Evaluating Audit Findings – A Practical Approach

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Abstract

Audit findings evaluation is an important step in each and every audit report irrespective of the related industry or organization. Both Audit Committee, management and other stakeholders wish to receive accurate, timely, constructive and relevant information regarding audit findings. However, relevant research (Koutoupis, 2009) demonstrates that there are many complaints by both management and audit committee members as to the volume and the size of audit reports delivered to them by internal audit departments. Currently, the vast majority of the Internal Audit departments evaluate audit findings using a simple scale of High, Medium, Low Risk (importance) scale based on the prior experience of Internal Auditors. Even, big Audit forms (e.g. PwC) has adopted this approach in order to keep the things simple (PwC Internal Audit Services Manual, 2007).

In this article we will try to develop a comprehensive methodology for evaluating audit findings as a mean to improve the quality of information sent to Audit committee members, management and other stakeholders (i.e. regulators). The relevant methodology is based on the practical experience of the authors as they were responsible for applying it in one of the largest Greek banks.

Based on the Internal Audit methodology (Standards, 2004), audit reports are considered as the main output (deliverable) of the audit work. Audit reports consist of several audit findings that are mainly derived either from the absence or inadequacy of controls or from no application or inadequate application of procedures and relevant controls.

The relevant methodology takes into account several quantitative and qualitative parameters which will be analyzed in detail:

Quantitative evaluation is used when immediate estimation of the financial impact is feasible. Moreover, qualitative evaluation can be used if we take into account several parameters such as the priority of the audit steps that consists a working program (audit program). On the other hand, Frequency of Occurrence of a specific control weakness when examining a certain sample size, or the likelihood of the related impact to the exception (when it is not possible to determine the frequency of occurrence) can be used. Likelihood is normally used for exceptions that are raised during the review of the adequacy of controls thus when we perform walkthrough tests rather than extensive sample (i.e. when there is an absence / inadequacy of a procedure or a control).
For determining either the impact and/or the frequency of occurrence or likelihood of an exception, specific tables are used containing relevant numerical categories for ensuring the effective application of the evaluation methodology of audit findings.

After concluding with the separate evaluation of the impact and/or the frequency of occurrence or likelihood of an audit finding, we may proceed with the overall audit finding evaluation, which is based on the combination of the above two (2) parameters.

Finally, we refer to a relevant table, where “Impact” evaluation lays vertically while “Frequency of Occurrence or Likelihood” lays horizontally.

The methodology introduces a six (6) grade scale for the findings evaluation (a range from 1 to 6), with number six (6) being of major importance and number one (1) being of minimum importance.

Key Words: Audit Reports, Audit Findings, Evaluation of Audit Findings, Audit Findings Impact, Audit Findings Likelihood.

1. Introduction

Audit findings usually raised after the execution of specific audit steps (several audit steps comprise an audit program). An Internal Audit report consists of several audit findings which can be normally categorized based on their significance (materiality). Recent surveys (Koutoupis, 2008) demonstrated that management and other stakeholders are not happy to receive lengthy reports with many audit findings. On the other hand, what they want to receive is executive summaries including high risk issues or issues that require particular attention.

Internal Audit departments tend to categorize audit findings based on the High, Medium, Low risk categorization. The above method may create a concentration on the Medium or High categorization scale and very often does not distinguish the material issues from non-material issues. During this phase Internal Auditors form their opinion regarding the substantiality and the risks related to the audited transaction cycle. In the international bibliography\(^1\) we can find extensive analysis over the theoretical meanings and the terminology that concerns the important subject of the evaluation of audit findings. However, no specific detailed methodology has been published for the evaluation of audit findings that would improve the internal audit practice.

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\(^1\) Chambers & Selim “Internal Auditing” - 1987 and Sawyer & Dittenhofer “Internal Auditing: The Practice of Modern Internal Auditing” - 1996
On our proposed methodology we refer to the terms of “Audit Programs” and “Exceptions”, which can be described as follows:

- An “Audit Program” is used for describing how the audit approach is to be implemented. It includes “Audit Steps” developed for guiding the auditor upon the nature and extent of the processes and activities to be audited.
- An audit “Exception” is considered to be evidence that is inconsistent with a relevant management assertion. An exception is a potential weakness and may be detected by the auditor during the diagnostic or detailed testing phase. In case it is considered important, it should also be reported (by the auditor) and therefore followed up.

In the current study, we attempt based on empirical data, to develop a detailed methodology for evaluating audit findings in order to ensure consistency, as well as objective opinions regarding the importance of deviations and their consequences for the assessment of the relevant risks involved.

Moreover, the application of the proposed methodology will contribute to:

- The more objective evaluation of the findings and the relevant audit areas as far as the adequacy and effectiveness of the Internal Controls concerned.
- The effective follow up and administration of the corrective actions that are related to the findings and the formulation of respective recommendations.
- The composition of more reliable internal audit reports.

2. Audit Findings

2.1 Collection of the Audit Findings

Several audit methods can be applied for ensuring the realization and the collection of audit findings. Some of the most important audit techniques are briefly described below:

- **Inquiry:** Auditing based on interviews.
- **Observation:** Observation of a process during its application in order to observe the difference between the actual process and the documented procedure. This technique also includes the “walkthrough” testing technique.
- **Examination:** The observation of a sample of files or transactions based on certain criteria so that the acceptance of the results is evaluated.

In the present study, it would be meaningful to refer to the last audit method (Examination) where the use of a sampling method is required. We suggest the use of the method of systematic sampling, which was the one we used during our research. The suggested sampling technique is used for describing the minimum sample size that will be used for the audit of the relevant controls that operate on a periodical basis (i.e. yearly, quarterly, monthly, weekly or many times on a daily basis). The suggested methodology...

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2 *Standards and Guidelines for the Professional Practice of Internal Auditing (2004)*
is in accordance with the principles of sampling theory and is based upon 404 sector of Sarbanes-Oxley audit.\textsuperscript{3}

Additionally, the suggestion for the minimum sample sizes is also aiming:

- To the harmonization across the process of selection of the minimum sample size.
- To the harmonization across methodology’s goals and the best practices.

\textbf{2.2 Rules of Sampling Proposed in this Study}

The selection among the various sampling techniques that might be used for the collection of findings is proportional to the audit objectives. In any case, the determination of minimal sample sizes should be held with particular attention. We will not extend over theoretical approaches to sampling techniques, however we will focus on two important factors that might be of interest:

\textbf{2.2.1 Combination of Sampling Methods}

Sometimes, instead of applying the concrete sampling method, it is useful for the auditor to combine two or more sampling techniques. By combining two or more sampling techniques the auditor can achieve greater coverage over different populations. An example can constitute the initial stratification of the entire population and then the selection of a desired sample size by using other sampling methods. Thus, after the stratification of the entire population it might be possible to examine the 100\% of the sample in order to cover all important elements of the sample size:

- Selection based on the evaluation of all elements which are individually significant because of their size.
- Selection based on the evaluation of all transactions that indicating warning signs / characteristics.
- Random sampling for the remaining population.

\textbf{2.2.2 Determination of Minimum Sample Sizes}\textsuperscript{4}

Audit findings are normally raised by examining a sufficient sample size during the testing phase of the audit. The sufficiency of the sample is of crucial importance and must be examined individually by the auditor. In any case, the determination of minimum sample sizes is inevitable and it should exist in all audit projects. The auditors usually determine the minimum sample sizes by examining: a) the frequency of the controls, b) the minimum sample / frequency and c) the population data that will be examined. At a later stage, it is decided whether the sample under examination is sufficient or it should be extended.

We propose this last process to be examined over three steps and answer the consequent questions, as follows:

\textsuperscript{3} \textit{The Sarbanes – Oxley Act of 2002: Summary of key provisions of interest to Internal Auditors.}

\textsuperscript{4} The present methodology is used only in cases where different directives do not exist within the audit program.
3. Exception Evaluation Framework

In order to evaluate the findings of the audit, it is necessary to categorize them and perform a short analysis of the parameters that must be considered during the audit. Specifically:

3.1. Exception Categories

The exceptions raised during fieldwork are normally distinguished into the following categories:

1. *Exceptions raised due to Absence or Inadequacy of Controls*

In this category we refer to exceptions that are raised due to:

- Absence of controls.
- Existing controls are not adequately designed for covering the potential risks the Company might be facing.

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5 The proposed exception evaluation framework has been applied by one of the biggest banks in Greece.

6 Sawyer and Dittenhofer *Internal Auditing: The Practice of Modern Internal Auditing* - 1996.
2. **No application or Inadequate Application of Procedures and Controls**

This category ranks all exceptions relevant to no application or to inadequate application of the existing procedures and their embedded audit mechanisms.

### 3.2 Exception Evaluation Parameters

In the proposed methodology, we consider two parameters as crucial for the evaluation of the exceptions: the quantitative or the qualitative impact and the frequency or the likelihood of the related to the exception impact to occur. For the evaluation of these parameters we have developed a relevant six-grade scale.

For the evaluation of an exception impact there are two options that can be used:

- The first one is used when an immediate estimation of the financial impact is feasible, while
- The second one is used when only qualitative estimation can be done. The evaluation is based upon the audit experience and the judgement of the auditor along with the significance of the related audit step.

Audit steps are developed for guiding the auditor upon the nature and extend of the process to be audited. It must be noted that the audit steps in this methodology have a three (3) scale ranking, based on the impact of the risk for each procedure that is being tested:

- High Impact
- Moderate Impact
- Low Impact

The impact of each procedure/activity that is described at each audit step, determined in cooperation with the process owners during the development of the audit program.

Bellow, there are some general principles that when they are applicable can guide the ranking of an audit step to “High Impact”:

I. Audit steps that are relevant with exceptions of non compliance with laws and regulations, which may lead to penalties. For example, non compliance with the requirements of Bank of Greece, Capital Markets Commission, Tax laws and regulations, etc. may lead to fines, so the relevant audit steps will be considered as high impact.

II. Audit steps that refer to operations that have occurred critical financial losses.

III. Audit steps that are related to critical procedures and activities.

IV. Audit steps that are related to Company’s Divisions were recent withdrawals of critical staff positions occurred or recently noted a significant increase over their operations.

V. Audit steps that are related to new products or company’s services.

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7 Audit Step: Detailed description of audit tests followed by the auditor during fieldwork.
4. Exception Evaluation Methodology

4.1. Evaluating Impact

For the evaluation of an exception, the first parameter that considered is the overall impact of the exception to the Company.

In case the impact of an exception can be estimated (in Euros), for example the importance can be determined by the following table:

<table>
<thead>
<tr>
<th>Impact Determination (Value based)</th>
<th>Very Low</th>
<th>Low</th>
<th>Moderate</th>
<th>High</th>
<th>Very High</th>
<th>Critical</th>
</tr>
</thead>
<tbody>
<tr>
<td>Less than 5,000 €</td>
<td>From 5,000 € to 50,000 €</td>
<td>From 50,000 € to 150,000 €</td>
<td>From 150,000 € to 500,000 €</td>
<td>From 500,000 € to 3,000,000 €</td>
<td>Over 3,000,000 €</td>
<td></td>
</tr>
</tbody>
</table>

Based on the above table A, an exception with a financial loss for the Company of Euro 65,000 will be ranked to the “Moderate” impact.

In any other case, when the financial value of the impact can not be determined easily, the evaluation is based upon the audit experience and the judgement of the auditor, who he/she considers the evaluation of the related audit step, based on the following table:

<table>
<thead>
<tr>
<th>Impact of the Audit Step</th>
<th>Impact Evaluation (Qualitative)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Low</td>
<td>Very Low</td>
</tr>
<tr>
<td>Low</td>
<td>Low</td>
</tr>
<tr>
<td>Moderate</td>
<td>Moderate</td>
</tr>
<tr>
<td>High</td>
<td>High</td>
</tr>
<tr>
<td>High</td>
<td>Very High</td>
</tr>
<tr>
<td>Critical</td>
<td>Critical</td>
</tr>
</tbody>
</table>

The following examples are based on the above table:

✓ From an audit step with a “Low Impact” ranking, the resulting exception would either be with “Very Low” or “Low” impact.
✓ From an audit step with a “Moderate Impact” ranking, the resulting exception would either be with “Moderate” or “High” impact.

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8 The numbers below are taken from a real life example and are in accordance with the bank’s risk appetite.
Finally, in cases where the impact can be evaluated both qualitatively and quantitatively, then both of the above tables must be considered. The ranking of the impact would be the higher among the two.

4.2 Evaluation of Frequency of the Occurrence or Likelihood

The second parameter for evaluating the impact of the exception is the frequency of occurrence of a specific negative observation (exception) when examining a certain sample size, or the likelihood of a negative event, related to the exception, to occur.

In cases where the exception derived from a sample (e.g. account reconciliation, completeness of the transaction vouchers, etc.), the likelihood determined based on the following table C:

<table>
<thead>
<tr>
<th>TABLE – C</th>
<th>Frequency of Occurrence Determination</th>
</tr>
</thead>
<tbody>
<tr>
<td>Very Low</td>
<td>Less than 5%</td>
</tr>
<tr>
<td>Low</td>
<td>5% - 10%</td>
</tr>
<tr>
<td>Moderate</td>
<td>10% - 25%</td>
</tr>
<tr>
<td>High</td>
<td>25% - 40%</td>
</tr>
<tr>
<td>Very High</td>
<td>40% - 50%</td>
</tr>
<tr>
<td>Critical</td>
<td>Over 50%</td>
</tr>
</tbody>
</table>

Based on the above table, in cases where a negative observation appears at a 35% over the total sample size, then the ranking of this exception would be at a “High” level.

In cases where the exception cannot be raised by examining a sample size, the auditor evaluates the likelihood of a negative observation (exception) to occur based on his/her experience, related to the absence or the inadequacy of the controls. The likelihood can be ranked based on the following scale (Table D):

<table>
<thead>
<tr>
<th>TABLE – D</th>
<th>Likelihood Determination</th>
</tr>
</thead>
<tbody>
<tr>
<td>Very Low</td>
<td>Up to 1 time in 10 years</td>
</tr>
<tr>
<td>Low</td>
<td>Up to 1 time in 3 years</td>
</tr>
<tr>
<td>Moderate</td>
<td>Up to 1 time annually</td>
</tr>
<tr>
<td>High</td>
<td>From 2 to 11 times annually</td>
</tr>
<tr>
<td>Very High</td>
<td>From 12 to 51 times annually</td>
</tr>
<tr>
<td>Critical</td>
<td>Over 52 times annually</td>
</tr>
</tbody>
</table>

The following examples are based on the above table D:
✓ In case that any negative event is likely to happen seven (7) times annually, then the related exception ranked as of “High” likelihood.
✓ In case that any negative event is likely to happen from twenty (20) to thirty (30) times annually, then the related exception ranked as of “Very High” likelihood.
4.3 Overall Exception Evaluation

The overall exception evaluation is based on the combination of the above two (2) parameters. Below is the table used for the overall exception evaluation based on the quantitative or qualitative impact and the frequency of occurrence or the likelihood of a negative event to occur:

<table>
<thead>
<tr>
<th>Impact</th>
<th>Critical</th>
<th>Very High</th>
<th>High</th>
<th>Moderate</th>
<th>Low</th>
<th>Very Low</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>4</td>
<td>3</td>
<td>3</td>
<td>2</td>
<td>1</td>
<td>1</td>
</tr>
<tr>
<td>Impact</td>
<td>4</td>
<td>4</td>
<td>3</td>
<td>3</td>
<td>2</td>
<td>1</td>
</tr>
<tr>
<td></td>
<td>5</td>
<td>4</td>
<td>4</td>
<td>3</td>
<td>2</td>
<td>1</td>
</tr>
<tr>
<td>Impact</td>
<td>5</td>
<td>5</td>
<td>3</td>
<td>3</td>
<td>2</td>
<td>1</td>
</tr>
<tr>
<td></td>
<td>6</td>
<td>5</td>
<td>4</td>
<td>3</td>
<td>2</td>
<td>1</td>
</tr>
<tr>
<td>Impact</td>
<td>6</td>
<td>6</td>
<td>5</td>
<td>3</td>
<td>2</td>
<td>1</td>
</tr>
</tbody>
</table>

Examples for the overall exception evaluation are followed below:

- An exception that has been ranked with a “Very High” impact and the frequency of occurrence in the selected sample is also “Very High” (30% - 40%), it is evaluated as of “Very High” importance (ranking 5).

- An exception that has been ranked with a “Moderate” impact and the frequency of occurrence in the selected sample is “High” (20% - 30%), it is then evaluated as of “Moderate” importance (ranking 3).

- An exception that has been ranked with a “Critical” impact and the likelihood of the related impact to occur is “Low”; it is then evaluated as of “High” importance (ranking 4).

The more significant exceptions for the company are those ranked in the upper right area of the above table D (ranking of 4, 5 and 6). Likewise, the exceptions of moderate importance are placed in the middle area of the table (ranking 3). Finally, the exceptions with a lower importance to the Company are placed over the lower left area of the table (ranking 1 and 2).

In Appendix I, there is an analytical flow process chart for the overall exception evaluation methodology, as it is described above.
APPENDIX I

Table of Qualitative Characteristics

Impact

Overall Impact Evaluation

Table of Quantitative Characteristics

Table for Frequency of Occurrence (Testing using a sample)

Overall Frequency or Likelihood Evaluation

Table for Likelihood (Testing without a sample)

Frequency or Likelihood

Overall Frequency or Likelihood Evaluation
5. Monitoring and Exception Reporting

In our exception evaluation methodology we have proposed specific guidelines for the unique monitoring, reporting and following-up of each raised exception. Below, we have summarized the proposed six-scale ranking (from “Very Low” to “Critical”):

- **Ranking 1 – Very Low**

  **Monitoring:** All related issues that are not of immediate priority. Their monitoring status is limited only to the Management of the Division.

  **Reporting:** The issues of this ranking are recorded to the detailed audit report.

  **Follow-up:** The follow-up audit is conducted by the Group Audit Division in the next audit assignment to that Division.

- **Ranking 2 – Low**

  **Monitoring:** All related exceptions that are not of immediate priority and require corrective actions from the Management of the Division at a reasonable time.

  **Reporting:** The exceptions of this ranking are recorded to the detailed audit report of the Division.

  **Follow-up:** The follow-up engagement is conducted by the Group Audit Division in the next regular audit assignment to that Division.

- **Ranking 3 – Moderate**

  **Monitoring:** In this ranking (3) are included remarkable issues that need corrective actions from the Management of the Division in the short term, while updating Group Audit Division.

  **Reporting:** The exceptions of this ranking are recorded to the detailed audit report of the Division and in special cases are also recorded to the Executive Summary.

  **Follow-up:** The follow-up engagement is conducted by the Group Audit Division in the next regular audit assignment to that Division. In the cases where exceptions are included in the Executive Summary, are probably included within the next follow-up of the Division.

- **Ranking 4 – High**

  **Monitoring:** Exceptions that are of high priority and need of immediate corrective actions to be taken from the Management of the Division while updating Group Audit Division.

  **Reporting:** Exceptions of “High” importance ranking are recorded both to the detailed audit report and to the Executive Summary.

  **Follow-up:** All exceptions of this category are monitored over the next follow-up of the Division.
1186 Andreas G. Koutoupis and Dimitrios G. Charamis

- **Ranking 5 – Very High**

*Monitoring:* Urgent exceptions that need instant corrective actions to be taken from the Management of the Division, while updating Group Audit Division.

*Reporting:* Exceptions with a “Very High” ranking are recorded both on the detailed audit report and in the Executive Summary. When the exceptions of this category are detected there is a “special note” over to the Senior Management of the Company or the Administration of the Company.

*Follow-up:* All exceptions of this rank (Very High) are monitored mandatory over the next follow-up of the Division and in many cases it is likely to be the cause of a special audit (preventive or suppressive).

- **Ranking 6 – Critical**

*Monitoring:* Exceptions ranked as “Critical” are related with events that lead to loss of assets or to other significant loss for the Company. Responsible of the monitoring of these exceptions is the Senior Management of the Company.

*Reporting:* When the exceptions of this rank are detected there is a “special note” sent over to the Senior Management of the Company. Exceptions of this category are recorded both in the detailed audit report and to the Executive Summary.

*Follow-up:* Exceptions of “Critical” importance needs continuous attendance from Group Audit Division until all necessary adjustments have been made and can be a cause of a special audit (preventive or suppressive).

6. Conclusions

The “Exception Evaluation Methodology” methodology aims to the formation of a consistent approach for evaluating the exceptions and the related risks faced by a company.

Each raised exception evaluated separately and the evaluation is based on following two parameters:

- “Quantitative” or “Qualitative” impact of the exception, that is, all negative impacts implied for the Company when the specific exception is addressed,

And

- The “Frequency of Occurrence” of a specific negative observation (exception) when examining a certain sample size,
  
  Or
  
  The “Likelihood” of the related to the exception impact to occur. This parameter is for exceptions that raised without examining any sample size (ex. absence/inadequacy of a procedure or a control, exception that raised from a spot test).
The developed methodology introduces a six (6) grade scale for the exception evaluation (a range from 1 to 6), with number six (6) being of major importance and number one (1) being of minimum importance.

The above specified exception scales can be modified, in order to be harmonised both with the potential alterations on the operational risk evaluation framework and with the results derived from the exceptions of the audit projects.

It must be noted that in the future it may be needed to modify the exception evaluation scales from the ones used for the operational risk evaluation, given the existed differences in the nature of the areas under consideration (risk – exception) along with the greater nature of the exceptions (association with credit risk, market risk, etc.).

The detailed determination of the above scales contributes to the minimization of the subjectivity of the auditors during the exception evaluation and reinforces the credibility of the fieldwork. Conversely, the judgement and the experience of the auditor still remains a significant factor for the evaluation of the exceptions.

Additionally, the implementation of the following methodology contributes to:

- The more objective evaluation of the audit areas and to the adequacy and effectiveness of the System of Internal Controls,
- The more effective supervision and administration of the recommended actions relevant to the exceptions (follow-up) along with the cure of potential weakness of the audit mechanisms and the improvement of existing procedures,
- The production, with greater reliability, of internal audit reports for the management.

We believe that this study will contribute to the minimization of the subjectivity of the Auditors during the evaluation of their findings and will amplify the objectivity of the audit.

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**PricewaterhouseCoopers** was established by the merger of PriceWaterhouse and Coopers & Lybrand companies. The new company is today the biggest independent organization in provision of business services worldwide. The aim of this merger was the creation of an international company providing assurance and business services that would offer integrated solutions to the complex problems and needs of its customers.

7. Bibliography


