthrough test is a form of peer review in which a work product is examined by the author along with one or more colleagues to evaluate technical parts of the product. It is a full description of the accounting system to participants and asks them to write some comments regarding the technical quality or document content. Walkthrough review is informally conducted to gain feedback about the technical content of the accounting system or product (7).

2.1.3 Internal Control System

22 internal control system is defined as “the process designed, implemented and maintained by those charged with governance, management and other personnel to provide reasonable assurance about the achievement of an entity’s objectives with regard to reliability of financial reporting, effectiveness and efficiency of operations and compliance with applicable laws and regulations”. Internal control systems are said to be the official, information-based routines and procedures that are used by managers to ensure that errors and frauds are detected and or prevented and the company’s assets safe guarded. Internal Control Systems greatly influence firm performance and quality audit (44).

Internal control as a concept, is wide and covers a whole range of policies and procedures of controls put in place by an entity to enhance the likelihood of achieving its set business goals and can be seen as a group of policies and procedure that are enshrined in the system to form control on entity's activities so as to ensure that the entity followed the objectives set by management and board of directors and to achieve same (8 and 45).
Control system is an important instrument for both making sure that the quality in the form of the value and usefulness derived from the accounting information and for the purpose of monitoring and improving activities is achieved (14).

“Internal controls are all the measures which are put in place by those charged with governance to ensure relative confidence about proper implementation of affairs and compatibility to the imposed regulations and policies so that operation’s efficiency and usefulness is increased and predetermined goals are achieved and these include organization’s plan and coordination of all procedures listed in an organization which are prescribed to protect the assets, deal with accuracy and reliability of accounting data, promote and encourage efficient operations management” (42). It is the strategies put in place by firms to guarantee the integrity of financial and accounting information, meet targets of operations and productivity and transmit all administration arrangements through the association (4, 31 and 17).

2.1.4 Internal Control in Audit Process

Internal control is saddled with the controls operative in every area of a firm’s activity as well as with the way in which individual controls inter-relate with each other (15). Carrying out an examination of the control system is an gamine aspect of an audit process because it will help the external auditors to maximally provide the needed assurance services as it affects preparing and reporting of financial statements to shareholders and other stakeholders (48). 14 stated that the foundation of ethical and professional auditing is independence and therefore opined that the auditing of accounting information is needed for a report that is much more reliable that is needed to provide the anticipated confidence level to both the internal and external users. Different steps are undertaken by the external auditor to perform the needed audit process on the organization’s internal control system.

To be able to get a clear understanding of the client’s working environment which includes the internal control system, auditors often carry out different audit procedures to obtain the needed evidence such as risk assessment procedures which often gives them the ability to assess the level risk of material misstatement. 33 opined that these control activities ensures that the directives of management are duly undertaken such as the necessary actions needed to be carried out to help minimize the risks that inhibit the achievement of the firm’s desired objectives. 32 opined that before starting an audit procedures, there are some aspects of Internal controls that needs to be examined especially as it relates to the reliability of all evidences gathered about the various segments of control system and these are used then prepare an audit program that will help to underline the fact that internal control assessment is an essential process for the audit planning as well as the audit process math.

39 alluded that statutory auditor’s board are not only involved in the just the monitoring of control’s efficiency, they also carry the role of supervision role of last instance in the subject which is not limited to a mere examination of the functioning of the system but also helps to pass a judgment on its overall design, stability and effectiveness. Audit planning requires the auditor to gather and analyze all information needed to adequately identify the risk of material misstatements, whether due to fraud, evaluate these risks after assessing the organization’s internal audit and control program and feedback (38). 48 opined that internal control is an important part of the audit process in both the public and private sectors and it is a companywide system of policies and procedures that provide some level of assurance that the company is operating effectively and in compliance to all applicable laws.

2.1.5 Recording Control Systems

One of the first things that the auditor has to do in a new auditing job is to record the client’s accounting system. This will allow the auditor to evaluate the internal control system which will also enable the audit to be conducted more efficiently. Recording is the creation of documentary evidence of the transaction and its entry in the accounting records. 29 the assessment of the internal control systems is important to the process as controls may reduce some of the risks that would otherwise lead to material misstatements. Where it’s a repeat audit, the auditor must ensure that their records of the client system are updated and remain accurate. The Auditors must keep a record of the client’s systems which must be updated each year and this can be done through the use of narrative notes, flowcharts, questionnaires or checklists.

These techniques for recording the assessment of control risk or the system can be used depending on the nature and complexity of the system as well as the degree of reliance that the auditor anticipates to place on the system. 1 opined that in order to ensure reasonable assurance about the accomplishment of the company goals, monitoring describes the process of measuring the consistency of the system for internal control over time. 48 opined that while trying to have an understanding of the other control components of a firm, the
auditors should also obtain good knowledge about the client and an understanding of its documents. This he said can be done by the auditor performing different tests of control and by familiarizing with and understanding the accounting terminologies, transaction cycles, payroll cycles and acquisition process.

2.1.5.1 Narrative Notes
The main reason behind the narrative notes is to describe and explain the system, as well as making any comments or criticisms at the same time which will help to demonstrate an intelligent understanding of the system (3). With narrative notes, the auditor simply writes a few paragraphs explaining, for example, exactly what happens to a supplier’s invoice when it’s received; how it may be matched with goods received notes, how the calculations are checked, how is it filed, how it is posted to the payables ledger, and how the amount is eventually paid. Narrative notes can be relatively quick to prepare. Typically you observe what happens, you ask the client what happens, and you may also look at the accounting procedures which they have established more formally. 41 stated that auditors after adopting the new audit approach, now use narratives more often instead of other formats because of the perceived improvement of audit efficiency and high flexibility of narratives that can always fit well into the new audit approach.

2.1.5.2 Flowcharts
Flowchart is one of the most effective techniques that is being used to capture the flow of transactions and their associated application and manual controls that is used within an end-to-end business process, as they illustrate transaction flows. Due to the difficulty of fitting the actual control descriptions on the flowchart, it is prudent to instead simply number the controls on the flowchart and have a separate document, such as a risk and controls matrix that contains the control descriptions and associated information. However, flowcharts may not be applicable all of the time (9).

In flowcharts, diagrams are used to show the documents, the files, the calculations, and the checks that are performed. Flowcharts can be somewhat slower to produce and are certainly more difficult to amend (though nowadays, flowcharting has been helped greatly by computer graphics systems). Flowcharting imposes a great discipline on how systems are recorded as it has very specific rules about how flowcharts are to be drawn. In addition, there is usually a special symbol which is reserved to show where checks are performed. Auditors are particularly interested where checks are performed because this is helping the client to reduce their control risk. Flowcharts can take many forms, but in general are graphic illustrations of the physical flow of information through the accounting system. Flow lines represent the sequences of the processes and other symbols represent the inputs and outputs to a process. A more elaborate flowchart representation helps to facilitate the audit of a business process and also increases the audit effectiveness (10).

2.1.5.3 Questionnaires
Questionnaires can be used to record the accounting system, but they go slightly further than mere recording: they actually begin to evaluate the accounting system. Auditors who make use of an internal control questionnaire are likely to identify internal control design weaknesses than auditors who prepare a narrative (12). Auditors mostly use narratives which is followed by questionnaires and flowcharts (41). In recent times, auditors collect and evaluate information on several fundamentally different documentation formats ranging from flexible narratives to structured aids like questionnaires or matrices to graphical formats such as flowcharts or organizational charts (11). 13are of the opinion that the questionnaire’s elements can be different from one entity to another taking into consideration the influence of the vision of each manager as well as the opinion of the audittees regarding the ways that internal audit could deliver more added value.

2.1.6 Revision of Risk Assessment, Audit Strategy and Audit Plan
The auditors may find that the evidence they obtain from controls testing indicates that controls did not operate as well as they expected. If the evidence contradicts the original risk assessment, the auditors will have to amend the further procedures they have planned to carry out. In particular, if controls testing reveals that controls have not operated effectively throughout the year, the auditor may have to extend substantive testing. Revising the risk assessment and audit procedures will necessitate an update of the audit strategy, which sets out the scope, timing and direction of the audit. For example, if tests of control highlights that many controls are not operating as expected, this may lead to an increase in the strategy’s emphasis on substantive procedures.

2.1.7 Communication of Deficiencies in Internal Control
Significant deficiencies in internal controls should be communicated in writing to the management. 22 states that the auditor should communicate appropriately in writing and on a timely basis to the management any deficiency in internal control that was identified during the audit which the auditor considers are of sufficient importance to warrant their attention. It requires the auditor to determine whether one or more deficiencies in
internal control have been identified and if so and if they constitute significant deficiencies in internal control. The importance of a deficiency depends on the magnitude of the misstatement and its potential effect on the system and audit outcome.

2.1.8 Impact of Deficiencies on the Auditor’s Reliance on Internal Control

If the controls are not adequately designed or not operating effectively, the auditor needs to revisit the risk assessment and design sufficient substantive testing over that financial statement are. Therefore, where significant deficiencies are identified, unless there are robust compensating controls, the auditor will have no choice but to use purely substantive procedures to obtain sufficient appropriate audit evidence. The auditor will not seek to place reliance on internal controls (22). It may be that the deficiencies were not identified during planning and risk assessment, but only become apparent later in the audit process. If this is the case, and the original audit plan was based on a reliance on internal controls, that audit plan will need to be amended, with the likely result that further audit procedures will need to be performed. These communications should include a vivid description of the identified deficiency, its likely impact on the entity’s reports and likely solution to the identified deficiency.

2.2 Theoretical Review

The theoretical framework upon which this work is anchored on is the Theory of Inspired Confidence and the Lending Credibility Theory and they are discussed below:

2.2.1 The Theory of Inspired Confidence

Prof. Theodore Limperg propounded the Theory of Inspired Confidence in 1932. The theory posits that the demand for the services that an auditor renders arose because of the participation of other stakeholders other than the shareholders in an organization. The shareholders demand accountability from the managers of the firm for the capital contributed to the firm left for them to manage on the behalf of the shareholders. Due to the lack of trust existing between the shareholders and the managers, the auditor is needed to audit the information provided by the managers to the shareholders and in order to express their opinion to the truth and fairness of the financial report presented and to bring the level of assurance that will both satisfy the shareholders as well as the managers. The audit report will as also to a great extent should be able to meet the desire of the public expectation as well.

2.2.2 Lending Credibility Theory

Lending credibility theory suggests that adding credibility to financial statements is an integral part of auditing, making it a fundamental service auditors provide to clients. Audited financial statements boost users’ confidence in an organizations financial records and management’s stewardship; in turn, improving their decision quality such as, investment or new contracts, based on reliable information. This is because stakeholders need to have faith in the financial statements. The credibility gained by financial statements would affect decisions by stakeholders and also helps shareholders put trust in management; reducing the ‘information asymmetry’ between stakeholders and management. The study according to 24 opined that the lending credibility theory suggests that the primary function of the audit is to add credibility to the financial statements. This theory regards the primary function of auditing to be the addition of credibility to the financial statements. Audited financial statements are used by management (agent) in order to enhance the principal’s faith in the agent’s stewardship and reduce the information asymmetry (40). The lending credibility theory which is mostly seen from the management point of view where and a firm is therefore use their audited financial statements to enhance the stakeholder’s faith in the management.

2.2.3 Reliability Theory

Reliability theory is a theory that tries to describe the probability of a system being able to complete its expected function during an interval of time (19). The theory postulates that internal control systems are primarily set up for the assessment and control of risks within an entity and opines that weak internal control systems result in more substantive auditing work and hence produces greater cost (25). 19 opined that the determination of the weakness of any internal control system is mainly judgmental. Therefore, the formulation of the process and system reliability estimates, comparison with financial data from the organization’s past performances may will likely provide a more solid basis for judgment of the impact the internal control system will have on the firm’s income risk.

28 stated that one of the main advantage of the reliability theory is its close relationship to the needs of an organization as regards understanding the internal control system and control risk assessment of the entity. Theory of inspired confidence, lending credibility theory and reliability theory are all relevant to this study as they all intend to bring about the boosting of the confidence of the shareholders and other stakeholders on the reports presented by the managers to them through the work done by the auditors.
2.3 Empirical Review

42 worked to identify and determine the impact of effective internal controls on audit process applying survey design and data were analyzed and examined by SPSS and LISREL statistical software. The results obtained from the study showed that though the internal controls do not reduce the audit time and cost, they can reduce incidental auditing during the period. The results also indicated that the effectiveness of internal controls can enhance the quality of audit, and increase the detection of significant errors and distortions. It can also increase the credibility of financial statements. 44 carried out a study to ascertain the impact of Internal Control System on Financial Performance of Microfinance Institutions in Central Region –Uganda. The study employed quantitative-qualitative methodology and cross sectional and correlation designs to analyze the data and the study revealed that internal control system is strongly and positively correlated with financial performance while its elements were found to be positive predictors of financial performance.

45 on the effect of internal control on performance of commercial banks in Nigeria used a survey method as well as stratified random sampling technique to administer a total of 382 questionnaires to either staff of operations, marketing, or security department in the Nigerian commercial banks. The study showed that there is a positive and significant relationship existing between the control environment, control activities, monitoring and risk assessment which are the four components of internal control and bank performance. 32 conducted a research to examine the relationship that exists between components of risk assessment, environmental control and control activities of internal control system and how it affects the effectiveness of the audit program in Vietnamese firms. Data were collected via questionnaires sent to management, internal auditors and accountants and analysis of variables and findings show that control environment, risk assessment and control activities contribute significantly to an effective audit program.

29 on Internal Control assessment and interference effects, found that auditors who first identified risks, identified more and importantly, internal control deficiencies than did auditors first identifying controls. In all, the results suggest that audit efficiency and effectiveness depend on the sequence in which internal control evaluation subtasks are carried out by the auditors. 43 carried out a study on addressing fraud risk by testing the effectiveness of internal control over financial reporting case of Romanian financial investment companies and findings showed that internal controls have considerable impact on reliability of prepared financial statements and significantly influence investment decisions. Hence, auditors should properly evaluate fraud risk factors. His research findings showed that increased effectiveness of internal controls reduces fraud risk in financial assets. Internal control and audit contribute majorly to responsible reporting, the increase of confidence and makes available opportunities for the capitalization and usefulness of accounting information for the management (14).

III. METHODOLOGY

The design adopted for this study was review and descriptive research. Some related scholarly literatures on evaluation of accounting and internal control systems on audit quality were reviewed for this study and a vivid description of the evaluation methods and processes carried out to bring about the required understanding of the accounting and internal controls systems was done. 48 concluded that internal control system is essential in the audit process and in meeting the organizational goals and objectives and recommends that internal controls should be proactive and value-adding as it plays a significant role in the auditing process and the report of external auditors based on the understanding of the internal control mechanism.

IV. CONCLUSION

In conclusion, this study was able to highlight that the establishment and maintenance of the accounting and internal control systems is the responsibility of management. The external auditor needs to evaluate both the accounting system and internal control system to enable him have a good understanding of these systems and how effective that they are so as to enable him decide the level of reliance to place on the system as well as the level of work to be done in order to produce a reliable audit report to the entity’s shareholders and other relevant stakeholders. The use of walk-through method could be employed to evaluate the accounting system and the narrative notes, flowcharts and questionnaires could be employed to evaluate the internal control system. Where there are deficiencies noticed by as a result of evaluations, the auditors will then need to come up with appropriate planning and strategy for the audit which will be needed to be put in place for a reliable audit report. The deficiencies will also need to be reported to the management too by the auditors to enable the management seek for possible solution and correction. Where the systems are computerized, the appropriate evaluation of both the general and application controls are also outlined.
REFERENCES


