Audit components: Literature Review on Audit Plan, Risk and Materiality and Internal Control

ISSN 1857-9973 657.6.01

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Abstract

This paper is an attempt to shed some light into auditing process. Our main focuses in this paper were main audit components, such as audit plan, risk and materiality, and internal control. The relevant literature review is provided to support our arguments regarding above mentioned auditing components. Based on the literature review it was found that each of these auditing components are of a great interest for any auditing process. In addition, given the dynamics of the companies in the modern globalized world, the latter components should be approached in a dynamic manner.

Key words: auditing, audit plan, risk, materiality, internal, control

1. Introduction

Private and public companies of modern world are engaged in various business financial transactions. In the dynamic globalised business environment it is a necessity and moreover, obligatory to record all financial transaction and present them as financial reports.
Furthermore, the transactions presented in financial reports need to be reliable and in compliance with the applicable norms, rules, regulations and standards. Therefore, governments all over the world without exception in order to control financial and nonfinancial transactions of public and private companies have established various norms and instruments.
One of the key instruments established to control budgetary and financial reliability, efficiency and compliance to the regulations in power of private and public companies is auditing. "Auditing is a systematic process of objectively obtaining and evaluating evidence regarding assertions about economic actions and events to ascertain the degree of correspondence between those assertions and established criteria and communicating the results to interested users" (American Accounting Association, 1972) cited in Florea and Florea (2011, p. 350). [1]
In correlation to the latter conclusion, this paper is about to analyze some auditing aspects. The main auditing components, such as audit plan, risk and materiality, and internal control are going to be discussed. In addition findings about the latter auditing components will be supported by the latest literature review.
The rest of the paper is organized as follows: the next section of the paper respectively the literature review is divided in three parts. The first part of literature review is related to audit plan.

The second part of literature review provides the latest literature review on risk and materiality. Whilst, the third last part of literature review covers aspects of internal control.

2. Literature review

2.1. Literature review on audit plan

Audit planning includes deciding on the overall audit strategy and developing an audit plan. Auditing Standard No. 9 from the Public Company Accounting Oversight Board (PCAOB) describes an external auditor's responsibility and the requirements for planning an audit. According to standard No. 9, an audit plan is expected to describe the planned nature, extent, and timing of the procedures for risk assessment and the tests to be done on the controls and substantive procedures, along with a description of other audit procedures planned to ensure the audit meets PCAOB standards.
For internal auditing, the Institute of Internal Auditors provides guidance for audit planning. Planning starts with determining the scope and objectives of the audit.
Internal auditors need to understand the business, operations, and unique characteristics of the department/unit being audited and to develop an audit plan that defines the procedures needed to do an efficient and effective audit.
Planning an audit involves establishing the overall audit strategy for the engagement and developing an audit plan. Adequate planning benefits the audit of financial statements in several ways, including the following:

- Helping the auditor identify and devote appropriate attention to important areas of the audit
- Helping the auditor identify and resolve potential problems on a timely basis
- Helping the auditor properly organize and manage the audit engagement so that it is performed in an effective and efficient manner
- Assisting in the selection of engagement team members with appropriate levels of capabilities and competence to respond to anticipated risks and allocating team member responsibilities
- Facilitating the direction and supervision of engagement team members and the review of their work
- Assisting, when applicable, in coordination of work done by auditors of components and specialists.

Audit plans have been and remain to be an important scholarly academic subject. Recently many scholars have analyzed various aspects of audit plans. Etheridge (2011) emphasizing the importance of audit plan suggests that for an effective audit plan a proper auditing planning is crucial. In this aspect Etheridge (2011) states: “Planning identifies key audit areas such as material account balances and situations with high risk and guides the auditor’s approach and responses to these areas” (p. 83). [2] Moreover the same author claims that planning occurs in advance of fieldwork and usually begins with an evaluation of the auditing plan in order to determine the scope of the audit.
According to Mock and Wright (1999) audit planning is a two stage process: [3]

1. Risk assessment and
2. Evidential planning.

The above mentioned authors claim that both stages are important for developing an audit plan, because even if the auditor manages to assess the client risks, he would need to develop an appropriate evidential plan in order to react to those risks.

The opinions of scholars regarding audit plans have their specifics. However their common opinion is that audit plans should be risk adjusted (e.g. Bechara and Kapoor, 2012: Hammersley, 2011: Fukukava, Mock and Right, 2006: Vandervelde, 2006:).
Hammersley (2011) emphasizes the need of dynamic modification of the audit plan. [4] The mentioned author claims that because of the fraud risks identified during the auditing process the audit plan prepared in preliminary phase need to be object of modification.
Vandervelde (2006) also suggests that adaptation of audit plans should be in direct proportion with the associated risk, claiming that an auditor should response to any change of the risk factor when compiling an audit plan. [5]
Bechara and Kapoor (2012) ighlight the issue of risk-based audit plans, claiming that traditional audit plans are based on suspicion and usually directed from senior management. [6] The traditional auditing approach according to the above mentioned authors did not show to be effective during and before the recent financial crisis. Therefore, Bechara and Kapoor (2012) insist for a comprehensive risk based audit plan, enabling detection of the risks in the prism of strategic objectives.
Noel and Patterson (2003) suggest that formulating an audit plan is a complex task especially when the auditee has a multiple way of frauds. [7] These frauds according to the author may be defalcation, fraudulent financial reporting, and a combination of these two. In addition the authors explain that which of these frauds would occur depends on:

1. The relative difference of rewards and penalties from each type of fraud,
2. Strength of audit procedures, and
3. Current industry conditions the company is part of.

Fukukava, Mock and Right (2006) found that the some financial risk items such as liquidity, profitability and flow from operations have a significant influence on audit planning decisions, whereas, the risks which are governance-related have minor impact on audit plans.[8]
In regard of governmental audits Meinhardt, Moraglio and Steinberg (1987) suggest that there are issues to be addressed, such as auditing standard violation related to non compliance with rules and regulations in power.
Cohen, et al. (2011) claim that even if the rules, regulations, and standards are emplaced, the interference and the pressure from senior management to the auditors may minimize the chances for reliable and impartial presentation of financial statement in particular or to an entire auditing process in general. [9]

2.2. Literature review on materiality and risk

Audit materiality is one of the most important concepts for auditors. Misstatements, including omissions, are considered to be material if, individually or in the aggregate, they are reasonably expected to influence the economic decisions of users based on the financial statements. Materiality in audit comprises both quantitative and qualitative aspects.
When dealing with materiality in quantitative aspects, we must consider the following five steps:

1. Set a preliminary judgment of materiality
   - It is usually done at the planning stage of an audit
   - The general rule of thumb is either 1) 5-10% of normalized net income (normalized excludes one-time gains/losses and discontinued operations) or 2) 0.5-2% of total assets
2. Consider performance materiality
   - Materiality more on a line item basis, i.e., accounts receivable, inventory
3. Estimate misstatement in a cycle or account
4. information, to a user, in the context of decision to be made" (p. Estimate the total aggregate misstatements

5. Compare 4 with 1 and determine if overall the financial statements are materially misstated

Audit materiality, as mentioned before, is not just quantitative in nature. There are numerous qualitative factors to consider as well. For example, if a company does not provide adequate disclosures regarding contingent liabilities or related party transactions, it may be considered to be material. In addition, an inaccurate description of an accounting policy may also be material if a company chooses to use 50 years to amortize an asset when in the note disclosures it is stated to be 5.

Small errors in financial statements can also lead to severe covenant violations. For example, if the company enters into a covenant with their local bank to maintain a current ratio of 1.0, a minute $2,000 misstatement can change a violation of the covenant to a maintenance of the covenant. Thus, an auditor needs to consider both aspects of materiality in an engagement.

The main challenge faced by majority of internal auditors is how to allocate limited internal audit resources in the most effective way - how to choose the audit subjects to examine. This requires an assessment of risk across all the auditable areas that an auditor might examine. The objective is of risk-based planning is to ensure that the auditor examines subjects of highest risk to the achievement of the organisation's objectives. Strategic and annual audit plans must be developed through a process that identifies and prioritizes potential audit topics. The entire population of potential auditable areas, which can be categorized in many ways, is called the audit universe. For each element of the audit universe the risks or opportunities have to be assessed and decisions taken on other risk factors that may influence the priority to be given to each element of the audit universe (audit objects).

The key definitions concerning risk are: "Event – an incident or occurrence, from sources internal or external to an organisation, which may affect the achievement of objectives". Events can have negative impact, positive impact or both. Events with negative impact represent risks. Events with positive impact represent opportunities.

Key risks are these risks that, if properly managed, will make the organisation successful in the achievement of its objectives or, if not well managed, it (the organisation) will not achieve its objectives.

Inherent risk is the level of risk before any risk mitigation actions such as control activities have been taken into account (e.g. the inherent risk of flooding before taking into account flood prevention measures).

Residual risk is the level of risk after taking into account risk mitigation actions such as control activities. The auditor is most concerned with the level of residual risk. (In some cases inherent and residual risk will be the same. But areas that are well controlled will usually have lower levels of residual risk.)

According to Comert (2012) materiality and risk are the most important concepts in audit planning. Back in 1970 Frishkoff defined materiality as "The relative, quantitative importance of some piece of financial 116). However, the concept of materiality has evolved, thus, nowadays there is a common opinion among scholars that materiality defines the responsibility of an auditor to determine whether financial statements are materially misstated, in order to alert the client for the potential risk. [10]

Whilst, auditing risk according to Etheridge (2012) can be described as a process of identifying types of potential misstatements and a controlling activities process in order to prevent or promptly detect those misstatements that are relevant to the preparation of the financial statements. [11]

Grejadan, Joldos and Stanciu (2010) suggest that materiality is a relative category, stating that an amount of a financial position considered as materiality value may be important for a particular entity, whereas for another one may not. [12]

In this aspect Paterson and Smith (2003) urge that the relativism of materiality could increase the auditing risk because the contextualization and relativism of materiality provides a reason for ignoring some small financial misstatement, which could generate uncertainty, resulting in

auditing risk in the future. Therefore, the authors insist for a conservative approach regarding auditing materiality. [13]

Socol (2008) considers materiality as a subjective concept. However, the same author analyzing the audit materiality in the prism of subjectivism and professional judgment claims that although considered subjective, absence of rules and regulations in this aspect may create drawbacks and difficulties in regard of what is material misstatement whilst auditing financial statements, adding that subjectivism endangers professional auditing. [14]

Furthermore, Socol (2008) states: “The objective of an audit of the financial statements is to enable an independent auditor to express an opinion as to whether the societies financial statements are prepared, in all material respects, in accordance with an identified financial reporting framework” (p. 212).

Lynford and Saurav (1998) although consider materiality as a relative category propose an auditing method that will approach to the materiality planning based on constraints imposed by ratios and other combinations of accounts. This, according to the latter authors would enable auditor to disaggregate materiality levels to different accounts based on their relative size and relative auditing cost.

Jankunaite (2007) stresses out the risk of materially misstated financial statements, taking as example financial fraud scandals, such as Enron and Parlamalat, urging for a regulatory improvements. [15]

In this aspect is worth mentioning enforcement of auditing standards. In regard of auditing standards related to risk and materiality Fogarty, Graham and Shubert (2006) emphasize the importance of statement on auditing standards SAS no. 107 which in original is as follows: “Audit risk and materiality in conducting an audit, makes clear that the overall objective of an audit is to provide reasonable assurance-a high, but not absolute level of assurance that the financial statements are free of material misstatements “(p. 44). [16]

2.3. Literature review on internal control

Internal controls are nothing more than policies or procedures put in place to safeguard an asset, provide reliable financial information, promote efficient and effective operations, and ensure policy compliance. For example: When you came to work this morning did you lock the doors to your house? If so, that's an example of an "internal control" you used to protect the assets you own. Generally there are three types of control:

- **Preventative Controls** - are designed to discourage errors or irregularities from occurring. For example: Processing a requisition only after it has been properly approved by the appropriate personnel.
- **Detective Controls** - are designed to find errors or irregularities after they have occurred. For example: Reviewing the monthly Statement of Account for activity in your area's general ledger.
- **Directive Controls** - are designed to encourage a desirable event. For example: written policies and training seminars assist in the accomplishment of area goals and objectives.

Internal control should have the following objectives:

- **Efficient conduct of business:**
  Controls should be in place to ensure that processes flow smoothly and operations are free from disruptions. This mitigates against the risk of inefficiencies and threats to the creation of value in the organisation.
- **Safeguarding assets:**
  Controls should be in place to ensure that assets are deployed for their proper purposes, and are not vulnerable to misuse or theft. A comprehensive approach to his objective should consider all assets, including both tangible and intangible assets.

- **Preventing and detecting fraud and other unlawful acts:**
  Even small businesses with simple organisation structures may fall victim to these violations, but as organisations increase in size and complexity, the nature of fraudulent practices becomes more diverse, and controls must be capable of addressing these.
- **Completeness and accuracy of financial records:**
  An organisation cannot produce accurate financial statements if its financial records are unreliable. Systems should be capable of recording transactions so that the nature of business transacted is properly reflected in the financial accounts.
- **Timely preparation of financial statements:**
  Organisations should be able to fulfil their legal obligations to submit their account, accurately and on time. They also have a duty to their shareholders to produce meaningful statements. Internal controls may also be applied to management accounting processes, which are necessary for effective strategic planning, decision taking and monitoring of organisational performance.

Many scholars in their most recent publications have analyzed the issue of internal audit control. There is a wide consensus amongst them that the goals of audit internal control are to check reliability, efficiency and effectiveness of financial reporting, and also make sure that financial reports are compiled in accordance with the laws and regulations in power.

According to Etheridge (2012) the term itself has it routs back in 1949 when the American Institute of Certified Public Accountants (AICPA) defined the term “Internal Control”, referring to the control of financial statements. In addition, Etheridge (2012) states that Statements on Auditing Standards (SAS) No. 109, provides guidance to auditors related to consideration of internal control as part of an audit. “It requires auditors to obtain an understanding of internal control that is sufficient to assess the risk of material misstatement of the financial statements due to error or fraud and to design the nature, timing, and extent of further audit procedures” (p. 67).

According to Cosmin (2011) internal control is an auditing instrument providing a reasonable assurance that company has capacity to achieve its objectives. [17] Moreover, the same author insists that in order to attain its auditing objective and tackle financial fraud effectively, it is necessary to develop instruments which would monitor internal control activities to make sure that internal control is emplaced in accordance to the rules and regulations in power and not deteriorate.

According to Nagaraja and Vijayakumar (2012) a proper system of internal audit control in an organization enables effective risk management through early detection and prevention of frauds and misstatements. [18] Furthermore, relating this issue with public organizations, the same authors claim that appropriate system of internal control also ensures reliable financial reporting and compliance with laws and regulations in power.

Dogic (2011) emphasizes the need of establishing a functional system of internal control especially in large companies. [19] According to the same author in small companies the process of internal audit control is easily managed and usually dictated by senior management, whilst for large companies which are in frequent domestic and overseas interaction proposes a sophisticated system of internal control in order to correct and avoid future financial risks. Hyehner (2011) analyzing some issues related to public organizations in general and local government auditing issues in particular, relates the issue of efficient internal control with the level of monitoring, stating “Inadequate monitoring leads to weaknesses in internal controls, which in turn provide an opportune environment for fraud, abuse, and waste, and may result in loss or inefficient use of municipal resources and added costs to taxpayers” (p. 21). [20]

Limsuwam and Wittayapoom (2012) suggest that reliability of financial reporting is based on the effectiveness of internal control. [21] In addition the authors provides some specifics about the interaction of various factors effecting internal control, which in the last stage impacts the reliability of financial reporting. Those factors effecting effectiveness of internal control according to the same authors are:

1. Risk management efficiency,
2. Compliance quality,
3. Potential of intra organization communication, and
4. Continuous monitoring adequacy.

3. Conclusions

This paper provided an analysis about auditing. The main focuses of the paper were audit plan, risk and materiality, and internal control. The findings regarding these components were supported by the relevant scholarly academic publications. Based on the literature review it was found that each of these auditing components are of a great interest for any auditing process. In addition, given the dynamics of the companies in the modern globalized world, the latter components should be approached in a dynamic manner.
To obtain reasonable assurance, the International Standards on Auditing (ISAs) require the auditor to obtain sufficient appropriate audit evidence to reduce the risk of giving an inappropriate audit opinion when the financial statements are materially misstated, in this way allowing the auditor to draw reasonable conclusions on which to base his audit opinion.
Under the ISAs, an effective audit should be performed by adopting a risk-based approach that seeks to identify and assess specific risks of material misstatement concerning the financial statements of an entity and addresses them with audit procedures designed to result in audit evidence that is sufficient, relevant and reliable.

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