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Systems Audit (Auditing Internal Control)–Dangers and Possibilities: A Case of KPMG Karlstad

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ABSTRACT

During the last few years, the global economy has experienced some corporate scandals, collapses and financial failures occurred due to unnecessary risk taking and irresponsibility by some businesses connected with a number of flaws in the internal control system of these companies. Therefore after 1980s the internal control is designed to enhance companies' prospect to accomplish company goals by avoiding frauds and auditing has been developed as a business prerequisite once. It became evident that a standardized form of accountancy must exist to avoid fraud and it has developed into a standardized yet multifarious field that is regarded as an essential procedure in the management of business finance and accounting. Most of the businesses are distinguished by a separation between management and control in today's competitive marketplace. It means that the owners and managers of these businesses are not the same people. Therefore, competent auditors are called to review the management reports presented to different stakeholders. The auditors, then, give their own audit views about these reports whether the reports show true picture of business affairs or have any kind of ambiguity leading towards the personal or business interest. KPMG Karlstad is a Limited Liability Company. The company believes particularly in financial services are the leading professional services firms in the world and it is also a global network of advisory professionals, tax and auditing. The KPMG auditors are responsible not only to give an opinion about an entity but also to detect weaknesses in auditing internal controls and to provide professional services to their clients.
The purpose of this study is to investigate the dangers and possibilities of auditing internal control.

KEYWORDS: *COSO: Committee of Sponsoring Organizations of the Treadway Commission; GAAP: Generally Accepted Accounting Principles; GAAS: Generally Accepted Auditing Standards, SOX: The Sarbanes-Oxley Act; FAR: Föreningen Auktoriserade Revisorer; KPMG Karlstad*

INTRODUCTION

Auditing: Auditing primary function is to lend credibility to the financial statements prepared by management[1]. Today business world management and ownership of the company is often separated, it means that the investors are not directly involved in the operation of the company. That's why the management of the company needs to communicate the financial position of the company to the investors, because it is the main source of information for investors[2]. Therefore the legislator has decided that the companies are required to be under continuous control by auditors, which are assigned at the general meeting[3]. The auditor not only controls the company, he/ she could also be an advisor in how the company should improve its operations and decisions. The role auditor as an advisor depends on his/her skills and experience and it is an additional assignment which is important for auditor independence towards the shareholders[4].

According to the legislation (Companies Act, 10ch 3 §), the auditor's assignments are to carry out the financial and management audit. The financial audit is a review of the accounting and annual reports while the management audit concern that how the Board Of Directors (BODs) and Chief Executive Officers (CEO) has managed the company. The review ought to be conducted according to the Generally Accepted

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Auditing Standards**. This signifies that steps in auditing are changed based on the area expansions of auditing. The Generally Accepted Auditing Standards don't say that an auditor has to review all the events in a company but to give more attention to the risks related areas and an audit varies from company to company[5].

An audit starts with the selection of areas to examine and the choice has to make that how thoroughly the areas are going to be reviewed. The selection of the areas is based on the principle of materiality and risk, where the area with the highest risk for errors should be reviewed most thoroughly. As each company is unique, therefore the audit has to be attuning to fit each company's special features. The auditor should select the most cost efficient way to reach the goals of the audit. The auditor examine the companies in two ways; audit of internal control and substantive testing. The internal control method of auditing is using for judgment that how well the internal controls are functioning by an audit of internal controls. By observing the method the controls are being done, or by observing that how well they have worked, are verified. While on the other hand the substantive testing is a form of audit of different entities, income statement, balance sheet as well as their business transactions. The selection of such entities will be made on the basis of selecting large and unusual entities. The selection can also be made by systematically choosing or by random selection[6].

The most important aim of an audit for an auditor is to produce an audit report. An audit report should cover the answers of two questions. The first question aims to describe that the annual report, the accounts, and the management been audited according to Generally Accepted Auditing Standards. The second question is that the annual report has been established according to the Companies Act. If an audit report consist on an adverse opinion (of auditor), it should be clearly stated the reason for such opinion. An adverse opinion may be results of various things, i.e. due to the negligence by the CEO or BODs, violation of the Companies Act, deficiency in the internal control, departure from the rules about paying taxes, and many other things[6].

Internal Control: Internal control is a key part of corporate governance and the management of the company is responsible to design and implement it properly. Related to internal control auditor issues internal control audit report, which provides judgments towards the effectiveness of internal control of the company. The timely issuance of corporate internal control report is subjected to the completeness of the audit. Some prior studies have presented empirical evidence, which reports that the timeliness of audit is the most influential factor in the timely report of financial statements[7]. About 70 percent of companies not announce their earnings until the publication of their annual audit report. It shows the importance of a timely audit, earnings information as well as the role of the annual audit in determining the timing of information releasing. Besides, internal control audit report provides useful information to the investors and its delay could directly affects the timeliness of accounting information, which, in turn, frustrates investors' confidence in capital market. While on its time disclosures make it possible for the public investors to access the non-financial information. Thus, the timeliness of internal control audit report is much more significant for investors to make decisions based on financial and non-financial information, which strengthens investors' confidence in capital market. On the other hand, it will reduce the rate of managers' performing adverse selection and ethical hazard resulted from information irregularity, thus shielding the benefits of investors[8]. The timeliness of public disclosures (i.e. earnings information and audit opinions) is significance because delays compromise the ideal of equal access to information among investors[9]. The issuance of audit report is absolutely associated with the timely disclosure of earnings information[10]. Moreover, the unanticipated lag of audit report is perhaps relevant to inferior quality of information[11].

COSO present a definition of internal control as: "A process, affected by an entity's board of directors, management, and other personnel, designed to provide reasonable assurance regarding the achievement of objectives in the following categories;

- Effectiveness and efficiency of operations
- Reliability of financial reporting
- Compliance with applicable laws and regulations[12]."

Internal control plays a vital role in the area of how management meets to its stewardship and agency responsibilities. Right internal controls can easily monitored efficiency and effectiveness and safeguarding

** *Guidance can for example be found in accounting recommendations published by the professional in statute for authorized public accountants (FAR, 2006).*

assets and records also possible. The information need of the users is very diverse of financial statements. The management needs a control system that creates reliable information for decision making and auditor need assurance about the data generated reliability by the information system in terms of, how it affects the fairness of the financial statements, how well the assets, and records of the entity are safeguarded. Auditor obtains understanding about internal control risk only if he/she has enough knowledge about their job. The auditor uses this understanding of internal control to identify the kinds of potential misstatements; consider aspects that influence the risk of material misstatement and plan the nature, timing and extent of further audit procedures[13]. *"The audit explosion has been possible because of the assumption that internal control systems are auditable"*[12]. The financial audits are concerned; the idea of auditing internal control systems is at the heart of the financial audit explosion. The result of the rise of internal control systems, external audits are more focused on auditing systems and less focused on auditing outcomes.

Internal Control Components:
There are five interrelated components of internal control[13];

a) Monitoring and Control
b) Information and Communication
c) Control Activities
d) Risk Assessment, and
e) Control Environment

COSO's Internal Control: Integrated Framework
Source: Enisa, 2012.[19].

a) Monitoring of control

Monitoring of control is a procedure which evaluates the excellence of internal control performance, design and operation controls over a period of time. Therefore, management needs to monitor the internal control system and other aspects of the organization[13].

b) The Information system and communication

The information systems and communication refers to the information system applicable to financial reporting objectives such as; the accounting system including manual procedures and "records established to initiate, record, process and report entity transactions and to maintain accountability for the related assets, liabilities and equity". The communication engages in providing an understanding of individual position and responsibilities pursuing to internal control over financial reporting[13].

c) Control Activities

It includes policies and procedures and ensures that management observes the likelihood of their occurrence decides upon actions to manage them and ensures that orders are carried out. The automatic control activities have different intentions, take place in diverse organization, functional levels and they contain activities applicable to audits like approvals, verifications, authorizations, reconciliations, security of assets, operating performance reviews and separation of duties or responsibilities[13].

d) Risk Assessment

The entity's risk assessment process involves the process identifying as well as reacts to business risk and their results. The entity's risk assessment process for financial intention includes how management identifies risks relevant to the preparation of financial statements that are fairly presented in agreement with the suitable financial reporting framework[13].

e) Control Environment

The control environment sets the tone of the organization and persuades the control consciousness of its people. It is the foundation for effective internal control, providing discipline, and structure. It includes attitudes, awareness, policies and` actions of management and those charged with governance concerning the entity's internal control and its importance in the entity. It is consequently the basis for all the other components[13].

Sarbanes-Oxley Act (SOX)-On Internal Control: After facing accounting scandals, USA Congress passed the landmark Sarbanes-Oxley Act (SOX) in 2002[14]. The Sarbanes-Oxley Act, Section 404 is one of the most significant provisions, which stated that the external auditor should assess the internal control over financial reporting. The external auditors then publicly disclose the internal control audit report in SEC 10-

K filings. Sarbanes-Oxley Act, Section 409 authorizes the Security and Exchange Commission (SEC) to induce reporting firms rapidly to disclose to the public information regarding to any material changes in their financial conditions or operations. SEC has phased-in accelerated deadlines for filing Form 10-Ks (from 90 days to 75 days, and then to 60 days) over a three-year period starting from Year 2003[15].

This report in Section 404 (4th title) portrays about the internal control on financial reporting, while most of the other Sections of this report illustrates about companies and auditors. This report guides the management about risks recognition concerning the financial reporting and controls established to tackle those risks and to assure that controls are properly recognized, verified and calculated. The financial reporting should include management's judgment of internal control, which gives to the management of the company an inclusive and clear direction. Besides, the external auditors have to comment on the internal control of the company after judging the company's financial reports. Strict actions might be taken against the management and the external auditors for not fulfilling the requirements or performing any unlawful activity[16].

Auditing Internal Control - Dangers and Possibilities: Most of the research of internal control resides on the nature of firms that provides material weaknesses in internal control from which dangers of auditing internal control can be derived. Weaknesses internal control are normally found in firms that are; financially weaker, smaller, younger, more complex, growing rapidly or undergoing reforming while firms with less severe, account specific problems are healthy financially although complex, diversified and have quickly changing operations[17]. The proof on firms internal control quality under Post-Sarbanes-Oxley regime is little, material weakness is one of the sternest types of internal control deficiency and that smaller firms have weaker internal controls compare to the large firms.

There are lots of material weaknesses connected to the separation of duties and staffing are: the insufficient segregation of duties, inadequate competent staffing, resources or lack of a full time CFO[17]. There are also problems of application and understanding of complex accounting standards.

MATERIAL AND METHODS

Case Study: The KPMG Karlstad[18] encountered lot of dangers during auditing internal control of their clients and the most difficult task which they face is that sometimes all transactions are not fully documented particularly in small firm. This lack of documentation coupled with the fact that different companies have different perceptions regarding internal control posses some hurdles to auditors. Also, managers sometimes try to ignore even away from their boundaries and a lack of segregation of duties further compounds the problems when auditing internal control. The company faces too many flaws when auditing internal control, because of very few clients actually come to the firm for consultancy service. Rather they come up only when audits are to be carried out and at times already having some weaknesses in its internal control system. KPMG checks their clients internal control system through their audit, which are performed by well trained professionals who know how to do their job. Whenever the firm sees any weakness in the internal control, they disclose it. By doing so, many companies try to check their internal control and therefore KPMG audits go a long way to help companies in order to sort out ways of improving their internal control system. During performing an audit IAS and GAAPs and other regulations are being followed by auditors. Doing the thing right is important and which is the essence of the entire regulatory framework regarding the preparation of audits. Also, the company tries to do the right thing by considering certain issues which are valid to certain countries depending on which country the audit is being carried out. The firm uses the same audit manual but there is often a cultural twist concerning certain laws applicable in certain countries but this does not turn aside the purpose of the audit in finding out whether the information provided to the various stakeholders present a trust and fair view of the entity in question, so it is important to do the right thing in the right way.

KPMG provides IT experts for any big assignment to their clients, who review the IT system of clients firms and see if sure alteration needs to be made before their commencing the audit. Small companies usually have less documentation than large companies and several things are instead based on trust in the company. This makes it difficult to carry out substantive testing as at times, what is material is not documented by such small firms where documentation is too small, it is almost impossible to audit such an internal control system and the KPMG resigns as auditors from such firms.

Discussion/ Analysis and Interaction of the Case:

In this section we will briefly analyse and interpret the case in order to obtain a better understanding of the systems audit (auditing internal control) dangers and possibilities and what we can learn from the study.

In businesses the identification of problem is the first step to resolve it and the company meets to too many dangers during auditing the internal control of their clients. The most serious danger is the error of commission in firms. The KPMG professional offer assistance to their clients in the identifying and managing risk to create efficient and stable processes in their clients firms not only but also provides consultancy services with the national and international regulatory codes. Still there are so many flaws when auditing internal control. The clients come for consultancy services relatively when audits are to be carried out and at that time having some weaknesses in its internal control system. It means there is need for companies to regard the designing of a good internal control system as part of a way of reducing risks. It is better to take safety measures than to manage disasters. The KPMG help out companies to check their internal control system is through audit which is performed by well trained professionals and IAS and GAAPs rules are being followed by auditors. The company believes that doing the thing right is more important and the relationship between weaknesses in the internal control system and audit fee is depends upon the substantive testing and the time conducting the audit.

Today, most of the firms have complex computerized systems. Auditing the internal control of these firms will engage that the auditors require must be sure whether the IT clients are reliable because of the substantive testing. In today competitive business world the substantive testing mostly depends upon IT. Non genuine computerized internal control system will be leads to a faulty report as well. The complexity of the internal control systems is a problem to audits and after fully understanding the business of the clients the auditors can audit the internal control of any company. In understanding the business, the IT system review is the elementary aspect in this regard. It is done to be sure that the system is according to the codes or rules of accounting. This area brings out the distinction among accountants and auditors. We often listen that not all accountants are auditors but all auditors are accountants; auditors need a lot of other skills other than book keeping.

It is clear that most of the small firms have some limitations or flaws in their internal control system as compared to large firms and the main reason behind the fact is that small companies usually have less documentation than large companies. In small companies several things are instead based on trust and they give little consideration to the rules and regulation of the company. The lack of rules and regulation and not proper documentation brings dangers as well as risk to the firm; and such internal control is impossible to audit.

Conclusion:

The main aim of the paper was to find out KPMG auditing internal control-dangers and possibilities. This paper demonstrate that whether there are any dangers or possibilities of Auditing Internal Control of KPMG company, if not, Why? And if yes, what are they?

No doubt that there are a lot of possibilities as well as dangers when we see the auditing internal control system of the KPMG in both theoretical and in empirical part. Audit of internal control is possible if the audit professionals and specialist completely recognize the system and if they have access to the information which they required.

It was found that the scope and performance of the audit work influence the internal control of a firm. The management of the audit department, professional proficiency and evaluation influence the monitoring aspects of internal control, small firms obviously have less or weak internal control than large firms. Continuous monitoring is a key for the firm effective internal control system and employees who perform several tasks in a single time create loop holes to fraud. The management portrayal of responsibilities as well as authority within the organization and the capable employees who performed their responsibilities efficiently can also enhance internal control. The proficient audit and audit reporting influences the system (internal control).

Hence, there are weaknesses as well as possibilities in auditing internal control as well. Through the proper implementations and the practices of rules and regulations the company not only enhances an effective internal control, but may also go a long way to decrease such weaknesses in firms.

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