Internal Audit (ACCT 337)

Chapter 13
Conducting the Assurance Engagement

EXHIBIT 13-2
THE ASSURANCE ENGAGEMENT PROCESS

Plan
Chapter 13

- Determine engagement objectives and scope.
- Understand the auditee, including auditee objectives and assertions.
- Identify and assess risks.
- Identify key controls.
- Evaluate adequacy of control design.
- Create a test plan.
- Develop a work program.
- Allocate resources to the engagement.

Perform
Chapter 13

- Conduct tests to gather evidence.
- Evaluate evidence gathered and reach conclusions.
- Develop observations and formulate recommendations.

Communicate
Chapter 14

- Perform observation evaluation and escalation process.
- Conduct interim and preliminary engagement communications.
- Develop final engagement communications.
- Distribute formal and informal final communications.
- Perform monitoring and follow-up procedures.

Planning 1: Determining Engagement Objectives and Scope

- **Determining the reasons for performing assurance engagement**
  1. The engagement was identified in the annual plan, based on the risk assessment
  2. The engagement is part of the annual requirement to evaluate the organization system of internal controls (SOX 2002)
  3. A recent event (fraud)
  4. Change in the business or industry
  - Books2Buy: cash disbursement process engagement was included in the annual audit plan (inherent risk)

- **Establishing the engagement objectives**
  "To evaluate the design adequacy and operating effectiveness related to the cash disbursement process"

Planning 1: Determining Engagement Objectives and Scope

- **Determining the scope of the engagement**
  - Scope: What is or is not included within the engagement (In scope/out of scope)
  - In scope subprocess: invoice matching / disbursement input / payment process
- **Determining expected outcomes and deliverables**
  - Begin with an end in mind
  - Potential outcomes of the test are:

  1. • **Financial statement errors or misclassifications** within financial accounts, balances, or disclosures.

  2. • **Control deficiencies** indicating specific controls that are not achieving the desired effect, that is, mitigating the corresponding risks to the desired level.

  3. • **Shortfalls in objective achievement** due to control deficiencies or inadequate performance.

  4. • **Inefficiencies** due to resources not being deployed in an optimal manner.

  5. • **Out-of-compliance situations** when laws, regulations, or policies are not complied with consistently.

Planning 1: Determining Engagement Objectives and Scope

- **Determining expected outcomes and deliverables (continued)**
  - Auditee expectations regarding the engagement communication

1. Full-scope, internal reports typically have a wide distribution and, thus, require sufficient appropriate evidence that this wide range of recipients can understand to support conclusions and recommendations for improvements.

2. Internal memoranda may be used for more limited distribution, stating the work performed and support for the conclusions and recommendation only to the extent necessary for the intended audience to understand the underlying deficiencies and conclusions.

3. Reports for third-party use should assume such parties are less familiar with policies and procedures unique to the organization and, therefore, may require greater levels of detail to ensure the readers understand the nature and context of the observations and recommendations.

Planning 2: Understanding the auditee (process)

- **Determining key process objectives (according to COSO)**
  1. Strategic objectives
  2. Operations objectives
  3. Reporting objectives
  4. Compliance objectives

- **Gathering information about how the process operates**
  - Process owner
  - Ps&Ps
  - Organizations chart
  - Job descriptions
  - Relevant contacts, laws and regulations

Planning 2: Understanding the auditee (process)

- **Performing analytical procedures**
  - High level assessments that may reveal process activities that need more attention and more detailed testing.

- **Documenting the process flow**
  - To depict the current "AS-IS" state not the desired "TO-BE" state. WHY?
  1. Process maps
  2. Narrative memorandum

Planning 3: Identifying and Assessing Risks

- What is risk?
- Identify risks: brainstorming the possible risks
- Assess risks:
  1. impact
  2. likelihood

Planning 4: Identifying Key Controls

- Key control: an activity designed to reduce risks associated with a critical business objective

- Examples

# Planning 5: Evaluating the adequacy of controls design

Any gaps identified should be:

- Discussed with management
- Documented as preliminary engagement observation

Three conclusions can be regarding the adequacy of control design:

1. Design is adequate with no gaps
2. Design is adequate with minor gaps
3. Design is inadequate with significant gaps

Planning 6: Creating a Test Plan
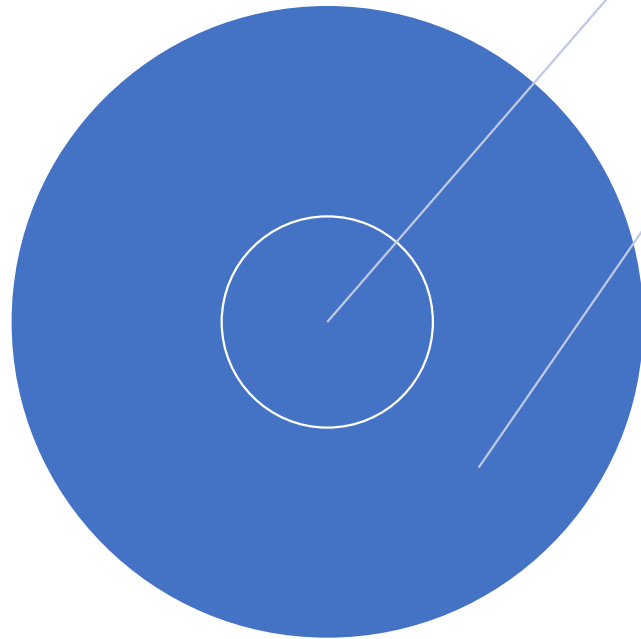
To gather sufficient appropriate audit evidence:

IA auditors should do the following to create a test plan:

- Determine which controls to test their operating effectiveness (control design is adequate)
- Develop a testing approach: nature/extent/ timing of audit tests
- Document the testing approach (see next slide)

Testing Approach - Exmaples

EXHIBIT 13-12
EXAMPLE RISK AND CONTROL MATRIX FOR CASH DISBURSEMENTS

Process-Level Risk	Key Control	Testing Approach
Expectations Risk – Lack of well-developed and well-articulated policies, procedures, and other forms of communications from management may result in employees carrying out their responsibilities in a manner that is inconsistent with management's expectations and desires (accuracy, timeliness, recording, compliance, and approval objectives).	• Delegation of authority policy establishes approval levels for procurement and disbursement decisions. • Accounts payable has developed detailed procedures covering all key disbursement tasks.	1. Review delegation of authority policy and evaluate whether it appears to be current and appropriate given the present responsibilities of individuals. 2. Select a sample of 80 disbursements (10% risk, 5% tolerable deviation rate, and 1% expected deviation rate) and test for approvals in accordance with the policy. 3. Review and discuss procedures with accounts payable personnel to determine whether the procedures accurately reflect the required tasks and could be followed by others.
Duplicate Payments Risk – Failure to identify multiple inputs of invoices may result in duplicate payments to vendors that could go undetected or prove difficult to collect (accuracy and recording objectives).	• The purchasing system alerts the AP clerk if the vendor number, invoice number, and invoice amount match an invoice previously entered. • The cash disbursements run will flag any payments of identical amounts to the same vendor for review prior to disbursement.	1. Test the system's duplicate invoice functionality by attempting to enter duplicate invoice numbers. Also, test what happens if a digit or symbol is added to the end of a duplicate invoice number. 2. Since the system only alerts the user to the possibility of a duplicate payment, extract 100% of the payments for the last year and test for possible duplicate payments. 3. Test to ensure the cash disbursements flag operates as designed.

Planning 7: Developing a Work Program

- A document that lists the procedures to be followed during the engagement
  - Standards template or checklist
  - A memo summarizing the tasks completed

Planning 8: Allocating resources to the engagement

Budgeting the resources	Allocating proper HR	Scheduling these resources to ensure completion on time
• Number of hours	• Who?	• Considering vacations/trainings etc

Performing 1: Conducting Tests to Gather Evidence

- Testing approach developed in planning phase is now executed to test operating effectiveness of ICs.

- Results of the tests.

Duplicate Payments Risk –Failure to identify multiple inputs of invoices may result in duplicate payments to vendors that could go undetected or prove difficult to collect (accuracy and recording objectives).

1. Test the system's duplicate invoice functionality by attempting to enter duplicate invoice numbers. Also, test what happens if a digit or symbol is added to the end of a duplicate invoice number.

2. Since the system only alerts the user to the possibility of a duplicate payment, extract 100% of the payments for the last year and test for possible duplicate payments.

3. Test to ensure the cash disbursements flag operates as designed.

Results of Testing

1. The system rejected all duplicate invoice entries. However, it accepted invoices where a digit or symbol was added to the end of the invoice number, creating the opportunity for a duplicate payment (Z-4) (WP X-4).

2. Fourteen (14) potentially duplicate payments were identified, totaling $357,782. A/P management is following up on all items, which appear to be due to the deficiency noted on working paper X-4 (X-5).

3. The test transactions for this control were all flagged in the cash disbursements run. The 14 transactions identified in the duplicate payments test were from different disbursement batches and, thus, were not flagged by this control (WP X-6).

Performing 2: Evaluating Evidence Gathered and Reaching Conclusions

- Based on the test results

Duplicate Payments Risk – Failure to identify multiple inputs of invoices may result in duplicate payments to vendors that could go undetected or prove difficult to collect (accuracy and recording objectives).	Results of Testing	Testing Conclusion
	1. The system rejected all duplicate invoice entries. However, it accepted invoices where a digit or symbol was added to the end of the invoice number, creating the opportunity for a duplicate payment (Z-4) (WP X-4).	While the systematic controls appear to be operating effectively, it is possible to circumvent these controls through submission and input of a different invoice number or adding a digit at the end of the existing invoice number (see working paper Z-4). This represents a deficiency in the design of controls relating to this risk, which, along with the design deficiency noted in working paper Z-2, indicates that this risk is **not** adequately mitigated.
	2. Fourteen (14) potentially duplicate payments were identified, totaling $357,782. A/P management is following up on all items, which appear to be due to the deficiency noted on working paper X-4 (X-5).	
	3. The test transactions for this control were all flagged in the cash disbursements run. The 14 transactions identified in the duplicate payments test were from different disbursement batches and, thus, were not flagged by this control (WP X-6).	

Performing 3: Developing Observations and Formulating Recommendations

- Observation: a finding derived from IAs test results
- Key Elements of audit observation:
    1. Criteria
    2. Condition
    3. Cause
    4. Effect

Performing 3: Developing Observations and Formulating Recommendations

- Example (Key Elements of audit observation)

Criteria: Payments should be made in a timely manner, consistent with management's expectations regarding avoidance of late payment fees.

Condition: There were 172 payments (1.1% of total disbursements) made late resulting in late-payment fees being charged on 21 of the payments. Follow-up by A/P management resulted in such fees being waived for nine of the 21 late payments. Fees paid totaled $24,489.

Cause: For a variety of reasons, invoice approvals were not timely in 19 of the 21 instances; thus, the payments missed the company's disbursement processing deadlines. In the remaining two instances, the delays were a result of management's decisions to withhold payment until a disagreement with the vendor could be resolved.

Effect: The company incurred late payment fees totaling $24,489.

End of Chapter