Internal Inspection Practice Aid
Addressing Non-Compliance with Internal Control Requirements in AU-C 315

Overview

In reviewing an engagement, the individual performing the inspection (“the reviewer”) seeks to determine if the auditor who performed the engagement (“the auditor”) has obtained sufficient appropriate audit evidence to reduce audit risk to an acceptably low level and support the auditor’s opinion.

To reduce audit risk to an acceptably low level, auditors are required to obtain an understanding of internal control relevant to the audit in accordance with AU-C 315.

When reviewing an audit engagement, if the reviewer determines that the auditor failed to comply with the requirements related to internal control embedded in AU-C 315 such that audit risk was not reduced to an acceptably low level, the reviewer should conclude that the audit was not conducted in accordance with GAAS and that the auditor failed to obtain sufficient appropriate audit evidence to support the audit opinion.

Evaluating if Internal Control Requirements in AU-C 315 are met

When determining if the internal control requirements in AU-C 315 were met, the reviewer should consider the following:

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1This practice aid is intended to help auditors consider the requirements pertaining to internal control appearing in AU-C section 315, Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement, and AU-C section 330, Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained, when performing inspections as part of a firm’s monitoring procedures. This publication is an “other auditing publication” as defined in AU-C section 200, Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Generally Accepted Auditing Standards (AICPA, Professional Standards). Other auditing publications have no authoritative status; however, they may help you understand and apply certain auditing standards.

In applying the guidance included in an “other auditing publication”, the auditor should, exercising professional judgment, assess the relevance and appropriateness of such guidance to the circumstances of the audit. The auditing guidance in this document has been reviewed by the AICPA Audit and Attest Standards staff and published by the AICPA and is presumed to be appropriate. This document has not been approved, disapproved or otherwise acted on by any senior technical committee of the AICPA.
Identify controls relevant to the audit

AU-C 315.13 states:

The auditor should obtain an understanding of internal controls relevant to the audit. Although most controls relevant to the audit are likely to relate to financial reporting, not all controls that relate to financial reporting are relevant to the audit. It is a matter of the auditor’s professional judgment whether a control, individually or in combination with others, is relevant to the audit.

Controls relevant to an audit will vary based on the client’s size, complexity and nature of operations. There are some controls which will always be relevant to the audit, such as those that:

- Address significant risks (including fraud risks),
- Which the auditor plans to rely upon and test for operating effectiveness,
- Address risks which substantive procedures alone will do not provide sufficient, appropriate audit evidence, or
- Support journal entries.

In addition, controls which are designed to prevent or detect and correct misstatements of relevant assertions are also relevant controls. A relevant assertion is a financial statement assertion that has a reasonable possibility of containing a misstatement or misstatements that would cause the financial statements to be materially misstated.

Some auditors may indicate that their client has no controls because they are not documented or sophisticated, which is a false assumption. Even the smallest of audit clients has some level of control. Examples of controls for smaller entities include monitoring of financial results by management; reconciliation of accounts, such as cash, accounts receivable and accounts payable; computer log-on credentials, and communications from management to employees about the importance of properly recording transactions.

Evaluate design and implementation of controls relevant to the audit

AU-C 315.14 states:

When obtaining an understanding of controls that are relevant to the audit, the auditor should evaluate the design of those controls and determine whether they have been implemented by performing procedures in addition to inquiry of the entity’s personnel.

Reviewers may encounter auditors who think evaluating the design of controls relevant to the audit and determining if controls exist are one and the same. This is not an appropriate reading of the standard. Auditors are expected to:

- Consider what could go wrong as the client prepares their financial statements,
- Identify controls which are meant to mitigate those financial reporting risks, and
- Evaluate the likelihood that controls are capable of effectively preventing or detecting and correcting material misstatements.

In reviewing evidence supporting the evaluation of control design and implementation, reviewers must remember that inquiry of client personnel is insufficient. Auditors can obtain evidence about the design and implementation of controls relevant to the audit by observing the client
apply the controls, inspecting documents and reports, or tracing transactions through the client’s financial reporting system.

Other auditors may suggest that they did not evaluate the design and implementation of controls relevant to the audit because they are not planning to rely on the operating effectiveness of the controls. Regardless of whether the auditor is relying on the operating effectiveness, evaluation of design and implementation is required in every audit.

Reviewers should ensure that significant deficiencies and material weaknesses, if any, were properly reported under AU-C 265, Communicating Internal Control Related Matters Identified in an Audit. AU-C 265.09 states that if the auditor has identified one or more deficiencies in internal control, the auditor should evaluate each deficiency to determine, on the basis of the audit work performed, whether, individually or in combination, they constitute significant deficiencies or material weaknesses. The auditor should communicate in writing to those charged with governance on a timely basis significant deficiencies and material weaknesses identified during the audit, including those that were remediated during the audit.

Assess the level of control risk
Regardless of the “level” of control risk assigned, auditors should have a reasonable basis for the assessment of risk of material misstatement, including control risk. An auditor’s reasonable basis may be that they have designed a substantive strategy and testing controls is not necessary for an appropriate response.

Control risk is required to be set at the maximum unless the auditor is planning to rely on the operating effectiveness of controls. The reviewer may encounter auditors who believe they can lower the level of control risk without testing whether the controls were operating effectively throughout the period of intended reliance. Placing reliance on the operating effectiveness of controls without testing those controls represents non-compliance with AU-C 330.08.

Additionally, testing for operating effectiveness is not the same as evaluating the design and implementation of controls. Paragraph .A77 of AU-C 315 states that “obtaining audit evidence about the implementation of a manual control at a point in time does not provide audit evidence about the operating effectiveness of the control at other times during the period under audit”.

If the requirements of AU-C 315 were not met
Conclude on the Review of the engagement
If the reviewer determines that the auditor did not obtain sufficient appropriate audit evidence to meet if the reviewer determines that the requirements for AU-C 315 were not met such that the audit risk was not reduced to an acceptably low level, the reviewer should conclude that the audit was non-conforming (i.e., was not performed and/or reported on in conformity with applicable professional standards in all material respects). The reviewer should document this conclusion in the monitoring documentation.

AU-C 585 Consideration
If the engagement subject to review is deemed non-conforming, the firm should consider its obligations under AU-C 585, Consideration of Omitted Procedures After the Report Release Date.
The firm should investigate the issue in question and determine what action, if any, should be
taken, including actions planned or taken to prevent unwarranted continued reliance on its
previously issued reports.

The firm should then document the results of its investigation, including parties consulted and
actions planned or taken or its reasons for concluding that no action is required.

**Systemic Evaluation**

The reviewer should seek to understand the underlying cause of the finding. Gaining an
understanding will involve analysis of the firm’s quality control policies and procedures and
discussion with the firm’s partners and/or personnel.

When audit procedures or audit evidence were not documented, these discussions should
determine whether the procedures were performed but not documented as required or whether
the procedures were not performed at all. Additionally, the reviewer should ascertain whether
the personnel understood the requirements of AU-C 315 and should address the sufficiency and
appropriateness of audit evidence necessary to reduce audit risk to an acceptably low level.

Once the underlying cause of the matter is understood, the firm should take appropriate
remedial action to address it.