

Smart Mandatory Audits Analyzing Impact of Controls' Effectiveness on Audit Efficiency and Economy

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It is said that what counts is not the hours you put in your work but the work that you put in the hours.¹ SAI auditors are expected to be cost and quality conscious and audits they perform have to be efficient and effective.² How can auditors fulfil these expectations? They are advised to channelize their energies on the essential and necessary work only and ward off the tendency of having too much on their platter. That makes sense and serves as strong base to efficient audits-ones that typically use minimum resources to achieve their objectives. The pre-requisite to this approach is that audit management at all levels is sensitized about the cost of audit and of the need to keep this to minimum. There is a need to instill in the workforce pride to work more using minimum financial, human, time and other resources. In the long run it will improve the cost-benefit ratio of the SAI and would fulfil basic expectations from SAIs to manage their “operations economically, efficiently, effectively and in accordance with applicable laws and regulations, and report publicly on these matters, as appropriate.”³ A SAI therefore needs to be appreciative of the cost of audit at all stages of audit work. SAI Pakistan conducts several types of audits. Among these, only financial audits are categorized 'mandatory' audits. Financial audits are a type of regularity audits. The applicable law requires these audits to be performed and reported every year.⁴ The rest are all 'discretionary' audits and the SAI has considerable leverage in determining the frequency of these audits on the basis of their perceived relative importance. Audit planning guidelines require that, on annual basis, we assess our resources and, as a first step, make allocations for mandatory audits.

Discretionary audits will have to be managed from left-over resources.⁵ That vindicates our case for smart and efficient mandatory audits as resources saved from these could be utilized to audit high-risk and high-profile issues of broader public importance where there are strong perceptions about non-compliance and/or serious compromises on the VFM front. There are additional benefits in terms of keeping audit deterrence at its optimum level, increasing the frequency of discretionary audits and facilitating client entities by having them wait no longer than necessary for audit to find time and do its job. Conversely, ignoring the issues that are in public debate and are of high risk and materiality coupled with absence of audits for considerable time period may pose or increase reputation risk of the SAI and also cause laxity in client entities in maintaining record for audit, taking action on previously identified deviations, errors and irregularities. How can we make our mandatory audits smart and efficient? One very workable and practical way to do that is by considering the overall sources of assurance available to the SAI auditors when performing mandatory audits. There are three main sources of assurance: assurance from inherent organizational environment, assurance from the internal controls

¹<https://www.amazon.com/Its-Not-Hours-What-Ewing/dp/B004YKUTBC>

²ISSA-100/48-Fundamental-Principles-of-Public-Sector-Auditing

³INTOSAI-P-12/8- The Value and Benefits of Supreme Audit Institutions – making a difference to the lives of citizens

⁴Section 7 (Auditor General's ordinance, 2001)

⁵Para 2.3.6 (d)(7), Financial Audit Manual, Department of Auditor-General of Pakistan, 2012

and assurance from substantive testing by the auditor. The last one typically depends on the first two sources. Inherent environment is given and we do not have much leverage in that. The applicable guidelines bind SAI Pakistan not to seek assurance from inherent environment beyond 60%. This limit is basically the maximum and, on a realistic level, inherent assurance may be in the range of 30-50%. That leads us to look towards internal controls and if they have adequately plugged the areas where inherent risks were on the higher side, then there is some hope that we may derive some assurance from the internal controls and thus burden the limited and finite resources of the SAI to the minimum. However, this is not possible unless we audit the internal controls. In other words, let us make our substantive audit work dependent on our evaluation of internal controls. Sometimes auditors prefer not to test the efficacy of internal controls and assume that control risk is maximum (100%) in view of their knowledge of the entity and on the basis of previous audit findings and their follow up. They accordingly go on to perform substantive testing directly. While this approach may lead to reduction of risks for the auditors as they operate with the maximum sample size, in all likelihood, it may unnecessarily increase the workload of the auditors and consume more resources of the SAI on consistent basis contributing to inefficiencies in audit planning, performance and reporting. What should be equally worrisome for us is that entity management and stakeholders with oversight responsibilities may well be deprived of critical audit input on entity risk assessment and control systems and strengthen the traditional view of audit as a destructive villain and not as a partner and helper to the management in finding ways to achieve good governance. Therefore, it would be in the interest of audit as well as of management that auditors perform a formal assessment of internal controls and on the basis of conclusions drawn, determine the quantum of substantive audit. This is one way to make smart the mandatory audits. Auditors may arguably question the utility of testing controls when the result is already known: non-existent, inadequate and not reliable controls. They would say that being regular auditors, they have developed an adequate level of understanding of the client entity and know exactly the condition of controls in these entities. Testing controls and then performing

substantive testing would increase cost and not decrease it, they would conclude. While we may not reject this thinking and approach outright, we should contend that this scenario may hold true for a year or two but ultimately, in the medium to long term, extent of substantive testing by audit would decrease drastically as management will now have specific audit findings, conclusions and recommendations on their control systems and with auditors pushing on the implementation of new controls or strengthening of existing ones, the overall control environment would see improvement. To implement our recommended strategy, we need an understanding of the controls, their objectives and motivations for the management to invest on controls. Why would the management need internal controls? What is the motivation behind investment on internal controls? What is the process of establishing internal controls? How are the internal controls reviewed by the auditors? How do the SAI auditors audit the internal controls? How to draw a representative sample for testing internal controls as well as for evaluating their effectiveness using Audit Command Language (a type of CAATs)? How is substantive testing influenced by effectiveness of internal controls? The process whereby we answer these questions will lead us to perform smart audits. Let us recall that internal controls are established to ensure that assets of the organization are safeguarded, reliable financial information is produced and laws are respected. It is the responsibility of the management to establish, maintain, review and continuously improve the internal controls so as to help achieve objectives.

BOX-1

Now a days we see that clothing outlets have small anti-theft tags attached to their individual pieces (assets). These starts making beep sounds whenever an attempt is made to take the item outside a pre-defined radius. When the customer makes the payments at the cash counter, these are removed. This is an internal control put in place to safeguard assets of the clothing outlet. This control is the result of risk assessment that indicated likelihood of clothes being stolen or misplaced from the shop causing loss to the business. Some control was therefore needed. In addition to other controls, this control was established and has made its acceptance across the clothing outlets. However, the control needs to be checked for continued efficacy so that the search remains open for better, more effective and more economical controls.

Several controls exist in government departments. Controls in one government department may vary in nature as well as in intensity depending on the overall control environment and management's attitudes or the tone at the top. Some of the common types of controls target the budgeting process, exercise of financial powers by the government functionaries, procurements, accounting, financial reporting, record keeping etc. Cash books and asset registers, for instance, are two very basic controls that are supposed to exist in all government entities. The use of technology in the field of internal controls is benefitting the corporate and public entities alike. For instance, making payments using bio-metric controls does add credibility to the process. Auditors must take advantage of the entity controls and after evaluating their efficacy make calculated reliance on these. Controls cost money and money spent by government on establishing these controls could at least be compensated by the SAI when it relies on these and accordingly reduces its extent of audit that in turn saves the public resources at the disposal of the SAI. Box-I illustrates the extent to which electronic controls are helping safeguard the assets. The process of establishing internal controls is a bit complex. As a first step, management needs to understand risks pertaining to achievement of objectives. This understanding comes from periodic as well as on-going risk assessments that help the managers assess where controls need to intervene. Risk assessment therefore precedes establishment of internal controls. Risk assessment of internal controls starts with two questions. What can go wrong and what would be the impact if it does go wrong? This is the assessment of inherent risk. While determining the inherent risks, we enter into a hypothetical environment where there are no internal controls and then assess the risks to assets, tasks, transactions and events in the bare environment. Imagine you are in far off area away from the noise of city life and suddenly you find that there is a USD 100 note right on the road. What would you do? There are several possibilities. For simplicity let us stick with these two. You ignore it and move ahead or you pick it up and keep in your pocket. Remember that there are no internal controls here and you do not have any consequences to face. Take this example to your organization. The cash chest is always open and is unguarded and daily you see the money carefully

staked. What would you do. Again, imagine there are no controls in place. No cashier. No CCTV. No lock and keys. No restricted access. Your organization trusts its people and has not established any internal controls over cash. You decide one day to appropriate a USD 100 note and you get away with it. But this act of yours alerts the management and make them realize that gone were the times when they could trust the intrinsic values of the human beings and therefore, they decide to put the cash under lock and key, put a CCTV camera focused right on the cash chest and appoint a person to physically control access to the room as well as record all cash in and out. This is how controls are conceived. This would cost a lot of money but management considers it necessary weighing the benefit-cost ratio. Conclusion. Risk assessment or understanding of the inherent risks lead the management to establish internal controls in the areas where risk of loss, misappropriation, theft, non-compliance and defective reporting is on the higher side and the impact is very high. Controls are not needed everywhere but only in those areas where there is high likelihood and significant impact of non-achievement of objectives. Where there is low likelihood and low impact, then internal controls are either not established or established if cost-effective. SAI auditors should be wary of excessive internal controls and should watch that management is not spending a pound to save a penny! Sufficiency or adequacy of controls is also required to be determined. Having said that, it remains a fact that internal controls may minimize chances of loss, defective financial reporting and non-adherence to the regulatory regimes but these cannot eliminate it. Internal controls may prevent some of the errors some time but they will not be able to prevent or detect all of the errors all the time. Consider a typical procurement episode. It is considered a high-risk event. Therefore, management need to put action controls over it. They separate ordering, approving, sanctioning and payment authorities and introduce team-based decision making by constituting a procurement committee which is different from inspection committee and both these have nothing to do with the payment authorities. What is the utility of these 'internal' controls for the 'external' auditors? The presence of these controls may considerably

minimize the risks pertaining to mis-procurement, however these would not eliminate it collusion among those approving, ordering, processing, receiving, paying and receiving the procured goods and services cannot be ruled out. Internal controls therefore would be giving SAI auditors reasonable assurance only and they should feel contented with it. In fact, they know this and that's why do not plan their audits to obtain all the assurance from the internal controls. If controls in a specific component are assessed to be good in Year 1, external auditors can place reliance on these as appropriate. If these get better in Year 2, they can increase their reliance and if these prove to be best in year 3, they can place maximum reliance on the controls. However, despite

this high dependence offered by the internal controls, the external auditors are not authorized to obtain all their assurance from the controls even if these have been assessed to be excellent (up to 80% control assurance is admissible). Reasons are so many. Collusiveness as explained above could be one factor. Auditors taking a sample to test the effectiveness of controls could be another reason. On the other hand, if controls are found to be bad and get from worse to worst, auditors place limited or no reliance on these. The latter would increase cost of audit as now more assurance will have to be provided by auditors through substantive testing which is a

Box-II

SAI auditors are performing financial audit of entity ABC. They have decided to place high reliance on the procurement related internal controls. The reason is that in the government procurement is generally considered a high-risk activity and hence normally controls are established in this critical area. Auditors therefore want to rely on these controls. Auditing standards require them to check the efficacy of controls through compliance testing or audit of internal controls. This is meant to help them determine precise assurance from these controls. Auditors however can test only a sample of procurement related transactions. Let us help auditors select an appropriate sample size using ACL (Record Sample). The sample size is determined by several factors:

- Confidence level: How much assurance the auditors wish to obtain from their tests of controls. Since auditors have decided to place high reliance on procurement controls, they need to set confidence level at 95%.
- Population size: Total number of procurement related transactions. In this case consider, 30,000 procurement transactions.
- Tolerable Deviation Rate: It is equivalent to the concept of materiality. Internal control deviations found above TDR may well produce errors exceeding materiality amount. In that eventuality, auditors would have to reduce the reliance on procurement controls. Consider TDR to be 9%.
- Expected Deviation Rate: Normally a conservative level of 1% is used.

The sample size will be determined using ACL as in Box-III:

BOX-III

Input	Value
Confidence	95
Population	30000
Upper Error Limit (%)	9
Expected Error Rate (%)	1
Sample Size	53
Interval	566.03
Number of Tolerable Errors	1

method to gain direct assurance by the auditor instead of indirect assurance provided by controls. Remember audits have to be efficient. Auditors therefore, would take pains to identify the gaps in the functioning of controls and make suggestions about establishing new controls as well as making more effective the existing controls so that next year when he/she comes to perform audit, control structure is found to be significantly improved and achieving management achieve organizational objectives. This improved state would impact the allocation of resources for the substantive testing especially for

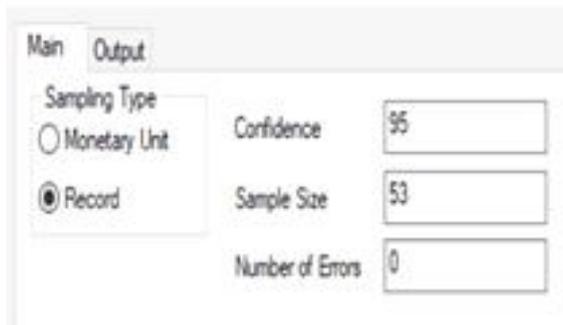
BOX-IV

Output	Value
Confidence	95
Sample Size	53
Number of Errors	3

ACL calculates 14.64% as the maximum possible deviation rate.

the tests of details. How do the SAI auditors evaluate the effectiveness of internal controls? There are several methods available including use of observation and walk throughs. However, the preferred method is to audit the internal controls

BOX-V



Main		Output	
Sampling Type		Confidence	95
<input type="radio"/> Monetary Unit		Sample Size	53
<input checked="" type="radio"/> Record		Number of Errors	0

ACL calculates 5.66% as the maximum possible deviation rate.

with reduced costs. Even in case of undesirable results (as in Box-IV) and auditor not being able to place any or limited reliance on internal controls, the effort to audit internal controls is not wasted and will prove to be worthwhile in later years. The SAI, being the regular and legal auditor of the entity ABC will make sure that gaps in expectations from internal controls highlighted by it in year 1 are followed up with management and those tasked with the governance of the entity with the objective that from year 2 onwards, with controls in place in the deficient areas, maintained and monitored for continuous improvement, SAI would be all set to reap tangible benefits in all future audit engagements.

$${}^{\circ}\text{TDR} = (\text{Materiality} * \text{multiplier}) / \text{population value}$$

using a sample of transactions especially when we intend high reliance on the controls and in this case we do. The process is explained in Box-II&III. After the auditor has audited the selected sample, he/she can interpret the results. Suppose, auditor found that out of 53 procurement transactions, 3 were not approved by the assigned delegated authority rather these were processed by a lower authority. Auditor would use ACL to interpret the results (Box-IV). Since the TDR⁶ (materiality level of controls) was 9%, the upper error limit of 14.64% would tell the auditors that high reliance on internal controls over procurement is not possible and therefore the auditor would increase the extent of substantive testing. Conversely if the auditors did not find any deviation in the selected sample then the results would be as in Box-V. Now the auditor can place high reliance on the internal controls and this would help decrease the extent of audit and achieve our objectives of doing only the necessary work and thereby performing a smart audit