CHAPTER 10

CONSIDERING INTERNAL CONTROL

LEARNING OBJECTIVES

After studying this chapter, you should be able to

- **10-1** Describe the three primary objectives of effective internal control.
- **10-2** Contrast management's responsibilities for maintaining internal control with the auditor's responsibilities for evaluating and reporting on internal control.
- **10-3** Explain the five components of the COSO internal control framework.
- **10-4** Obtain and document an understanding of internal control.
- **10-5** Assess control risk by linking key controls and control deficiencies to transaction-related audit objectives.
- **10-6** Describe the process of designing and performing tests of controls.
- **10-7** Understand Section 404 requirements for auditor reporting on internal control.
- **10-8** Describe the differences in evaluating, reporting, and testing internal control for nonpublic companies.

Rogue Trader Circumvents Controls Causing $7 Billion In Losses

The size of the trading losses at French bank Société Générale were staggering. Jérôme Kerviel, a junior trader with a modest base salary of around $70,000, had gambled more than the bank's entire net worth in high-risk bets involving unauthorized trades related to European stock index funds.

Kerviel's role was to make trades that bet whether European stock markets would rise or fall. Each bet was supposed to be offset by a trade in the opposite direction to keep risk at a minimum, with the bank making profit or loss based on the difference between the parallel bets. However, within months of joining the trading desk, he began placing his bets all in one direction, rather than hedging the trades as he was expected to do. One bet paid off handsomely after an attack on the London transport system sent European markets into a dive. "Bingo, 500,000 euros," Kerviel said in an interview with investigators. This success led him to make even bolder bets.

Société Générale played up their use of computer systems to ward off risk. The bank's equity-derivatives unit had not experienced a major incident in 15 years. "We didn't think it was possible," said one Société Générale executive discussing the losses. Unfortunately, Kerviel knew how to hide his trades to avoid detection. He masked his positions with fake trades, creating the illusion that his positions were hedged.

Keeping his trades hidden required constant vigilance. He needed to continue to delete and re-enter fake trades to avoid detection. As a result, Kerviel regularly skipped holidays and rarely took vacation. "It is one of the rules of controls: a trader who doesn't take holidays is trader who doesn't want his books to be seen by others," Kerviel stated to investigators.

Finally, a fictitious trade made in the name of a German brokerage house triggered an alarm in Société Générale's systems. Under repeated questioning, Kerviel revealed that his bets had over 50 billion euros (€) at risk for the bank. By the time the French bank unwound the bets, it had lost €4.9 billion ($7.4 billion), nearly destroying the 145-year-old bank.

At Kerviel's June 2010 trial, one of the bank's former executives admitted that the bank failed by creating an environment where there was "too much trust." And, his former boss commented, "If you're not looking for anything, you don't find anything."

Sources: 1. Nicola Clark and Katrin Behnhold, "A Société Générale Trader Remains a Mystery as His Criminal Trial Ends," *The New York Times* (June 25, 2010); 2. David Gauthier-Villars and Carrick Mollenkamp, "Portrait Emerges of Rogue Trader at French Bank," *The Wall Street Journal* (February 2–3, 2008) p. A1.

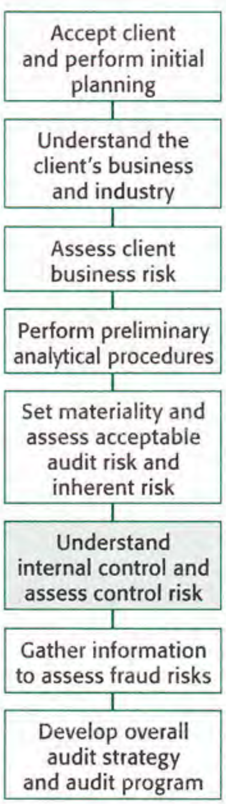
The opening story involving Société Générale demonstrates how deficiencies in internal control can cause significant losses resulting in material misstatements in financial statements. Financial reporting problems at companies such as Enron and WorldCom also exposed serious deficiencies in internal control. To address these concerns, Section 404 of the Sarbanes–Oxley Act requires management of U.S. public companies to assess and report on the effectiveness of their internal control over financial reporting, and auditor reports on the effectiveness of internal control are required for larger public companies. Similar legislation has arisen around the world, such as Japan's "J-SOX," which also mandates management and auditor reporting on internal controls for Japanese companies.

This is the third chapter dealing with planning the audit. It shows how effective internal controls can reduce planned audit evidence in the audit of financial statements. To support the assessment of the control risk component of the audit risk model, auditors must obtain an understanding of internal control and gather evidence to support that assessment. The chart in the margin shows where these tasks fit into planning the audit. The chapter also describes how public company auditors integrate evidence to provide a basis for their report on the effectiveness of internal control over financial reporting with the assessment of control risk in the financial statement audit. The end of the chapter identifies and discusses the differences in assessing control risk and testing controls for nonpublic companies compared to public companies. By the end of the chapter, you will see that there are more similarities than differences in the two approaches.

INTERNAL CONTROL OBJECTIVES

OBJECTIVE 10-1

Describe the three primary objectives of effective internal control.



A system of internal control consists of policies and procedures designed to provide management with reasonable assurance that the company achieves its objectives and goals. These policies and procedures are often called controls, and collectively, they make up the entity's **internal control**. Management typically has three broad objectives in designing an effective internal control system:

1. *Reliability of financial reporting.* As we discussed in Chapter 6, management is responsible for preparing statements for investors, creditors, and other users. Management has both a legal and professional responsibility to be sure that the information is fairly presented in accordance with reporting requirements of accounting frameworks such as U.S. GAAP and IFRS. The objective of effective internal control over financial reporting is to fulfill these financial reporting responsibilities.
2. *Efficiency and effectiveness of operations.* Controls within a company encourage efficient and effective use of its resources to optimize the company's goals. An important objective of these controls is accurate financial and nonfinancial information about the company's operations for decision making.
3. *Compliance with laws and regulations.* Section 404 requires management of all public companies to issue a report about the operating effectiveness of internal control over financial reporting. In addition to the legal provisions of Section 404, public, nonpublic, and not-for-profit organizations are required to follow many laws and regulations. Some relate to accounting only indirectly, such as environmental protection and civil rights laws. Others are closely related to accounting, such as income tax regulations and anti-fraud legal provisions.

Management designs systems of internal control to accomplish all three objectives. The auditor's focus in both the audit of financial statements and the audit of internal controls is on controls over the reliability of financial reporting plus those controls over operations and compliance with laws and regulations that could materially affect financial reporting.

MANAGEMENT AND AUDITOR RESPONSIBILITIES FOR INTERNAL CONTROL

OBJECTIVE 10-2

Contrast management's responsibilities for maintaining internal control with the auditor's responsibilities for evaluating and reporting on internal control.

Responsibilities for internal controls differ between management and the auditor. Management is responsible for establishing and maintaining the entity's internal controls. Management is also required by Section 404 to publicly report on the operating effectiveness of those controls. In contrast, the auditor's responsibilities include understanding and testing internal control over financial reporting. Auditors of larger public companies are required by the SEC to annually issue an audit report on the operating effectiveness of those controls.

Management's Responsibilities for Establishing Internal Control

Management, not the auditor, must establish and maintain the entity's internal controls. This concept is consistent with the requirement that management, not the auditor, is responsible for the preparation of financial statements in accordance with applicable accounting frameworks such as GAAP or IFRS. Two key concepts underlie management's design and implementation of internal control—reasonable assurance and inherent limitations.

Reasonable Assurance A company should develop internal controls that provide reasonable, but not absolute, assurance that the financial statements are fairly stated. Internal controls are developed by management after considering both the costs and benefits of the controls. Reasonable assurance is a high level of assurance that allows for only a low likelihood that material misstatements will not be prevented or detected on a timely basis by internal control.

Inherent Limitations Internal controls can never be completely effective, regardless of the care followed in their design and implementation. Even if management can design an ideal system, its effectiveness depends on the competency and dependability of the people using it. Assume, for example, that a carefully developed procedure for counting inventory requires two employees to count independently. If neither of the employees understands the instructions or if both are careless in doing the counts, the inventory count is likely to be wrong. Even if the count is correct, management might override the procedure and instruct an employee to increase the count to improve reported earnings. Similarly, the employees might decide to overstate the counts to intentionally cover up a theft of inventory by one or both of them. An act of two or more employees who conspire to steal assets or misstate records is called **collusion.**

Management's Section 404 Reporting Responsibilities

Section 404(a) of the Sarbanes–Oxley Act requires management of all public companies to issue an internal control report that includes the following:

- A statement that management is responsible for establishing and maintaining an adequate internal control structure and procedures for financial reporting
- An assessment of the effectiveness of the internal control structure and procedures for financial reporting as of the end of the company's fiscal year

Management must also identify the framework used to evaluate the effectiveness of internal control. The internal control framework used by most U.S. companies is the Committee of Sponsoring Organizations of the Treadway Commission (COSO) *Internal Control—Integrated Framework.* Other internal control frameworks exist around the world, such as the United Kingdom's *Internal Control: Guidance for Directors on the Combined Code* (known as the Turnbull Report) and Canada's *Guidance on Assessing Control* (known as "CoCo").

Management's assessment of internal control over financial reporting consists of two key aspects. First, management must evaluate the *design* of internal control

FIGURE 10-1 **Example Section 404 Management Report on Internal Control Over Financial Reporting**

The management of Marble Corporation is responsible for establishing and maintaining adequate internal control over financial reporting. Marble's internal control system was designed to provide reasonable assurance to the company's management and board of directors regarding the preparation and fair presentation of published financial statements.

Marble management assessed the effectiveness of the company's internal control over financial reporting as of December 31, 2013. In making this assessment, it used the criteria set forth by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) in *Internal Control–Integrated Framework*. Based on our assessment, we believe that, as of December 31, 2013, the company's internal control over financial reporting is effective based on those criteria.

Marble's independent auditors have issued an audit report on our assessment of the company's internal control over financial reporting. This report appears on the following page.

February 15, 2014

Fred Narsky, President — Karen Wilson, Chief Financial Officer

over financial reporting. Second, management must test the *operating effectiveness* of those controls.

Design of Internal Control Management must evaluate whether the controls are designed and put in place to prevent or detect material misstatements in the financial statements. Management's focus is on controls that address risks related to all relevant assertions for all significant accounts and disclosures in the financial statements. This includes evaluating how significant transactions are initiated, authorized, recorded, processed, and reported to identify points in the flow of transactions where material misstatements due to error or fraud could occur.

Operating Effectiveness of Controls In addition, management must test the operating effectiveness of controls. The testing objective is to determine whether the controls are operating as designed and whether the person performing the control possesses the necessary authority and qualifications to perform the control effectively. Management's test results, which must also be documented, form the basis for management's assertion at the end of the fiscal year about the controls' operating effectiveness. Management must disclose any material weakness in internal control. Even if only one material weakness is present, management must conclude that the company's internal control over financial reporting is not effective.

The SEC requires management to include its report on internal control in its annual Form 10-K report filed with the SEC. Figure 10-1 includes an example of management's report on internal control that complies with Section 404 requirements and related SEC rules.

Auditor Responsibilities for Understanding Internal Control

One of the principles in the preface to the clarified AICPA auditing standards is that the auditor "identifies and assesses risks of material misstatement, whether due to fraud or error, based on an understanding of the entity and its environment, including the entity's internal control."[1] Auditing standards require the auditor to obtain an understanding of internal control relevant to the audit on every audit engagement. Auditors are primarily concerned about controls over the reliability of financial reporting and controls over classes of transactions.

Controls Over the Reliability of Financial Reporting Auditors focus primarily on controls related to the first of management's internal control concerns: reliability of financial reporting. Financial statements are not likely to correctly reflect GAAP

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or IFRS if internal controls over financial reporting are inadequate. Unlike the client, the auditor is less concerned with controls that affect the efficiency and effectiveness of company operations, because such controls may not influence the fair presentation of financial statements. Auditors should not, however, ignore controls affecting internal management information, such as budgets and internal performance reports. These types of information are often important sources used by management to run the business and can be important sources of evidence that help the auditor decide whether the financial statements are fairly presented. If the controls over these internal reports are inadequate, the value of the reports as evidence diminishes.

As stated in Chapter 6, auditors have significant responsibility for the discovery of material fraudulent financial reporting and misappropriation of assets, and must also perform audit procedures to identify noncompliance with laws and regulations that may have a material effect on the financial statements. Auditors are therefore also concerned with a client's internal control over the safeguarding of assets and compliance with laws and regulations if they affect the fairness of the financial statements. Internal controls, if properly designed and implemented, can be effective in preventing and detecting fraud.

Controls over Classes of Transactions Auditors emphasize internal control over classes of transactions rather than account balances because the accuracy of accounting system outputs (account balances) depends heavily on the accuracy of inputs and processing (transactions). For example, if products sold, units shipped, or unit selling prices are wrong in billing customers for sales, both sales and accounts receivable will be misstated. On the other hand, if controls are adequate to ensure correct billings, cash receipts, sales returns and allowances, and write-offs, the ending balance in accounts receivable is likely to be correct. Because of the emphasis on classes of transactions, auditors are primarily concerned with the transaction-related audit objectives discussed in Chapter 6 when assessing internal controls over financial reporting. These objectives were discussed in detail on pages 177–179. Table 10-1 illustrates the development of transaction-related audit objectives for sales transactions.

Even though auditors emphasize transaction-related controls, the auditor must also gain an understanding of controls over ending account balance and presentation and disclosure objectives. For example, transaction-related audit objectives typically have no effect on two balance-related audit objectives: realizable value and rights and obligations. They also are unlikely to have an effect on the four presentation and disclosure objectives. The auditor is likely to evaluate separately whether management has implemented internal control for each of these two account balance objectives and the four presentation and disclosure objectives.

TABLE 10-1 Sales Transaction-Related Audit Objectives

Transaction-Related Audit Objective—General Form	Sales Transaction-Related Audit Objectives
Recorded transactions exist (occurrence).	Recorded sales are for shipments made to existing customers.
Existing transactions are recorded (completeness).	Existing sales transactions are recorded.
Recorded transactions are stated at the correct amounts (accuracy).	Recorded sales are for the amount of goods shipped and are correctly billed and recorded.
Recorded transactions are correctly included in the master files and are correctly summarized (posting and summarization).	Sales transactions are correctly included in the master files and are correctly summarized.
Transactions are correctly classified (classification).	Sales transactions are correctly classified.
Transactions are recorded on the correct dates (timing).	Sales are recorded on the correct dates.

Auditor Responsibilities for Reporting on Internal Control

Section 404(b) of the Sarbanes–Oxley Act requires that the auditor report on the effectiveness of internal control over financial reporting. As discussed in Chapter 1, as a result of the Dodd–Frank federal financial reform legislation passed by Congress in July 2010 only larger public companies (accelerated filers) are required to obtain an audit report on internal control over financial reporting.

To express an opinion on these controls, the auditor obtains an understanding of and performs tests of controls for all significant account balances, classes of transactions, and disclosures and related assertions in the financial statements. We will discuss tests of controls later in the chapter and in considerable detail in several other chapters throughout the text. Auditor reporting on internal control is also discussed later in the chapter.

COSO COMPONENTS OF INTERNAL CONTROL

OBJECTIVE 10-3

Explain the five components of the COSO internal control framework.

COSO's *Internal Control—Integrated Framework*, the most widely accepted internal control framework in the United States, describes five components of internal control that management designs and implements to provide reasonable assurance that its control objectives will be met. Each component contains many controls, but auditors concentrate on those designed to prevent or detect material misstatements in the financial statements. The COSO internal control components include the following:

1. Control environment
2. Risk assessment
3. Control activities
4. Information and communication
5. Monitoring

As illustrated in Figure 10-2, the control environment serves as the umbrella for the other four components. Without an effective control environment, the other four are unlikely to result in effective internal control, regardless of their quality.

COSO UPDATES INTERNAL CONTROL—INTEGRATED FRAMEWORK

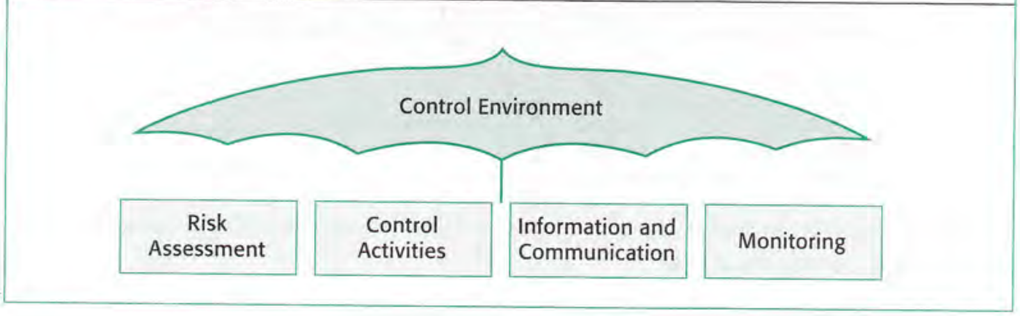
COSO's *Internal Control–Integrated Framework* was first developed in 1992 and has become the most widely accepted internal control framework in the United States and the world. Since the original development of the Framework, business and operating environments have become more global, complex, and technologically driven. Stakeholders have become more engaged, seeking greater transparency and accountability for the integrity of systems of internal control. The COSO Board has updated the Framework to make it more relevant in the current business environment.

The general structure of the Framework will be unchanged, including the same definition of internal control, three categories of objectives–effectiveness and efficiency of operations, reliability of reporting, and compliance with laws and regulations; and five components of internal control–control environment, risk assessment, control activities, information and communication, and monitoring activities. The following are some of the key changes to the framework:

- Applies a principles-based approach–The updated Framework explicitly states seventeen broad principles that apply across all types of entities.
- Reflects the increased relevance of technology–Reliance on sophisticated, decentralized technologies has increased significantly in many entities, impacting how internal control is implemented.
- Enhances governance concepts–Expanded discussion of governance includes the audit, compensation, and nomination committees.
- Expands the reporting category of objectives–The financial reporting objective considers external reporting beyond financial reporting.
- Enhances consideration of anti-fraud expectations–The updated Framework includes more discussion of fraud and the relationship between fraud and internal control.
- Considers different business models and organizational structures–Business models increasingly involve the use of external parties to provide products and services. The revised Framework explicitly considers these extended business models.

Sources: 1. COSO Internal Control–Integrated Framework Update Project Frequently Asked Questions, COSO, April 2012; 2. COSO Internal Control–Integrated Framework Draft, COSO, December 2011 (www.coso.org).

FIGURE 10-2 **Five Components of Internal Control**



The Control Environment

The essence of an effectively controlled organization lies in the attitude of its management. If top management believes that control is important, others in the organization will sense this commitment and respond by conscientiously observing the controls established. If members of the organization believe that control is not an important concern to top management, it is almost certain that management's control objectives will not be effectively achieved.

The **control environment** consists of the actions, policies, and procedures that reflect the overall attitudes of top management, directors, and owners of an entity about internal control and its importance to the entity. To understand and assess the control environment, auditors should consider the most important control subcomponents.

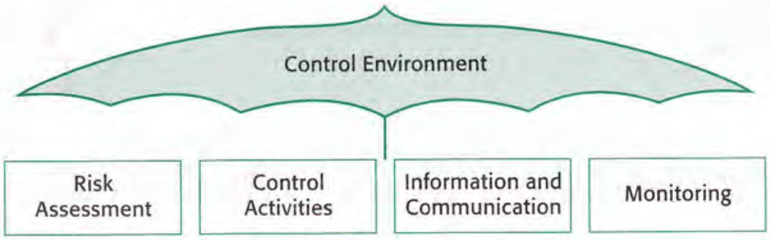
Integrity and Ethical Values Integrity and ethical values are the product of the entity's ethical and behavioral standards, as well as how they are communicated and reinforced in practice. They include management's actions to remove or reduce incentives and temptations that might prompt personnel to engage in dishonest, illegal, or unethical acts. They also include the communication of entity values and behavioral standards to personnel through policy statements, codes of conduct, and by example.

Commitment to Competence Competence is the knowledge and skills necessary to accomplish tasks that define an individual's job. Commitment to competence includes management's consideration of the competence levels for specific jobs and how those levels translate into requisite skills and knowledge.

Board of Director or Audit Committee Participation The board of directors is essential for effective corporate governance because it has ultimate responsibility to make sure management implements proper internal control and financial reporting processes. An effective board of directors is independent of management, and its members stay involved in and scrutinize management's activities. Although the board delegates responsibility for internal control to management, it must regularly assess these controls. In addition, an active and objective board can reduce the likelihood that management overrides existing controls.

To assist the board in its oversight, the board creates an audit committee that is charged with oversight responsibility for financial reporting. The audit committee is also responsible for maintaining ongoing communication with both external and internal auditors, including the approval of audit and nonaudit services done by auditors for public companies. This allows the auditors and directors to discuss matters that might relate to such things as management integrity or the appropriateness of actions taken by management.

The audit committee's independence from management and knowledge of financial reporting issues are important determinants of its ability to effectively evaluate internal controls and financial statements prepared by management. The Sarbanes–Oxley Act directed the SEC to require the national stock exchanges (NYSE and NASDAQ) to strengthen audit committee requirements for public companies listing securities on



the exchanges. In response, the exchanges will not list any security from a company with an audit committee that:

1. Is not comprised solely of independent directors
2. Is not solely responsible for hiring and firing the company's auditors
3. Does not establish procedures for the receipt and treatment of complaints (e.g., "whistleblowing") regarding accounting, internal control, or auditing matters
4. Does not have the ability to engage its own counsel and other advisors
5. Is inadequately funded

Similar provisions exist outside the U.S., such as the European Commission's 8th Directive that requires each public-interest entity to have an audit committee with at least one member who is independent and who has competence in accounting or auditing. PCAOB Standard 5 requires the auditor to evaluate the effectiveness of the audit committee's oversight of the company's external financial reporting and internal control over financial reporting.

Many privately held companies also create an effective audit committee. For other privately held companies, governance may be provided by owners, partners, trustees, or a committee of management, such as a finance or budget committee. Individuals responsible for overseeing the strategic direction of the entity and the accountability of the entity, including financial reporting and disclosure, are called **those charged with governance** by auditing standards.

Management's Philosophy and Operating Style Management, through its activities, provides clear signals to employees about the importance of internal control. For example, does management take significant risks, or is it risk averse? Are sales and earnings targets unrealistic, and are employees encouraged to take aggressive actions to meet those targets? Can management be described as "fat and bureaucratic," "lean and mean," dominated by one or a few individuals, or is it "just right"? Understanding these and similar aspects of management's philosophy and operating style gives the auditor a sense of management's attitude about internal control.

Organizational Structure The entity's organizational structure defines the existing lines of responsibility and authority. By understanding the client's organizational structure, the auditor can learn the management and functional elements of the business and perceive how controls are implemented.

Human Resource Policies and Practices The most important aspect of internal control is personnel. If employees are competent and trustworthy, other controls can be absent, and reliable financial statements will still result. Incompetent or dishonest people can reduce the system to a shambles—even if there are numerous controls in place. Honest, efficient people are able to perform at a high level even when there are few other controls to support them. However, even competent and trustworthy people can have shortcomings. For example, they can become bored or dissatisfied, personal problems can disrupt their performance, or their goals may change.

Because of the importance of competent, trustworthy personnel in providing effective control, the methods by which persons are hired, evaluated, trained, promoted, and compensated are an important part of internal control.

USING KEY RISK INDICATORS FOR RISK AWARENESS

COSO has issued thought guidance to assist management and boards in the development of key risk indicators (KRIs) to provide early signals of increasing risk exposures. KRIs help management and the board be prepared for and better manage risk events that may arise in the future.

KRIs should be distinguished from key performance indicators (KPIs). KPIs are metrics that provide a high-level overview of past performance. Such measures may not provide a warning of developing risks because they focus on results that have already occurred. In contrast, KRIs are leading indicators of emerging risks. For example, data about recent write-offs of accounts receivable is a key performance indicator for accounts receivable collection. In contrast, analysis of financial results of major customers could be used as a key risk indicator of future collection concerns.

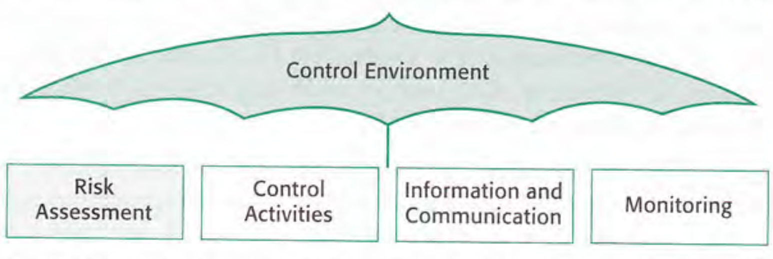
KRIs can provide timely and relevant information for effective risk oversight. Ideally, these indicators should be developed by teams that include risk management staff and business unit managers, and developed in conjunction with strategic plans for business units. Developing KRIs can result in improved performance by reducing losses and identifying risks that can be strategically exploited to the company's benefit. Use of KRIs can improve processes by reducing the risk of service disruptions and episodes of crisis management. Well-developed KRIs reduce surprises by placing management and boards in a proactive, rather than a reactive stance.

Source: Mark Beasley, Bruce Branson, and Bonnie Hancock, "Developing Key Risk Indicators to Strengthen Enterprise Risk Management," COSO, December 2010 (www.coso.org).

After obtaining information about each of the subcomponents of the control environment, the auditor uses this understanding as a basis for assessing management's and directors' attitudes and awareness about the importance of control. For example, the auditor might determine the nature of a client's budgeting system as a part of understanding the design of the control environment. The operation of the budgeting system might then be evaluated in part by inquiry of budgeting personnel to determine budgeting procedures and follow-up of differences between budget and actual.

Risk Assessment

Risk assessment for financial reporting is management's identification and analysis of risks relevant to the preparation of financial statements in conformity with appropriate accounting standards. For example, if a company frequently sells products at a price below inventory cost because of rapid technology changes, it is essential for the company to incorporate adequate controls to address the risk of overstating inventory. Similarly, failure to meet prior objectives, quality of personnel, geographic dispersion of company operations, significance and complexity of core business processes, introduction of new information technologies, economic downturns, and entrance of new competitors are examples of factors that may lead to increased risk. Once management identifies a risk, it estimates the significance of that risk, assesses the likelihood of the risk occurring, and develops specific actions that need to be taken to reduce the risk to an acceptable level.



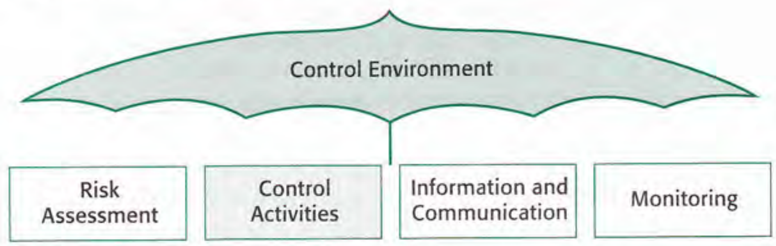
Management's risk assessment differs from but is closely related to the auditor's risk assessment discussed in Chapter 9. While management assesses risks as a part of designing and operating internal controls to minimize errors and fraud, auditors assess risks to decide the evidence needed in the audit. If management effectively assesses and responds to risks, the auditor will typically accumulate less evidence than when management fails to identify or respond to significant risks.

Auditors obtain knowledge about management's risk assessment process using questionnaires and discussions with management to determine how management identifies risks relevant to financial reporting, evaluates the significance and likelihood of the risks occurring, and decides the actions needed to address the risks.

Control Activities

Control activities are the policies and procedures, in addition to those included in the other four control components, that help ensure that necessary actions are taken to address risks to the achievement of the entity's objectives. There are potentially many such control activities in any entity, including both manual and automated controls. The control activities generally fall into the following five types, which are discussed next:

1. Adequate separation of duties
2. Proper authorization of transactions and activities
3. Adequate documents and records
4. Physical control over assets and records
5. Independent checks on performance



Adequate Separation of Duties

Four general guidelines for adequate **separation of duties** to prevent both fraud and errors are especially significant for auditors.

Separation of the Custody of Assets from Accounting To protect a company from embezzlement, a person who has temporary or permanent custody of an asset should not account for that asset. Allowing one person to perform both functions increases the risk of that person disposing of the asset for personal gain and adjusting the records to cover up the theft. If the cashier, for example, receives cash and is responsible for data entry for cash receipts and sales, that person could pocket the cash received and adjust the customer's account by failing to record a sale or by recording a fictitious credit to the account.

Separation of the Authorization of Transactions from the Custody of Related Assets It is desirable to prevent persons who authorize transactions from having control over the related asset, to reduce the likelihood of embezzlement. For example, the same person should not authorize the payment of a vendor's invoice and also approve the disbursement of funds to pay the bill.

Separation of Operational Responsibility from Record-Keeping Responsibility To ensure unbiased information, record keeping is typically the responsibility of a separate department reporting to the controller. For example, if a department or division oversees the creation of its own records and reports, it might change the results to improve its reported performance.

Separation of IT Duties from User Departments As the level of complexity of IT systems increases, the separation of authorization, record keeping, and custody often becomes blurred. For example, sales agents may enter customer orders online. The computer authorizes those sales based on its comparison of customer credit limits to the master file and posts all approved sales in the sales cycle journals. Therefore, the computer plays a significant role in the authorization and record keeping of sales transactions. To compensate for these potential overlaps of duties, it is important for companies to separate major IT-related functions from key user department functions. In this example, responsibility for designing and controlling accounting software programs that contain the sales authorization and posting controls should be under the authority of IT, whereas the ability to update information in the master file of customer credit limits should reside in the company's credit department outside the IT function.

Proper Authorization of Transactions and Activities Every transaction must be properly authorized if controls are to be satisfactory. If any person in an organization could acquire or expend assets at will, complete chaos would result. Authorization can be either general or specific. Under **general authorization**, management establishes policies and subordinates are instructed to implement these general authorizations by approving all transactions within the limits set by the policy. General authorization decisions include the issuance of fixed price lists for the sale of products, credit limits for customers, and fixed reorder points for making acquisitions.

Specific authorization applies to individual transactions. For certain transactions, management prefers to authorize each transaction. An example is the authorization of a sales transaction by the sales manager for a used-car company.

The distinction between authorization and approval is also important. Authorization is a policy decision for either a general class of transactions or specific transactions. Approval is the implementation of management's general authorization decisions. An example of a general authorization is management setting a policy authorizing the ordering of inventory when less than a 3-week supply is on hand. When a department orders inventory, the clerk responsible for maintaining the perpetual record approves the order to indicate that the authorization policy has been met. In other cases, the computer approves the transactions by comparing quantities of inventory on hand to a master file of reorder points and automatically submits purchase orders to authorized suppliers in the vendor master file. In this case, the computer is performing the approval function using preauthorized information contained in the master files.

Adequate Documents and Records Documents and records are the records upon which transactions are entered and summarized. They include such diverse items as sales invoices, purchase orders, subsidiary records, sales journals, and employee time cards. Many of these documents and records are maintained in electronic rather than paper formats. Adequate documents are essential for correct recording of transactions and control of assets. For example, if the receiving department completes an electronic receiving report when material is received, the accounts payable computer application can verify the quantity and description on the vendor's invoice by comparing it with the information on the receiving report, with exceptions resolved by the accounts payable department.

Certain principles dictate the proper design and use of documents and records. Documents and records should be:

- Prenumbered consecutively to facilitate control over missing documents and records and as an aid in locating them when they are needed at a later date. Prenumbered documents and records are important for the completeness transaction-related audit objective.
- Prepared at the time a transaction takes place, or as soon as possible thereafter, to minimize timing errors.
- Designed for multiple use, when possible, to minimize the number of different forms. For example, a properly designed electronic shipping record can be the basis for releasing goods from storage to the shipping department, informing billing of the quantity of goods to bill to the customer and the appropriate billing date, and updating the perpetual inventory records.
- Constructed in a manner that encourages correct preparation. This can be done by providing internal checks within the form or record. For example, computer screen prompts may force online data entry of critical information before the record is electronically routed for authorizations and approvals. Similarly, screen controls can validate the information entered, such as when an invalid general ledger account number is automatically rejected when the account number does not match the chart of accounts master file.

A control closely related to documents and records is the **chart of accounts**, which classifies transactions into individual balance sheet and income statement accounts.

PHANTOM BOOKS

Senior executives at Livent, Inc., the Toronto theater owner and producer of Broadway-style shows including Show Boat, Ragtime, and Phantom of the Opera, took their theatrics to a new level when they allegedly engaged in a pervasive fraud to materially distort their financial statements over an eight-year period. According to charges filed by the Securities and Exchange Commission, the former chairman and CEO and former president together coaxed several of their longtime company associates, including the CFO and IT manager, to participate in a multifaceted scheme to manipulate profits.

In addition to orchestrating vendor kickback schemes to siphon off millions of dollars and numerous customer side-agreements to falsify revenues, senior management manipulated the accounting records to shift costs of shows to fixed assets from expenses. Their techniques included alteration of computer programs to lower expenses without a trace in order to hide the fraud from Livent auditors. In addition, they created "phantom" accounting records showing the adjustments so senior management could track the fraudulent entries and know the company's true financial condition. Ultimately, their distortions were revealed, and the executives faced charges both in the United States and Canada. Livent filed for bankruptcy and was subsequently sold to a team headed by a former Walt Disney Company executive.

Sources: 1. Securities and Exchange Commission, *Litigation Release No. 16022*, Washington, DC, January 1999; 2. Canadian Broadcasting Company, "Livent Founders Charged with Fraud," *Arts Now*, Toronto, October 10, 2002.

The chart of accounts is helpful in preventing classification errors if it accurately describes which type of transactions should be in each account.

Physical Control Over Assets and Records To maintain adequate internal control, assets and records must be protected. If assets are left unprotected, they can be stolen. If records are not adequately protected, they can be stolen, damaged, altered, or lost, which can seriously disrupt the accounting process and business operations. When a company is highly computerized, its computer equipment, programs, and data files must be protected. The data files are the records of the company and, if damaged, could be costly or even impossible to reconstruct.

The most important type of protective measure for safeguarding assets and records is the use of physical precautions. An example is the use of storerooms for inventory to guard against theft. When the storeroom is under the control of a competent employee, there is further assurance that theft is minimized. Fireproof safes and safety deposit vaults for the protection of assets such as currency and securities are other important physical safeguards in addition to off-site back-up of computer software and data files.

Independent Checks on Performance The last category of control activities is the careful and continuous review of the other four, often called **independent checks** or internal verification. The need for independent checks arises because internal controls tend to change over time, unless there is frequent review. Personnel are likely to forget or intentionally fail to follow procedures, or they may become careless unless someone observes and evaluates their performance. Regardless of the quality of the controls, personnel can make errors or commit fraud.

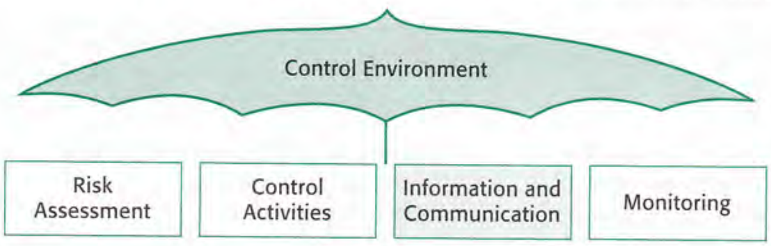
Personnel responsible for performing internal verification procedures must be independent of those originally responsible for preparing the data. The least expensive means of internal verification is the separation of duties in the manner previously discussed. For example, when the bank reconciliation is done by a person independent of the accounting records and handling of cash, there is an opportunity for verification without incurring significant additional costs.

Computerized accounting systems can be designed so that many internal verification procedures can be automated as part of the system. For example, the computer can prevent processing payment on a vendor invoice if there is no matching purchase order number or receiving report number for that invoice included in the system.

Auditing standards require the auditor to obtain an understanding of the process company employees follow to reconcile detail records supporting a significant account balance to the general ledger balance for that account to help the auditor more effectively design and perform audit procedures. For example, an auditor is likely to send confirmations of customer accounts receivable selected from accounts receivable master files. Before planning the confirmation procedures, the auditor needs to understand the design and implementation of controls that company personnel use to reconcile the accounts receivable master file to the related general ledger account balance.

Information and Communication

The purpose of an entity's accounting **information and communication** system is to initiate, record, process, and report the entity's transactions and to maintain accountability for the related assets. An accounting information and communication system has several subcomponents, typically made up of classes of transactions such as sales, sales returns, cash receipts, acquisitions, and so on. For each class of transactions, the accounting system must satisfy all of the six transaction-related audit objectives identified earlier in Table 10-1 (p. 311). For example, the sales accounting system should be designed to ensure that all shipments of goods are correctly recorded as sales (completeness and accuracy objectives) and are reflected in the financial statements in the proper period (timing objective). The system must also avoid duplicate recording of sales and recording a sale if a shipment did not occur (occurrence objective).



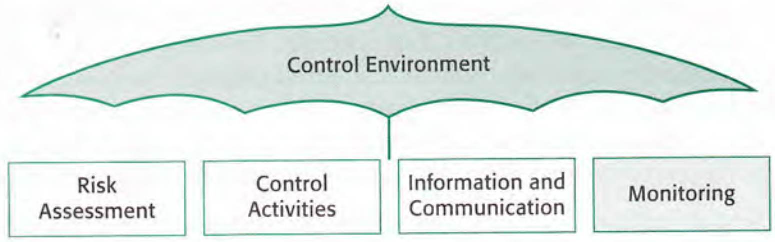
To understand the design of the accounting information system, the auditor determines (1) the major classes of transactions of the entity; (2) how those transactions are initiated and recorded; (3) what accounting records exist and their nature; (4) how the system captures other events that are significant to the financial statements, such as declines in asset values; and (5) the nature and details of the financial reporting process followed, including procedures to enter transactions and adjustments in the general ledger.

Monitoring

Monitoring activities deal with ongoing or periodic assessment of the quality of internal control by management to determine that controls are operating as intended and that they are modified as appropriate for changes in conditions. The information being assessed comes from a variety of sources, including studies of existing internal controls, internal auditor reports, exception reporting on control activities, reports by regulators such as bank regulatory agencies, feedback from operating personnel, and complaints from customers about billing charges.

For many companies, especially larger ones, an internal audit department is essential for effective monitoring of the operating performance of internal controls. To be effective, the internal audit function must be performed by staff independent of both the operating and accounting departments and report directly to a high level of authority within the organization, either top management or the audit committee of the board of directors.

In addition to its role in monitoring an entity's internal control, an adequate internal audit staff can reduce external audit costs by providing direct assistance to the external auditor. PCAOB Standard 5 defines the extent that auditors can use the work done by internal auditors when reporting on internal control under Section 404. Auditing standards provide guidance to help the external auditor obtain evidence that supports the competence, integrity, and objectivity of internal auditors, which allows the external auditor to rely on the internal auditor's work in a number of ways.



COSO's five components of internal control discussed in the preceding sections are summarized in Table 10-2. Certain control elements within the five COSO control components have a pervasive effect on the entity's system of internal control and are referred to as **entity-level controls** in PCAOB auditing standards. Examples include the board and audit committee element of the control environment, the entity's risk assessment process, and internal audit's role in monitoring controls.

TABLE 10-2 COSO Components of Internal Control

	INTERNAL CONTROL	
Component	**Description of Component**	**Further Subdivision (if applicable)**
Control environment	Actions, policies, and procedures that reflect the overall attitude of top management, directors, and owners of an entity about internal control and its importance	Subcomponents of the control environment: • Integrity and ethical values • Commitment to competence • Board of director and audit committee participation • Management's philosophy and operating style • Organizational structure • Human resource policies and practices
Risk assessment	Management's identification and analysis of risks relevant to the preparation of financial statements in accordance with appropriate accounting frameworks such as GAAP or IFRS	Risk assessment processes: • Identify factors affecting risks • Assess significance of risks and likelihood of occurrence • Determine actions necessary to manage risks Categories of management assertions that must be satisfied: • Assertions about classes of transactions and other events • Assertions about account balances • Assertions about presentation and disclosure
Control activities	Policies and procedures that management has established to meet its objectives for financial reporting	Types of specific control activities: • Adequate separation of duties • Proper authorization of transactions and activities • Adequate documents and records • Physical control over assets and records • Independent checks on performance
Information and communication	Methods used to initiate, record, process, and report an entity's transactions and to maintain accountability for related assets	Transaction-related audit objectives that must be satisfied: • Occurrence • Completeness • Accuracy • Posting and summarization • Classification • Timing
Monitoring	Management's ongoing and periodic assessment of the quality of internal control performance to determine whether controls are operating as intended and are modified when needed	Not applicable

COSO MONITORING GUIDANCE

The Committee of Sponsoring Organizations of the Treadway Commission (COSO) has developed guidance that provides more extensive understanding of the monitoring component of the COSO *Internal Control-Integrated Framework*. This guidance is in response to observations that organizations are often not fully utilizing the monitoring component of internal control. For example, some public companies perform separate procedures to evaluate the operating effectiveness of internal control over financial reporting to comply with Section 404 responsibilities, even though the entity's existing monitoring activities generate sufficient evidence for management's Section 404 reporting.

COSO's *Guidance on Monitoring Internal Control Systems* is intended to help organizations improve the effectiveness and efficiency of their internal control systems, through more efficient and effective monitoring procedures. The guidance helps management, boards of directors, and internal and external auditors recognize effective monitoring where it exists and identify and correct weaknesses in the monitoring component of internal control.

Source: Based on *Guidance on Monitoring Internal Control Systems*, Committee of Sponsoring Organizations of the Treadway Commission (COSO), 2009 (www.coso.org).

OBTAIN AND DOCUMENT UNDERSTANDING OF INTERNAL CONTROL

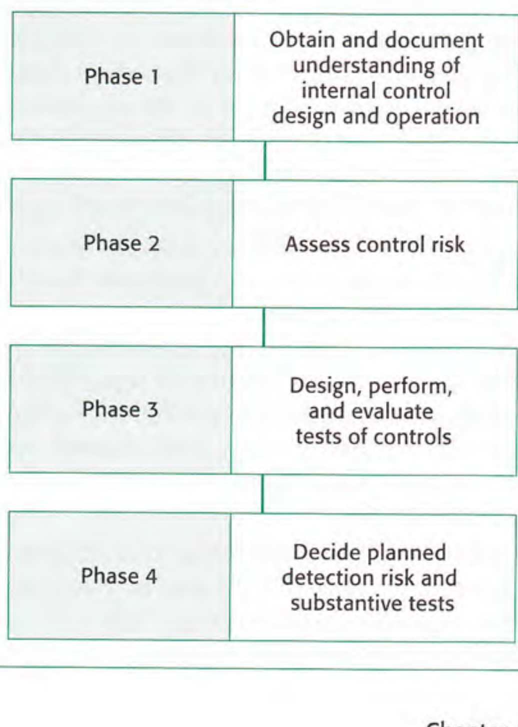
OBJECTIVE 10-4

Obtain and document an understanding of internal control.

Figure 10-3 provides an overview of the process of understanding internal control and assessing control risk for an integrated audit of the financial statements and the effectiveness of internal control over financial reporting. The figure shows that there are four phases in the process. Each of these four phases is discussed in this section.

The level of understanding internal control and extent of testing required for the audit of internal control exceeds what is required for an audit of only the financial statements. Therefore, when auditors first focus on the understanding and testing of internal control for the audit of internal controls, they will have met the requirements for assessing internal control for the financial statement audit.

FIGURE 10-3 Process for Understanding Internal Control and Assessing Control Risk



As discussed earlier, Section 404 requires management to document its processes for assessing the effectiveness of the company's internal control over financial reporting. Management must document the design of controls, including all five control components, and also the results of its testing and evaluation. The types of information gathered by management to assess and document internal control effectiveness can take many forms, including policy manuals, flowcharts, narratives, documents, questionnaires, and other paper and electronic forms.

Obtain and Document Understanding of Internal Control

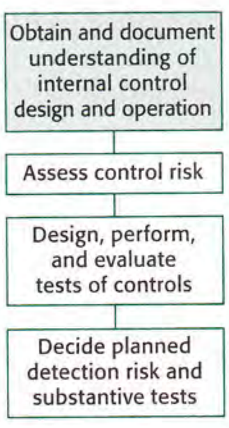
Auditing standards require auditors to obtain and document their understanding of internal control for every audit. This understanding is necessary for both the audit of internal controls over financial reporting and the audit of financial statements. Management's documentation is a major source of information in gaining the understanding.

As part of the auditor's risk assessment procedures, the auditor uses **procedures to obtain an understanding**, which involve gathering evidence about the design of internal controls and whether they have been implemented, and then uses that information as a basis for assessing control risk and for the integrated audit. The auditor generally uses four of the eight types of evidence described in Chapter 7 to obtain an understanding of the design and implementation of controls: inspection, inquiry of entity personnel, observation of employees performing control processes, and reperformance by tracing one or a few transactions through the accounting system from start to finish.

Auditors commonly use three types of documents to obtain and document their understanding of the design of internal control: narratives, flowcharts, and internal control questionnaires. Because Section 404 requires management to assess and document the design effectiveness of internal control over financial reporting, they have usually already prepared this documentation. Narratives, flowcharts, and internal control questionnaires, used by the auditor separately or in combination to document internal control, are discussed next.

Narrative A **narrative** is a written description of a client's internal controls. A proper narrative of an accounting system and related controls describes four things:

1. *The origin of every document and record in the system.* For example, the description should state where customer orders come from and how sales invoices are generated.
2. *All processing that takes place.* For example, if sales amounts are determined by a computer program that multiplies quantities shipped by standard prices contained in price master files, that process should be described.
3. *The disposition of every document and record in the system.* The filing of documents, sending them to customers, or destroying them should be described.
4. *An indication of the controls relevant to the assessment of control risk.* These typically include separation of duties (such as separating recording cash from handling cash), authorizations and approvals (such as credit approvals), and internal verification (such as comparison of unit selling prices to sales contracts).



Flowchart An internal control **flowchart** is a diagram of the client's documents and their sequential flow in the organization. An adequate flowchart includes the same four characteristics identified for narratives.

Well prepared flowcharts are advantageous primarily because they provide a concise overview of the client's system, including separation of duties, which helps auditors identify controls and deficiencies in the client's system. Flowcharts have two advantages over narratives: typically they are easier to read and easier to update. It is unusual to use both a narrative and a flowchart to describe the same system because both present the same information.

Internal Control Questionnaire An **internal control questionnaire** asks a series of questions about the controls in each audit area as a means of identifying internal control deficiencies. Most questionnaires require a "yes" or a "no" response, with "no" responses indicating potential internal control deficiencies. By using a questionnaire, auditors cover each audit area reasonably quickly. The two main disadvantages of questionnaires are their inability to provide an overview of the system and their inapplicability for some audits, especially smaller ones.

Figure 10-4 illustrates part of an internal control questionnaire for the sales and collection cycle of Hillsburg Hardware Co. Notice how the questionnaire incorporates the six transaction-related audit objectives A through F as each applies to sales transactions (see shaded portions). The same is true for all other audit areas.

FIGURE 10-4 Partial Internal Control Questionnaire for Sales

Client *Hillsburg Hardware Co.* Audit Date *12/31/13*

Auditor *MSW* Date Completed *9/30/13* Reviewed by *JR* Date Completed *10/1/13*

Objective (white box) and Question	Yes	No	N/A	Remarks
Sales				
A. Recorded sales are for shipments actually made to existing customers.				
1. Is customers' credit approved by a responsible official and is access to change credit limit master files restricted?	✓			*By Chulick, the president*
2. Is the recording of sales supported by authorized shipping documents and approved customer orders?	✓			*Pam Dilley examines underlying documentation.*
3. Is there adequate separation of duties between billing, recording sales, and handling cash receipts?	✓			
4. Are sales invoices prenumbered and accounted for?		✓		*Prenumbered but not accounted for. Additional substantive testing required.*
B. Existing sales transactions are recorded.				
1. Is a record of shipments maintained?	✓			
2. Are shipping documents controlled from the office in a manner that helps ensure that all shipments are billed?	✓			
3. Are shipping documents prenumbered and accounted for?	✓			
C. Recorded sales are for the amount of goods shipped and are correctly billed and recorded.				
1. Is there independent comparison of the quantity on the shipping documents to the sales invoices?	✓			
2. Is an authorized price list used and is access to change the price master file restricted?	✓			
3. Are monthly statements sent to customers?	✓			
D. Sales transactions are properly included in the master files and are correctly summarized.				
1. Does the computer automatically post transactions to the accounts receivable master file and general ledger?	✓			
2. Is the accounts receivable master file reconciled with the general ledger on a monthly basis?	✓			*By Erma, the accountant*
E. Recorded sales transactions are properly classified.				
1. Is there independent comparison of recorded sales to the chart of accounts?			✓	*All sales are on account and there is only one sales account.*
F. Sales are recorded on the correct dates.				
1. Is there independent comparison of dates on shipping documents to dates recorded?		✓		*Unmatched and unrecorded shippers are reviewed weekly.*

The use of questionnaires and flowcharts together is useful for understanding the client's internal control design and identifying internal controls and deficiencies. Flowcharts provide an overview of the system, while questionnaires offer useful checklists to remind the auditor of many different types of internal controls that should exist.

Evaluating Internal Control Implementation

In addition to understanding the design of the internal controls, the auditor must also evaluate whether the designed controls are implemented. In practice, the understanding of the design and implementation are often done simultaneously. Following are common methods.

Update and Evaluate Auditor's Previous Experience with the Entity Most audits of a company are done annually by the same CPA firm. After the first year's audit, the auditor begins with a great deal of information from prior years about the client's internal control. It is especially useful to determine whether controls that were not previously operating effectively have been improved.

Make Inquiries of Client Personnel Auditors should ask management, supervisors, and staff to explain their duties. Careful questioning of appropriate personnel helps auditors evaluate whether employees understand their duties and do what is described in the client's control documentation.

Examine Documents and Records The five components of internal control all involve the creation of many documents and records. By examining completed documents, records, and computer files, the auditor can evaluate whether information described in flowcharts and narratives has been implemented.

Observe Entity Activities and Operations When auditors observe client personnel carrying out their normal accounting and control activities, including their preparation of documents and records, it further improves their understanding and knowledge that controls have been implemented.

Perform Walkthroughs of the Accounting System In a **walkthrough**, the auditor selects one or a few documents of a transaction type and traces them from initiation through the entire accounting process. At each stage of processing, the auditor makes inquiries, observes activities, and examines completed documents and records. Walkthroughs conveniently combine observation, inspection, and inquiry to assure that the controls designed by management have been implemented.

ASSESS CONTROL RISK

OBJECTIVE 10-5

Assess control risk by linking key controls and control deficiencies to transaction-related audit objectives.

The auditor obtains an understanding of the design and implementation of internal control to make a preliminary assessment of control risk as part of the auditor's overall assessment of the risk of material misstatements. As described in Chapter 9, the auditor uses this preliminary assessment of control risk to plan the audit for each material class of transactions. However, in some instances the auditor may learn that the control deficiencies are significant such that the client's financial statements may not be auditable. So, before making a preliminary assessment of control risk for each material class of transactions, the auditor must first decide whether the entity is auditable.

Assess Whether the Financial Statements Are Auditable

Two primary factors determine auditability: the integrity of management and the adequacy of accounting records. The importance of management integrity was discussed in Chapter 8 under client acceptance and continuance. If management lacks integrity, most auditors will not accept the engagement.

The accounting records are an important source of audit evidence for most audit objectives. If the accounting records are deficient, necessary audit evidence may not be available. For example, if the client has not kept duplicate sales invoices and vendors' invoices, it is usually impractical to do an audit.

In complex IT environments, much of the transaction information is available only in electronic form without generating a visible audit trail of documents and records. In that case, the company is usually still auditable; however, auditors must assess whether they have the necessary skills to gather evidence that is in electronic form and can assign personnel with adequate IT training and experience.

Determine Assessed Control Risk Supported by the Understanding Obtained

After obtaining an understanding of internal control, the auditor makes a preliminary **assessment of control risk** as part of the auditor's overall assessment of the risk of material misstatement. This assessment is a measure of the auditor's expectation that internal controls will prevent material misstatements from occurring or detect and correct them if they have occurred.

The starting point for most auditors is the assessment of entity-level controls. By nature, entity-level controls, such as many of the elements contained in the control environment, risk assessment, and monitoring components, have an overarching impact on most major types of transactions in each transaction cycle. For example, an ineffective board of directors or management's failure to have any process to identify, assess, or manage key risks, has the potential to undermine controls for most of the transaction-related audit objectives. Thus, auditors generally assess entity-level controls before assessing transaction specific controls.

Once auditors determine that entity-level controls are designed and placed in operation, they next make a preliminary assessment for each transaction-related audit objective for each major type of transaction in each transaction cycle. For example, in the sales and collection cycle, the types of transactions usually involve sales, sales returns and allowances, cash receipts, and the provision for and write-off of uncollectible accounts. The auditor also makes the preliminary assessment for controls affecting audit objectives for balance sheet accounts and presentations and disclosures in each cycle.

Use of a Control Risk Matrix to Assess Control Risk

Many auditors use a **control risk matrix** to assist in the control risk assessment process at the transaction level. The purpose is to provide a convenient way to organize assessing control risk for each audit objective. Figure 10-5 (p. 326) illustrates the use of a control risk matrix for sales transaction audit objectives of Hillsburg Hardware Co. While Figure 10-5 only illustrates the control risk matrix for transaction-related audit objectives, auditors use a similar control risk matrix format to assess control risk for balance-related and presentation and disclosure-related audit objectives. We now discuss the preparation of the matrix.

Identify Audit Objectives The first step in the assessment is to identify the audit objectives for classes of transactions, account balances, and presentation and disclosure to which the assessment applies. For example, this is done for classes of transactions by applying the specific transaction-related audit objectives introduced earlier, which were stated in general form, to each major type of transaction for the entity. For example, the auditor makes an assessment of the occurrence objective for sales and a separate assessment of the completeness objective. Transaction-related audit objectives are shown for sales transactions for Hillsburg Hardware at the top of Figure 10-5.

Identify Existing Controls Next, the auditor uses the information discussed in the previous section on obtaining and documenting an understanding of internal control to identify the controls that contribute to accomplishing transaction-related audit objectives. One way for the auditor to do this is to identify controls to satisfy each objective. For example, the auditor can use knowledge of the client's system to identify controls that are likely to prevent errors or fraud in the occurrence transaction-related audit objective. The same thing can be done for all other objectives. It is also helpful for the auditor to use the five control activities (separation of duties, proper authorization, adequate documents and records, physical control over assets and records, and independent checks on performance) as reminders of controls. For example: Is there adequate separation of duties and how is it achieved? Are transactions properly authorized? Are prenumbered documents properly accounted for? Are key master files properly restricted from unauthorized access?

FIGURE 10-5 Control Risk Matrix for Hillsburg Hardware Co. – Sales

	INTERNAL CONTROL	SALES TRANSACTION-RELATED AUDIT OBJECTIVES: Recorded sales are for shipments actually made to nonfictitious customers (occurrence).	Existing sales transactions are recorded (completeness).	Recorded sales are for the amount of goods shipped and are correctly billed and recorded (accuracy).	Sales transactions are correctly included in the accounts receivable master file and are correctly summarized (posting and summarization).	Sales transactions are correctly classified (classification).	Sales are recorded on the correct dates (timing).
CONTROLS	Credit is approved automatically by computer by comparison to authorized credit limits (C1).	C					
CONTROLS	Recorded sales are supported by authorized shipping documents and approved customers orders (C2).	C		C			
CONTROLS	Separation of duties exists among billing, recording of sales, and handling of cash receipts (C3).	C	C		C		
CONTROLS	Shipping documents are forwarded to billing daily and are billed the subsequent day (C4).	C					C
CONTROLS	Shipping documents are prenumbered and accounted for weekly (C5).		C				C
CONTROLS	Batch totals of quantities shipped are compared with quantities billed (C6).	C	C	C			
CONTROLS	Unit selling prices are obtained from the price list master file of approved prices (C7).			C			
CONTROLS	Sales transactions are internally verified (C8).					C	
CONTROLS	Statements are mailed to customers each month (C9).	C		C	C		
CONTROLS	Computer automatically posts transactions to the accounts receivable subsidiary records and to the general ledger (C10).				C		
CONTROLS	Accounts receivable master file is reconciled to the general ledger on a monthly basis (C11).				C		
DEFICIENCY	There is a lack of internal verification for the possibility of sales invoices being recorded more than once (D1).	D					
DEFICIENCY	There is a lack of control to test for timely recording (D2).						D
	Assessed control risk	Med.	Low	Low	Low	Low*	Med.

*Because there are no cash sales, classification is not a problem.
C = Control; D = Control Deficiency.

Note: This matrix was developed using an internal control questionnaire, part of which is included in Figure 10-4 (p. 323), as well as flowcharts and other documentation of the auditor's understanding of internal control.

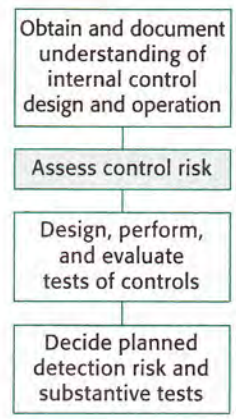
The auditor should identify and include only those controls that are expected to have the greatest effect on meeting the transaction-related audit objectives. These are often called **key controls**. The reason for including only key controls is that they will be sufficient to achieve the transaction-related audit objectives and also provide audit efficiency. Examples of key controls for Hillsburg Hardware are shown in Figure 10-5.

Associate Controls with Related Audit Objectives Each control satisfies one or more related audit objectives. This can be seen in Figure 10-5 for transaction-related audit objectives. The body of the matrix is used to show how each control contributes to the accomplishment of one or more transaction-related audit objectives. In this illustration, a C was entered in each cell where a control partially or fully satisfied an objective. A similar control risk matrix would be completed for balance-related and presentation and disclosure-related audit objectives. For example, the mailing of statements to customers satisfies three objectives in the audit of Hillsburg Hardware, which is indicated by the placement of each C on the row in Figure 10-5 describing that control.

Identify and Evaluate Control Deficiencies, Significant Deficiencies, and Material Weaknesses Auditors must evaluate whether key controls are absent in the design of internal control over financial reporting as a part of evaluating control risk and the likelihood of financial statement misstatements. Auditing standards define three levels of the absence of internal controls:

1. *Control deficiency.* A **control deficiency** exists if the design or operation of controls does not permit company personnel to prevent or detect misstatements on a timely basis in the normal course of performing their assigned functions. A *design deficiency* exists if a necessary control is missing or not properly designed. An *operation deficiency* exists if a well-designed control does not operate as designed or if the person performing the control is insufficiently qualified or authorized.
2. *Significant deficiency.* A **significant deficiency** exists if one or more control deficiencies exist that is less severe than a material weakness (defined below), but important enough to merit attention by those responsible for oversight of the company's financial reporting.
3. *Material weakness.* A **material weakness** exists if a significant deficiency, by itself or in combination with other significant deficiencies, results in a reasonable possibility that internal control will not prevent or detect material financial statement misstatements on a timely basis.

   To determine if a significant internal control deficiency or deficiencies are a material weakness, they must be evaluated along two dimensions: likelihood and significance. The horizontal line in Figure 10-6 (p. 328) depicts the likelihood of a misstatement resulting from the significant deficiency, while the vertical line depicts its significance. If there is more than a reasonable possibility (likelihood) that a material misstatement (significance) could result from the significant deficiency or deficiencies, then it is considered a material weakness.

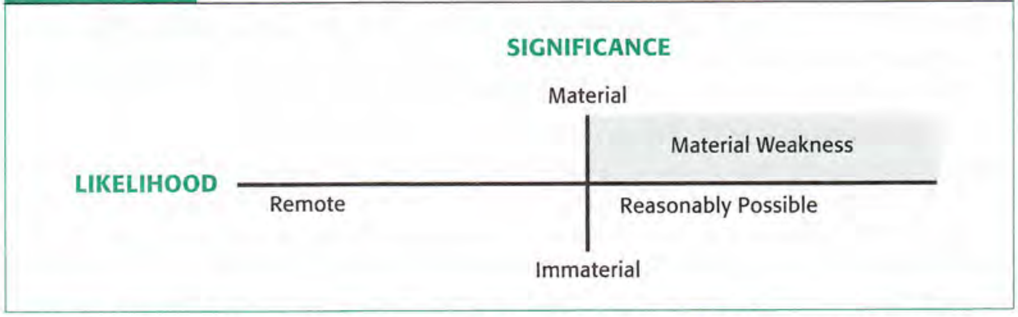


Identify Deficiencies, Significant Deficiencies, and Material Weaknesses

A five-step approach can be used to identify deficiencies, significant deficiencies, and material weaknesses:

1. *Identify existing controls.* Because deficiencies and material weaknesses are the absence of adequate controls, the auditor must first know which controls exist. The methods for identifying controls have already been discussed.
2. *Identify the absence of key controls.* Internal control questionnaires, flowcharts, and walkthroughs are useful tools to identify where controls are lacking and the likelihood of misstatement is therefore increased. It is also useful to examine the control risk matrix, such as the one in Figure 10-5, to

FIGURE 10-6 **Evaluating Significant Control Deficiencies**



Source: Michael Ramos, "Section 404 Compliance in the Annual Report," *Journal of Accountancy*, October 2004, pp. 43–48. Copyright by American Institute of CPAs. All rights reserved. Used with permission.

look for objectives where there are no or only a few controls to prevent or detect misstatements.

3. *Consider the possibility of compensating controls.* A **compensating control** is one elsewhere in the system that offsets the absence of a key control. A common example in a small business is the active involvement of the owner. When a compensating control exists, there is no longer a significant deficiency or material weakness.
4. *Decide whether there is a significant deficiency or material weakness.* The likelihood of misstatements and their materiality are used to evaluate if there are significant deficiencies or material weaknesses.
5. *Determine potential misstatements that could result.* This step is intended to identify specific misstatements that are likely to result because of the significant deficiency or material weakness. The importance of a significant deficiency or material weakness is directly related to the likelihood and materiality of potential misstatements.

Figure 10-7 for Hillsburg Hardware includes two control deficiencies. Neither deficiency was considered a material weakness; the first weakness related to prenumbered sales invoices was considered a significant deficiency.

Associate Control Deficiencies with Related Audit Objectives The same as for controls, each significant deficiency or material weakness can apply to one or more related audit objectives. In the case of Hillsburg Hardware in Figure 10-5 (p. 326), there are two control deficiencies, and each applies to only one transaction-related objective. The control deficiencies are shown in the body of the figure by a D in the appropriate objective column.

Assess Control Risk for Each Related Audit Objective After controls and control deficiencies are identified and associated with transaction-related audit objectives, the auditor can assess control risk for transaction-related audit objectives. This is the critical decision in the evaluation of internal control. The auditor uses all of the information discussed previously to make a subjective control risk assessment for each objective. There are different ways to express this assessment. Some auditors use a subjective expression such as high, moderate, or low. Others use numerical probabilities such as 1.0, 0.6, or 0.2.

Again, the control risk matrix is a useful tool for making the assessment. Referring to Figure 10-5, the auditor assessed control risk for each objective for Hillsburg's sales by reviewing each column for pertinent controls and control deficiencies and asking, "What is the likelihood that a material misstatement would not be prevented or detected, or corrected if it occurred, by these controls, and what is the effect of the deficiencies or weaknesses?" If the likelihood is low, then control risk is low, and so

FIGURE 10-7 **Deficiencies in Internal Control**

Client *Hillsburg Hardware Co.* **Schedule** *P-3*

Deficiencies in Internal Control **Prepared by** *JR*

Cycle *Sales and Collection* **Period** *12/31/13*

Deficiency	Compensating Control	Potential Misstatement	Materiality	Effect on Audit Evidence
1. Prenumbered sales invoices are not accounted for.	None	Duplicate sales recorded	Potentially material	Use audit software to search for duplicate sales invoice numbers. Perform analytical procedures of sales and gross margin. Consider the implication for the audit of internal control.
2. There is no independent comparison of dates on shipping documents to dates recorded.	Unmatched and unrecorded shippers are reviewed weekly.	N/A	N/A	N/A

forth. Figure 10-5 for Hillsburg Hardware shows that all objectives are assessed as low except occurrence and timing, which are medium.

This assessment is not the final one. Before making the final assessment at the end of the integrated audit, the auditor will test controls and perform substantive tests. These procedures can either support the preliminary assessment or cause the auditor to make changes. In some cases, management can correct deficiencies and material weaknesses before the auditor does significant testing, which may permit a reduction in control risk.

After a preliminary assessment of control risk is made for sales and cash receipts, the auditor can complete the three control risk rows of the evidence-planning worksheet that was introduced in Chapter 9 on page 290. If tests of controls results do not support the preliminary assessment of control risk, the auditor must modify the worksheet later. Alternatively, the auditor can wait until tests of controls are done to complete the three control risk rows of the worksheet. An evidence-planning worksheet for Hillsburg Hardware with the three rows for control risk completed is illustrated in Figure 15-6 on page 516.

Communications To Those Charged With Governance and Management Letters

As part of understanding internal control and assessing control risk, the auditor is required to communicate certain matters to those charged with governance. This information and other recommendations about controls are also often communicated to management.

Communications to Those Charged With Governance The auditor must communicate significant deficiencies and material weaknesses in writing to those charged with governance as soon as the auditor becomes aware of their existence. The communication is usually addressed to the audit committee and to management.

Timely communications may provide management an opportunity to address control deficiencies before management's report on internal control must be issued. In some instances, deficiencies can be corrected sufficiently early such that both management and the auditor can conclude that controls are operating effectively as of the balance sheet date. Regardless, these communications must be made no later than 60 days following the audit report release.

Management Letters In addition to these matters, auditors often identify less significant internal control-related issues, as well as opportunities for the client to make operational improvements. These should also be communicated to the client. The form of communication is often a separate letter for that purpose, called a **management letter**. Although management letters are not required by auditing standards, auditors generally prepare them as a value-added service of the audit.

TESTS OF CONTROLS

OBJECTIVE 10-6

Describe the process of designing and performing tests of controls.

We've examined how auditors link controls and control deficiencies to related audit objectives to assess control risk for each objective. Now we'll address how auditors test those controls that are used to support a control risk assessment. For example, each key control in Figure 10-5 (p. 326) that the auditor intends to rely on to support a control risk of medium or low must be supported by sufficient tests of controls. We will deal with tests of controls for both audits of internal control for financial reporting and audits of financial statements.

Purpose of Tests of Controls

Assessing control risk requires the auditor to consider both the design and operation of controls to evaluate whether they will likely be effective in meeting related audit objectives. During the understanding phase, the auditor will have already gathered some evidence in support of both the design of the controls and their implementation by using procedures to obtain an understanding (see pages 321–324). In most cases, the auditor *will not* have gathered enough evidence to reduce assessed control risk to a sufficiently low level. The auditor must therefore obtain additional evidence about the operating effectiveness of controls throughout all, or at least most, of the period under audit. The procedures to test effectiveness of controls in support of a reduced assessed control risk are called **tests of controls**.

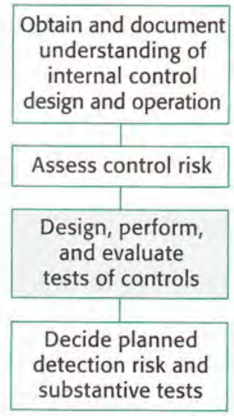
If the results of tests of controls support the design and operation of controls as expected, the auditor uses the same assessed control risk as the preliminary assessment. If, however, the tests of controls indicate that the controls did not operate effectively, the assessed control risk must be reconsidered. For example, the tests may indicate that the application of a control was curtailed midway through the year or that the person applying it made frequent misstatements. In such situations, the auditor uses a higher assessed control risk, unless compensating controls for the same related audit objectives are identified and found to be effective. When applicable, the auditor must also consider the impact of those controls that are not operating effectively on the auditor's report on internal control.

Procedures for Tests of Controls

The auditor is likely to use four types of procedures to support the operating effectiveness of internal controls. Management's testing of internal control will likely include the same types of procedures. The four types of procedures are as follows:

1. *Make inquiries of appropriate client personnel.* Although inquiry is not a highly reliable source of evidence about the effective operation of controls, it is still appropriate. For example, to determine that unauthorized personnel are denied access to computer files, the auditor may make inquiries of the person who controls the computer library and of the person who controls online access security password assignments.

2. *Examine documents, records, and reports.* Many controls leave a clear trail of documentary evidence that can be used to test controls. Suppose, for example, that when a customer order is received, it is used to create a customer sales order, which is approved for credit. (See the first and second key controls in Figure 10-5 on page 326.) Then the customer order is attached to the sales order as authorization for further processing. The auditor can test the control by examining the documents to make sure that they are complete and properly matched and that required signatures or initials are present.
3. *Observe control-related activities.* Some controls do not leave an evidence trail, which means that it is not possible to examine evidence that the control was executed at a later date. For example, separation of duties relies on specific persons performing specific tasks, and there is typically no documentation of the separate performance. (See the third key control in Figure 10-5.) For controls that leave no documentary evidence, the auditor generally observes them being applied at various points during the year.
4. *Reperform client procedures.* There are also control-related activities for which there are related documents and records, but their content is insufficient for the auditor's purpose of assessing whether controls are operating effectively. For example, assume that prices on sales invoices are obtained from the master price list, but no indication of the control is documented on the sales invoices. (See the seventh key control in Figure 10-5.) In these cases, it is common for the auditor to reperform the control activity to see whether the proper results were obtained. For this example, the auditor can reperform the procedure by tracing the sales prices to the authorized price list in effect at the date of the transaction. If no misstatements are found, the auditor can conclude that the procedure is operating as intended.



Extent of Procedures

The extent to which tests of controls are applied depends on the preliminary assessed control risk. If the auditor wants a lower assessed control risk, more extensive tests of controls are applied, both in terms of the number of controls tested and the extent of the tests for each control. For example, if the auditor wants to use a low assessed control risk, a larger sample size for inspection, observation, and reperformance procedures should be applied. The extent of testing also depends on the frequency of the operation of the controls, and whether it is manual or automated.

Reliance on Evidence from the Prior Year's Audit When auditors plan to use evidence about the operating effectiveness of internal control obtained in prior audits, auditing standards require tests of the controls' effectiveness at least every third year. If auditors determine that a key control has been changed since it was last tested, they should test it in the current year. When there are a number of controls tested in prior audits that have not been changed, auditing standards require auditors to test some of those controls each year to ensure there is a rotation of controls testing throughout the three-year period.

Testing of Controls Related to Significant Risks **Significant risks** are those risks that the auditor believes require special audit consideration. When the auditor's risk assessment procedures identify significant risks, the auditor is required to test the operating effectiveness of controls that mitigate these risks in the current year audit, if the auditor plans to rely on those controls to support a control risk assessment below 100%. The greater the risk, the more audit evidence the auditor should obtain that controls are operating effectively.

Testing Less Than the Entire Audit Period Recall that management's report on internal control deals with the effectiveness of internal controls as of the end of the fiscal year. PCAOB Standard 5 requires the auditor to perform tests of controls that are adequate to determine whether controls are operating effectively at year-end. The timing

TABLE 10-3	Relationship of Assessed Control Risk and Extent of Procedures	
	Assessed Control Risk	
Type of Procedure	**High Level: Procedures to Obtain an Understanding**	**Lower Level: Tests of Controls***
Inquiry	Yes—extensive	Yes—some
Inspection	Yes—with transaction walk-through	Yes—using sampling
Observation	Yes—with transaction walk-through	Yes—at multiple times
Reperformance	No	Yes—using sampling

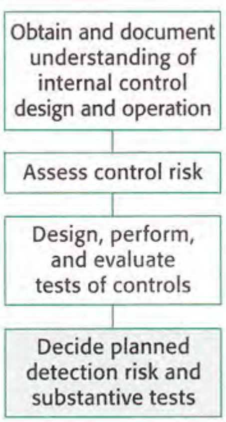
**Note:* In an integrated audit for a public company, the auditor will likely combine procedures to obtain an understanding with tests of controls and perform them simultaneously.

of the auditor's tests of controls will therefore depend on the nature of the controls and when the company uses them. For controls that are applied throughout the accounting period, it is usually practical to test them at an interim date. The auditor will then determine later if changes in controls occurred in the period not tested and decide the implication of any change. Controls dealing with financial statement preparation occur only quarterly or at year-end and must therefore also be tested at quarter and year-end.

Relationship Between Tests of Controls and Procedures to Obtain an Understanding

There is a significant overlap between tests of controls and procedures to obtain an understanding. Both include inquiry, inspection, and observation. There are two primary differences in the application of these common procedures.

1. In obtaining an understanding of internal control, the procedures to obtain an understanding are applied to all controls identified during that phase. Tests of controls, on the other hand, are applied only when the assessed control risk has not been satisfied by the procedures to obtain an understanding.
2. Procedures to obtain an understanding are performed only on one or a few transactions or, in the case of observations, at a single point in time. Tests of controls are performed on larger samples of transactions (perhaps 20 to 100), and often, observations are made at more than one point in time.



For key controls, tests of controls other than reperformance are essentially an extension of procedures to obtain an understanding. Therefore, assuming the auditors plan to obtain a low assessed control risk from the beginning of the integrated audit, they will likely combine both types of procedures and perform them simultaneously. Table 10-3 illustrates this concept in more detail. One option is to perform the audit procedures separately, as shown in Table 10-3, where minimum procedures to obtain an understanding of design and operation are performed, followed by additional tests of controls. An alternative is to combine both columns and do them simultaneously. The same amount of evidence is accumulated in the second approach, but more efficiently.

The determination of the appropriate sample size for tests of controls is an important audit decision. That topic is covered in Chapter 15.

DECIDE PLANNED DETECTION RISK AND DESIGN SUBSTANTIVE TESTS

We've focused on how auditors assess control risk for each related audit objective and support control risk assessments with tests of controls. The completion of these activities is sufficient for the audit of internal control over financial reporting, even though the report will not be finalized until the auditor completes the audit of financial statements.

The auditor uses the control risk assessment and results of tests of controls to determine planned detection risk and related substantive tests for the audit of financial statements. The auditor does this by linking the control risk assessments to the balance-related audit objectives for the accounts affected by the major transaction types and to the four presentation and disclosure audit objectives. The appropriate level of detection risk for each balance-related audit objective is then decided using the audit risk model. The relationship of transaction-related audit objectives to balance-related audit objectives and the selection and design of audit procedures for substantive tests of financial statement balances are discussed and illustrated in Chapter 13.

SECTION 404 REPORTING ON INTERNAL CONTROL

OBJECTIVE 10-7

Understand Section 404 requirements for auditor reporting on internal control.

Based on the auditor's assessment and testing of internal control, the auditor is required to prepare an audit report on internal control over financial reporting for accelerated filer public companies subject to Section 404(b) reporting requirements. As described in Chapter 3, the auditor may issue separate or combined audit reports on the financial statements and on internal control over financial reporting. An example of a separate report is illustrated in Figure 3-3 on page 72.

The scope of the auditor's report on internal control is limited to obtaining reasonable assurance that material weaknesses in internal control are identified. Thus, the audit is not designed to detect deficiencies in internal control that individually, or in the aggregate, are less severe than a material weakness. The distinction between deficiencies, significant deficiencies, and material weaknesses was discussed earlier.

Types of Opinions

Unqualified Opinion The auditor will issue an unqualified opinion on internal control over financial reporting when two conditions exist:

- There are no identified material weaknesses.
- There have been no restrictions on the scope of the auditor's work.

Adverse Opinion When one or more material weaknesses exist, the auditor must express an adverse opinion on the effectiveness of internal control. The most common cause of an adverse opinion in the auditor's report on internal control is when management identified a material weakness in its report.

Qualified or Disclaimer of Opinion A scope limitation requires the auditor to express a qualified opinion or a disclaimer of opinion on internal control over financial reporting. This type of opinion is issued when the auditor is unable to determine if there are material weaknesses, due to a restriction on the scope of the audit of internal control over financial reporting or other circumstances where the auditor is unable to obtain sufficient appropriate evidence.

Because the audit of the financial statements and the audit of internal control over financial reporting are integrated, the auditor must consider the results of audit procedures performed to issue the audit report on the financial statements when issuing the audit report on internal control. For example, assume the auditor identifies a material misstatement in the financial statements that was not initially identified by the company's internal controls. The following four responses to this finding are likely:

1. Because there is a material error in the financial statements, the auditor should consider whether the misstatement indicates the existence of a material weakness. Determining if the misstatement is in fact a material weakness or a significant deficiency involves judgment and depends on the nature and size of the misstatement.
2. The auditor can issue an unqualified opinion on the financial statements if the client adjusts the statements to correct the misstatement prior to issuance.
3. Management is likely to change its report on internal control to assert that the controls are not operating effectively.
4. The auditor must issue an adverse opinion on internal control over financial reporting if the deficiency is considered a material weakness.

FIGURE 10-8 **Partial Section 404 Auditor Report on Internal Control when Material Weaknesses Exist (bold added)***

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

[*Definition of material weakness paragraph*]

A **material weakness** is a deficiency, or combination of deficiencies, in internal control over financial reporting, such that there is a **reasonable possibility** that a material misstatement of the company's interim or annual financial statements will not be prevented or detected on a timely basis.

[*Opinion paragraph*]

In our opinion, because of the effect of the material weakness described above on the achievement of the objectives of the control criteria, Kincannon Company has not maintained effective internal control over financial reporting as of December 31, 2013, based on criteria established in *Internal Control—Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO).

Kellum & Kellum, LLP
Brentwood, Tennessee

February 2, 2014

*The introductory, scope, definition of internal control, inherent limitations of internal control, and reference to the opinion on the financial statements paragraphs use standard wording and are not included. The explanatory paragraph describing the nature of the weakness is also not included.

Figure 10-8 illustrates the definition of material weakness and opinion paragraphs from an auditor's separate report on internal control when the auditor expresses an adverse opinion on the effectiveness of internal control over financial reporting because of the existence of a material weakness. If the material weakness has not been included in management's assessment, the report should note that a material weakness has been identified but not included in management's assessment.

EVALUATING, REPORTING, AND TESTING INTERNAL CONTROL FOR NONPUBLIC COMPANIES

OBJECTIVE 10-8

Describe the differences in evaluating, reporting, and testing internal control for nonpublic companies.

The chapter to this point has discussed internal control and an integrated audit of internal control and financial statements for public companies under the Sarbanes–Oxley Act. Most of the concepts in the chapter also apply equally to nonpublic companies. This section deals with the differences in evaluating, reporting, and testing internal control for nonpublic companies.

A common misconception of nonpublic companies is that they are automatically small and less sophisticated than public companies. While it is true that many nonpublic companies are small, others are large and have sophisticated internal controls. This section assumes there is considerable variation in the size and complexity of the controls in nonpublic companies.

The following identifies and discusses the most important differences in evaluating, reporting, and testing internal control for nonpublic companies.

1. *Reporting requirements.* In audits of nonpublic companies, there is no requirement for an audit of internal control over financial reporting. The auditor, therefore, focuses on internal control only to the extent needed to do a quality audit of financial statements. Attestation standards provide guidance when nonpublic entities engage the auditor to conduct an examination of the design and operating effectiveness of internal controls over financial reporting that is integrated with the audit of the financial

statements. The approach for an integrated audit of a nonpublic company under the attestation standards is consistent with the approach to an integrated audit of a public company under PCAOB Standard 5.

The auditor is required by auditing standards to issue a written report on significant deficiencies and material weaknesses in internal control to those charged with governance and management, the same as for public companies. The report in Figure 10-9 (p. 336) is used in the audit of a nonpublic company.

2. *Extent of required internal controls.* Management, not the auditor, is responsible for establishing adequate internal controls in nonpublic companies, just like management for public companies. If the control environment or documentation is inadequate, the auditor may decide to withdraw from the engagement or issue a disclaimer of opinion on the financial statements. Well-run nonpublic companies understand the importance of effective controls to reduce the likelihood of errors and fraud and to improve effectiveness and efficiency.

A company's size has a significant effect on the nature of internal control and the specific controls that are implemented. Obviously, it is more difficult to establish adequate separation of duties in a small company. It is also unreasonable to expect a small firm to have internal auditors. However, if the various components of internal control are examined, it becomes apparent that most are applicable to both large and small companies. Even though it may not be common to formalize policies in manuals, it is certainly possible for a small company to have (1) competent, trustworthy personnel with clear lines of authority; (2) proper procedures for authorization, execution, and recording of transactions; (3) adequate documents, records, and reports; (4) physical controls over assets and records; and, (5) to a limited degree, independent checks on performance.

A major control available in a small company is the knowledge and concern of the top operating person, who is often an owner–manager. A personal interest in the organization and a close relationship with personnel make careful evaluation of the competence of the employees and the effectiveness of the overall system possible. For example, internal control can be significantly strengthened if the owner conscientiously performs such duties as signing all checks after carefully reviewing supporting documents, reviewing bank reconciliations, examining accounts receivable statements sent to customers, approving credit, examining all correspondence from customers and vendors, and approving bad debts.

Some nonpublic companies are unwilling to implement ideal internal control systems because of costs. For a small nonpublic company, hiring additional personnel might achieve only small improvements in the reliability of accounting data. Instead, it is often less expensive for nonpublic companies to have auditors do more extensive auditing than to incur higher internal control costs.

3. *Extent of understanding needed.* Auditing standards require that the auditor obtain a sufficient understanding of internal control to assess control risk. In practice, the procedures to gain an understanding of internal control vary considerably from client to client. For smaller nonpublic clients, many auditors obtain a level of understanding sufficient only to assess whether the statements are auditable and to evaluate the control environment for management's attitude toward internal control. If the auditor determines that the overall attitude of management about the importance of internal control is inadequate to support the other four components of internal control, the auditor assesses control risk at maximum and designs and performs detailed substantive procedures. For larger clients, the understanding can be the same as that described for public companies.

4. *Assessing control risk.* The most important difference in a nonpublic company in assessing control risk is the assessment of control risk at maximum for any or all control-related objectives when internal controls for the objective or objectives are nonexistent or ineffective. Because of the expectation that public companies should

FIGURE 10-9 **Letter Regarding Significant Deficiencies in Internal Control**

JOHNSON AND SEYGROVES
Certified Public Accountants
2016 Village Boulevard
Troy, Michigan 48801

February 12, 2014

Audit Committee
Airtight Machine Company
1729 Athens Street
Troy, MI 48801

In planning and performing our audit of the financial statements of Airtight Machine Company as of and for the year ended December 31, 2013, in accordance with auditing standards generally accepted in the United States of America, we considered Airtight Machine Company's internal control over financial reporting (internal control) as a basis for designing audit procedures that are appropriate in the circumstances for the purpose of expressing our opinion on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of Airtight Machine 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. However, as discussed below, we identified certain deficiencies in internal control 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 significant deficiency is a control deficiency, or combination of control deficiencies, that adversely affects the entity's ability to initiate, authorize, record, process, or report financial data reliably in accordance with generally accepted accounting principles that is less severe than a material weakness, yet important enough to merit attention by those charged with governance. We consider the following deficiency to be a significant deficiency in internal control:

> There is a lack of independent verification of the key entry of the customer's name, product number, quantity shipped, prices used, and the related mathematical extensions on sales invoices and credit memos. As a consequence, errors in these activities could occur and remain uncorrected, adversely affecting both recorded net sales and accounts receivable. This deficiency is significant because of the large size of the average sale at Airtight Machine Company.

This communication is intended solely for the information and use of management and the board of directors and is not intended to be and should not be used by anyone other than these specified parties.

Very truly yours,

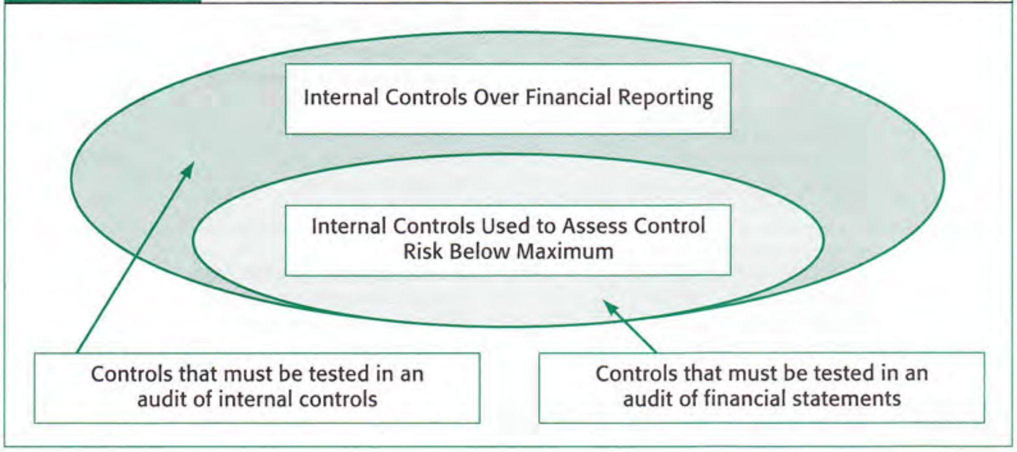
Johnson and Seygroves

Johnson and Seygroves, CPAs

have effective internal controls for all significant transactions and accounts, there is an initial presumption that control risk is low in the audit of public company financial statements. Thus, it is unlikely that a public company auditor will make a preliminary assessment of control risk at maximum.

As with public company audits, it is useful for auditors to use a control risk matrix for nonpublic company audits. The same format suggested in Figure 10-5 (p. 326) is appropriate.

FIGURE 10-10 **Differences in Scope of Controls Tested in an Audit of Internal Control and an Audit of Financial Statements**



5. *Extent of tests of controls needed.* The auditor will not perform tests of controls when the auditor assesses control risk at maximum because of inadequate controls. When control risk is assessed below the maximum for a nonpublic company, the auditor designs and performs a combination of tests of controls and substantive procedures to obtain reasonable assurance that the financial statements are fairly stated.

In contrast, the number of controls tested by auditors to express an opinion on internal controls for a public company is significantly greater than that tested solely to express an opinion on the financial statements. This is illustrated in Figure 10-10. To express an opinion on internal controls for a public company, the auditor obtains an understanding of and performs tests of controls for all significant account balances, classes of transactions, and disclosures and related assertions in the financial statements. Those controls might or might not be tested in a financial statement audit of a nonpublic company.

SUMMARY

This chapter focused on management's and the auditor's responsibility for understanding, evaluating, and testing internal control, including integrated audits of financial statements and internal control over financial reporting under Section 404 of the Sarbanes–Oxley Act and PCAOB requirements. To rely on a client's internal controls to report on internal control over financial reporting and to reduce planned audit evidence for audits of financial statements, the auditor must first obtain an understanding of each of the five components of internal control. Knowledge about the design of the client's control environment, risk assessment, control activities, information and communication, and monitoring activities and information about whether internal control components have been implemented assist the auditor in assessing control risk for each transaction-related audit objective.

The chapter ended with a discussion of the differences in the audit of nonpublic companies because they are not subject to Section 404 and PCAOB requirements to report on internal control over financial reporting. For nonpublic companies, auditors have the option of assessing a higher level of control risk, depending on the quality of the client's internal controls and cost–benefit considerations.

The process followed by auditors in assessing control risk for integrated audits of financial statements and internal control over financial reporting and audits of the financial statements only is summarized in Figure 10-11 (p. 338).

FIGURE 10-11 Summary of Understanding Internal Control and Assessing Control Risk

Financial Statement Audit		Integrated Audit of Financial Statements and Internal Control over Financial Reporting	
Sufficient to audit financial statements	Obtain an understanding of internal control design and operation	Sufficient to audit internal control over financial reporting	PHASE 1
Varies depending on extent and effectiveness of controls and the auditor's planned reliance on controls	Decide control risk at the objective level for each transaction type Three alternatives Maximum / Intermediate / Low	Decide low for all objectives unless there are significant deficiencies or material weaknesses	PHASE 2
Varies depending on assessed level of control risk	Plan and perform tests of controls and evaluate results	Extensive tests for all objectives	PHASE 3
Revise for tests of controls results	Revise assessed control risk if appropriate	Revise for tests of controls results	
Likely to be more reliance on substantive tests, depending on assessed control risk option selected	Plan detection risk and perform substantive tests considering control risk and other audit risk model factors	Likely to be less reliance on substantive tests due to extensive tests of controls	PHASE 4
Must communicate in writing to those charged with governance describing significant deficiencies or material weaknesses.	Issue internal control report or letter	Must issue report on internal control over financial reporting and issue a written communication to audit committee describing significant deficiencies or material weaknesses	

ESSENTIAL TERMS

Assessment of control risk—a measure of the auditor's expectation that internal controls will neither prevent material misstatements from occurring nor detect and correct them if they have occurred; control risk is assessed for each transaction-related audit objective in a cycle or class of transactions

Chart of accounts—a listing of all the entity's accounts, which classifies transactions into individual balance sheet and income statement accounts

Compensating control—a control elsewhere in the system that offsets the absence of a key control

Collusion—a cooperative effort among employees to steal assets or misstate records

Control activities—policies and procedures, in addition to those included in the other four components of internal control, that help ensure that necessary actions are taken to address risks in the achievement of the entity's objectives; they typically include the following five specific control activities: (1) adequate separation of duties, (2) proper authorization of transactions and activities, (3) adequate documents and records, (4) physical control over assets and records, and (5) independent checks on performance

Control deficiency—a deficiency in the design or operation of controls that does not permit company personnel to prevent or detect and correct misstatements on a timely basis

Control environment—the actions, policies, and procedures that reflect the overall attitudes of top management, directors, and owners of an entity about internal control and its importance to the entity

Control risk matrix—a methodology used to help the auditor assess control risk by matching key internal controls and internal control deficiencies with transaction-related audit objectives

Entity-level controls—Controls that have a pervasive effect on the entity's system of internal control; also referred to as company-level controls

Flowchart—a diagrammatic representation of the client's documents and records and the sequence in which they are processed

General authorization—companywide policies for the approval of all transactions within stated limits

Independent checks—internal control activities designed for the continuous internal verification of other controls

Information and communication—the set of manual and/or computerized procedures that initiates, records, processes, and reports an entity's transactions and maintains accountability for the related assets

Internal control—a process designed to provide reasonable assurance regarding the achievement of management's objectives in the following categories: (1) reliability of financial reporting, (2) effectiveness and efficiency of operations, and (3) compliance with applicable laws and regulations

Internal control questionnaire—a series of questions about the controls in each audit area used as a means of indicating to the auditor aspects of internal control that may be inadequate

Key controls—controls that are expected to have the greatest effect on meeting the transaction-related audit objectives

Management letter—an optional letter written by the auditor to a client's management containing the auditor's recommendations for improving any aspect of the client's business

Material weakness—a significant deficiency in internal control that, by itself, or in combination with other significant deficiencies, results in a reasonable possibility that a material misstatement of the financial statements will not be prevented or detected

Monitoring—management's ongoing and periodic assessment of the quality of internal control performance to determine that controls are operating as intended and are modified when needed

Narrative—a written description of a client's internal controls, including the origin, processing, and disposition of documents and records, and the relevant control procedures

Procedures to obtain an understanding—procedures used by the auditor to gather evidence about the design and implementation of specific controls

Risk assessment—management's identification and analysis of risks relevant to the preparation of financial statements in accordance with an applicable accounting framework

Separation of duties—separation of the following activities in an organization: (1) custody of assets from accounting, (2) authorization from custody of assets, (3) operational responsibility from record keeping, and (4) IT duties from outside users of IT

Significant deficiency—one or more control deficiencies exist that is less severe than a material weakness, but important enough to merit attention by those responsible for oversight of the company's financial reporting

Significant risks—risks the auditor believes require special audit consideration; the auditor is required to test the operating effectiveness of controls that mitigate these risks in the current year audit if control risk is to be assessed below the maximum

Specific authorization—case-by-case approval of transactions not covered by companywide policies

Tests of controls—audit procedures to test the operating effectiveness of controls in support of reduced assessed control risk

Those charged with governance—the person(s) with responsibility for overseeing the strategic direction of the entity and its obligations related to the accountability of the entity, including overseeing the financial reporting and disclosure process

Walkthrough—the tracing of selected transactions through the accounting system to determine that controls are in place

REVIEW QUESTIONS

10-1 (Objective 10-1) Describe the three broad objectives management has when designing effective internal control.

10-2 (Objective 10-1) Describe which of the three categories of broad objectives for internal controls are considered by the auditor in an audit of both the financial statements and internal control over financial reporting.

10-3 (Objective 10-2) Section 404(a) of the Sarbanes–Oxley Act requires management to issue a report on internal control over financial reporting. Identify the specific Section 404(a) reporting requirements for management.

10-4 (Objective 10-2) What two aspects of internal control must management assess when reporting on internal control to comply with Section 404 of the Sarbanes–Oxley Act?

10-5 (Objective 10-2) Chapter 8 introduced the eight parts of the planning phase of audits. Which part is understanding internal control and assessing control risk? What parts precede and follow that understanding and assessing control risk?

10-6 (Objectives 10-2, 10-4, 10-8) What is the auditor's responsibility for obtaining an understanding of internal control? How does that responsibility differ for audits of public and nonpublic companies?

10-7 (Objective 10-2) When performing an integrated audit of a public company, what are the auditor's responsibilities related to internal control as required by PCAOB standards?

10-8 (Objectives 10-2, 10-5) State the six transaction-related audit objectives.

10-9 (Objectives 10-2, 10-3) Management must identify the framework used to evaluate the effectiveness of internal control over financial reporting. What framework is used by most U.S. public companies?

10-10 (Objective 10-3) What are the five components of internal control in the COSO internal control framework?

10-11 (Objective 10-3) What is meant by the control environment? What are the factors the auditor must evaluate to understand it?

10-12 (Objective 10-3) What is the relationship among the five components of internal control?

10-13 (Objective 10-3) List the types of specific control activities and provide one specific illustration of a control in the sales area for each control activity.

10-14 (Objective 10-3) The separation of operational responsibility from record keeping is meant to prevent different types of misstatements than the separation of the custody of assets from accounting. Explain the difference in the purposes of these two types of separation of duties.

10-15 (Objective 10-3) For each of the following, give an example of a physical control the client can use to protect the asset or record:

1. Petty cash
2. Cash received by retail clerks
3. Accounts receivable records
4. Raw material inventory
5. Perishable tools
6. Manufacturing equipment
7. Marketable securities

10-16 (Objective 10-3) Explain what is meant by independent checks on performance and give five specific examples.

10-17 (Objective 10-4) Describe the four phases performed by the auditor when obtaining an understanding of internal control and assessing control risk.

10-18 (Objective 10-4) What two aspects of internal control must the auditor assess when performing procedures to obtain an understanding of internal control?

10-19 (Objective 10-4) What is a walkthrough of internal control? What is its purpose?

10-20 (Objective 10-4) Describe how the nature of evidence used to evaluate the control environment differs from the nature of evidence used to evaluate control activities.

10-21 (Objectives 10-5, 10-7) Distinguish a significant deficiency in internal control from a material weakness in internal control. How will the presence of one significant deficiency affect an auditor's report on internal control under PCAOB standards? How will the presence of one material weakness affect an auditor's report on internal control under PCAOB standards?

10-22 (Objectives 10-3, 10-5) Frank James, a highly competent employee of Brinkwater Sales Corporation, had been responsible for accounting-related matters for two decades. His devotion to the firm and his duties had always been exceptional, and over the years, he had been given increased responsibility. Both the president of Brinkwater and the partner of an independent CPA firm in charge of the audit were shocked and dismayed to discover that James had embezzled more than $500,000 over a 10-year period by not recording billings in the sales journal and subsequently diverting the cash receipts. What major factors permitted the embezzlement to take place?

10-23 (Objective 10-5) Jeanne Maier, CPA, believes that it is appropriate to obtain an understanding of internal control about halfway through the audit, after she is familiar with the client's operations and the way the system actually works. She has found through experience that filling out internal control questionnaires and flowcharts early in the engagement is not beneficial because the system rarely functions the way it is supposed to. Later in the engagement, the auditor can prepare flowcharts and questionnaires with relative ease because of the knowledge already obtained on the audit. Evaluate her approach.

10-24 (Objectives 10-6, 10-8) Distinguish the auditor's responsibility for testing controls in an integrated audit of a public company from the responsibility to test controls in an audit of a nonpublic company.

10-25 (Objective 10-6) Describe why auditors generally evaluate entity-level controls before evaluating transaction-level controls.

10-26 (Objective 10-6) During the prior-year audits of McKimmon, Inc., a private company, the auditor did tests of controls for all relevant financial statement assertions. Some of the related controls are manual while others are automated. Describe the extent the auditor can rely on tests of controls performed in prior years.

10-27 (Objective 10-6) The auditor's risk assessment procedures identified several risks that the auditor deems to be significant risks. Several internal controls exist that are designed to mitigate the risks identified. Describe the auditor's responsibilities for considering those controls in the current audit.

10-28 (Objective 10-7) What two conditions must be present for the auditor to issue an unqualified opinion on internal control over financial reporting? What type of condition will cause the auditor to issue a qualified or disclaimer of opinion on internal control over financial reporting?

10-29 (Objective 10-7) Describe the concept of an integrated audit of the financial statements and internal control required by PCAOB standards.

MULTIPLE CHOICE QUESTIONS FROM CPA EXAMINATIONS

10-30 (Objectives 10-1, 10-2, 10-3) The following are general questions about internal control. Choose the best response.

a. When considering internal control, an auditor must be aware of the concept of reasonable assurance, which recognizes that the
   (1) employment of competent personnel provides assurance that management's control objectives will be achieved.
   (2) establishment and maintenance of internal control is an important responsibility of management and not of the auditor.
   (3) cost of internal control should not exceed the benefits expected to be derived therefrom.
   (4) separation of incompatible functions is necessary to ascertain that the internal control is effective.

b. Which of the following would not be considered an inherent limitation of the potential effectiveness of an entity's internal control structure?
   (1) Incompatible duties
   (2) Management override
   (3) Mistakes in judgment
   (4) Collusion among employees

c. Actions, policies, and procedures that reflect the overall attitude of management, directors, and owners of the entity about internal control relate to which of the following internal control components?
   (1) Control environment
   (2) Information and communication
   (3) Risk assessment
   (4) Monitoring

d. Vendor account reconciliations are performed by three clerks in the accounts payable department on Friday of each week. The accounts payable supervisor reviews the completed reconciliations the following Monday to ensure they have been completed. The work performed by the supervisor is an example of which COSO component?
   (1) Control activities
   (2) Information and communication
   (3) Risk assessment
   (4) Monitoring

10-31 (Objectives 10-5, 10-7) The following questions deal with deficiencies in internal control. Choose the best response.

a. Which of the following is an example of an operation deficiency in internal control?
   (1) The company does not have a code of conduct for employees to consider.
   (2) The cashier has online ability to post write-offs to accounts receivable accounts.
   (3) Clerks who conduct monthly reconciliation of intercompany accounts do not understand the nature of misstatements that could occur in those accounts.
   (4) Management does not have a process to identify and assess risks on a recurring basis.

b. A material weakness in internal control represents a control deficiency that
   (1) more than remotely adversely affects a company's ability to initiate, authorize, record, process, or report external financial statements reliably.
   (2) results in a reasonable possibility that internal control will not prevent or detect material financial statement misstatements.
   (3) exists because a necessary control is missing or not properly designed.
   (4) reduces the efficiency and effectiveness of the entity's operations.

c. An auditor of a large public company identifies a material weakness in internal control. The auditor
   (1) will be unable to issue an unqualified opinion on the financial statements.
   (2) must issue a qualified or disclaimer of opinion on internal control over financial reporting.
   (3) may still be able to issue an unqualified opinion on internal control over financial reporting.
   (4) must issue an adverse opinion on internal control over financial reporting.

d. When a nonpublic company auditor's tests of controls identify deficiencies in internal control over financial reporting, the auditor
   (1) must communicate to management all deficiencies identified.
   (2) must communicate both significant deficiencies and material weaknesses to those charged with governance.

(3) may communicate orally or in writing to the board all significant deficiencies and material weaknesses identified.
(4) must issue an adverse opinion on the financial statements.

10-32 (Objectives 10-5, 10-6, 10-8) The following questions deal with assessing control risk in a financial statement audit. Choose the best response.

a. When obtaining an understanding of an entity's internal control procedures, an auditor should concentrate on the substance of procedures rather than their form because:
   (1) the procedures may be operating effectively but may not be documented.
   (2) management may establish appropriate procedures but not enforce compliance with them.
   (3) the procedures may be so inappropriate that no reliance is contemplated by the auditor.
   (4) management may implement procedures whose costs exceeds their benefits.

b. The auditor's tests of controls revealed that required approvals of cash disbursements were absent for a large number of sample transactions examined. Which of the following is least likely to be the appropriate auditor response?
   (1) The auditor will communicate the deficiency to those charged with governance.
   (2) The auditor will increase the planned detection risk.
   (3) The auditor will not select more sample items to audit.
   (4) The auditor will perform more extensive substantive tests surrounding cash disbursements.

c. An auditor uses assessed control risk to
   (1) evaluate the effectiveness of the entity's internal controls.
   (2) identify transactions and account balances where inherent risk is at the maximum.
   (3) indicate whether materiality thresholds for planning and evaluation purposes are sufficiently high.
   (4) determine the acceptable level of detection risk for financial statement assertions.

d. On the basis of audit evidence gathered and evaluated, an auditor decides to increase assessed control risk from that originally planned. To achieve an audit risk level (AcAR) that is substantially the same as the planned audit risk level (AAR), the auditor will
   (1) increase inherent risk.
   (2) increase materiality levels.
   (3) decrease substantive testing.
   (4) decrease planned detection risk.

DISCUSSION QUESTIONS AND PROBLEMS

10-33 (Objective 10-3) Following are descriptions of ten internal controls.

1. The company's computer systems track individual transactions and automatically accumulate transactions to create a trial balance.
2. On a monthly basis, department heads review a budget to actual performance report and investigate unusual differences.
3. The company must receive university transcripts documenting all college degrees earned before an individual can begin their first day of employment with the company.
4. Senior management obtains data about external events that might affect the entity and evaluates the impact of that information on its existing accounting processes.
5. Each quarter, department managers are required to perform a self-assessment of the department's compliance with company policies. Reports summarizing the results are to be submitted to the senior executive overseeing that department.
6. Before a cash disbursement can be processed, all payee information must be verified by matching the payee to the company's approved vendor listing.
7. The system automatically reconciles the detailed accounts receivable subsidiary ledger to the accounts receivable general ledger account on daily basis.
8. The company has developed a detailed series of accounting policy and procedures manuals to help provide detailed instructions to employees about how controls are to be performed.

9. The company has an organizational chart that establishes the formal lines of reporting and authorization protocols.
10. The compensation committee reviews compensation plans for senior executives to determine if those plans create unintended pressures that might lead to distorted financial statements.

Required Indicate which of the five COSO internal control components is best represented by each internal control.

a. Control environment
b. Risk assessment
c. Control activities
d. Information and communication
e. Monitoring

10-34 (Objectives 10-3, 10-4, 10-5, 10-6) The following are internal controls that the auditor has identified for various cycles.

1. Sales invoices are matched with shipping documents and customer orders before recording in the sales journal.
2. Receiving reports are prenumbered and accounted for on a daily basis.
3. Sales invoices are independently verified before being sent to customers.
4. Payments by check are received in the mail by the receptionist, who lists the checks and restrictively endorses them.
5. Overtime hours for payroll are approved by the employee's supervisor.
6. Checks are signed by the company president, who compares the checks with the underlying supporting documents.
7. Unmatched shipping documents are accounted for on a daily basis.
8. All payroll payments must have a valid employee identification number assigned by the human resources department at the time of hiring.
9. The accounts receivable master is reconciled to the general ledger on a monthly basis.

Required

a. For each internal control, identify the type(s) of specific control activity (or activities) to which it applies (such as proper authorization and adequate documents and records).
b. For each internal control, identify the transaction-related audit objective(s) to which it applies.

10-35 (Objectives 10-3, 10-4, 10-5, 10-6) Each of the following internal controls has been taken from a standard internal control questionnaire used by a CPA firm for assessing control risk in the payroll and personnel cycle.

1. Approval of department head or foreman on time records is required before preparing payroll.
2. All prenumbered time records are accounted for before beginning data entry for preparation of payroll.
3. The computer calculates gross and net pay based on hours inputted and information in employee master files, and payroll accounting personnel double-check the mathematical accuracy on a test basis.
4. All voided and spoiled payroll checks are properly mutilated and retained.
5. Human resources policies require an investigation of an employment application from new employees. Investigation includes checking the employee's background, former employers, and references.
6. The payroll accounting software application will not accept data input for an employee number not contained in the employee master file.
7. Persons preparing the payroll do not perform other payroll duties (timekeeping, distribution of checks) or have access to payroll data master files or cash.
8. Written termination notices, with properly documented reasons for termination, and approval of an appropriate official are required.
9. All checks and notices of electronic payments not distributed to employees are returned to the treasurer for safekeeping and follow-up.
10. Online ability to add employees or change pay rates to the payroll master file is restricted via passwords to authorized human resource personnel.

a. For each internal control, identify the type(s) of specific control activity (or activities) to which it applies (such as adequate documents and records or physical control over assets and records). **Required**

b. For each internal control, identify the transaction-related audit objective(s) to which it applies.

c. For each internal control, identify a specific misstatement that is likely to be prevented if the control exists and is effective.

d. For each control, list a specific misstatement that could result from the absence of the control.

e. For each control, identify one audit test that the auditor could use to uncover misstatements resulting from the absence of the control.

10-36 (Objectives 10-3, 10-4, 10-5) The following are misstatements that have occurred in Fresh Foods Grocery Store, a retail and wholesale grocery company:

1. On the last day of the year, a truckload of beef was set aside for shipment but was not shipped. Because it was still on hand the inventory was counted. The shipping document was dated the last day of the year, so it was also included as a current-year sale.
2. The incorrect price was used on sales invoices for billing shipments to customers because the wrong price was entered into the computer master file of prices.
3. A vendor invoice was paid even though no merchandise was ever received. The accounts payable software application does not require the input of a valid receiving report number before payment can be made.
4. Employees in the receiving department took sides of beef for their personal use. When a shipment of meat was received, the receiving department filled out a receiving report and forwarded it to the accounting department for the amount of goods actually received. At that time, two sides of beef were put in an employee's pickup truck rather than in the storage freezer.
5. An accounts payable clerk processed payments to himself by adding a fictitious vendor address to the approved vendor master file.
6. During the physical count of inventory of the retail grocery, one counter wrote down the wrong description of several products and miscounted the quantity.
7. A salesperson sold an entire carload of lamb at a price below cost because she did not know the cost of lamb had increased in the past week.
8. A vendor's invoice was paid twice for the same shipment. The second payment arose because the vendor sent a duplicate copy of the original 2 weeks after the payment was due.

a. For each misstatement, identify one or more types of controls that were absent. **Required**

b. For each misstatement, identify the transaction-related audit objectives that have not been met.

c. For each misstatement, suggest a control to correct the deficiency.

10-37 (Objective 10-3) The division of the following duties is meant to provide the best possible controls for the Meridian Paint Company, a small wholesale store:

†1. Approve credit for customers included in the customer credit master file.
†2. Input shipping and billing information to bill customers, record invoices in the sales journal, and update the accounts receivable master file.
†3. Open the mail and prepare a prelisting of cash receipts.
†4. Enter cash receipts data to prepare the cash receipts journal and update the accounts receivable master file.
†5. Prepare daily cash deposits.
†6. Deliver daily cash deposits to the bank.
†7. Assemble the payroll time cards and input the data to prepare payroll checks and update the payroll journal and payroll master files.
†8. Sign payroll checks.
†9. Assemble supporting documents for general and payroll cash disbursements.

†10. Sign general cash disbursement checks.

†11. Input information to prepare checks for signature, record checks in the cash disbursements journal, and update the appropriate master files.

†12. Mail checks to suppliers and deliver checks to employees.

13. Cancel supporting documents to prevent their reuse.
14. Update the general ledger at the end of each month and review all accounts for unexpected balances.
15. Reconcile the accounts receivable master file with the control account and review accounts outstanding more than 90 days.
16. Prepare monthly statements for customers by printing the accounts receivable master file; then mail the statements to customers.
17. Reconcile the monthly statements from vendors with the accounts payable master file.
18. Reconcile the bank account.

Required You are to divide the accounting-related duties 1 through 18 among Robert Smith, James Cooper, and Bill Miller. All of the responsibilities marked with a dagger (†) are assumed to take about the same amount of time and must be divided equally between Smith and Cooper. Both employees are equally competent. Miller, who is president of the company, is not willing to perform any functions designated by a dagger and will perform only a maximum of two of the other functions.*

10-38 (Objectives 10-2, 10-4, 10-8) Lew Pherson and Vera Collier are friends who are employed by different CPA firms. One day during lunch they are discussing the importance of internal control in determining the amount of audit evidence required for an engagement. Pherson expresses the view that internal control must be evaluated carefully in all companies, regardless of their size or whether they are publicly held, in a similar manner. His CPA firm requires a standard internal control questionnaire on every audit as well as a flowchart of every transaction area. In addition, he says the firm requires a careful evaluation of the system and a modification in the evidence accumulated based on the controls and deficiencies in the system.

Collier responds by saying she believes that internal control cannot be adequate in many of the small companies she audits; therefore, she simply ignores internal control and acts under the assumption of inadequate controls. She goes on to say, "Why should I spend a lot of time obtaining an understanding of internal control and assessing control risk when I know it has all kinds of weaknesses before I start? I would rather spend the time it takes to fill out all those forms in testing whether the statements are correct."

Required

a. Express in general terms the most important difference between the nature of the potential controls available for large and small companies.

b. Criticize the positions taken by Pherson and Collier, and express your own opinion about the similarities and differences that should exist in understanding internal control and assessing control risk for different-sized companies.

c. Discuss whether Collier's approach is acceptable under existing auditing standards for either public or nonpublic companies.

d. Describe what additional procedures Pherson must perform if auditing the financial statements of a public company.

10-39 (Objectives 10-3, 10-5) The following are partial descriptions of internal controls for companies engaged in the manufacturing business:

1. When Mr. Clark orders materials, an electronic copy of the purchase order is sent to the receiving department. During the delivery of materials, Mr. Smith, the receiving clerk, records the receipt of shipment on this purchase order and then sends the purchase order to the accounting department, where it is used to record materials purchased and accounts payable. The materials are transported to the storage area by forklifts. The additional purchased quantities are recorded on storage records.

2. Every day, hundreds of employees clock in using their employee identification cards at Generous Motors Corporation. The data on these time records is used in the preparation of the labor cost distribution records, the payroll journal, and the payroll checks and electronic payments. The treasurer, Mrs. Webber, compares the payroll journal with the payroll records, signs the checks, and returns the checks and payroll notifications to Mr. Strode, the supervisor of the computer department. The payroll checks and payment notices are distributed to the employees by Mr. Strode.
3. The smallest branch of Connor Cosmetics employs Mary Cooper, the branch manager, and her sales assistant, Janet Hendrix. The branch uses a bank account to pay expenses. The account is kept in the name of "Connor Cosmetics—Special Account." To pay expenses, checks must be signed by Mary Cooper or by the treasurer, John Winters. Cooper receives the cancelled checks and bank statements. She reconciles the branch account herself and files cancelled checks and bank statements in her records. She also periodically prepares reports of cash disbursements and sends them to the home office.

Required

a. List the deficiencies in internal control for each of these situations. To identify the deficiencies, use the methodology that was discussed in this chapter.

b. For each deficiency, state the type(s) of misstatement(s) that is (are) likely to result. Be as specific as possible.

c. How would you improve internal controls for each of the three companies?*

10-40 (Objective 10-5) Anthony, CPA, prepared the flowchart (p. 348) which portrays the raw materials purchasing function of one of Anthony's clients, Medium-Sized Manufacturing Company, from the preparation of initial documents through the vouching of invoices for payment in accounts payable. Assume that all documents are prenumbered.

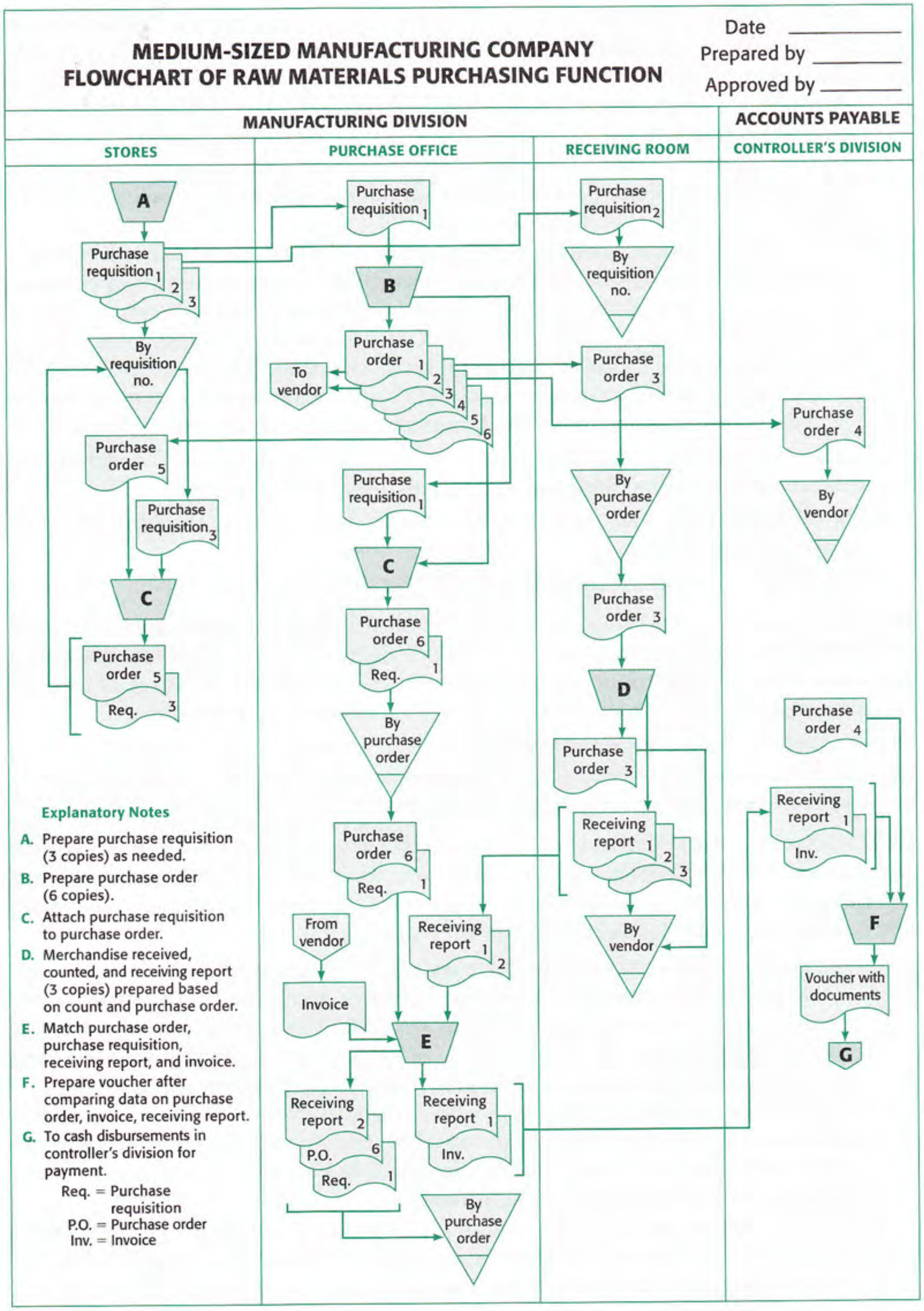
Required

Identify the deficiencies in internal control that can be determined from the flowchart. Use the methodology discussed in this chapter. Include internal control deficiencies resulting from activities performed or not performed.*

10-41 (Objective 10-6) Internal controls 1 through 5 were tested in prior audits. Evaluate each internal control independently and determine which controls must be tested in the current year's audit of the December 31, 2013, financial statements. Be sure to explain why testing is or is not required in the current year.

Required

1. The general ledger accounting software system automatically reconciles totals in each of the subsidiary master files for accounts receivable, accounts payable, and inventory accounts to the respective general ledger accounts. This control was most recently tested in the prior year. No changes to the software have been made since testing and there are effective controls over IT security and software program changes.
2. The accounts payable clerk matches vendor invoices with related purchaser orders and receiving reports and investigates any differences noted. This control was tested in the 2012 fiscal year end audit. No changes to this control or personnel involved have occurred since testing was performed.
3. The sales system automatically determines whether a customer's purchase order and related accounts receivable balance are within the customer's credit limit. The risk of shipping goods to customers who exceed their credit limit is deemed to be a significant risk. This control was last tested in the December 31, 2011, financial statement audit.
4. The perpetual inventory system automatically extends the unit price times quantity for inventory on hand. This control was last tested in the audit of December 31, 2011, financial statements. During 2013, the client made changes to this software system.
5. The client's purchase accounting system was acquired from a reputable software vendor several years ago. This system contains numerous automated controls. The auditor tested those controls most recently in the 2012 audit. No changes have been made to any of these controls since testing and the client's controls over IT security and software program changes are excellent.



10-42 (Objective 10-7) The following are independent situations for which you will recommend an appropriate audit report on internal control over financial reporting as required by PCAOB auditing standards:

1. The auditor identified a material misstatement in the financial statements that was not detected by management of the company.
2. The auditor was unable to obtain any evidence about the operating effectiveness of internal control over financial reporting.
3. The auditor identified several significant deficiencies in internal control. Because of these significant deficiencies, the auditor believes that there is a reasonable

possibility that internal control will not prevent or detect material misstatements on a timely basis.

4. The auditor determined that a deficiency in internal control exists that will not prevent or detect a material misstatement in the financial statements.
5. During interim testing, the auditor identified and communicated to management a significant control deficiency. Management immediately corrected the deficiency and the auditor was able to sufficiently test the newly-instituted internal control before the end of the fiscal period.
6. As a result of performing tests of controls, the auditor identified a significant deficiency in internal control over financial reporting; however, the auditor does not believe that it represents a material weakness in internal control.

Required

For each situation, state the appropriate audit report from the following alternatives:

- Unqualified opinion on internal control over financial reporting
- Qualified or disclaimer of opinion on internal control over financial reporting
- Adverse opinion on internal control over financial reporting

CASE

10-43 (Objective 10-5) The Cotton Company, a retail store dealing in expensive linens and clothing, has a staff of about 20 salesclerks. The sales are done in cash or credit, using the store's own billing rather than credit cards. Most of the larger sales are on credit. Each salesclerk has his own sales book with prenumbered, three-copy, multicolored sales slips attached, but perforated. Only a central cash register is used, run by the store manager. He's been working for Zafir Diab, the store owner, for over 15 years. The cash register is physically positioned to monitor the entire store and the front door.

All transactions are recorded in the salesclerks' sales books. The original and second copies for each sale are given to the cashier. The third copy is retained by the salesclerk in the sales book. When the sale is for cash, the customer pays the salesclerk, who marks all three copies "paid" and takes the money to the supervisor.

The supervisor compares the clothing to the description on the invoice and the price on the sales tag. He also rechecks the clerk's calculations. Any corrections are approved by the salesclerk. The clerk changes his sales book at that time, and the items are packaged and given to the customer.

A credit sale must be approved by the supervisor from an approved credit list after the salesclerk prepares the three-part invoice. Next, the supervisor enters the sale in his cash register as a credit or cash sale. The second copy of the invoice, which has been validated by the cash register, is given to the customer. Diab must approve of any credit sales that exceed $500. At the end of the day, the salesclerks give their books to the supervisor, and the supervisor compares the totals to the cash register tape. He then creates a summary of the day's transactions. The cash is deposited in the bank the next morning by Diab, and he receives a deposit slip, which he gives to the accounts receivable clerk. If Diab is unable to deposit the money, the supervisor goes instead. The cashier's copies of the invoices are also given to the accounts receivable clerk along with a summary of the day's receipts.

Khalid, the accounts receivable clerk, reviews the sales books and the register tape. He inputs all sales invoice information into the firm's computer, which provides a complete printout of all input and summaries. The accounting summary includes sales by the salesclerk, cash sales, credit sales, and total sales. Khalid compares this output with the summary and reconciles all differences.

The computer updates accounts receivable, inventory, and general ledger master files. After the update procedure has been run on the computer, Khalid's assistant files all sales included in the sales printout. Khalid uses these files to create bills that are mailed to the customers. The mail is opened each morning by Diab's secretary. She gives all correspondence to Diab and all payments to the supervisor. The supervisor totals the amounts and adds this cash to the register for later deposit. He gives the total to Khalid to update customer accounts on the computer. Khalid uses this list and all the remittances to record cashreceipts and update accounts receivable, again by computer. He reconciles the total receipts on the pre-list to the deposit slip and to her printout. At the same time, he compares the deposit slip received from the bank for cash sales to the cash receipts journal. He has online access to the store's bank account, which he accesses monthly to pay the store's bills online. The computer generates a weekly aged trial balance of accounts receivable. A separate listing of all unpaid bills is also automatically prepared, and both are given to Diab. He approves all write-offs of uncollectible items and forwards the list to Khalid, who writes them off.

Each month Khalid mails computer-generated statements to customers. Complaints and disagreements are resolved by Diab, who then informs Khalid in writing of any write-downs or misstatements that require correction.

The computer system also automatically totals the journals and posts the totals to the general ledger. A general ledger trial balance is printed out, from which Khalid prepares financial statements. Khalid also prepares monthly bank reconciliations and reconciles the general ledger to the aged accounts receivable trial balance.

Because of the importance of inventory control, Khalid prints out the inventory perpetual totals monthly, on the last day of each month. Salesclerks count all inventory after store hours on the last day of each month for comparison with the perpetuals. An inventory shortage report is provided to Diab. The perpetuals are adjusted by Khalid after Diab has approved the adjustments.

Required

a. For each sales transaction-related audit objective, identify one or more existing controls.

b. For each cash receipts transaction-related audit objective, identify one or more existing controls.

c. What are some possible deficiencies in the store's system? How would you, as the auditor, suggest ways to improve their system?

INTEGRATED CASE APPLICATION—PINNACLE MANUFACTURING: PART III

10-44 (Objective 10-5) In Parts I and II of this case, you performed preliminary analytical procedures and assessed acceptable audit risk and inherent risk for Pinnacle Manufacturing. Your team has been assigned the responsibility of auditing the acquisition and payment cycle and one related balance sheet account, accounts payable. The general approach to be taken will be to reduce assessed control risk to a low level, if possible, for the two main types of transactions affecting accounts payable: acquisitions and cash disbursements. The following are furnished as background information:

- A summary of key information from the audit of the acquisition and payment cycle and accounts payable in the prior year, which was extracted from the previous audit firm's audit files (Figure 10-12)
- A flowchart description of the accounting system and internal controls for the acquisition and payment cycle (Figure 10-13, p. 352)—the flowchart shows that although each of the company's three divisions has its own receiving department, the purchasing and accounts payable functions are centralized

The purpose of Part III is to obtain an understanding of internal control and assess control risk for Pinnacle Manufacturing's acquisition and cash disbursement transactions.

a. Familiarize yourself with the internal control system for acquisitions and cash disbursements by studying the information in Figure 10-12 and Figure 10-13.

b. Prepare a control risk matrix for acquisitions and a separate one for cash disbursements using Figure 10-5 on page 326 as a guide. A formatted control risk matrix is provided on the textbook Web site. The objectives should be specific transaction-related audit objectives for acquisitions for the first matrix and cash disbursements for the second matrix. See pages 620–624 in Chapter 18 for transaction-related audit objectives for acquisitions and cash disbursements. In doing Part III, the following steps are recommended:

FIGURE 10-12 Information for Audit of Accounts Payable – Previous Year

Accounts payable, 12-31-12	
Number of accounts	452
Total accounts payable	$9,460,776
Range of individual balances	$33.27–$677,632.97
Performance materiality for accounts payable	$230,000
Transactions, 2012	
Acquisitions:	
Number of acquisitions	16,243
Total acquisitions	$92,883,712
Cash disbursements:	
Number of disbursements	23,661
Total cash disbursements	$87,280,031
Results of audit procedures–tests of controls and substantive tests of transactions for acquisitions (sample size of 100):	
Purchase order not approved	1
Purchase quantities, prices, and/or extensions not correct	1
Transactions charged to wrong general ledger account	2
Transactions recorded in wrong period	1
No other exceptions	
Results of audit procedures–cash disbursements (sample size of 100):	
Cash disbursement recorded in wrong period	2
No other exceptions	
Results of audit procedures–accounts payable: (50% of vendors' balances were verified; combined net understatement amounts were projected to the population as follows):	
Three cutoff misstatements	$52,349
One difference in amounts due to disputes and discounts	$9,552
No adjustment was necessary because the total projected misstatement was not material.	

(1) *Controls*
   a. Identify key controls for acquisitions and for cash disbursements. After you decide on the key controls, include each control in one of the two matrices.
   b. Include a "C" in the matrix in each column for the objective(s) to which each control applies. Several of the controls should satisfy multiple objectives.

(2) *Deficiencies*
   a. Identify key deficiencies for acquisitions and for cash disbursements. After you decide on the deficiencies, include each deficiency in the bottom portion of one of the two matrices.
   b. Include a "D" in the matrix in each column for the objective(s) to which each control deficiency applies.

(3) Assess control risk as high, medium, or low for each objective using your best judgment. Do this for both the acquisitions and cash disbursements matrices.

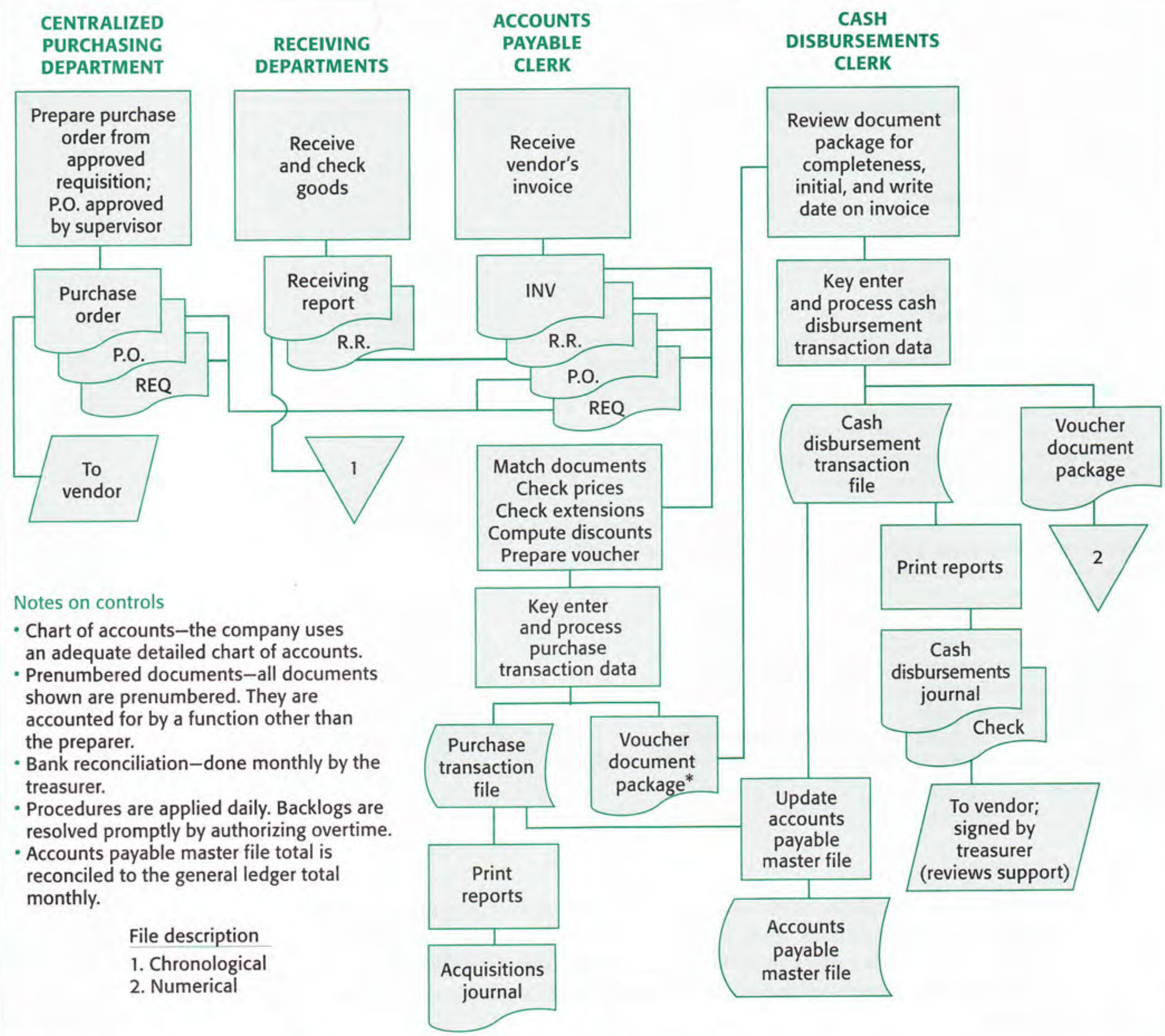
RESEARCH PROBLEM 10-1: DISCLOSURE OF MATERIAL WEAKNESSES IN INTERNAL CONTROL OVER FINANCIAL REPORTING

Section 404(a) of the Sarbanes–Oxley Act requires management of a public company to issue a report on internal control over financial reporting (ICOFR) as of the end of the company's fiscal year. Many companies have reported that their ICOFR was operating effectively, while others have reported that such controls were not effective in design or operation.

Required

1. Visit the SEC Web site (www.sec.gov) and search for the Form 10-K filing for Organic Alliance, Inc., for fiscal year ended December 31, 2011.

FIGURE 10-13 Pinnacle Manufacturing–Acquisition and Payment Cycle



Notes on controls

- Chart of accounts–the company uses an adequate detailed chart of accounts.
- Prenumbered documents–all documents shown are prenumbered. They are accounted for by a function other than the preparer.
- Bank reconciliation–done monthly by the treasurer.
- Procedures are applied daily. Backlogs are resolved promptly by authorizing overtime.
- Accounts payable master file total is reconciled to the general ledger total monthly.

File description
1. Chronological
2. Numerical

*Includes voucher, vendor's invoice, receiving report, purchase order, and purchase requisition.

2. Locate Management's Annual Report on Internal Control Over Financial Reporting to answer the following questions:
   a. Who is responsible for establishing and implementing effective internal controls?
   b. What type of internal controls is the report addressing?
   c. What framework did management use to evaluate its internal control?
   d. What was management's conclusion about the operating effectiveness of internal control?
   e. What information is provided to help readers understand why management arrived at that conclusion?
   f. What changes, if any, has management made to improve internal controls?
3. Locate the report of the independent registered public accounting firm. What information, if any, does the audit firm provide about its evaluation of internal controls over financial reporting?