Investigating Possibilities and Threats in Performing an Audit of Internal Control Systems - An Empirical Study on KPMG Company

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Abstract: The purpose of this study is to investigate the threats and possibilities of auditing internal control. To achieve the purpose, data was collected using a qualitative research approach. The empirical data has been collected through face-to-face interviews with respondents from KPMG Company in Karlstad, Sweden. The study concludes that there are weaknesses in auditing internal control and possibilities as well and author is not saying that his recommendations can completely solve these problems or weaknesses; rather he say that if they are properly applied it may go a long way to reduce such weaknesses.

Index Terms - Audit, Internal Control, Material Weaknesses, KPMG,

1. INTRODUCTION
The auditing discipline is almost as old as human civilization. Auditing is all concerned with lending credibility about an event. Many businesses in today’s competitive market place are characterized by a divorce between management and control; such that the real owners of these businesses are not the same people who manage these businesses. This call for competent independent persons (auditors) to subject the report presented by management to the various stakeholders under scrutiny and present an opinion contained in an audit as to whether the reports present a true and fair view of the business in question. In recent years, the global economy has experienced some corporate collapses, scandals and financial failures stemming from excessive risk taking and irresponsibility by some businesses coupled with many weaknesses in the internal control system of these companies. In recent years, the auditor’s responsibility in many countries has been extended from just presenting an opinion regarding an entity to the identification of weaknesses in the internal control system (auditing internal control). The threats and possibilities of auditing internal control is what this paper is trying to investigate.

1.1 Problem Statement: The evolution of auditing has made business fraud to be a major concern in the auditing profession and in the business community at large. According to SEC (1988) in (Doyle et al., 2007) pre-Sarbanes-Oxley required firms to maintain an adequate system of internal control but only disclose any deficiencies publicly if there was a new auditor. But Doyle et al., (2007) believe that there is little proof about the quality of internal control for firms in general, under the new Sarbanes-Oxley regime. On that note, Power (1997) in (Humphrey and Owen, 2000) argues that the auditing objective is no more centering on the quality of operations but now focuses on the quality of systems of control over operations. And according to Patterson and Reed (2007), the current audit environment emphasizes the independent auditor’s responsibility for detecting and deterring fraud and managers of public companies are subject to new fraud prevention measures enacted under the Sarbanes-Oxley Act of 2002 and administered by the Securities and Exchange Commission (SEC). Auditing internal control is one of such steps towards fraud detection. The pressing issue at hand is that there is so much complexity regarding the internal control system of many companies causing auditors to encounter some threats while carrying out their duty.

1.2 Purpose: The purpose of this study is to investigate the threats and possibilities of auditing internal controls. The paper will also try to question the integrity of an auditor while auditing internal control.

2. METHODOLOGY
The paper will take the form of a qualitative case study approach. This paper starts with a short theory on the method used in study, followed by a theoretical framework on the main topic of internal controls, and then empirical part followed by the analysis is presented. Thereafter is presented the findings and recommendations and ends with conclusions.

2.1. A Brief Presentation of the Case Study Method: Case study research focuses on understanding the dynamics present within single settings and can be used for several purposes: to provide description, to test theory or to generate
experience…" to be in harmony with the reader’s own observation and archives (Eisenhardt 1989). Collecting data, such as interviews, questionnaires, to combine qualitative and quantitative methods of data collection, allows for a more comprehensive understanding of the research topic.

When conducting a case study, it is common to combine qualitative and quantitative methods of collecting data, such as interviews, questionnaires, observation and archives (Eisenhardt 1989).

2.2. Validity and Reliability: Validity and reliability are some of the main objections for case study research (Brown, 1998). Validity is defined as: “An account is valid or true if it represents accurately those features of the phenomena that it is intended to describe, explain or theories” (Hammersley, 1992 in Brown, 1998 p.85). In social science there is no objective truth, the closest we can come to the truth is when a number of people argue that something is a correct description (Jacobsen 2007).

According to Bryman and Bell (2007), there are two types of validity; External validity and internal validity. External validity is “the degree to which findings can be generalized across social settings” and Internal validity is “whether or not there is a good match between the researcher’s observations and the theoretical ideas they develop” (Bryman & Bell, 2007 p.410). Reliability is the notion that if the researcher or someone else were to conduct the same study again, they would come to the same results as the first one (Brown, 1998). This is what Bryman and Bell (2007) refer to as external reliability. Internal reliability refers to the probability that if there is more than one observer, members of the research team agree about interpretations (Bryman & Bell 2007).

2.3 Conducting the Case Study: A case study can be useful if we want to achieve a deeper understanding of a certain situation (Jacobsen 2007) – this is the goal of this paper, to better understand the threats and possibilities of auditing internal control from the perspective of a re-known Audit firm called KPMG in Karlstad, Sweden. As stated previously, case studies typically combine different methods of collecting data both quantitative and qualitative (Eisenhardt, 1989), in this study author have not combined methods but have taken a qualitative approach and used the interview method, particularly face-to-face interviews for gathering information. Consistent with author’s choice, Bryman and Bell (2007) believe that the interview is the most widely used method in qualitative research.

Similarly, Silverman (2010) points out that interview studies based on a few cases and using open-ended questions constitute qualitative research. In this study only open-ended questions have been used in order not to limit respondents and to allow flexibility. A potential problem in the research is the control over the data (Brown, 1998). According to Bryman and Bell (2007), qualitative research has problems of generalization. This was identified as a problem when writing this paper since most of the information was limited to or provided by a few respondents allocated to researcher by the company. Author has tried to find alternative sources and to have a critical view on the data in order to minimize this problem.

2.3.1 Face-to-Face Interview: For investigation, a face-to-face interview was carried out with the respondents to get information. According to Bryman and Bell (2007), with face-to-face interviews researchers can create personal contact with the interviewees leading to more reliable information; which is an advantage to this study. Furthermore, face-to-face interviews are also disadvantageous because they take time, resources and also the researcher can influence the interviewee’s answer through their facial expressions (Bryman and Bell, 2007).

2.3.2 Interview Preparation: The first step was to design an interview guide. According to Silverman (2010 p.194), “qualitative interview studies tend to be conducted with quite small numbers and with rather informal patterns of questioning” so that the interviewee can set the pace. Similarly, Bryman and Bell (2007) emphasize that in qualitative interviews the interest is more on the interviewee’s perspective. That is why researcher chose to use only open-ended questions to allow flexibility. Author of this paper had to come up with several questions in relation to the purpose for his study which he puts together, selected those that were appropriate for his investigation and then formulated the interview guide with 12 open-ended questions. Author has tried to relate the interview guide to his theoretical framework so that the data collected can be easily analyzed. An appointment was then made with KPMG to schedule a date for conducting the interview.

2.3.3 The Interview Process: Prior to the start of the interview, the respondents were assured of anonymity after this study, researcher introduced himself and informed them the purpose for his study. Silverman (2010) asserts that it is a must for interviews to be recorded. Following that researcher asked the respondents if he could record the interview and so his interview was recorded. The interview was carried out during KPMG working.
hours at the scheduled time that researcher was given and lasted for one hour.

2.4 Analyzing the Data: According to Eisenhardt (1989), “analyzing data is the heart of building theory from case studies” and Miles (1979) in Bryman and Bell (2007) further states that qualitative data is an “attractive nuisance” because its richness makes it attractive and yet it is hard to analyse that richness. For his analysis researcher has used some raw data from the interview as he carried out since his respondents were not many.

3. FRAME OF REFERENCE
3.1 Internal Control: Before theorizing internal control, it is important to know what auditing means. According to Eilifsen et al. (2006) a widely cited definition of auditing is the following:

“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” (Ibid, p. 11).

According to SEC (1988) in (Doyle et al., 2007) pre-Sarbanes-Oxley required firms to maintain an adequate system of internal control but only disclose any deficiencies publicly if there was a new auditor. But Doyle et al., (2007) believe that there is little proof about the quality of internal control for firms in general under the new Sarbanes-Oxley regime. On that note, Power (1997) in (Humphrey and Owen, 2000) argues that the auditing objective is no more centering on the quality of operations but now focuses on the quality of systems of control over operations.

According to COSO (1992) in (Maijoor, 2000) internal control is defined as: “A process, effected 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: a. Effectiveness and efficiency of operations; b. Reliability of financial reporting and, c. Compliance with applicable laws and regulations”

Internal control is a vital role in how management meets its stewardship or agency responsibilities. Efficiency and effectiveness can be easily monitored and the safeguarding of assets and records is also possible where there is the right internal control (Eilifsen et al., 2006, p.177). The information need of the users of financial statements is very diverse. According to (Eilifsen et al., 2006), management needs a control system that generates reliable information for decision making. Eilifsen et al., (2006) also point out that, auditor need assurance about the reliability of the data generated by the information system in terms of how it affects the fairness of the financial statements and how well the assets and records of the entity are safeguarded. The auditor can only obtain an understanding of an entity’s internal control risk if he or she has enough reliable information relevant for this job. Eilifsen et al., (2006) pointed out that the auditor uses this understanding of internal control to identify the types of potential misstatements; consider factors that affect the risk of material misstatement; and design the nature, timing and extent of further audit procedures.

Power (1997, p. 83) in (Maijoor, 2000) argues that “the audit explosion has been possible because of the assumption that internal control systems are auditable”. Maijoor (2000) pointed out that as far as financial audits are concerned, the concept of auditing internal control systems is at the heart of the financial audit explosion and as a result of the rise of internal control systems, external audits are less focused on auditing outcomes, and more focused on auditing systems. Power (1997) mentioned that whether or not a system is auditable is not determined by technical auditing aspects but by the acceptance of audit ability by the profession.

3.2 Internal Control Components: According to Eilifsen et al., (2006 p.178) there are five interrelated components for internal control as mentioned below;

1. Control Environment: This sets the tone of the organization and influences the control consciousness of its people (Eilifsen et al., 2006) and 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 (Eilifsen et al., 2006). It’s therefore the foundation for all the other components.

2. The Entity’s Risk Assessment Process: This entails the procedure identifying and responding to business risk and their results. According to Eilifsen et al., (2006) the entity’s risk assessment process for financial purposes includes how management identifies risks relevant to the preparation of financial statements that are
fairly presented in accordance with the applicable financial reporting framework.

3. Control Activities: Control activities comprises policies and procedures that help ensure that management sees the likelihood of their occurrence and decides upon actions to manage them and ensures that directives are carried out (Eilifsen et al., 2006). Manual or automated control activities have various intentions and take place in diverse organization and functional levels and they include activities applicable to audits like approvals, authorizations, verifications, reconciliations, operating performance reviews, security of assets, and segregation of duties (Eilifsen et al., 2006).

Section 404 of the Sarbanes-Oxley Act requires “companies to report on the internal control over financial reporting and requires auditors to render an opinion on that report and an opinion on the effectiveness of the internal control” (Weirich et al., 2005). Back then investors were not really concerned about internal control issues because management hardly discussed it in their annual reports (Weirich et al., 2005).

4. The Information System and Communication: This is concerned with the information system applicable to financial reporting objectives like the accounting system, including automated or manual procedures and “records established to initiate record, process and report entity transactions and to maintain accountability for the related assets, liabilities and equity” (Eilifsen et al., 2006). The above authors’ further point out that communication involves providing an understanding of individual roles and responsibilities pertaining to internal control over financial reporting.

5. Monitoring of Control: According to Eilifsen et al. (2006), monitoring of control is a process which evaluates the quality of internal control performance as well as the design and operation controls over a period of time. Hence, internal control system must be monitored by management and others concerned in the organization.

3.4 Threats and Possibilities of Auditing Internal Control: Most research on internal control dwells on the nature of firms that disclose material weaknesses in internal control from which threats of auditing internal control can be derived. According to Doyle et al. (2007) internal control weaknesses are commonly found in firms that are smaller, younger, financially weaker, more complex, growing rapidly, or undergoing restructuring while firms with less severe, account-specific problems are healthy financially although complex, diversified, and have rapidly changing operations. Doyle et al., (2007) also argue that the evidence on firm’s internal control quality under post Sarbanes-Oxley regime is little. They believe that Adattachment weakahd is the most severe type of internal control deficiency and that smaller firms have weaker internal controls than the large firms.

According to Paul (2005), the disparity between auditing internal control and a financial statement is the chance to put right deficiencies. Using auditors suggested adjustments firms can correct detected material misstatements of a financial statement audit
in progress, but the problem is the auditor may not be able to fix in time the material control weaknesses he may detect. The auditor’s view is “as of” the balance sheet date and this causes him to render an adverse opinion on internal control in times when material weaknesses are present and the possibility is that the auditor may also in the same audit report “render an unqualified opinion on management's assessment if it also concludes that internal control is not effective (Paul, 2005). Paul (2005) further highlights some facts that can be related to threats of auditing internal control since they result in the auditor’s adverse opinion.

a. In circumstances where the company has not recognized material misstatements and the auditor detects them, this can cause the auditor to render an adverse opinion of the audit.

b. A possible material weakness is inadequate documentation and this is a control deficiency which can cause the auditor to render an adverse opinion.

c. When there is inadequate management assessment, a scope limitation requiring “a disclaimer, a qualified opinion on internal control, or withdrawal from the engagement” is created. This is because it necessitates auditors to exceed the review and evaluation of controls which was the norm for reporting on financial statements.

Doyle et al. (2007) also point out that there are many material weaknesses which are associated with segregation of duties and that the common issues related to staffing are “inadequate segregation of duties,” “inadequate qualified staffing and resources,” or “lack of a full-time CFO.” They additionally reveal that there are also problems of interpretation and application of complex accounting standards.

Studies examining big vis-à-vis small accounting firms show that it is very hard to make inferences regarding the quality of the auditor or the incentives for auditors due to problems of selection. ACK (Ashbaugh, Collins, and Kinney) in Leone (2007) believe that firms that are audited by big audit firms will more likely report internal control deficiencies than firms audited by small audit firms other factors constant (Leone, 2007). They believe that it is due to the fact that “large auditors are better able to identify internal control problems, and also have litigation-related incentives to pressure firms to report these deficiencies” (Leone, 2007).

4. EMPIRICAL DATA AND ANALYSIS

4.1 About the KPMG: KPMG AB is “a Swedish limited liability company and a member firm of the KPMG network of independent member firms affiliated with KPMG International Cooperative (“KPMG International”), a Swiss entity” (KPMG, 2016). The Company believes to be one of the leading professional services firms particularly in the area of financial services. KPMG is also part of the leading global networks of Audit, Tax and Advisory professionals in services related auditing. The company aims to provide its clients professional services that meet today’s market high demands (KPMG, 2016).

4.2 Perceptions about Auditing Internal Control: KPMG believes that corporate governance is crucial to companies' sustained development and success and that Internal Audit, Risk & Compliance Services (IARCS) integrates corporate governance from the areas of internal audit, internal control, risk management and sustainability. This audit firm tries to deploy multidisciplinary teams experienced in financial and operational internal auditing, IT, fraud analytics and risk assessment, shared services, finance management, treasury and financial instruments, and the supply chain to enhance organizations’ existing internal audit capabilities (KPMG, 2016).

KPMG helps its clients achieve their corporate goals in a more targeted manner by outlining business risks more transparently, setting up controls more effectively, and assisting clients with enhancing their corporate governance structure. This audit firm’s in-depth practical know-how coupled with its broad project experience with companies of various types and sizes in a wide range of industries enables it to develop efficient strategies in line with clients' specific needs (KPMG, 2016).

In 1999, KPMG reviewed its internal control structure (to what they call a practical manual). Provision D.2.2 of this practical manual advocated that Companies which do not have an internal audit function should from time to time review the need for one. KPMG believes that internal control is very essential for all companies but also acknowledges the fact that internal control can help minimize the occurrence of errors and breakdowns but cannot provide absolute assurance that they will not occur (KPMG Internal Control Practical Guide, 1999). From KPMC’s view point (going by the practical guide regarding internal control, 1999); sound internal control and risk management supplement entrepreneurship and not replace it and the role of internal control is to manage risk rather than to eliminate it.

4.3 Threats of Auditing Internal Control: KPMG Karlstad is a subsidiary of KPMG whose
main mission is to inspire confidence, create value, and reduce risk (KPMG, 2016).

Mathias Eriksson is the manager of KPMG, Karlstad who is strongly devoted to promoting the goal of this KPMG subsidiary. In an interview with Mathias, author tried to find out whether there are any threats and possibilities encountered when auditing the internal control of various clients. His answer was:

“`Yes of course there are threats in auditing internal control. The most difficult task is that at times not all transactions have full documentation especially in small firms. This lack of documentation coupled with the fact that different companies have different perceptions regarding internal control poses some difficulties to auditors. Also, managers at times try to override even beyond their boundaries and a lack of segregation of duties further compounds the problems when auditing internal control´´

This fits what Doyle et.al. (2007) point out that the common material weaknesses related to staffing are “inadequate segregation of duties,”. In business, the first step towards the solving of any problem is to first identify that the problem exists in the first place. KPMG's risk professionals therefore help companies and organizations identify and manage operating risks and create stable and effective processes within their organizations. They also provide advice concerning risks associated with the application of and compliance with new national and international regulatory codes including offering a wide array of services and advice; internal audit and control, business monitoring and follow-up, financial risk management, IT audit and IT security, streamlining of processes and solutions for effective and secure information management. KPMG also tries to custom-tailor multidisciplinary teams of professionals from various disciplines within KPMG so as to meet client related needs (KPMG, 2016).

Mindful of the above, author also tried to find out why there are still so many weaknesses when auditing internal control nowadays despite the fact that KPMG provides all these services to audit clients? Responding to this question, Mathias Eriksson said that:

“`Despite the fact that KPMG provides all these services, very few clients actually come to the firm for this advisory service. Rather they come up only when audits are to be carried out and at times already having some weaknesses it’s the internal control system...´´

Therefore, there is need for companies to regard the designing of a good internal control system as part of a way of reducing cost and risks. It is better to take precautions than to manage disasters. This is because author also tried to find out from Mathias whether it means that KPMG cannot help companies that much to design a good internal control system and avoid risk since many audit clients is skeptical about coming for advisory services. He said that:

“`The best way we help out companies to check their internal control system is through our audit. Our audits are carried out by well trained professionals who know how to do their job. Whenever we see any weaknesses in the internal control, we make sure that these are disclosed. By so doing, many companies try to check their internal control...so our audits go a long way to help companies sort out ways of improving their internal control system´´.

Mindful of the above it may seem very obvious that the auditors of KPMG exercise a lot of professionalism when carrying out audits. The subjectivity of the concept of integrity is another issue. If auditing is all concerned with lending credibility regarding a particular event, it means that independence of auditors is a very important issue. Based on the argument that very few audit clients are willing to spend some money on internal control related advisory services, coupled with the fact that audit reports can go a long way to mitigate many weaknesses regarding internal control, it means that the independence of the auditors must be checked in order to make a decision regarding a company’s internal control system based on an audit report. Past and recent financial crisis showed many lapses regarding the independence of many audit firms. Auditing standards were amended and the SOX also points to the fact that regulation regarding this profession is increasing every day.

Hence, the impairment of independence must not be overlooked.

The question that arises now is whether auditors are interested in “`doing the thing right´” or are they interested in “`doing the right thing´”. Doing the thing right means carrying out an audit following IAS and GAAPs and other regulations, while doing the right thing means doing what is correct from a moral perspective. When author posed this question to Mathias, he said that:

“`It all depends on the integrity of the auditor in question. Doing the thing right is important and that is the essence of the entire regulatory framework regarding the preparation of audits. Also, we try to do the right thing by considering certain issues which are applicable to certain countries depending on which country the audit is being carried out, we use the same audit manual but there is often a cultural twist concerning certain laws applicable in
4.4 Possibilities of Auditing Internal Control:
The complexity of the business world calls to mind some pertinent issues to be considered when auditing internal control. Many companies nowadays have complex computerized systems. Auditing the internal control of these companies will entail that auditors need to first of all be sure whether the IT set up of such clients is reliable. This is because substantive testing during an audit in today’s competitive business world depends mostly on IT. A faulty computerized internal control system will therefore mean that there is going to be a faulty report as well. Author also tried to find out from Mathias how possible can KPMG auditors carry out an efficient audit when this audit depends mostly on a system designed by someone else. He said that:

"it is true that the complex nature of many internal control systems is a very big problem when carrying out our audits...whenever we have a big assignment, there are auditors in this firm who are experts in IT. What we do is that we send them to first of all review the IT system and see if certain adjustments need to be made before we commence our audit.”

This means that, before auditors can audit the internal control of any company, they must first of all fully understand the business of the client. This is an area that brings out the distinction between auditors and accountants. It is often said that all auditors are accountants but not all accountants are auditors because auditors require many other skills other than book keeping.

Auditing post SOX is very much more interested in first of all understanding how possible it is to audit a company’s internal control system before doing so. Statistics have shown that many small companies show weaknesses in the internal control system than large companies just like Doyle et al., (2007) mentioned internal control weaknesses are commonly found in firms that are smaller, younger, financially weaker, more complex, growing rapidly, or undergoing restructuring. Author tried to find out in his interview with Mathias why this is the case and he said that:

"the reason stems from the fact that small firms usually have less documentation than large companies and many things are instead based on trust. This makes it very difficult to carry out substantive testing because at times what is material is not documented by such small firms. In cases where documentation is too small, it is almost impossible to audit such an internal control system...and we resign as auditors from such firms”

5.0 FINDINGS AND RECOMMENDATION
The main objective of this paper was to find out whether there are any threats and possibilities of auditing internal control of companies and if yes, what are they? The answer to this lies in this part of the paper. Yes, no doubt there are many threats and possibilities when auditing internal control as seen in the theoretical and empirical part stemming from limited documentation of transactions, which in turn complicates substantive testing, lack of segregation of duties stemming from the staffing of many companies etc. It is only possible to audit an internal control system if auditors can have access to information that they need and if there are audit professionals and specialists to fully understand such a system. The question now is how can weaknesses in the internal control system be reduced? The first step in reducing the weaknesses in an internal control system is to acknowledge that weakness and identify it. This can be done through audit advisory services from audit firms (like KPMG). Also, in researcher interview with Mathias, he suggested that:
“Having engagement control reviews, more segregation of duties, employment of specialists with a good mastery of fair value accounting, management should not override...can go a long way in reducing these weaknesses”.

Author also thinks that management should ensure that:

1. All transactions are within the limits according to the policy or that appropriate officials have endorsed exceptional transactions. This is in order to prevent fraud.
2. It is important for continuous monitoring of the company’s internal control systems and operations, by assessing them and writing reports on their effectiveness annually.
3. Management should also try to create the right control environment by having a positive tone at the top based on ethical values. So that it is spread to the rest of the team as a guide for employee behavior in regard to adhering to internal controls in the company.
4. Internal controls can also be improved by ensuring that employees are competent enough to execute their duties professionally. Management should discipline personnel who do not follow the internal controls for the sake of the company.
5. Effective internal control entails the segregation of duties. For this to happen management has to ensure that at no time is one employee left to carry out several tasks as this creates loop holes for fraud. So management should clearly define the responsibilities and authority within the organization.
6. The auditor regardless of what is on ground should always be professional in his duties by being independent in fact and appearance and also maintaining his integrity.
7. Auditors should first analyze and assess the information systems as these can be manipulated in the company which may cause the auditor to have an adverse opinion.
8. From their findings, auditors can advise management on how to improve their internal control systems and also point out risk related areas.
9. Auditors themselves must be fully competent to be able to carry out audits for internal controls successfully.

Company operations should be audited and auditors should point out the weaknesses. They can also suggest solutions for improving these operations in addition to how the internal controls can be more enforced. Auditors can follow up to ensure that recommendations are well implemented in the companies they audit.

Hence, author conclude that there are weaknesses in auditing internal control and possibilities as well and he is not saying that the above recommendations can completely solve these problems or weaknesses; rather he says that if they are properly applied it may go a long way to reduce such weaknesses.

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6. REFERENCES


