Responsibility of the external auditor in assessing and responding to internal control risks when auditing financial statements

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Abstract:

The aim of this study is to identify the responsibility of the external auditor in assessing and responding to internal control risks when conducting a financial statement audit.The study develops a self-assessment check-list of the multiple phases of assessing the internal control risk.

The designated check-list was distributed on 20 external auditor which were interviewed to determine their compliance with procedures in evaluating internal control risk and its relevance in discovering misstatements due to fraud, the results of the study showed that the questioned external auditors apply the necessary procedures to evaluating internal control risk to determine the extent of the verification program of accounts.

Keywords: external audit; internal control risk; misstatements due to fraud; audit risk.

Jel Classification Codes:M42, M40.

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1. Introduction :

The modern business environment has witnessed significant changes and increased interest in internal control by organizations and institutions, especially after the financial crises and collapses that many companies and institutions were exposed to.

Internal control can assure compliance with laws and regulations as well as accurate and timely financial reporting and data collection, it helps to maintain operational efficiency by identifying problems and correcting lapses. The external auditor in its mission in auditing financial statements is required to comply with the requirements of professional conduct and to plan and perform the audit by understanding the entity's internal and external environment including internal control, evaluating the internal control system and finally issuing his report about whether the financial statements are free from material misstatements due to error or fraud.

This is why evaluating internal control is an important phase for the auditor, which is considered a continuous and permanent process that must be performed in all areas of the entity's activity, andthe external auditor relies on the efficiency of the internal control system in detecting errors and misstatements by evaluating the internal control risk to determine the scope of the verification program.

In order to cover all aspects of the study, we pose the following problem:

What is the responsibility of the external auditor in assessing and responding to internal control risks when auditing financial statements?

This problem can be exposed through several questions:

- Does the external auditor identify the internal and external environment of the audited company?
- Does the external auditor identify the internal control system in the audited company?
- Does the external auditor evaluate internal control risk?

To answer these research questions, we will test the following hypotheses:

- The external auditor identifies the internal and external environment of the audited company.
- The external auditor identifies the internal control system in the audited company.
- The external auditor evaluates the internal control risk in order to determine the verification program of the accounts.

This study seeks to shed the light on the nature of the relationship between external audit and the internal control system by defining the procedures that the auditor takes to determine the risk of internal control and its impact on the verification program to fulfill the objective of the external audit to obtain reasonable assurance whether the financial statements are free from material misstatements due to error or fraud.

In order to achieve the objectives of the study, 20 external auditor has been interviewed based on a self-assessment check-list that describes the multiple phases of assessing internal control system.

1.1. Prior researches:

- **Fawzi Al Sawalqa, Atala Qtish (2012),** This study aimed at examining the relationship between audit control and the effectiveness of audit program in Jordan, based on 43 questionnaire, the study showed that the risk assessment does contributes significantly towards an effective audit program; but not the control environment and control activities which indicates that Jordanian companies lack the necessary experience to deal with the current tools of internal control evaluation.
- **Omer Ali Kamil, Esraa Abbdulsattar Ahmed (2020),** this research aimed at identifying the extent of adoption of external auditors on internal control in bank auditing, after conducting the study on 25 auditors, the study resulted thatthe external auditor adopt accounting control, internal audit within the internal control system in bank audits.
- **Ismail Sebti, Abderrahmane Elguerri, Hachmi Benouadah (2021),** this study aimed at analyzing and clarifying the external auditor's role in detecting fraud and error, the results of the study on a sample of external auditors showed that the external auditor does not correct the discovered errors and does not advise management or owners, instead, the auditor prepares reports expressing his opinion to all relevant parties.
- **Khadidja Slimanie, Ahmed Neguaz (2022),** this study aimed at identifying the extent to which external auditor understands the requirements of the company's control environment according to ISA 315, the results of the study showed that the external auditor understands the importance of the existence of control environment based on integrity, ethics and competence. This may affect the assessment of control risks resulting from the failure of the internal control system in preventing and detecting risks of material misstatements.

2. The theoretical aspect of the study:

2.1 The importance of external auditing:

The main obejctif of an external audit or statutory audit is to obtain a reasonable assurance that the financial statements are presented fairly in all material respects.

The external auditor who is defined as the person who performs the audit procedures and expresses an opinion on the financial statements of the entity, aims at providing a degree of adequate protection against two types of risks:

Firstly, the risk that the financial statements contain material misstatements due to error or fraud, and secondly the risk of non-detection of the defencies in the internal control system which is the basis to determine the quantity of samples subject to auditing. (Omer Ali Kamil, Esraa Abbdulsattar Ahmed, 2020, p614)

External audit can be defined as a critical examination to ensure that the financial statements issued by the entity are correct and free from material misstatements. The audit includes all tests conducted by an independent external professional to express anobjectif opinion on the reliability, integrity and transparency of the financial statements.(Ismail Sebti, Abderrahmane Elguerri, Hachemi Benouadah, 2021,p 441)

According to the AICPA, the core of every audit is to identify and assess risks of material misstatements, and that can be achieved by obtaining an understanding of the organisation'sinternal control system and assessing control risk, this enables the auditor to determine responsive procedures.(AICPA)

The auditor seeks to achieve its designed purpose through :(Omer Ali Kamil, Esraa Abbdulsattar Ahmed, 2020, p618)

- The evaluation of the accounting system and the internal conrol system adopted by the company.

-Testing the operating of the internal control procedures to establish an audit plan that includes the nature, extent and timing of audit procedures.

- Performing the necessary tests and procedures to verify that the accounting equations and account balances are correct.

The importance of external audit is due to the audit report, which represents the auditor's opinion about the entity's financial position after a thorough examination of the financial reports issued by the entity. This validation is of interest both for the company's shareholders and for society as a whole and critical to decision making process.

The importance of external audit is evident in the advantages it offers, which can be summarized in the following, aside from the legal requirements:

- Improvement of the internal control system, as the auditor focuses on understanding the company's control environment which enables him to detect defect points in the control system for which recommendations can be made, making the company less prone to fraud or error.

- The auditor's report provides credibility that the accounts are free from material misstatements.

- Conducting an external audit by an independent professional provides shareholders with confidences and transparency that their interests are well protected.

2.2 Audit risk assessement:

The audit risk is that the auditor may mistankenly present his opinion that the financial statements are fairly presented and free from material misstatements. According to the IAASB glossary of terms, audit risk is defined as: "the risk that the auditor expresses an inappropriate audit opinion when the financial statements are materially misstated. Audit risk is a function of material misstatements and detection risk." (IAASB Handbook, 2021)

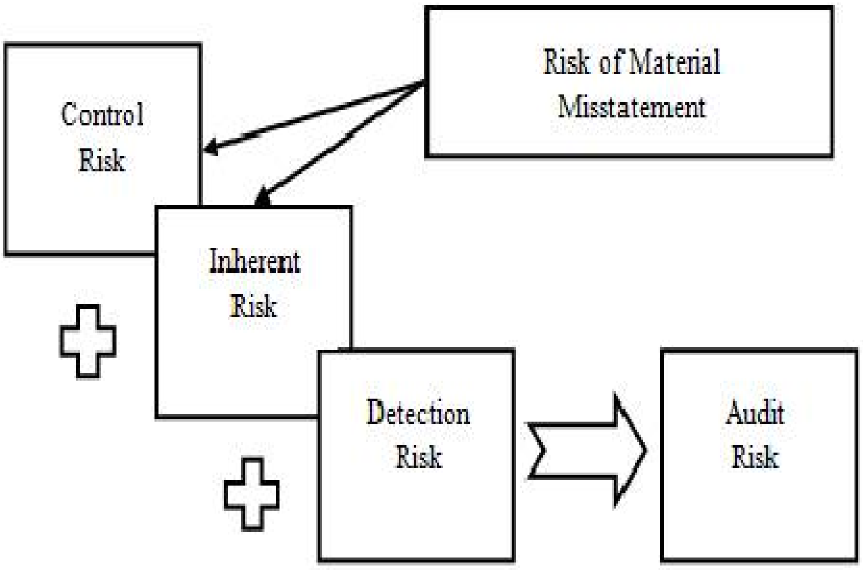
The risk of audit consists of: inherent risk, control risk and the risk of non detection.

Inherent risk is linked to the company's external or internal environment such as: complex system, lack of training;

Control risk is that the internal control system fails to detect errors that occur and may be material in a timely manner to prevent or correct them;

The risk of non detectionis the associated with the auditor and his ability to detect material misstatements.

Figure 1: Audit risk components



Source:Pece Nikolovski and al (2016), the concept of audit risk, p25

The auditor determines the acceptable level of audit risk, which varies according to the possibility of material misstatements. Whereas, after evaluationg both inherent and control risks, the auditor will determine the acceptable level of non-detection risk and therefore the overall risk of audit, and at this stage the auditor formulates the appropriate auditing strategy concerning the nature, timing and extent of audit procedures.(Pece Nikolovski and al, 2016, p28-29)

When the internal control system is effective, strong, and reliable, the risk of internal control decreases, and therefore the auditor relies on limited tests. Contrary to that, when the internal control system is ineffective, the risk of the latter increases. In this case, the auditor must conduct extensive tests to reduce the risk of non-detection and therefore audit risk.

Therefore, studying and evaluating the internal control system is considered one of the main factors in determining the nature, timing and extent of the scope of tests.

In order to design the appropriate audit procedures relating the entity, the auditor performs several risk assessment procedures including:

•Identify and evaluate the entity and its environment;

•Identify and evaluate the risks of fraud at the entity;

•Identify the internal control processes and procedures at the entity and evaluate their effectiveness;

•Evaluate all the information obtained and the risks assessed;

•Design appropriate audit procedures to respond to the risks of material misstatement.

2.3internal control and audit program effectiveness:

According to COSO, internal control can be defined as an ongoing process that provides reasonable assurance about the ability of the entity's to meet its objectives related to operations, reporting and compliance, with the intervention of the board of directors, management and all personnel.COSO Report, 2013)

So, internal control is a program of activities, its main objective is to monitor, spot and prevent any potential error, omission, misstatement, or a fraud. (Afshan younas, azaazlinakassim, 2019, p3)

Based on the integrated framework of COSO, internal control consists of five intergrated components (COSO Report, 2013): control environment, risk assessment, control activities, information and communication and monitoring.

- **Control environment**is related to the management behaviours' and their ethics and values toward control system.
- **Risk assessment**relates to identifying and highlighting risk areas by the management.
- **Control activities** refer to control system procedures, which consists of separation of duties from authority.
- **Information and communication**, this component concerns the internal and external communication methods and how the information is transmitted.
- **Monitoring activities**, this last component motivate management to monitorthe control system and identify the problem and find solutions throughcommunication.

Hence the importance of evaluating the internal control system as an essential step when auditing financial statements, as it enables the auditor to give the maximum assurance regarding the preparation and reporting of financial statements for stakeholders.

When auditing financial statements, the auditor goes through several steps, the most important of which is evaluating the internal control system through understanding of the audited entity and its environment, including internal control as well as perform different audit procedures. Also, they use the risk assessment approach to obtain other evidence and assess the risk of material misstatement. (Afshan younas, azaazlinakassim, 2019, p4)

At the end of his mission, the externa auditor expresses an opinion on the financial statements based on the audit procedures he performed, and as part of this mission he tests the company's accounting processes and internal controls and provide an opinion as to their effectiveness.

The management letters issued by the external auditor can provide valuable information about company's internal control system. In general, management letters highlight internal control deficiencies that the external auditor discovered in the conduct of the audit. They are typically communicated to management but should be also reviewed by the audit committee and/or that board of directors and the internal audit function; not only do management letters identify key control deficiencies, but they also provide recommendations on how to improve the respective weakness. (IFC, 2021, p 18)

The external auditor designs the detailed audit plan (the scope of the audit procedures) to respond to the risk assessment; where the inputs in audit planning include all the audit risk assessment procedures, and the outputs of the audit risk assessment process are audit strategy and audit plan according to the assessment of the risk of material misstatement (inherent risk x control risk assessment).

3. The methodological framework of the study:

Our survey is carried out by a checklist that was designed to describe the phases of assessing the internal control risk, which was answered by 20 external auditors (governor of accounts).

The population of the study includes external auditors in Skikda, while the sample is a chosen sample of 20 external auditors. Data required for the accomplishment of the study had been gathered from different primary and secondary sources.

Secondary data includes international auditing standards, thesis and reports, journals. As for the required primary data, it was collected through interviews with external auditors using a checklist as the study tool.

Through the interviews, the respondents were asked to answer questions regarding their compliance with some statements and procedures that are essential in the phase of assessing the internal control risk to to determine the risk of internal control and its impact on the verification program to fulfill the objective of the external audit to obtain reasonable assurance whether the financial statements are free from material misstatements due to error or fraud.

We developed a self assessment checklist for external auditors containing two sections, The first section encompasses the demographic data of the respondents, specifically: academicals degree, years of experience, and the number of personnel in the auditing team.

The second section consists of questions divided to three axes describing the multiple phases of assessing internal control, the first axe describes the external auditors awareness of the internal and external environment of the audited company, the second axe is about identifying the existence and effectiveness of the internal control system and the risk related to it, and the third and last axe is about finishing with the auditor's response to the assessed risk and its impact on the verification program of accounts.

We mentioned that the external auditors are the respondents to the study questionnaire, and we were able to interview 20 of them. With regard to the respondents academicals degree, all of the respondents have the college degree required, which indicates that they are educated enough to be able to respond to the questions in place and give more credible and transparent answers.

Also, 50% of the respondents have more than 15 years of experience, and the other half have from 5 to 10 years of experience, and it's considered high, which indicates that the questioned auditors are experienced enough to answer the question in hand and provide more credibility to the study too.

4. **Results and discussion:**

- **First hypothesis:** The external auditor identifies the internal and external environment of the audited company.

Table 1: identifying the environment of the audited company

Axe N° 1	Responses of the 20 external auditor
1	All of the questioned external auditors agreed that they take in consideration the nature of the company's activity when auditing.
2	- 60% of the questioned external auditors stated that understanding the nature of company's activity enables them to: identify the elements of the company's environment influencing the financial information, identifying how the financial result is formed, identifying the financial impacts of the decisions that the management takes. - 40% of the questioned external auditors stated that understanding the nature of company's activity enables them to: identify the elements of the company's environment influencing the financial information, identifying how the financial result is formed.
3	All of the questioned external auditors agreed that they make sure to collect all the internal and external documents related to the audited company including: rules of internal procedures, organizational chart, internal auditors' reports, the founding contract of the company, and the previous reports of external auditors.
4	90% of the questioned external auditors stated that they perform interviews with the management staff and the personnel in order to collect information about the company. The remaining 10% stated that they perform these interviews only if necessary and they need more queries about certain information.
5	70% of the questioned external auditor stated that they adapt their examinations to the specifics of each company by taking into account: the international, regional and national economic environment, tax, accounting and legal specifies and funding sources. The remaining 30% stated that in addition to these specifies, they also take in consideration syndicate agreements (conventions).
6	100% of the audited external auditors stated that they do make sure of the accounting policies applied in dealing with the financial operations related to the business of the company.

Source: prepared by the authors based on the results of the check-list

Table (1) shows that the majority of the questioned external auditors if we not say all, identify the internal and external environment of the audited company including the nature of the company's activity, rules of internal procedures, organizational chart, internal auditors' reports, the founding contract of the company, the previous reports of external auditors, the international, regional and national economic environment, tax, accounting and legal specifies and funding sources also conducting interviews with the management staff and the personnelin order to determine the associates risks to the company.

All these procedures are essential to establish a better understanding of the company's internal and external environment, also determine risk areas. And that enables the auditor to assess and estimate the level of inherent risk.

We can say that the interviewed external auditorsdo identify the internal and external environment of the audited companywhich proves the first hypothesis.

- **Second hypothesis:** The external auditor identifies the internal control system in the audited company.

Table 2: identifying the internal control system in the audited company

Axe N° 2	Responses of the 20 external auditor
1	All of the questioned external auditors agreed that they make sure that there is an internal procedure manual.
2	All of the questioned external auditors review these procedures to ensure that they are acceptable and satisfactory.
3	80% of the questioned external auditors stated that they make sure that there is a risk map for the company.
4	Only 50% of the questioned external auditors verify that the risk areas have been dealt with through internal control.
5	70% of the questioned external auditors make sure that the internal control function exists in the audited company and that it is under the direct supervision of the directorate general (its independence from the executive management)
6	50% of the questioned external auditors make sure that the internal control contains sufficient human and material resources in view of its program of interventions.

Source: prepared by the authors based on the results of the check-list

Table (2) shows that the majority of the questioned external auditors, identify the existence and effectiveness of the internal control system of the audited company by making sure that the internal control procedures are acceptable and satisfactory, the existence of a risk map and these risks have been dealt with through internal control, the separation of duties from authority,in order to determine the defect points in the internal control system and to which extent that the external auditor can rely on this system by assessing the internal control risk, to further determine the acceptable level of the non-detection risk thus the audit risk as whole. All of this aids the auditor to planify the audit mission, choose the sample of the verification program and to set the scope of the audit procedures.

Based on the answers given by the interviewed external auditors, we can conclude thatthey do identify the internal control system in the audited company andall of this proves the second hypothesis.

- **Third hypothesis:** The external auditor evaluates the internal control risk in order to determine the verification program of the accounts.

Table 3: evaluating the internal control risk

Axe N° 3	Responses of the 20 external auditor
1	All of the questioned external auditors focus on areas that are likely to reveal material misstatements. Where 90% of them stated that these accounts are determines based on: accounts whose balance represents an important part of the financial statements, accounts that are inherently risky, accounts that do not have a significant balance but pass through them valuable data.
2	50% of the questioned external auditor describes the company's cycles (purchase cycle, sales cycle, treasury...) through a document flow chart.
3	All of the questioned external auditors stated that they do evaluate inherent risks and internal control risks and make sure that it's in an acceptable level.
4	90% of the questioned external auditors stated that they verify the effectiveness of the internal control system through conformity tests and validity tests.
5	80% of the questioned external auditors stated that in case if the internal control system is judged ineffective, the auditor resorts to increasing the scope of the audit program.

Source: prepared by the authors based on the results of the check-list

Table (3) shows that the majority of the questioned external auditors evaluate the internal control system: They focus on areas that are likely to reveal material misstatements such as accounts whose balance represents an important part of the financial statements, accounts that are inherently risky, accounts that do not have a significant balance but pass through them valuable data.

They describe the company's cycles (purchase cycle, sales cycle, treasury...) through a document flow chart.

They do evaluate inherent risks and internal control risks and make sure that it's in an acceptable level afterverifying theeffectiveness of the internal control system through conformity tests and validity tests, to make sure that it's in an acceptable level, on which they can set the verification program of the accounts, and determine the scope of it, and in case the internal control system is judged ineffective, the auditor resorts to supplement audit procedures in an attempt to reduce the non-detection risk to a lower level.

5. Conclusion:

This study aimed at identifying the relationship between the external audit and the internal control system, by showing the responsibility of the external auditor (governor of accounts) in evaluating the internal control risk and its impact on the verification program, and through our study and the interview of 20 external auditor, we were able to confirm all the hypotheses of the study.

We concluded to a numerous results:

- The basis of the relationship between the internal control system and external auditing is that external auditing is concerned with measuring the effectiveness of the internal control system in the company, and the extent of its contribution to achieving its objectives. And the auditor is interested in this system preventing the occurrence of misstatement.
- The auditor's understanding of the internal control system, enables him to assess the control risk that is used as base to his tests.
- The assessment of the material misstatement risk, enables the external auditor to determine the acceptable level of non-detection risk thus the risk of audit.
- To maintain an acceptable level of audit risk, the auditor resorts to conducting supplement audit procedures by increasing the scope of the audit.
- The first hypothesis saying that the external auditor identifies the internal and external environment of the audited company, has been accepted.
- The second hypothesis saying that the external auditor identifies the internal control system in the audited company, has been accepted.
- The third hypothesis saying that the external auditor evaluates the internal control risk in order to determine the verification program of the accounts, also has been accepted.

Recommendations:

- Raising the awareness of professionals in Algeria of the need for continuous updating of their skills and competencies, through continuous review of all the developments at the international level in the field of the external audit. Especially concerning the evaluation of internal control.
- The importance of highlighting the effectiveness of the internal control system in the Algerian companies by professionals in Algeria through recommending the application of leading international model such as COSO 2013.
- Participation of professionals in Algeria in training programs in the field of auditing and internal control system, to enable them to detect and assess the risks of material misstatements.

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