

**PECULIARITIES OF THE AUDIT ASSESSMENT OF THE INTERNAL CONTROL
SYSTEM OF A BUSINESS ENTITY**

**ОСОБЕННОСТИ АУДИТОРСКОЙ ОЦЕНКИ СИСТЕМЫ ВНУТРЕННЕГО
КОНТРОЛЯ СУБЪЕКТА ХОЗЯЙСТВОВАНИЯ**

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Abstract. The article defines the key issues and approaches to assessing the internal control system of a business entity during the audit of financial statements. Particular attention is paid to determining the auditor's understanding and assessment of the elements of the control environment of an entity, the problems of assessing the effectiveness of the internal control system for the implementation of management decisions. The results of the analysis show that the effectiveness of the internal control system depends primarily on the degree of its understanding by the management and owners of the entity, and a correct assessment of the auditor allows him to determine the most appropriate choice of a set of audit procedures when planning and conducting an audit. The correct understanding of the effectiveness of the entity's internal control system, underestimation or overestimation of its condition and confidence in it during the audit has a significant impact on the level of audit risk. The application of certain approaches ensures a sufficient understanding of the internal control system and its assessment by the auditor.

Keywords: audit risk, effectiveness of the operation of internal control, evaluation of the control system

JEL Classification: M42

Introduction

Internal control at all levels of management is a requirement for a modern enterprise. Effective management control in general provides certain guarantees of the company's successful operation in a competitive market environment.

International Standards on Auditing (hereinafter referred to as ISAs) require the auditor to exercise professional judgment and maintain professional skepticism in planning and performing the audit, including in relation to the identification and assessment of the risks of material misstatement, whether due to fraud or error, based on an understanding of the entity and its environment, including the entity's internal control [1].

Thus, in accordance with the requirements of the standards, the audit, along with other issues, examines and assesses the state of the company's ICS. The nature and quality of the audit will largely depend on such an assessment of the client's existing internal control system.

Basic Content of the Paper

The relevance of the issue of assessing the internal control system of an enterprise, and in particular during the external audit, is due to the constant scientific interest of researchers. Significant contribution to the development of scientific thought on internal control of enterprises was made by such authors as S.V. Bardash, M.T. Bilukha, F.F. Butynets, N.G. Vygovska, E.V. Kalyuga, L.M. Kramarovsky, M.V. Kuzhelnyi, A.M. Kuzminsky, V.F. Maksimova, L.V. Napadovska, V.V. Sopko, B.F. Usach and others.

The issues of internal control assessment in the process of external audit are considered in the works of N.I. Dorosh, L.P. Kulakovska, T.O. Kamenska, O.A. Petryk, O.Y. Redko [2; 3; 5].

The state of scientific research on internal control is confirmed by the presence of a number of controversial issues regarding the problems of definitions, fundamental approaches to its organization, standardization of control procedures, regulatory and methodological support for the functioning of internal control systems of business entities in various fields of activity. Some methodological issues still remain open, such as assessing the quality of the internal control system (hereinafter – ICS), the factors of economic violations, the need to develop effective means of influencing the ineffective control environment, etc.

Standards on quality control, auditing, review, other assurance and related services in Ukraine include a number of standards, that contain provisions on key matters on which the auditor should obtain information, that would enable the practitioner to gain an understanding of the entity's internal control. Such standards include, in particular, the following: ISA 200 «General Objectives of the Independent Auditor and the Performance of the Audit in Accordance with International Standards on Auditing», ISA 230 «Audit Documentation», ISA 240 «Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements», ISA 250 «Considerations of Legal and Regulatory Requirements in the Audit of Financial Statements», ISA 315 «Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and its Environment», ISA 320 «Materiality in Planning and Performing the Audit», ISA 330 «Auditor's Response to Evaluated Risks», ISA 610 «Use of Internal Auditors» etc. [1].

ISAs define internal control as a process that is designed, implemented and maintained by those charged with governance, management, and other employees to provide reasonable assurance regarding the achievement of an entity's objectives relating to the reliability of financial reporting, efficiency and effectiveness of operations, and compliance with applicable laws and regulations [1, p.17].

In general, the consideration of ISA 315 approaches to the internal control system is consistent with the COSO model.

According to ISAs: internal control is designed, implemented and maintained to respond to identified business risks, that impede the achievement of any of the entity's objectives relating to: the reliability of the entity's financial statements; the efficiency and effectiveness of its operations; and the entity's compliance with applicable laws and regulations.

The way internal controls are designed, implemented and maintained varies depending on the size and complexity of the entity.

There are also a number of interpretations of the concept of internal control in scientific publications. It should be noted that internal control is also considered as a system, a process, an independent assessment of the compliance of the company's activities with the tasks set, etc.

Let us note some of them, which, in our opinion, meet the goal of obtaining an understanding by the external auditor of the internal control of the client's activities.

L. V. Napadovska understands internal control as a process, that ensures the quality development and effective achievement of the goals set by the organization through the organization of management decisions [8, p. 18].

V.F. Maksimova, considering control as a system, emphasizes, that the control system is an organizational aggregate, that forms a well-defined integrity, a unity of elements that are, on the one hand, in relations and connections with each other, on the other - with other components of an integrated management system [6, p. 103].

M.D. Korinko notes, that internal control is a system of measures determined by the management of the enterprise and implemented at the enterprise in order to ensure the most efficient performance by all employees of their duties to ensure and carry out business operations. Internal control determines the legality of these operations and their economic feasibility for the enterprise [4, p. 53].

The internal control system of an enterprise includes methods and procedures of three main categories that are developed and used by the administration to provide sufficient assurance of compliance with the control tasks. They are called elements of the internal control system, they include: control environment; accounting system: control points (procedures).

The organization of the company's internal control depends on its legal form, types and scope of activities, complexity of the organizational structure, availability of sufficient financial resources, expediency of controlling various aspects of activities, management's awareness of the importance and necessity of control and responsibility for its organization and implementation.

The system of internal control in a corporation usually includes:

- a governance structure to facilitate the exchange of information and ensure a certain degree of collegiality in decision-making, taking into account measures to avoid undue concentration of power, in order to reduce the risk of abuse or fraud;
- procedures for identifying conflicts of interest relating to directors or other officers, and for reporting them to the governing bodies and, where appropriate, to the owners;
- a procedure, that ensures management's effective control over the company's activities;
- availability of qualified internal auditors, auditors responsible for monitoring compliance with the established internal regulations, aspects of compliance with regulatory and legal requirements, proper professional behavior and fair business practices;
- engaging independent external auditors to determine the reliability of the corporation's financial statements, analyze and confirm the proper financial condition, and externally monitor compliance with applicable rules.

The assessment of the client's internal control system is inextricably linked to the auditor's understanding of the business entity and its environment, including internal control. The main approaches to obtaining such an understanding are set out in ISA 315.

The standard requires the auditor to obtain an understanding of the internal control environment. To do so, the auditor should evaluate:

- (a) whether management, under the supervision of those charged with governance, has established and maintained a culture of integrity and ethical behavior;
- b) whether the elements of the control environment together create an acceptable basis for other components of internal control and whether the deficiencies of the control environment have a negative impact on these other components [1].

The division of internal control into five components (control environment; entity risk assessment process; information system; including related business processes relevant to financial reporting and communication of information; control measures; monitoring of control measures) provides a useful basis for auditors, to consider how various aspects of an entity's internal control may affect the audit. This categorization allows for a systematic view of the existence and operation of the individual components of the framework in relation to how an entity designs, implements and maintains internal control, or in relation to any individual component.

The control environment includes power and management functions, as well as the attitude, awareness and actions of those with the highest authority and management personnel related to the internal control system and its importance to the entity [1, p.17]. The control environment is a component of the internal control system. That is, the control environment provides a set of conditions, that determine the functioning of control, establishing processes, operations, regulations, structures and distribution of powers, rules and principles of human resource management aimed at achieving certain goals. Control objectives are related to the risks that control measures are aimed at mitigating.

ISAs identify seven elements of the control environment that may be relevant to the auditor's understanding of the control environment. These elements include: communication and enforcement of professional integrity and ethical values; commitment to competence; participation of those most

closely related to the audit; management philosophy and work style; organizational structure; assignment of authority and responsibilities; and human resources policies and practices.

The external auditor's risk assessment of an entity is aimed at identifying and analyzing risks related to the preparation of financial statements in accordance with the chosen conceptual framework and compliance with generally accepted accounting principles.

The assessment of the company's internal control system is inextricably linked to gaining an understanding of the company's risk assessment process. This process provides the basis for management to determine the existence of various types of internal and external risks that can be managed. Accordingly, the auditor's objective is to identify the risks not identified by management and the reasons why, and whether the process is acceptable in the circumstances. The auditor determines whether there are material weaknesses in internal control over the identification of business risks relevant to the financial statements.

The auditor focuses primarily on those controls that are relevant to the audit. Controls are important in relation to: completeness and accuracy of information, if the auditor will use this information; performance and compliance objectives, if they are related to the data being evaluated; and asset protection, which is limited to those related to the reliability of the statements.

In general, controls relevant to the audit are associated with: reviewing and analyzing results; ensuring efficient information processing, in particular, by individual applications; physical controls designed to prevent theft and damage to assets; segregation of duties to eliminate opportunities for concealment of errors and fraud.

The assessment of a control measure is aimed at determining whether the measure, alone or in combination with other measures, is capable of effectively preventing or detecting and correcting a material misstatement. The decision whether a control is appropriate for the audit is a matter of the auditor's professional judgment.

A direct relationship is considered to exist between an entity's objectives and the controls it implements to achieve those objectives. Controls are policies and procedures, that help to ensure compliance with management's instructions and are designed to provide reasonable assurance, that the objectives will be achieved. The term "control measures" refers to any aspect of one or more components of internal control [1, p.17]. Therefore, it is important to consider the impact of the nature of the environment on the significance or absence of certain control measures. The auditor gets an idea of the client by determining the specifics of measures and procedures in relation to each element of the control structure, and by finding out whether they actually work, i.e. whether they are used in the enterprise, how and whether they meet the specified goals.

For example, small enterprises may apply less structured internal control measures, have a limited amount of segregation of duties of personnel in accordance with the available staff and simultaneously strengthen supervision by the manager. However, in the overall approach of balancing the interaction of components, such a structure can provide an appropriate level of internal control.

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The Standards provide a list of important factors for the auditor's judgment in relation to the event under review. These factors include: materiality; significance of the risk involved; size of the entity; nature of its business, including its organizational and ownership structure; variety and complexity of business transactions; applicable legal and regulatory requirements; circumstances and applicable component of internal control; and nature and complexity of systems that are part of internal control. To obtain evidence of the correct use of measures and procedures, the auditor analyzes records, documents, reports; makes inquiries to personnel; monitors the application of measures; conducts tracking through information systems, etc. In doing so, the auditor should determine the optimal amount of information to be investigated and take into account that the cost of evidence should be minimal.

Monitoring of control measures is a process designed to assess the effectiveness of internal control over time [1]. Management is responsible for organizing and implementing internal control on an ongoing basis. Monitoring activities can be performed by internal auditors or other personnel with this authority. Such actions are aimed at continuous or periodic assessment of the quality and effectiveness of internal control.

For the external auditor, it is important to gain an understanding of:

- the main types of actions taken by the entity to monitor internal control over financial reporting and how they affect the need to modify controls in certain circumstances;
- the main sources of information for monitoring and the grounds for considering such information sufficient and appropriate for monitoring activities.

The auditor's understanding of the control structure is formed on the basis of the previously accumulated experience of previous audits, current questioning of the client's personnel, observation of the performance of their duties and analysis of the description of measures and procedures prepared by the client, as well as studying the relevant type of documentation, using a combination of measures. In addition to the above, discussing the organization and implementation of control with management is one of the most common ways to achieve an understanding of internal control.

An adequate assessment of the internal control system by the auditor is the basis for making the right decision regarding a certain range of issues addressed by the auditor. Underestimation of the concept of internal control of a business entity during the audit may lead to unreasonable labor costs, loss of efficiency of the auditor's work, increase in the audit time, etc. Accordingly, overestimation of the quality of the internal control system and its compliance (overconfidence) may result in: insufficient level of audit research (scope of procedures applied) and increased risk of missing material misstatements; provision of an unreliable opinion; financial losses due to subsequent claims of the client and users of the statements; loss of a positive image of the auditor.

Thus, the assessment of the internal control system is necessary to optimize the scope, content and sequence of audit procedures during external control. The development of a methodology for assessing the internal control system by audit entities is a rather relevant issue for practicing auditors. It may be noted, that the process of assessing the internal control of an enterprise includes several main interrelated stages, namely: preliminary assessment of the overall structure in the process of familiarization with the business entity; obtaining an understanding of the reliability of the system and control measures relevant to the audit; monitoring of control measures; confirmation of the reliability of the assessment.

Regulation by the audit standards of approaches to determining the main characteristics of the internal control system, that should be taken into account by the auditor is aimed at forming a correct understanding of the features of the existing internal control system, determining its key components that are subject to a certain assessment by the auditor and guides auditors to identify and formalize the necessary criteria for such assessment.

One of the most common methods of assessing the adequacy of the internal control system is testing. The testing should cover all five components of the system outlined above and determine the

existence of specific risks at the enterprise and weaknesses in internal control. Sampling in testing helps the auditor to determine the required amount of data for verification and how to select it. An important factor in determining the sample size is the significance of the accounting and reporting information and the degree of confidence established by the company's management. An insufficient number of tested items increases the risk of incorrect conclusions. The number of such items should be optimal, taking into account all key approaches, that determine compliance with the established criteria. The scope of testing of a particular control procedure depends on many factors, including the possibility of using manual or computerized tools.

It should be borne in mind, that the internal control system cannot be assessed as perfectly effective due to possible limitations, for example: the time of control procedures; resources of the internal control system; the presence of a subjective component regarding individual judgments of the internal control system employees; neglect of the internal control principles, etc.

Most often, the reliability of the internal control system is assessed on a scale of priorities as high, medium, or low, respectively.

The authors of scientific publications on possible assessments of internal control identify several types of assessments: assessment of the effectiveness of the control system; assessment of the quality of control processes; assessment of the quality of information obtained as a result of control. Each of the assessments can be considered as a completely independent assessment, with different aspects being characterized [2]. Accordingly, depending on the tasks facing the auditor and the need to consider certain aspects and his professional judgment, the auditor may apply these assessments.

We share the opinion of the authors, that the concept of control quality should be based on the systematic approach, i.e. on the study of internal control as a system that has both system-wide and its own principles of organization and functioning, and only it has inherent evaluation criteria. Accordingly, we believe that it is possible to use the matrix approach to determine the degree of implementation of the principles of organization and functioning of the internal economic control system according to a certain set of criteria for assessing its quality as an assessment method [7].

Conclusions

The need for the auditor to obtain an understanding of the company's internal control system during the external audit is not only due to the requirements of the applicable regulations, but is an objective reality and a requirement of the present. Obtaining such an understanding by the auditor is associated with a number of actions and procedures that require certain holistic knowledge of the construction and functioning of the company's internal control system. As a rule, the more complex the company's accounting and internal control systems are, the more difficult it is to analyze and evaluate them, the greater the scope of audit procedures to be performed by the auditor and, accordingly, the greater the amount of working documentation to be prepared.

Further research is required to detail the content of audit procedures for assessing the internal control system in accordance with its individual components and to substantiate the criteria for the sufficiency and reliability of the audit evidence obtained to understand the internal control system of the entity and the criteria for assessing its effectiveness. Particular attention should be paid to the methodological support of practicing auditors in meeting the requirements of ISAs in accordance with the issues of understanding the internal control system of various organizational and legal forms of business entities, taking into account industry specifics.

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