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# Boosting Audit Quality: A Crafted Practical Approach to Journal Entry Testing

**Is Journal Entry Testing required in every financial statement audit, and why?**

Journal entry testing is required in every financial statement audit. Regardless of how strong an organisation's internal controls appear, the risk of management override of controls persists and often manifests through journal entries—especially those recorded at period end, routed outside normal approvals, or posted to unusual accounts. Robust journal entry testing helps ensure transactions are properly recorded and that financial statements are free from material misstatement.

This article emphasises the need to assess the risk of management override of controls and provides a crafted practical approach to journal entry testing along with the good practices for the journal entry testing.

## Meaning of Journal Entry

A journal entry (JE) records the financial effects of a transaction in the accounting records / system. Every journal entry consists of major components like posting date and time, debit and credit accounts, amount of transaction, description / narration, voucher reference, and maker and checker identifiers, etc. Journal entries may be either automated (system-generated) or manual (user-entered).

## Types of Journal entries and their audit relevance

Journal entries are not all the same. Some are posted by people, some are created automatically by the system, and some happen only occasionally depending on business events. Most of the entities take a hybrid approach; they use manual entries for adjustments and automated entries for routine transactions.

A manual journal entry is a journal entry made by hand either physically

or through some accounting software. Normally, manual journal entries include accruals, deferrals, adjustments entries, reclassification entries, consolidation entries and audit adjustments. Since manual journal entries are entered by human, a major risk exists in these types of entries. The risk exists because of the judgement, pressure to meet the expectations, estimations, period-end adjustments etc. Accordingly, the auditor is required to spend more time here, checking whether the entry was properly authorised and whether there are enough support and justification behind it.

Manual journal entries can be standard journal entries and non-standard journal entries. Non-standard or one-off journal entries are the unusual entries. These entries do not happen frequently and are outside the normal process, for example- Journal entries relating to business combination, amalgamation or merger etc. Non-standard entries involve a lot of

judgement, complexity, sometime are of a significant amount. These entries require deeper audit testing and robust documentation.

Automated journal entries, use fixed rules and algorithms to record a transaction. For instance, monthly depreciation run can be done through an automatic journal entry.

It cannot be said that automated entries are risk free. These entries are to be evaluated through testing of IT General Controls (ITGC) and IT application controls (ITAC).

As per the Standard on Auditing (SA) 240 - "The Auditor's Responsibilities Relating to Fraud in an Audit or Financial Statements", the management override of controls is a presumed risk in audit. The risk is presumed in audits without regard to the effectiveness of controls. Management override can involve a range of scenarios. For instance, the management may override controls by showing expenses

as capital assets or asset under development, recording fictitious sales near the period closer, reversal of provisions to manage profits etc.

Some of the common indicators that point towards management override can include posting on weekends or late nights, unusual debit and credit combinations which are not aligned with the process, entries posted by top management who normally do not post entries, entries with narrations like adjustment, reclass, rectification, rounded number adjustments' and entries which are outside the normal workflow.

Hence, it becomes pivotal for the auditor to design the nature, timing, and extent of the journal entry testing procedure and test the appropriateness of journal entries made in preparing the financial statements to detect the management override of controls. The auditor should come up with procedures that will be unpredictable and specifically target to detect high risk journal entries.

### How to plan and perform Journal entry testing?

The auditor should follow a systematic targeted approach consistent with the standards on auditing for performing journal entry testing.

First and foremost, the auditor should gain understanding of the financial reporting process and controls. The auditor should ask questions such as:

- Who can post journal entries?
- How are journal entries posted?
- Who approves Journal entries?
- Can one person be both the maker and checker of a journal entry?
- Have there been any unusual journal entries during the year?
- Has the management asked anyone to override controls over journal entries during the year?
- Who has super user rights?

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The auditor should perform a walkthrough of a key transaction to identify areas susceptible to misstatement. The auditor should understand authorisation hierarchy and segregation of duties. The auditor should understand the processes around initiating, processing, authorising, and recording journal entries. The auditor should understand who perform the control activities, what the control frequency is and what supporting documentation is available with respect to manual journal entries, non-recurring / non-standard journal entries and post-closing journal entries.

The auditor should assess the design and implementation of controls over journal entry initiation, review and posting. Then perform the test of operating effectiveness of controls over journal entries. This will ensure that the auditor understands how journal entries flow from source document to financial statements.

In the second step, the auditor should inquire from the management and key personnel about awareness of unusual journal entries, cases of override or manipulation, authorisation rights for manual posting, and incentive, pressure or rationalisation that might result in fraud. Such inquiries should be corroborated through audit procedures.

In the third step, the auditor determines the testing approach. The Auditor



determines the high-risk criteria based on fraud risk assessment, IT control environment, and engagement specific factors.

### How to Determine the High Risk Criteria?

Generic risk filters do not work and a tailored approach to criteria needs to be developed for the control environment and business risk in each engagement. The Auditor is required to take consideration of six risk factors while identifying high risk journal entries that required granular audit. These include:

1. Risk of material misstatement due to fraud: Transactions linked to areas with high fraud susceptibility for instance, revenue recognition, estimates;
2. Control effectiveness: Where control over journal entry initiation, approval or posting are weak or ineffective;
3. Nature and complexity of accounts affected: Entries involving provisions, reserves related party balances, or adjustments without underlying transactions;
4. System complexity, the entity's financial reporting process, and nature of evidence that can be tested;

5. Entries processed outside the normal course of business;
6. The characteristics of fraud and journal entries.

In the step four, the auditor determines the period subject to testing.

### How to Determine the Period Subject to Testing?

Now let's discuss how to determine the period that is subject to testing. The standards on auditing provide three sub-populations within the entire population of journal entries. Those made at the end of the period; those made throughout the period and those made during the preparation of the financial statements i.e. Post-closing entries. Regardless of whether a specific risk of misstatement due to fraud is identified, the auditor should still test material post-closing entries and other adjustments made in the preparation of financial statements. The auditor also considers whether there is a need to test journal entries and other adjustments throughout the period because material misstatement due to fraud can also occur throughout the period and may involve extensive audit efforts to conceal how it is accomplished. The auditor may however, choose to test journal entries throughout the reporting period to consider an element of unpredictability.

The relevant population to request from the entity in order to identify journal entries for testing is general ledger extract of all Journal entries recorded throughout the period and listing of post-closing entries passed in preparing the financial statements. The auditor should ensure that the appropriate screening and layering of journal entries is performed to narrow down and refine the population.

In the step five, to identify and select entries for testing before carrying analysis, auditor must ensure that the population of journal entries is complete and accurate. There could be risk related to data reliability, such as input risk, integrated risk, extraction risk, and manipulation risk.

### How to perform completeness testing?

Completeness testing may include:

1. Roll forward of all account balances, confirming that all the transactions from opening to closing balances are included.
2. Roll forward of selected account balances. It is applicable when risk is limited to particular ledgers.
3. System query extraction creating a full journal entry data.

These extracted totals are verified to the general ledgers, trial balance and financial statements to confirm the completeness.

### How to perform accuracy testing of relevant data elements?

Basis the nature of relevant data elements (RDE's) evaluate whether the RDE's can be tested and relied upon before performing the testing. RDE's such as prepare ID, date, General Ledger (GL) amount, debit / credit, description, GL name, GL code etc, must be accurate. To evaluate whether the population of journal entries is sufficiently reliable, evaluate the accuracy and completeness of the information by using the below approach:



■ **Control approach:** Test management controls over the accuracy and completeness of the internal information.

■ **Direct approach:** To directly test accuracy and completeness of the internal information.

This reliability test should be completed and documented before identifying high risk entries.

After evaluating the reliability of the population of journal entries including determining the completeness of the population of journal entries, the next step is applying the high-risk criteria to the relevant population to select journal entries for testing. If ITGC's and ITAC's are effective, the auditor should exclude automated entries from the journal entries population while applying high-risk criteria.

When the testing is completed by the auditor, determine whether any anomaly indicate deficiency in controls, or intentional misstatement. Please note that not all the unusual journal entries are indicative of fraud. However, every unusual journal entry demands explanations.

When exceptions are identified, obtain supporting documentation, understand who initiated and why, test authorisation, evaluate accounting rationale and assess whether it indicate control failure or intent and then document properly, what the auditor tested, why the auditor tested what the auditor found, why the auditor concluded it's acceptable / unacceptable.

### Common Pitfalls Observed in Journal Entry Testing

Among other issues highlighted during reviews and peer inspections, there have been concerns about:

- Failure to document the rationale for determining high-risk criteria and failure to document the decision not to test the high-risk criteria identified during the audit risk assessment stage;

- Use of generic criteria across audits without tailoring to it with the specific risk associated with the entity;
- Use of journal entries population without performing testing procedures for the completeness and accuracy;
- Using sampling on identified high-risk entries, whereas the auditor is required to test all entries identified under the high-risk criteria;
- Too broad classification of large populations as high risk without applying refined filters.
- Failure to perform in-depth testing on the non-standard journal entries and post-closing journal entries;
- Failure to reconcile the journal entries population to the audited financial statements.

The above-mentioned errors undermine the audit quality and are inconsistent with standards on auditing.

### Case Studies on Journal Entry Frauds

#### Case 1: WorldCom

WorldCom fraud case is a good example of management override of controls. If we look back at the WorldCom case, the Company had inflated profits by capitalising the operating expenses. The Company capitalised 'line costs' as assets via manual journal entries. The external auditors failed to check these top-level journal entries. The lesson here is- It is important to examine large manual capitalisation entries.

#### Case 2: Enron

Enron fraud case is a good example of involving complex accounting terms like Special Purpose Entities and Mark to Market. Enron mislead stakeholders about its financial situation. Special Purpose Entities were used as a vehicle for concealing liabilities. Journal entries were used to shift liabilities off

the balance sheet and boost revenue. The lesson here is- the consolidation and related-party adjustments are to be independently tested for economic substance and documentation support.

#### Case 3: Capitalisation of revenue expenditure

In an audit of a company, the quarter-end close was clearly driven by pressure to maintain EBITDA margins. During journal entries testing, the audit team identified manual journal entries posted in the final week of the quarter with narrations like "reclass", "capitalisation", and "project cost." Many of them were round-number entries and were posted by top finance employees. This was executed through manual journal entries.

On analysing, it was observed that routine operating expenses like repairs, subcontracting and admin costs were being moved from the profit and loss account to the balance sheet such as CWIP, intangibles and prepaid, hence resulting in an improvement in EBITDA.

#### Case 4: Deferment of revenue

In a company, the top management bonus pay-outs were linked to achieving a minimum 5% quarterly top line growth. In Q1 (Quarter-1), the company 'performed strongly



and achieved close to 10% growth. To ensure that the bonus threshold could be met in Q2 as well, management instructed the finance team to defer a portion of Q1 revenue into the next quarter. This was executed through manual journal entries passed during the closing process in Q1 and reposting them in Q2. The entries resulted in revenue shifted between quarters without commercial rationale, indicating an incentive driven override.

#### Case 5: Reversal of adjustment entries

A few manual entries caught attention near the closing period in a multinational company. Group reporting deadlines often precede statutory audit completion in India. As per the management, last year's statutory audit adjustments were correctly booked in the Indian statutory financial statements, but they were not considered in the group reporting pack sent to the parent because reporting was finalised earlier than the statutory audit closure. So instead of updating the group numbers or maintaining a proper statutory-to-group reconciliation, the finance team chose the easier route this year, they reversed the earlier audit adjustments in the statutory books to make the statutory books align with group reporting.

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### Good Practices in Journal Entry Testing

1. Engagement specific high-risk criteria should be tailored by the auditor in line with the entity's environment and risk profile.
2. The auditor should document the rationale for each high-risk criteria considered for journal entries testing.
3. The Auditor should ensure the use of screening and layering of journal entry population. High risk criteria identified at the risk assessment stage should be reevaluated and documented post the screening procedure.
4. Engagement team should ensure engagement partner level oversight while performing journal entries testing.
5. If after running a high-risk criteria routine, a large number of entries come, then revisit the high-risk criterion and rerun the routine.
6. Perform detailed testing on non-standard entries and post-closing adjustments.
7. Use of information technology to identify unusual patterns in the Journal entry population.

### Incorporating Technology in Journal Entry Testing

The emergence of new industries like crypto-currency, gaming industry, digital assets and e-commerce platforms have created a new challenge that traditional audit approach might not be able to handle, hence use of the data analytics (D&A) and artificial intelligence (AI) in the journal entries



testing process becomes pivotal. D&A and AI can be used as discussed below in performing the journal entries testing.

- AI powered anomaly detection: The algorithms can look at the 100% population of JEs and can detect risky or fraudulent journal entries.
- Machine Learning Models: These models learn from the past fraud instances / irregularities to make predictions regarding the possibility of management override risk.
- Pattern recognition: AI can identify patterns such as several small entries below the threshold for authorisations, entries passed on weekends / holidays.

Despite these technologies, standards on auditing emphasise that the sufficiency and appropriateness of audit evidence remain the auditor's responsibility. While technology helps with efficiency, it does not substitute for the auditor's professional scepticism.

### Conclusion

In nutshell, Journal entries are the building blocks of the financial statements. Journal entry testing is

a pillar of every financial statement audit and acts as the frontline defence against management override of controls. It is to be noted that journal entry testing is only as robust as the approach behind it.

To conclude, the quality of Journal entry testing is a determining factor in overall quality of the financial statements, hence the auditor should strengthen audit procedures in respect of journal entry testing to provide a greater assurance to the stakeholders.

### References

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- ICAI – SA 240: *The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements.*
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