Internal Control
SECOND STANDARD OF FIELDWORK

A. The second standard of fieldwork: The auditor must obtain a sufficient understanding of the entity and its environment, including its internal control, to assess the risk of material misstatement of the financial statements whether due to error or fraud, and to design the nature, timing, and extent of further audit procedures.

B. Assessment of risk of material misstatement (RMM) of the financial statements affects nature, extent, and timing (the NET) of further audit procedures:

1. Nature
   a. If RMM assessed to be low, auditor can be more comfortable using client’s records
   b. If RMM assessed to be high, auditor will need more outside corroboration

2. Extent
   a. If RMM assessed to be low, auditor will not need as much evidence
   b. If RMM assessed to be high, auditor will need a lot more evidence

3. Timing
   a. If RMM assessed to be low, auditor will probably do some interim testing
   b. If RMM assessed to be high, testing will need to be done after yearend.

Notes: RMM=Risk of material misstatement  
NET= Nature, Extent, Timing
OBJECTIVES OF INTERNAL CONTROL

Objectives of internal control are to provide reasonable assurance about:

A. **Reliability** of financial reporting
   - Controls prevent, detect, and correct misstatements in the financial statements

B. **Effectiveness and efficiency** of operations

C. **Compliance** with laws and regulations

Notes:
COMPONENTS OF INTERNAL CONTROL

A. Mnemonic for elements (components) of internal control:

   C  Control activities
   R  Client’s Risk assessment
   I  Information and communication systems
   M  Monitoring
   E  Control Environment

B. Control activities are the policies and procedures that ensure that management directives are carried out

   1. All transactions are properly authorized, initiated, executed and recorded

   2. Proper separation of duties mnemonic:

      A  Authorization
      R  Recording
      C  Custody

   3. Physical controls; safeguarding of assets, include:

      a. Locks
      b. ID badges
      c. Alarms

C. Client’s risk assessment, i.e., how client manages RMM; errors and fraud

   1. External risks
   2. Internal risks
   3. Change = risk

D. Information and communication systems

   1. Information refers to the quality of the accounting records
2. Communication is establishing individual responsibilities and communicating those responsibilities to the employees

E. Monitoring refers to how the client evaluates internal controls over an extended period of time

F. Control environment refers to the overall attitude; the tone at the top

Notes: CRIME

Control activities

ARC----Authorization, Recording, Custody
BASIC AUDIT STEPS

A. Establish understanding with client; document it in an engagement letter
   1. Management is responsible for the financial statements
   2. Auditor’s responsibility is to render an opinion
   3. Other requirements, agreements, fees, etc.

B. Obtain an understanding of the entity and its environment, including internal control, and perform risk assessment procedures

C. Assess the RMM in the financial statement assertions

D. Determine the nature, extent, and timing of further audit procedures; the NET

E. Perform further audit procedures

F. Evaluate audit evidence

G. Form opinion and write audit report

Notes: RMM

NET
MANAGEMENT’S vs. AUDITOR’S RESPONSIBILITY

A. Management is responsible for the internal control structure; establishing it and maintaining it

B. Auditor’s responsibility is to see if the controls work; to determine

1. If controls are preventing, detecting and correcting material misstatements on a timely basis

2. Effect that the internal control structure has on financial statement assertions
LIMITATIONS INHERENT TO INTERNAL CONTROL

A. Inherent limitations are part of any system

B. Human fallibility

C. Collusion

D. Management override

Notes: Incompatible duty-----not inherent limitation
RISK ASSESSMENT PROCEDURES & INTERNAL CONTROL DOCUMENTATION REQUIREMENTS

A. Risk assessment procedures:
   1. Observation
   2. Inquiry
   3. Inspection
   4. Reperform procedures
   5. Walk-throughs
   6. Analytical procedures

B. Auditor is required to document review and understanding of internal control structure in the workpapers; documentation should include:
   1. Elements (components) of internal control (CRIME)
      a. Control activities
      b. Client’s Risk assessment
      c. Information and communication systems
      d. Monitoring
      e. Control Environment
   2. Sources of information from which understanding was obtained

C. Obtaining understanding of internal control and performing risk assessment procedures are done concurrently

Notes: Basis of conclusion

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8
AUDIT RISK

A. Control risk is the risk that internal controls are not preventing, detecting, or correcting material misstatements on a timely basis, i.e., the internal control structure is not functioning well. **Client side**

B. Inherent risk is the risk that a given account by its very nature could be misstated. **Client side**

C. Detection risk is the risk that the auditor will fail to detect material misstatements, errors and fraud that do exist. **Auditor side**
   - Cannot be reduced to zero because auditors do not examine 100% of the evidence

   Editor note: Other factors that affect detection risk include the possibility that an auditor might select an inappropriate audit procedure, misapply an appropriate audit procedure, or misinterpret the audit results.

D. Audit risk is the risk that the financial statements are materially misstated and the auditor does not detect the misstatement.

E. RMM = control risk and inherent risk

F. Inverse relationships
   1. If RMM assessed as low, auditor can set detection risk higher
      - And can do less substantive testing / further audit procedures
   2. If RMM assessed as high, auditor needs to set detection risk low
      - And will need to do more substantive testing / further audit procedures

G. Direct relationships
   1. If RMM is high, auditor must do extensive substantive testing / further audit procedures
   2. If RMM is low, auditor can do less substantive testing / further audit procedures

Notes: RMM=control risk and inherent risk
MULTIPLE-CHOICE QUESTIONS 1 - 22

1. Which of the following most likely would not be considered an inherent limitation of the potential effectiveness of an entity’s internal control?
   a. Incompatible duties
   b. Management override
   c. Mistakes in judgment
   d. Collusion among employees

   Separation of duties

2. In the consideration of an entity’s internal control, the auditor is basically concerned that the controls provide reasonable assurance that
   a. Operational efficiency has been achieved in accordance with management plans.
   b. Errors and fraud have been prevented or detected.
   c. Management cannot override the controls.
   d. Controls have not been circumvented by collusion.

3. Proper segregation of functional responsibilities in an effective internal control structure calls for separation of the functions of
   a. Authorization, payment, and recording
   b. Authorization, recording, and custody
   c. Custody, execution, and reporting
   d. Authorization, execution, and payment

4. Proper segregation of duties reduces the opportunities to allow persons to be in positions to both
   a. Journalize entries and prepare financial statements
   b. Record cash receipts and cash disbursements
   c. Establish internal controls and authorize transactions
   d. Perpetuate and conceal errors and fraud

5. The overall attitude and awareness of an entity’s board of directors concerning the importance of internal control usually is reflected in its
   a. Computer-based controls
   b. System of segregation of duties
   c. Control environment
   d. Safeguards over access to assets

   Attitude

6. Which of the following is not a component of an entity’s internal control?
   a. Control risk
   b. Control activities
   c. The information and communication systems
   d. The control environment

ARC
7. The primary objective of procedures performed to obtain an understanding of the entity and its environment, including its internal control, is to provide an auditor with

a. Knowledge necessary to assess the risk of material misstatement and design further audit procedures
b. An evaluation of the consistency of application of management’s policies
c. A basis for modifying tests of controls
d. Audit evidence to use in assessing inherent risk

8. Which of the following factors would most likely be considered an inherent limitation to an entity’s internal control?

a. The complexity of the information processing system
b. Human judgment in the decision making process
c. The ineffectiveness of the board of directors
d. The lack of management incentives to improve the control environment

9. Which of the following factors would least likely affect the extent of the auditor’s consideration of the client’s internal controls?

a. The amount of time budgeted to complete the engagement
b. The size and complexity of the client
c. The nature of specific relevant controls
d. The auditor’s prior experience with client operations

10. The objective of tests of details of transactions performed as tests of controls is to

a. Monitor the design and use of entity documents such as prenumbered shipping forms
b. Determine whether internal controls have been implemented
c. Detect material misstatements in the account balances of the financial statements
d. Evaluate whether internal control procedures operated effectively

11. When obtaining an understanding of an entity’s control environment, an auditor should concentrate on the implementation of the procedures because

a. The procedures may be operating effectively but may not be documented.
b. Management may implement procedures whose costs exceed their benefits.
c. The procedures may be so inappropriate that no reliance is contemplated by the auditor.
d. Management may establish appropriate procedures but not enforce compliance with them.

12. In an audit of financial statements, an auditor’s primary consideration regarding an internal control policy or procedure is whether the policy or procedure

a. Reflects management’s philosophy and operating style
b. Affects management’s financial statement assertions
c. Provides adequate safeguards over access to assets
d. Enhances management’s decision-making processes

Management assertion—Financial statement
13. In planning an audit, the auditor’s knowledge about the design of relevant internal control policies and procedures should be used to

a. Identify the types of potential misstatements that could occur  
b. Assess the operational efficiency of internal control  
c. Determine whether controls have been circumvented by collusion  
d. Document the assessed level of control risk  

Identify  (5951)

14. In obtaining an understanding of an entity's internal control in a financial statement audit, an auditor is not obligated to

a. Determine whether the control procedures have been implemented  
b. Perform procedures to understand the design of the internal control policies  
c. Document the understanding of the entity’s internal control  
d. Search for significant deficiencies in the operation of the internal control  

(4256)

15. In obtaining an understanding of an entity's internal control, an auditor is required to obtain knowledge about the

<table>
<thead>
<tr>
<th>Operating efficiency of policies and procedures</th>
<th>Design of policies and procedures</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>b. No</td>
<td>Yes</td>
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<tr>
<td>c. Yes</td>
<td>No</td>
</tr>
<tr>
<td>d. No</td>
<td>No</td>
</tr>
</tbody>
</table>

(3908)

16. In accordance with SAS 110, which of the following statements is correct concerning the use of prior audit evidence regarding the operating effectiveness of controls?

a. If the auditor plans to rely on controls that have changed since they were last tested, the auditor should test those controls at least once every three years.  
b. If the auditor uses prior audit evidence for several controls, the auditor should test a sufficient portion of them in each audit so that each is tested every third audit.  
c. If the auditor plans to rely on controls that have not changed since they were last tested, the auditor should test those controls at least every other year.  
d. If the auditor plans to rely on controls that mitigate a significant risk, those controls should be tested at least every other year  

(8267)

17. On the basis of audit evidence gathered and evaluated, an auditor decides to increase the assessed level of control risk from that originally planned. To achieve an overall audit risk level that is substantially the same as the planned audit risk level, the auditor would

a. Decrease substantive testing  
b. Decrease detection risk  
c. Increase inherent risk  
d. Increase materiality levels  

(5083)
18. Regardless of the assessed level of control risk, an auditor would perform some
a. Tests of controls to determine the effectiveness of internal control policies
b. Analytical procedures to verify the design of internal control procedures
c. Substantive tests to restrict detection risk for significant transaction classes
d. Dual-purpose tests to evaluate both the risk of monetary misstatement and preliminary control risk

D ual p urpose t est (4260)

19. In obtaining an understanding of a manufacturing entity’s internal control concerning inventory balances, an auditor most likely would
a. Analyze the liquidity and turnover ratios of the inventory
b. Perform analytical procedures designed to identify cost variances
c. Review the entity’s descriptions of inventory policies and procedures
d. Perform test counts of inventory during the entity’s physical count

(5979)

20. After obtaining an understanding of the entity and its environment and assessing the risk of material misstatement, an auditor decided to perform tests of controls. The auditor most likely decided that
a. It would be efficient to perform tests of controls that would result in a reduction in planned substantive tests.
b. Additional evidence to support a further reduction in control risk is not available.
c. An increase in the assessed level of control risk is justified for certain financial statement assertions.
d. There were many internal control weaknesses that could allow errors to enter the accounting system.

RMM---Low----Test of control (5651)

21. Inherent risk and control risk differ from detection risk in that they
a. Arise from the misapplication of auditing procedures
b. May be assessed in either quantitative or nonquantitative terms
c. Exist independently of the financial statement audit
d. Can be changed at the auditor’s discretion

Client side---RMM (5081)

Auditor side---Detection risk

22. The acceptable level of detection risk is inversely related to the
a. Assurance provided by substantive tests
b. Risk of misapplying auditing procedures
c. Preliminary judgment about materiality levels
d. Risk of failing to discover material misstatements

(0044)
INFORMATION TECHNOLOGY’S IMPACT ON INTERNAL CONTROLS

A. Information technology (IT) can enhance effectiveness and efficiency of internal controls
   1. Improves mathematical accuracy of calculations
   2. Improves consistency of information

Editor note: Other possible benefits include improvements in timeliness and availability of information; facilitation of analysis of information; enhancement of ability to monitor performance of company’s activities, it may make some controls more difficult to circumvent, etc.

B. IT can also increase risks to internal control:
   1. IT cannot apply judgment or discretion, i.e., distinguish between reasonable and unreasonable input (Editor’s note: This can be mitigated to some degree in some applications with control totals.)
   2. People may have a tendency to be less skeptical of computer-generated data, i.e., rely on systems or programs that are processing data inaccurately, processing inaccurate data (garbage in gospel out), or both
   3. No natural audit trail for online transactions
   4. High concentration (lack of separation) of duties within IT

Editor note: Other potential risks include that unauthorized access may result in loss of data or improper changes to data or programs; and failure to maintain systems may cause inaccurate results.

Notes: Accuracy, Consistency

Lack of separation

Judgment, Discretion
INFORMATION TECHNOLOGY: GENERAL CONTROLS

A. General controls refer to the structure that is built around IT

B. Any weakness in general controls tends to have a pervasive effect on entire system

C. General controls include:

1. Segregation of functions between the IT Department and users

2. IT Department should never authorize or initiate transaction; the IT Department processes transaction

3. Procedures to review, test, approve, and document:
   a. Systems and changes to systems
   b. Programs and changes to programs

4. Utilization of hardware & software controls which include:
   a. Echo checks
   b. Virus protection
   c. Boundary protection
   d. Firewalls

5. Access controls; there should be restrictions on access to:
   a. Hardware
   b. Master files
   c. Programs
   d. Documentation

Editor note: There should be physical controls that restrict access to the facilities that house the IT equipment and documentation as well as electronic controls (for example, passwords) that limit system access.

6. Date and procedural controls
   a. Environmental protection to safeguard assets
Internal Control

(1) Smoke detectors

(2) Temperature and humidity (moisture) controls

b. File protection controls

(1) A disaster recovery plan that includes storing copies of master files off premises
(2) Daily procedures to back up files

Editor note: Other controls include careful labeling of files and physical devices to prevent accidental erasure of files.

7. Segregation of duties within IT

a. High concentration of duties within IT brings additional risks to internal control
b. Mnemonic: COPAL; the duties within IT that should be separated:

(1) Control group; maintains the IT internal controls, follows up on errors
(2) Operators; data input; convert accounting information into machine-readable form
(3) Programmers; write and document programs and changes to programs in system flowcharts and run manuals
(4) Analysts; design overall system and document system and changes to systems
(5) Librarians; keep track of master files, programs, and documentation

Notes: COPAL
INFORMATION TECHNOLOGY: APPLICATION CONTROLS

A. Three categories of application controls:
   1. **Input**
   2. **Processing**
   3. **Output**

B. *Input* application controls include:
   1. All transactions should be properly
      a. Initiated
   2. Conversion of accounting information into machine-readable form should be controlled
   3. Utilization of software controls, for example, check digits
   4. Control totals, including
      a. Record counts
      b. **Hash totals**
   5. Error log and follow-up procedures

C. *Processing* application controls include:
   1. Check digits (self-checking numbers); control totals; boundary protection;
      Virus protection
   2. Limit and reasonable checks
   3. Error log and follow-up procedures

D. *Output* application controls include:
   1. Control totals /record counts reconciled with input and processing totals
2. Error log and follow-up procedures

3. Internal Audit Department procedures

E. Auditing around vs. through the computer

1. When auditing around the computer, the computer is treated like a “black box” that is ignored, i.e., the auditor concentrates on inputs and outputs

2. When auditing through the computer, the auditor uses the computer to perform tests of controls and substantive tests
   a. Parallel simulation; client’s records are processed using auditor software and then auditor’s results are compared to client’s results
   b. Integrated test facility; auditor combines fictitious (test) data with the client’s actual data and then processes it as part of the client’s regular data processing to review the results

Notes: Parallel simulation

ITF----Integrated test facility
MULTIPLE-CHOICE QUESTIONS 23 - 28

23. Which of the following is an example of how specific internal controls in a database environment may differ from controls in a nondatabase environment?

a. Controls should exist to ensure that users have access to and can update only the data elements that they have been authorized to access.
b. Controls over data sharing by diverse users within an entity should be the same for every user.
c. The employee who manages the computer hardware should also develop and debug the computer programs.
d. Controls can provide assurance that all processed transactions are authorized, but cannot verify that all authorized transactions are processed.

24. Which of the following activities most likely would detect whether payroll data were altered during processing?

a. Monitor authorized distribution of data control sheets
b. Use test data to verify the performance of edit routines
c. Examine source documents for approval by supervisors
d. Segregate duties between approval of hardware and software specifications

25. When evaluating internal control of an entity that processes sales transactions on the Internet, an auditor would be most concerned about the

a. Lack of sales invoice documents as an audit trail
b. Potential for computer disruptions in recording sales
c. Inability to establish an integrated test facility
d. Frequency of archiving and data retention

26. Which of the following computer-assisted auditing techniques processes client input data on a controlled program under the auditor's control to test controls in the computer system?

a. Test date
b. Review of program logic
c. Integrated test facility
d. Parallel simulation

27. Which of the following computer-assisted auditing techniques allows fictitious and real transactions to be processed together without client operating personnel being aware of the testing process?

a. Integrated test facility
b. Input controls matrix
c. Parallel simulation
d. Data entry monitor
28. What two selections are crucial to achieving audit efficiency and effectiveness with a personal computer?

a. The appropriate audit tasks for personal computer applications
b. The appropriate software to perform the selected audit tasks
c. Audit procedures that are generally applicable to several clients in a specific industry
d. Client data that can be accessed by the auditor’s personal computer
DEFICIENCIES IN INTERNAL CONTROL IDENTIFIED IN AN AUDIT OF FINANCIAL STATEMENTS

A. A deficiency in internal control exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect and correct misstatements on a timely basis.

1. Deficiency in design means the control is not there or as defined by the SAS:

   A deficiency in design exists when a control necessary to meet the control objective is missing or an existing control is not properly designed so that even if the control operates as designed, the control objective would not be met.

2. Deficiency in operation means the control is there, but it doesn’t meet our objective, or as defined by the SAS:

   A deficiency in operation exists when a properly designed control does not operate as designed or the person performing the control does not possess the necessary authority or competence to perform the control effectively.

B. CPA is required to communicate, in writing, to management and those charged with governance, significant deficiencies and material weaknesses identified during the audit along with those communicated in previous audits that have not been remediated.

   Material weakness
C. A significant deficiency is a deficiency, or a combination of deficiencies, in internal control that is less severe than a material weakness, yet important enough to merit attention by those charged with governance.

D. A material weakness is a deficiency, or combination of deficiencies, in internal control such that there is a reasonable possibility that a material misstatement of the entity’s financial statements will not be prevented or detected and corrected on a timely basis.

E. Relationships between deficiency definitions

1. A significant deficiency is a very bad deficiency in internal control.
2. A material weakness is a very bad significant deficiency.
3. So all significant deficiencies are not material weaknesses, only very bad ones.
4. However, all material weaknesses are significant deficiencies.
5. All definitions refer to prevention of misstatements, but only the definition of material weakness labels the misstatement of concern to be a material misstatement.

F. Elements of required written communication on significant deficiencies and material weaknesses:

1. Statement that the purpose of the audit was to express an opinion on financial statements, but not to express an opinion on the effectiveness of internal control.
2. Statement that the auditor is (accordingly) not expressing an opinion on the effectiveness of internal control.
3. Statement that indicates the auditor’s consideration of internal control was not designed to identify all deficiencies in internal control that might be significant deficiencies or material weaknesses.
4. The definition of material weakness and where relevant the definition of significant deficiency.
5. Identification of the specific material weaknesses found and if applicable, the specific significant deficiencies found.
6. Restriction of report to management and those charged with governance and if applicable to a specific governmental authority.
G. Example of required written communication:

In planning and performing our audit of the financial statements of ABC Company (the "Company") as of and for the year ended December 31, 20XX, in accordance with auditing standards generally accepted in the United States of America, we considered the Company’s internal control over financial reporting (internal control) as a basis for designing our auditing procedures for the purpose of expressing our opinion on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of the Company’s internal control. Accordingly, we do not express an opinion on the effectiveness of the Company’s internal control.

Our consideration of internal control was for the limited purpose described in the preceding paragraph and was not designed to identify all deficiencies in internal control that might be significant deficiencies or material weaknesses and therefore, there can be no assurance that all deficiencies, significant deficiencies, or material weaknesses have been identified. However, as discussed below, we identified certain deficiencies in internal control that we consider to be material weaknesses [and other deficiencies that we consider to be significant deficiencies].

A deficiency in internal control exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect and correct misstatements on a timely basis. A material weakness is a deficiency, or a combination of deficiencies, in internal control, such that there is a reasonable possibility that a material misstatement of the entity’s financial statements will not be prevented, or detected and corrected on a timely basis. [We consider the following deficiencies in the Company’s internal control to be material weaknesses:]

[Describe the material weaknesses that were identified.]

[A significant deficiency is a deficiency, or a combination of deficiencies, in internal control that is less severe than a material weakness, yet important enough to merit attention by those charged with governance. We consider the following deficiencies in the Company’s internal control to be significant deficiencies:]

[Describe the significant deficiencies that were identified.]

This communication is intended solely for the information and use of management, [identify the body or individuals charged with governance], others within the organization, and [identify any specified governmental authorities] and is not intended to be and should not be used by anyone other than these specified parties.
H. Auditor must keep reporting significant deficiencies and material weaknesses that were communicated in previous audits and not remediated.

I. Deadline for written communication is no later than 60 days following the audit report release date, but it is recommended that it be made by the report release date.

Editor note: For issuers (public companies), the written communication is required to be made prior to the issuance of the auditor’s report on the financial statements.

J. Under no circumstances may an auditor issue a report stating that no significant deficiencies were found.

K. OK to issue a report that no material weaknesses were found if required by a governmental agency.
PURCHASES&ACCOUNTS PAYABLE TRANSACTION CYCLE

A. Learn:
   1. Flow of documents
   2. Related controls

B. User Department prepares prenumbered stores requisition
   1. Copy 1 is filed
   2. Copy 2 is sent to storeroom

C. Storeroom receives stores requisition and sends goods to User Department

D. Storeroom prepares 3-copy, prenumbered purchase requisition
   1. Copy 1 is filed
   2. Copy 2 is sent to Accounts Payable Department
   3. Copy 3 is sent to Purchasing Department

E. Purchasing Department receives purchase requisition

F. Purchasing Department prepares 4-copy, prenumbered purchase order
   1. Copy 1 is filed
   2. Copy 2 is sent to vendor
   3. Copy 3 (blind copy) is sent to Receiving Department
      - Receiving Department copy has quantity ordered blacked out so they will have no preconceived notion when they determine quantity received
   4. Copy 4 is sent to Accounts Payable Department

G. Receiving Department receives the blind copy of the purchase order and when the goods arrive they fill in the amount received

H. Receiving Department prepares a 3-copy, prenumbered receiving report
   1. Copy 1 is filed
2. Copy 2 is sent to Accounts Payable Department

3. Copy 3 is sent to Purchasing Department for a cross-check with it and original purchase order

I. Accounts Payable Department

1. Performs a cross-check on the 4 documents it has received:
   - Purchase requisition
   - Purchase order
   - Receiving report
   - Vendor invoice

2. Records the purchase in the accounts payable subsidiary ledger

3. Prepares a 3-copy, prenumbered voucher package
   a. Copy 1 is filed
   b. Copy 2 is sent to General Accounting Department
   c. Copy 3 is sent to the Treasury Department

J. Treasury Department

1. Receives voucher package and performs a cross-check on all documents

2. Prepares check and (in order to maintain custody) sends it to vendor

3. Cancels voucher package so invoice will not be paid again and documents can’t be used to arrange another purchase

Notes: __________________________________________________________
_______________________________________________________________
_______________________________________________________________
_______________________________________________________________
_______________________________________________________________
_______________________________________________________________
SALES&ACCOUNTS RECEIVABLE TRANSACTION CYCLE

A. Sales Department receives the customer’s sales order

B. Credit Department approves the customer’s credit

C. Shipping Department
   1. Prepares bill of lading
   2. Ships goods

D. Billing / Accounts Receivable Department
   1. Receives copies of
      - Sales order
      - Credit approval
      - Bill of lading
   2. Prepares invoice
   3. Records sale in sales journal
   4. Records in accounts receivable subsidiary ledger

E. Treasury Department approval is needed for any accounts receivable write-offs

Notes:________________________________________________________________________
________________________________________________________________________
________________________________________________________________________
________________________________________________________________________
CASH RECEIPTS TRANSACTION CYCLE CONTROLS

A. Daily listing of remittances received should be prepared and totaled by persons who open the mail

B. Deposits should be made daily and recorded daily in cash receipts journal

   Editor note: Person who makes deposits should be different from the one who handles the receipt of the cash and yet another individual should prepare the bank reconciliation.

C. Bank reconciliations should be done monthly by Internal Audit Department; bank statements should be sent directly to them from the bank

   Editor note: The Internal Audit Department may receive the bank statement directly and perform this function on an irregular basis as a control. Bank reconciliations can be prepared on a regular basis by the finance area if proper separation of duties is maintained. Bank reconciliations should not be done by persons with responsibility for handling cash receipts; nor should they be prepared by persons who sign checks or keep the records for receipts or disbursements.

D. A bank lock box service is a strong control; company’s customers send remittances directly to the company’s bank.

Notes:  

Remittance advice
Remittance listing
Bank lock box service
HUMAN RESOURCES & PAYROLL TRANSACTION CYCLE CONTROLS

A. Human Resources Department should do the hiring and firing; the Payroll Department should prepare the payroll

B. There should be a separate payroll bank account maintained on an imprest basis

C. Salary changes should be approved by the Human Resources Department

D. Signature machine and unused checks should be locked up and unclaimed payroll checks should be held by Internal Audit Department

Notes:
CONTROLS FOR INVENTORY AND PROPERTY, PLANT&EQUIPMENT TRANSACTION CYCLES

A. Inventory transaction cycle controls
   1. Proper separation of authorization, record keeping, and custody
   2. Adequate insurance coverage

B. Property, plant & equipment transaction cycle controls
   1. Major purchases approved by board of directors
   2. Adequate insurance coverage
   3. Physical safeguards and restricted access
   4. Accurate depreciation
   5. Appropriate policy set up and maintained for expense vs. capitalization determinations

Notes:  ARC

__________________________________________
Insurance coverage

__________________________________________
Board of directors
Number 3 (15 to 25 minutes)

The flowchart below depicts the activities relating to the purchasing, receiving, and accounts payable departments of Model Company, Inc.

Based only on the flowchart, describe the internal control procedures (strengths) that most likely would provide reasonable assurance that specific internal control objectives for the financial statement assertions regarding purchases and accounts payable will be achieved. Do not describe weaknesses in internal control.

1. Requisition is approved
2. Best price obtained within budget limit
3. Vendor's past history is checked
4. Purchase order is prenumbered
5. Copy of purchase order is blacked-out
6. Goods are counted in secure facility
FLOWCHART EVALUATION

A. Purchasing
   1. Authorization is obtained before PO is prepared.
   2. Comparison to budget.
   3. Vendors post history checked before approval.
   4. Prenumbered PO
   5. Original PO and requisition are filed for possible review by internal auditor.

B. Receiving
   1. Blind PO-Independent count by receiving clerk.
   2. Prenumbered receiving report.
   3. Receiving report filed for internal auditor.
   4. Copy of receiving report returned to purchasing.

C. Accounts Payable
   1. Match purchase requisition, PO, and receiving report before payment. Filed for internal auditor.
   2. Recompute math for accuracy – 4 documents.
   3. Compare invoice, PO, and receiving report.
   4. Prenumbered vouchers.
   5. Reconcile voucher register to control account.
   6. All documents matched before payments.

D. Overall: Appears that there is a proper segregation of duties.

Notes:____________________________________________________________________
____________________________________________________________________
____________________________________________________________________
____________________________________________________________________
____________________________________________________________________
SALES & ACCOUNTS RECEIVABLE TRANSACTION CYCLE FLOWCHART SIMULATION

While auditing the TOP Manufacturing Corporation, the auditor prepared the following flowchart of credit sales activities. In this flowchart, code letter “A” represents Customer.

Indicate what each of the code letter “B” through “P” represents. Do not discuss adequacies or inadequacies in the system of internal control.

A. Customer
B. Credit Dept.
C. Shipping Dept
D. Billing Dept.
E. Accounts receivable Dept.
F. File pending credit approval
G. Prepare 3 copies of sales invoice
H. Sales invoice
I. Journalize to sales journal
J. Approved sales order
K. Copy of sales invoice
L. Bill of lading
M. Customer purchase order
N. Sales order
O. File by customer name
P. Accounts receivable ledger
PREVENTING OR DETECTING ERRORS & FRAUD SIMULATION

Field, CPA, is auditing the financial statements of Miller Mailorder, Inc. (MMI) for the year ended January 31, Year 1. Field has compiled a list of possible errors and fraud that may result in the misstatement of MMI’s financial statements.

For each possible error and fraud listed, select one internal control procedure from the answer list that, if properly designed and implemented, most likely could assist MMI in preventing or detecting the errors and fraud.

Answer

Possible Errors & Fraud

C 1. Invoices for goods sold are posted to incorrect customer accounts.

G 2. Goods ordered by customers are shipped, but are not billed to anyone.

F 3. Invoices are sent for shipped goods, but are not recorded in the sales journal.

K 4. Invoices are sent for shipped goods and are recorded in the sales journal, but are not posted to any customer account.

I 5. Credit sales are made to individuals with unsatisfactory credit ratings.

B 6. Goods are removed from inventory for unauthorized orders.

D 7. Goods shipped to customers do not agree with goods ordered by customers.

L 8. Invoices are sent to allies in a fraudulent scheme and sales are recorded for fictitious transactions.
Internal Control Procedures

A. Shipping clerks compare goods received from the warehouse with the details on the shipping documents.

B. Approved sales orders are required for goods to be released from the warehouse.

C. Monthly statements are mailed to all customers with outstanding balances.

D. Shipping clerks compare goods received from the warehouse with approved sales orders.

E. Customer orders are compared with the inventory master file to determine whether items ordered are in stock.

F. Daily sales summaries are compared with control totals of invoices.

G. Shipping documents are compared with sales invoices when goods are shipped.

H. Sales invoices are compared with the master price file.

I. Customer orders are compared with an approved customer list.

J. Sales orders are prepared for each customer order.

K. Control amounts posted to the accounts receivable ledger are compared with control totals of invoices.

L. Sales invoices are compared with shipping documents and approved customer orders before invoices are mailed.

M. Prenumbered credit memos are used for granting credit for goods returned.

N. Goods returned for credit are approved by the supervisor of the Sales Department.

O. Remittance advices are separated from the checks in the mailroom and forwarded to the Accounting Department.

P. Total amounts pasted to the accounts receivable ledger from remittance advices are compared with the validated bank deposit slip.

Q. The cashier examines each check for proper endorsement.

R. Validated deposit slips are compared with the cashier’s daily cash summaries.

S. An employee, other than the bookkeeper, periodically prepares a bank reconciliation.

T. Sales returns are approved by the same employee who issues receiving reports evidencing actual return of goods.
MNEMONIC FOR GENERAL INTERNAL CONTROLS: BANCISMOP

BANCISMOP:

B  Bonding

Bonding is insurance coverage.

換金し易いものに保険を掛ける

A  Approval

色々出てきているので、復習のこと

N  Numeric check

Prenumber

C  Cross-check
Internal Control

I Internal audit function
   Filing

S Separation of duties

M Mechanical devices
   Lock
       金庫など

O Other

P Personnel policies & procedures
   有休を取らせる
MULTIPLE-CHOICE QUESTIONS 29 - 44

29. A weakness in internal control over recording retirements of equipment may cause an auditor to

a. Trace additions to the “other assets” account to search for equipment that is still on hand but no longer being used
b. Select certain items of equipment from the accounting records and locate them in the plant
c. Review the subsidiary ledger to ascertain whether depreciation was taken on each item of equipment during the year
d. Inspect certain items of equipment in the plant and trace those items to the accounting records

(0081)

30. An entity’s internal control requires for every check request that there be an approved voucher, supported by a prenumbered purchase order and a prenumbered receiving report. To determine whether checks are being issued for unauthorized expenditures, an auditor most likely would select items for testing from the population of all

a. Purchase orders
b. Canceled checks
c. Receiving reports
d. Approved vouchers

(2951)

31. For effective internal control, the Accounts Payable Department generally should

a. Obliterate the quantity ordered on the Receiving Department copy of the purchase order
b. Establish the agreement of the vendor’s invoice with the receiving report and purchase order
c. Stamp, perforate, or otherwise cancel supporting documentation after payment is mailed
d. Ascertain that each requisition is approved as to price, quantity, and quality by an authorized employee

(2949)

32. To provide assurance that each voucher is submitted and paid only once, an auditor most likely would examine a sample of paid vouchers and determine whether each voucher is

a. Supported by a vendor’s invoice
b. Stamped “paid” by the check signer
c. Prenumbered and accounted for
d. Approved for authorized purchases

(5652)
33. Which of the following controls would be most effective in assuring that recorded purchases are free of material errors?

a. The Receiving Department compares the quantity ordered on purchase orders with the quantity received on receiving reports
b. Vendors’ invoices are compared with purchase orders by an employee who is independent of the Receiving Department
c. Receiving reports require the signature of the individual who authorized the purchase
d. Purchase orders, receiving reports, and vendors’ invoices are independently matched in preparing vouchers

34. Which of the following procedures most likely would not be an internal control procedure designed to reduce the risk of errors in the billing process?

a. Comparing control totals for shipping documents with corresponding totals for sales invoices
b. Using computer programmed controls on the pricing and mathematical accuracy of sales invoices
c. Matching shipping documents with approved sales orders before invoice preparation
d. Reconciling the control totals for sales invoices with the accounts receivable subsidiary ledger

35. In testing controls over cash disbursements, an auditor most likely would determine that the person who signs checks also

a. Reviews the monthly bank reconciliation
b. Returns the checks to accounts payable
c. Is denied access to the supporting documents
d. Is responsible for mailing the checks

36. The authority to accept incoming goods in receiving should be based on a (an)

a. Vendor’s invoice
b. Materials requisition
c. Bill of lading
d. Approved purchase order

37. An auditor generally tests the segregation of duties related to inventory by

a. Personal inquiry and observation
b. Test counts and cutoff procedures
c. Analytical procedures and invoice recomputation
d. Document inspection and reconciliation

38. Which of the following circumstances most likely would cause an auditor to suspect an employee payroll fraud scheme?

a. There are significant unexplained variances between standard and actual labor cost.
b. Payroll checks are disbursed by the same employee each payday.
c. Employee time cards are approved by individual departmental supervisors.
d. A separate payroll bank account is maintained on an imprest basis.
39. Proper authorization of write-offs of uncollectible accounts should be approved in which of the following departments?

a. Accounts receivable  
b. Credit  
c. Accounts payable  
d. Treasurer  

Treasurer  

40. Employers bond employees who handle cash receipts because fidelity bonds reduce the possibility of employing dishonest individuals and

a. Protect employees who make unintentional errors from possible monetary damages resulting from their errors.  
b. Deter dishonesty by making employees aware that insurance companies may investigate and prosecute dishonest acts.  
c. Facilitate an independent monitoring of the receiving and depositing of cash receipts.  
d. Force employees in positions of trust to take periodic vacations and rotate their assigned duties  

(0073)  

41. The purpose of segregating the duties of hiring personnel and distributing payroll checks is to separate the

a. Human resources function from the controllership function  
b. Administrative controls from the internal accounting controls  
c. Authorization of transactions from the custody of related assets  
d. Operational responsibility from the record-keeping responsibility  

Authorization  

42. Which of the following questions would an auditor least likely include on an internal control questionnaire concerning the initiation and execution of equipment transactions?

a. Are requests for major repairs approved at a higher level than the department initiating the request?  
b. Are prenumbered purchase orders used for equipment and periodically accounted for?  
c. Are requests for purchases of equipment reviewed for consideration of soliciting competitive bids?  
d. Are procedures in place to monitor and properly restrict access to equipment?  

(5114)  

43. Which of the following statements is correct concerning control deficiencies in an audit?

a. An auditor is required to search for control deficiencies during an audit.  
b. All significant deficiencies are also considered to be material weaknesses.  
c. An auditor may communicate deficiencies during an audit or after the audit’s completion.  
d. An auditor may report that no significant deficiencies were noted during an audit.  

Significant deficiency  

Material weakness  

(5656)
44. Which of the following matters would an auditor most likely consider to be a significant deficiency to be communicated to management and those charged with governance?

a. Management's failure to renegotiate unfavorable long-term purchase commitments
b. Recurring operating losses that may indicate going concern problems

c. Evidence of a lack of objectivity by those responsible for accounting decisions

d. Management’s current plans to reduce its ownership equity in the entity

Lack of objectivity (7029)
1. Ans. A
   Inherent limitations = override, mistakes, errors, collusion. Incompatible duties は separation of duty により改善できる。

2. Ans. B
   Internal control について、監査人が concern するのは error や Fraud が prevented or detected。

3. Ans. B
   ARC＝Authorization, recording, custody

4. Ans. D
   職務を分ける＝Separation of duty. Reduce errors and fraud.

5. Ans. C
   Elements of I/C (CRIME) のなかで、control environment が awareness and attitude＝会社の経営姿勢。

6. Ans. A
   Control risk は Elements of I/C ではありません。

7. Ans. A
   To obtain understanding of I/C は Planning の時にします。RMM の Risk アセスメントのために必要だからです。

8. Ans. B
   Inherent limitation＝企業も監査人もどうすることもできない＝人間の経営判断。ほかの選択は改善できる。Complex は simple に。Ineffective を effective に。Incentive を与えて向上させる。

9. Ans. A
   I/C において least likely effect は今回の監査の予算。ほかの選択は most likely。

10. Ans. D
    Tests of detail は Substantive test のひとつで、これを Test of control として採用してもいいです。どのような場合にするのか？ 答：I/C が effective か evaluate するとき。

11. Ans. D
    I/C を理解するうえで、監査人が重点を置くのは、implementation of procedures ＋ its compliance です。

12. Ans. B
    監査では Financial statement は management assertion とも言います。特異な表現ですが暗記しましょう。実は F/S はいくつかの Assertion により成り立っていると理解してください。例えば、年度末、現金はこれだけあったと management は F/S の Balance sheet に記載します。これは assertion です。

13. Ans. A
    Planning のとき、I/C を理解していきます。それにより、misstement がどの勘定科目などで起こりえるか identify できます。

14. Ans. D
    監査はあら探しではありません。I/C の問題点を Search しません。他の選択は監査ではしなくてはいけない＝auditor is obligated to do
15. Ans. B
I/C を理解するとき、どのような policy、procedure があるのか知る必要があります。しかし、operating effectiveness, efficiency については I/C を理解した後に検証します（after obtaining an understanding of I/C）。問題文は I/C を理解する時を聞いています。

16. Ans. B
同じ企業の何年にもわたって監査している場合、I/C における過去の証拠を定期的証拠として採用しても大丈夫。しかし、これができるのは、その該当する I/C の箇所に変更がないことが条件です。もし、去年から I/C に変更があれば test しなければいけません。

17. Ans. B
Control risk is increased. そして overall の audit risk は変更しないなら、どこかを下げないといけません。Inverse relationship の detection risk。

18. Ans. C
Control risk のレベルがどうであれ、必ず substantive tests はします。

19. Ans. C
I/C を理解するとき、どのような policy、procedure があるか知らなければいけません。

20. Ans. A
Test of control する＝control risk is low.  Detection risk を下げて、substantive test はそんなにしません。

21. Ans. C
Inherent risk and control risk はクライアント側のリスク。監査に関係なく存在します。監査のときアセスメントします。Detection risk は監査側のリスクで監査すれば発生します。監査しなければなりません。

22. Ans. A
Detection risk と Inverse relationship にあるのは Control risk、substantive tests。選択にあったのは substantive tests。

23. Ans. A
Database (Computer), Non-database (Paper). Database における I/C で重要なのはアクセス権。

Processing control は use test data to verify the performance. Choice A は output control, Choice C は Input control, Choice D は General control。

25. Ans. B
ネットを使用して売上げ計上している場合、懸念は computer の disruption。

26. Ans. D
Input data on a auditor’s program under the auditor’s control = parallel simulation。

27. Ans. A
During the test, auditor uses fictitious and real transactions to be processed = Integrated test facility。

28. この問題は飛ばして下さい。
29. Ans. B
Retirement of equipment = 売却、破棄、処分など。現場には存在しないはずなので、監査人は帳簿から現場に確認しにいきます。

30. Ans. B
小切手が不正な支払いに issue されたかどうか test する場合、支払済の小切手を母集団にしていくつかサンプルで選んで voucher と照合します。

31. Ans. B
AP Dept がするのは＝伝票の照合をして prepare voucher です。Choice A and D は purchase dept。Choice C は Treasury dept。

32. Ans. B
2 度払いを防ぐ方法は paid スタンプを押す。Treasurer がします。

33. Ans. D
Choice の中で一番 error が発生しにくいのは、3 つの伝票の照合をしている D です。AP Dept がします。

34. Ans. D
Billing Dept するのは Choice A, B, and C です。D は AR dept です。

35. Ans. D
支払い小切手にサインするのは、Treasurer です。郵送もします。

36. Ans. D
購入商品を受け取る Dept は Receiving dept です。Approved PO がなければ商品を受け取ってはいけません。

37. Ans. A
職務分離のテスト = Test of control = inquiry, observation, inspection, reperformance です。

38. Ans. A
Choice の中で Fraud が起きて考えられるのは、significant unexplained variance と記載されている A です。ほかの Choice は問題ありません。

39. Ans. D
AR の write-off をするのは Treasurer です。

40. Ans. B
Bonding の意味＝解答 B の文章。

41. Ans. C
Hiring = Authorization. Distributing checks = Custody.

42. Ans. D
initiation and execution=購入や支払について。Choice D はアクセス権です。Security issue。

43. Ans. C
監査報告書の日付から 60 日以内であればいつでも可能です。監査中でも可能です。

44. Ans. C
Choice の中で significant deficiency は Evidence of lack of objectivity。lack of objectivity とは客観性の欠如という意味です。