

ASSESSING CONTROL RISK IN SMALL BUSINESS

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ABSTRACT

This paper describes the components of an assignment that engages students in assessing and computing Control Risk for a small business for the purpose of planning and performing financial audit. The assignment could be used in Auditing and Accounting Information Systems courses.

INTRODUCTION

For planning and performing audit of financial statements of a company, auditors are required to measure “audit risk”. Audit risk is the probability of issuing a wrong opinion -- such as unqualified or qualified opinion -- when the audited financial statements contain a material misstatement. Audit risk is defined as follows:

$$\text{Audit Risk} = \text{Inherent Risk} * \text{Control Risk} * \text{Detection Risk}$$

Inherent Risk is the probability of having a misstatement in the financial statements because of the nature of the client, client’s industry, or the nature of a particular account in the financial statement. Control risk is the probability that the client’s internal control can’t prevent or detect a material misstatement on a timely basis. Control risk is largely dependent on the effectiveness of the client’s existing internal controls. Detection risk is the probability that the auditor’s undertaken procedures will fail to detect a material misstatement in the financial statements.

Assume a CPA firm wants to audit the accounts receivable of a client and there is 60% chance that the account receivable balance is misstated materially (inherent risk) and 40% chance that the misstatement has not been detected by the company’s internal controls. Furthermore, assume that the audit procedures utilized by the CPA firm has a 20% percent chance of failing to detect a material misstatement. Under these assumptions, the audit risk is 5% (60% * 40% * 20%). That is, the CPA firm faces a 5 percent audit risk that material misstatement has occurred and evaded both client’s controls and the CPA firm’s audit procedures.

The auditor has no control on the inherent and control risks -- the auditor merely evaluates those risks as they exist for the purpose of computing audit risk. In contrast, detection risk is controllable by the auditor and largely depends on the auditor’s procedures and tests for the audit. For example, by expanding the scope and effectiveness of the audit procedures, the detection risk can be decreased.

OBJECTIVE OF PAPER

This paper describes an assignment that engages students in measuring control risk for small businesses for the computation of audit risk. The assignment could be used in Auditing course and/or Accounting Information Systems course. Students in the course should be divided in groups and each team should be assigned with an audit topic such as cash, accounts receivable, inventory, etc. Subsequently, each team should be asked to complete the following steps:

Step 1. Identifying appropriate internal controls for the subject of audit

The team should research and identify a number of relevant internal controls for the assigned area. For illustration purpose, assume the area of audit is cash disbursements and the team has identified the following internal controls.

Internal Controls for Cash Disbursements

1. Are all disbursements made by check?
2. Are pre-numbered checks used?
3. Does company examine and compare the content of purchase order, receiving report and vendor invoice before issuing a check for payment?
4. Is the owner’s signature required on checks?
5. Does the owner approve and cancel the documentation in support of all disbursements?
6. Are all voided checks retained and accounted for?
7. Does the owner review the bank reconciliation?
8. Does the owner never sign blank checks?
9. Do different people reconcile the bank records and write the checks?

Step 2. Determining the relative importance of the internal controls

The team, through carrying discussions, should determine the relative importance of each of the identified internal controls on a scale of 1 to 10 with 10 to be “very important”. The team should provide justification for the ratings in their report. Assume the team has developed the following ratings for various internal controls.

Internal Controls for Cash Disbursements	Importance Rating
1. Are all disbursements made by check?	5
2. Are pre-numbered checks used?	7
3. Does company examine and compare the content of purchase order, receiving report, and vendor invoice before issuing a check for payment? .	10
4. Is the owner’s signature required on checks?	6
5. Does the owner approve and cancel the documentation in support of all disbursements?	7
6. Are all voided checks retained and accounted for?	3
7. Does the owner review the bank reconciliation?	8
8. Does the owner never sign blank checks?	10
9. Do different people reconcile the bank records and write the checks?	6

Step 3. Visiting the chosen company for the assessment of internal control status

The team should visit the chosen small business site to observe and to determine which of the identified internal controls are in place and working in the company. If the internal control is in place and is working, the relative importance rating should be written under the “Yes” Column; otherwise a zero should be placed.

Internal Controls for Cash Disbursements	Importance Rating	Yes, is in place and is working
1. Are all disbursements made by check?	5	5
2. Are pre-numbered checks used?	7	7
3. Does company examine and compare the content of purchase order, receiving report, and vendor invoice before issuing a check for payment?	10	10
4. Is the owner’s signature required on checks?	6	0
5. Does the owner approve and cancel the documentation in support of all disbursements?	7	0
6. Are all voided checks retained and accounted for?	3	0
7. Does the owner review the bank reconciliation?	8	0
8. Does the owner never sign blank checks?	10	10
9. Do different people reconcile the bank records and write the checks?	6	0
Total	62	32

Step 3. Computing Control Risk

At this point the team should compute the control risk. From total 62 points available, the internal control of the chosen company obtained 32 points -- that result in 52% (32/62). Thus, control risk would be 48% (100% - 52% = 48%). In developing the final control risk figure, other controls that the company has applied for the cash disbursement should be considered and incorporated into the computations.

CONCLUSION

Control risk is one of the elements for the computation of audit risk. Audit risk affects the nature, timing, and the extent of audit procedures and tests to be performed during a financial audit. This paper describes an assignment that engages students in understanding and assessment of internal controls and the computation of control risk. The results should be of interest to educators and students.