

Auditing and Assurance Services, 14e (Arens)

Chapter 10 Section 404 Audits of Internal Control and Control Risk

Learning Objective 10-1

1) Which of the following is **not** one of the three primary objectives of effective internal control?

- A) reliability of financial reporting
- B) efficiency and effectiveness of operations
- C) compliance with laws and regulations
- D) assurance of elimination of business risk

Answer: D

Terms: Internal control objectives

Diff: Easy

Objective: LO 10-1

AACSB: Analytic skills

2) The Public Company Accounting Oversight Board states that *reasonable assurance* allows a:

- A) small likelihood of ineffective internal controls.
- B) remote likelihood that material misstatements will not be prevented or detected by internal control.
- C) likelihood that material misstatements will not be prevented or detected by internal control.
- D) high likelihood that material misstatements will not be prevented or detected by internal control.

Answer: B

Terms: Reasonable assurance

Diff: Easy

Objective: LO 10-1

AACSB: Reflective thinking skills

Topic: Public

3) Which of the following is most correct regarding the requirements under Section 404 of the Sarbanes Oxley Act?

- A) The audits of internal control and the financial statements provide reasonable assurance as to misstatements.
- B) The audit of internal control provides absolute assurance of misstatement.
- C) The audit of financial statements provides absolute assurance of misstatement.
- D) The audits of internal control and the financial statements provide absolute assurance as to misstatements.

Answer: A

Terms: Sarbanes Oxley Act Section 404

Diff: Easy

Objective: LO 10-1

AACSB: Reflective thinking skills

4) Which of management's assertions with respect to implementing internal controls is the auditor primarily concerned?

- A) efficiency of operations
- B) reliability of financial reporting
- C) effectiveness of operations
- D) compliance with applicable laws and regulations

Answer: B

Terms: Management's assertions

Diff: Easy

Objective: LO 10-1

AACSB: Reflective thinking skills

5) To issue a report on internal control over financial reporting for a public company, an auditor must:

- A) evaluate management's assessment process.
- B) independently assess the design and operating effectiveness of internal control.
- C) evaluate management's assessment process and independently assess the design and operating effectiveness of internal control.
- D) test controls over significant account balances.

Answer: C

Terms: Internal control over financial reporting for public company

Diff: Moderate

Objective: LO 10-1

AACSB: Reflective thinking skills

Topic: Public

6) A company frequently sells products at a price below inventory cost. Essential controls in the risk assessment process would include:

- A) adequate controls that address the risk of overstating inventory.
- B) adequate controls that address the risk of not including a purchased item in inventory.
- C) adequate controls that address the risk of understatement of inventory.
- D) adequate controls that address the risk of overstatement of cost of goods sold.

Answer: A

Terms: Controls in risk assessment process

Diff: Moderate

Objective: LO 10-1

AACSB: Analytic skills

7) Internal controls are not designed to provide reasonable assurance that:

- A) all frauds will be detected.
- B) transactions are executed in accordance with management's authorization.
- C) access to assets is permitted only in accordance with management's authorization.
- D) company personnel comply with applicable rules and regulations.

Answer: A

Terms: Internal controls; reasonable assurance

Diff: Moderate

Objective: LO 10-1

AACSB: Analytic skills

8) Describe each of the three broad objectives management typically has for internal control. With which of these objectives is the auditor primarily concerned?

Answer: The three objectives are:

- Reliability of financial reporting. Management has both a legal and professional responsibility to be sure that the information is fairly presented in accordance with reporting requirements such as GAAP.
- Efficiency and effectiveness of operations. Controls within an organization are meant to encourage efficient and effective use of its resources to optimize the company's goals.
- Compliance with laws and regulations. Public, non-public, 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.

The auditor's focus in both the audit of financial statements and the audit of internal controls is on the controls over the reliability of financial reporting plus those controls over operations and compliance with laws and regulations that could materially affect financial reporting.

Terms: Three broad objectives management has for internal control

Diff: Easy

Objective: LO 10-1

AACSB: Reflective thinking skills

9) The Sarbanes-Oxley Act of 2002 requires that public companies issue an internal control report.

A) True

B) False

Answer: A

Terms: Sarbanes-Oxley Act

Diff: Easy

Objective: LO 10-1

AACSB: Reflective thinking skills

Topic: SOX

10) The primary emphasis by auditors when evaluating and testing internal control is on controls over classes of transactions rather than controls over account balances.

A) True

B) False

Answer: A

Terms: Evaluating and testing internal controls

Diff: Moderate

Objective: LO 10-1

AACSB: Reflective thinking skills

Learning Objective 10-2

1) Which of the following is responsible for establishing a private company's internal control?

- A) Senior Management
- B) Internal Auditors
- C) Senior Management and auditors
- D) Audit committee

Answer: A

Terms: Internal control

Diff: Easy

Objective: LO 10-2

AACSB: Reflective thinking skills

2) Two key concepts that underlie management's design and implementation of internal control are:

- A) costs and materiality.
- B) absolute assurance and costs.
- C) inherent limitations and reasonable assurance.
- D) collusion and materiality.

Answer: C

Terms: Internal control design and implementation

Diff: Easy

Objective: LO 10-2

AACSB: Analytic skills

3) The PCAOB places responsibility for the reliability of internal controls over the financial reporting process to:

- A) the company's board of directors.
- B) the audit committee of the board of directors.
- C) the CEO and the CFO.
- D) the CFO and the Independent Auditors.

Answer: C

Terms: PCAOB; internal control responsibility

Diff: Easy

Objective: LO 10-2

AACSB: Reflective thinking skills

Topic: Public

4) Which of the following parties provides an assessment of the effectiveness of internal control over financial reporting for public companies?

A)

Management	Financial statement auditors
Yes	Yes

B)

Management	Financial statement auditors
No	No

C)

Management	Financial statement auditors
Yes	No

D)

Management	Financial statement auditors
No	Yes

Answer: A

Terms: Internal control effectiveness

Diff: Easy

Objective: LO 10-2

AACSB: Reflective thinking skills

5) An act of two or more employees to steal assets and cover their theft by misstating the accounting records would be referred to as:

A) collusion.

B) a material weakness.

C) a control deficiency.

D) a significant deficiency.

Answer: A

Terms: Employees steal assets

Diff: Easy

Objective: LO 10-2

AACSB: Ethical understanding and reasoning abilities

6) Sarbanes-Oxley requires management to issue an internal control report that includes two specific items. Which of the following is one of these two requirements?

A) A statement that management is responsible for establishing and maintaining an adequate internal control structure and procedures for financial reporting.

B) A statement that management and the board of directors are jointly responsible for establishing and maintaining an adequate internal control structure and procedures for financial reporting.

C) A statement that management, the board of directors, and the external auditors are jointly responsible for establishing and maintaining an adequate internal control structure and procedures for financial reporting.

D) A statement that the external auditors are solely responsible.

Answer: A

Terms: Sarbanes-Oxley; Internal control report

Diff: Easy

Objective: LO 10-2

AACSB: Reflective thinking skills

Topic: SOX

7) When management is evaluating the design of internal control, management evaluates whether the control can do which of the following?

A)

Detect material misstatements	Correct material misstatements
Yes	Yes

B)

Detect material misstatements	Correct material misstatements
No	No

C)

Detect material misstatements	Correct material misstatements
Yes	No

D)

Detect material misstatements	Correct material misstatements
No	Yes

Answer: C

Terms: Internal control design

Diff: Easy

Objective: LO 10-2

AACSB: Analytic skills

Topic: SOX

8) When one material weakness is present at the end of the year, management of a public company must conclude that internal control over financial reporting is:

- A) insufficient.
- B) inadequate.
- C) ineffective.
- D) inefficient.

Answer: C

Terms: Internal control weakness; Public company

Diff: Easy

Objective: LO 10-2

AACSB: Analytic skills

Topic: Public

9) The auditors primary purpose in auditing the client's system of internal control over financial reporting is:

- A) to prevent fraudulent financial statements from being issued to the public.
- B) to evaluate the effectiveness of the company's internal controls over all relevant assertions in the financial statements.
- C) to report to management that the internal controls are effective in preventing misstatements from appearing on the financial statements.
- D) to efficiently conduct the Audit of Financial Statements.

Answer: B

Terms: Primary purpose to audit system of internal control

Diff: Moderate

Objective: LO 10-2

AACSB: Analytic skills

Topic: Public

10) Management must disclose material weaknesses in internal control in its audit report:

- A) whenever the weakness is deemed significant to a single class of transactions.
- B) whenever the weakness is significant to overall financial reporting objectives.
- C) if the weakness exists at the end of the year.
- D) only if the auditor identifies the weakness as significant.

Answer: C

Terms: Material weaknesses in internal control

Diff: Moderate

Objective: LO 10-2

AACSB: Reflective thinking skills

Topic: Public

11) In performing the audit of internal control over financial reporting the auditor emphasizes internal control over class of transactions because:

- A) the accuracy of accounting system outputs depends heavily on the accuracy of inputs and processing.
- B) the class of transaction is where most fraud schemes occur.
- C) account balances are less important to the auditor than the changes in the account balances.
- D) classes of transactions tests are the most efficient manner to compensate for inherent risk.

Answer: A

Terms: Internal control over class of transactions

Diff: Moderate

Objective: LO 10-2

AACSB: Reflective thinking skills

Topic: Public

12) Internal controls can never be regarded as completely effective. Even if company personnel could design an ideal system, its effectiveness depends on the:

- A) adequacy of the computer system.
- B) proper implementation by management.
- C) ability of the internal audit staff to maintain it.
- D) competency and dependability of the people using it.

Answer: D

Terms: Internal control effectiveness

Diff: Moderate

Objective: LO 10-2

AACSB: Ethical understanding and reasoning abilities

13) Even with the most effectively designed internal control, the auditor must obtain audit evidence, beyond testing the controls, for every:

- A) transaction.
- B) financial statement account.
- C) material financial statement account.
- D) financial statement account that will be relied upon by third parties.

Answer: C

Terms: Effectively designed internal controls; testing of controls

Diff: Moderate

Objective: LO 10-2

AACSB: Analytic skills

14) Of the following statements about internal controls, which one is least likely to be correct?

- A) No one person should be responsible for the custodial responsibility and the recording responsibility for an asset.
- B) Transactions must be properly authorized before such transactions are processed.
- C) Because of the cost-benefit relationship, a client may apply controls on a test basis.
- D) Control procedures reasonably ensure that collusion among employees cannot occur.

Answer: D

Terms: Internal controls

Diff: Moderate

Objective: LO 10-2

AACSB: Reflective thinking skills

15) The Sarbanes-Oxley Act requires:

- A) all public companies to issue reports on internal controls.
- B) all public companies to define adequate internal controls.
- C) the auditor of public companies to design effective ICFR.
- D) the auditor of public companies to provide recommendations to correct material weaknesses.

Answer: A

Terms: Sarbanes-Oxley Act

Diff: Challenging

Objective: LO 10-2

AACSB: Reflective thinking skills

Topic: SOX

16) The financial statements may not correctly reflect accounting frameworks such as AAP or IFRS if the:

- A) controls affecting the reliability of financial reporting are inadequate.
- B) company's controls do not promote efficiency.
- C) company's controls do not promote effectiveness.
- D) company's controls do not promote compliance with applicable rules and regulations.

Answer: A

Terms: Financial statements reflect accounting frameworks

Diff: Challenging

Objective: LO 10-2

AACSB: Reflective thinking skills

17) The primary emphasis by auditors is on controls over:

- A) classes of transactions.
- B) account balances.
- C) both A and B, because they are equally important.
- D) both A and B, because they vary from client to client.

Answer: A

Terms: Primary emphasis by auditors on controls

Diff: Challenging

Objective: LO 10-2

AACSB: Reflective thinking skills

18) An auditor should consider two key issues when obtaining an understanding of a client's internal controls. These issues are:

- A) the effectiveness and efficiency of the controls.
- B) the frequency and effectiveness of the controls.
- C) the design and implementation of the controls.
- D) the implementation and efficiency of the controls.

Answer: C

Terms: Key issues understanding client's internal controls

Diff: Challenging

Objective: LO 10-2

AACSB: Reflective thinking skills

19) When a company designs and implements internal controls, cost of the controls is **not** a valid consideration.

A) True

B) False

Answer: B

Terms: Design and implement internal control; cost

Diff: Easy

Objective: LO 10-2

AACSB: Reflective thinking skills

Learning Objective 10-3

1) Which of the following activities would be least likely to strengthen a company's internal control?

A) separating accounting from other financial operations

B) maintaining insurance for fire and theft

C) fixing responsibility for the performance of employee duties

D) carefully selecting and training employees

Answer: B

Terms: Not strengthen internal control

Diff: Easy

Objective: LO 10-3

AACSB: Analytic skills

2) Which of the following components of the control environment define the existing lines of responsibility and authority?

A) Organizational Structure

B) Management philosophy and operating style

C) Human resource policies and practices

D) Management integrity and ethical values

Answer: A

Terms: Control environment components; Responsibility and authority

Diff: Moderate

Objective: LO 10-3

AACSB: Reflective thinking skills

3) Which of the following factors may increase risks to an organization?

A)

Geographic dispersion of company operations	Presence of new information technologies
Yes	Yes

B)

Geographic dispersion of company operations	Presence of new information technologies
No	No

C)

Geographic dispersion of company operations	Presence of new information technologies
Yes	No

D)

Geographic dispersion of company operations	Presence of new information technologies
No	Yes

Answer: A

Terms: Increase risks to an organization

Diff: Moderate

Objective: LO 10-3

AACSB: Analytic skills

4) Which of the following statements is most correct with respect to separation of duties?

A) Employees should not have temporary and permanent custody of assets.

B) Employees who authorize transactions should not have custody of related assets.

C) It is permissible to allow an employee to open cash receipts and record those receipts.

D) Employees who authorize transactions should have recording responsibility for these transactions.

Answer: B

Terms: Separation of duties

Diff: Moderate

Objective: LO 10-3

AACSB: Reflective thinking skills

5) Authorizations can be either general or specific. Which of the following is not an example of a general authorization?

A) Automatic reorder points for raw materials inventory.

B) A sales manager's authorization for a sales return.

C) Credit limits for various classes of customers.

D) A sales price list for merchandise.

Answer: B

Terms: General or specific authorizations

Diff: Moderate

Objective: LO 10-3

AACSB: Reflective thinking skills

6) Which of the following is correct with respect to the design and use of business documents?

- A) Not all documents used for internal purposes need to be prenumbered.
- B) Documents should be designed for single purposes only to avoid confusion in their use.
- C) Documents should be designed to be understandable only by those who use them.
- D) Documents designed for external use must be prenumbered.

Answer: D

Terms: Design and use of business documents

Diff: Moderate

Objective: LO 10-3

AACSB: Reflective thinking skills

7) Which of the following best describes the purpose of control activities?

- A) the actions, policies and procedures that reflect the overall attitudes of management
- B) the identification and analysis of risks relevant to the preparation of financial statements
- C) the policies and procedures that help ensure that necessary actions are taken to address risks to the achievement of the entity's objectives
- D) activities that deal with the ongoing assessment of the quality of internal control by management

Answer: C

Terms: Control activities

Diff: Moderate

Objective: LO 10-3

AACSB: Reflective thinking skills

8) Which of the following deal with ongoing or periodic assessment of the quality of internal control by management?

- A) Quality monitoring activities
- B) Monitoring activities
- C) Oversight activities
- D) Management activities

Answer: B

Terms: Quality of internal control

Diff: Moderate

Objective: LO 10-3

AACSB: Reflective thinking skills

9) Which of the following best describes an entity's accounting information and communication system?

A)

Monitor transactions	Record and process transactions	Initiate transactions
Yes	Yes	Yes

B)

Monitor transactions	Record and process transactions	Initiate transactions
No	No	No

C)

Monitor transactions	Record and process transactions	Initiate transactions
Yes	No	No

D)

Monitor transactions	Record and process transactions	Initiate transactions
No	Yes	Yes

Answer: D

Terms: Accounting information and communication system

Diff: Moderate

Objective: LO 10-3

AACSB: Reflective thinking skills

10) An audit procedure that would most likely be used by an auditor in performing tests of control procedures in which the segregation of functions and that leaves no "audit" trail is:

A) inspection.

B) observation.

C) reperformance.

D) reconciliation.

Answer: B

Terms: Tests of control procedures; segregation of functions

Diff: Moderate

Objective: LO 10-3

AACSB: Reflective thinking skills

11) Internal controls normally include procedures designed to provide reasonable assurance that:

- A) employees act with integrity when performing their assigned tasks.
- B) transactions are executed in accordance with management's authorization.
- C) decision processes leading to management's authorization of transactions are sound.
- D) collusive activities would be detected by segregation of employee duties.

Answer: B

Terms: Internal controls; reasonable assurance

Diff: Moderate

Objective: LO 10-3

AACSB: Reflective thinking skills

12) Which of the following is not one of the subcomponents of the control environment?

- A) management's philosophy and operating style
- B) organizational structure
- C) adequate separation of duties
- D) commitment to competence

Answer: C

Terms: Subcomponents of control environment

Diff: Moderate

Objective: LO 10-3

AACSB: Reflective thinking skills

13) It is important for the CPA to consider the competence of the clients' personnel because their competence bears directly and importantly upon the:

- A) cost/benefit relationship of the system of internal control.
- B) achievement of the objectives of internal control.
- C) comparison of recorded accountability with assets.
- D) timing of the tests to be performed.

Answer: B

Terms: Competence of client personnel

Diff: Moderate

Objective: LO 10-3

AACSB: Reflective thinking skills

14) Proper segregation of functional responsibilities calls for separation of:

- A) authorization, execution, and payment.
- B) authorization, recording, and custody.
- C) custody, execution, and reporting.
- D) authorization, payment, and recording.

Answer: B

Terms: Segregation of functional responsibilities

Diff: Moderate

Objective: LO 10-3

AACSB: Reflective thinking skills

15) Which of the following is correct regarding management's documentation of internal controls?

- A) inadequate documentation is not a control deficiency
- B) documentation needs to focus on interim controls
- C) documentation needs to have some focus on controls designed to detect fraud
- D) documentation should only focus on system design

Answer: C

Terms: Documentation of internal control

Diff: Challenging

Objective: LO 10-3

AACSB: Reflective thinking skills

16) Which of the following groups establishes and maintains the company's internal controls?

- A) Internal auditors
- B) Board of Directors
- C) Management
- D) Audit committee

Answer: C

Terms: Establishes and maintains company's internal control

Diff: Challenging

Objective: LO 10-3

AACSB: Reflective thinking skills

17) The independent auditor should acquire an understanding of the internal audit function as it relates to the independent auditor's study and evaluation of internal control because the:

- A) audit programs, working papers, and reports of internal auditors can often be used as a substitute for the work of the independent auditor's staff.
- B) procedures performed by the internal audit staff may eliminate the independent auditor's need for an extensive study and evaluation of internal control.
- C) work performed by internal auditors may be a factor in determining the nature, timing, and extent of the independent auditor's procedures.
- D) understanding of the internal audit function is an important substantive test to be performed by the independent auditor.

Answer: C

Terms: Understanding of internal audit functions

Diff: Challenging

Objective: LO 10-3

AACSB: Analytic skills

18) To promote operational efficiency, the internal audit department would ideally report to:

- A) line management.
- B) senior management.
- C) Chief Accounting Officer.
- D) audit committee.

Answer: D

Terms: Operational efficiency

Diff: Challenging

Objective: LO 10-3

AACSB: Reflective thinking skills

19) Hanlon Corp. maintains a large internal audit staff that reports directly to the chief financial officer. Audit reports prepared by the internal auditors indicate that the system is functioning as it should and that the accounting records are reliable. An independent auditor will probably:

- A) eliminate tests of controls.
- B) increase the depth of the study and evaluation of administrative controls.
- C) avoid duplicating the work performed by the internal audit staff.
- D) place limited reliance on the work performed by the internal audit staff.

Answer: D

Terms: Internal audit

Diff: Challenging

Objective: LO 10-3

AACSB: Analytic skills

20) External financial statement auditors must obtain evidence regarding what attributes of an internal audit (IA) department if the external auditors intend to rely on IA's work?

- A) Integrity
- B) Objectivity
- C) Competence
- D) All of the above

Answer: D

Terms: External auditor reliance on internal auditors' work

Diff: Challenging

Objective: LO 10-3

AACSB: Reflective thinking skills

21) To obtain an understanding of an entity's control environment, an auditor should concentrate on the substance of management's policies and procedures rather than their form because:

- A) management may establish appropriate policies and procedures but not act on them.
- B) the board of directors may not be aware of management's attitude toward the control environment.
- C) the auditor may believe that the policies and procedures are inappropriate for that particular entity.
- D) the policies and procedures may be so weak that no reliance is contemplated by the auditor.

Answer: A

Terms: Substance of management's policies and procedures

Diff: Challenging

Objective: LO 10-3

AACSB: Analytic skills

22) Control activities help assure that the necessary actions are taken to address risks to the achievement of the company's objectives. List the five types of control activities.

Answer:

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

Terms: Control activities

Diff: Moderate

Objective: LO 10-3

AACSB: Reflective thinking skills

Topic: Public

23) Certain principles dictate the proper design and use of documents and records. Briefly describe several of these principles.

Answer:

- Documents should be prenumbered consecutively to facilitate control over missing documents and as an aid in locating documents when they are needed at a later date.
- Documents and records should be prepared at the time a transaction takes place, or as soon as possible thereafter, to minimize timing errors.
- Documents and records should be designed for multiple uses, when possible, to minimize the number of different forms. For example, a properly designed and used shipping document 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.
- Documents and records should be 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 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.

Terms: Principles for design and use of documents and records

Diff: Moderate

Objective: LO 10-3

AACSB: Reflective thinking skills

24) Management's identification and analysis of risk is an ongoing process and is a critical component of effective internal control. An important first step is for management to identify factors that may increase risk. Identify at least five factors, observable by management, which may lead to increased risk in a typical business organization.

Answer: There are many factors that may lead to increased risk in an organization. Some examples include:

- 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, and
- entrance of new competitors.

Terms: Factors which may lead to increased risk

Diff: Moderate

Objective: LO 10-3

AACSB: Reflective thinking skills

25) Separation of duties is essential in preventing errors and intentional misstatements on the financial statements. List below the four general guidelines.

Answer:

1. Separation of custody of the assets from accounting
2. Separation of the authorization of transactions from custody of related assets
3. Separation of operational responsibility from record keeping responsibility
4. Separation of IT duties from user departments

Terms: General guidelines for separation of duties

Diff: Moderate

Objective: LO 10-3

AACSB: Reflective thinking skills

26) In developing an understanding of the client's accounting information system the auditor follows a sequential process. Describe the process below:

Answer:

1. Major classes of transactions of the entity
2. How these 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
5. The nature and details of the financial reporting process followed

Terms: Sequential process

Diff: Moderate

Objective: LO 10-3

AACSB: Reflective thinking skills

27) The internal control framework developed by COSO includes five so-called "components" of internal control. Discuss each of these five components.

Answer: Five components of internal control are:

- *The control environment.* 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 company.
- *Risk assessment.* This is management's identification and analysis of risks relevant to the preparation of financial statements in conformance with appropriate accounting standards.
- *Information and communication.* The purpose of the entity's system is to initiate, record, process, and report the entity's transactions and to maintain accountability for the related assets.
- *Control activities.* These are the policies and procedures that help ensure that necessary actions are taken to address risks to the achievement of the entity's objectives.
- *Monitoring.* This is management's ongoing and 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.

Terms: Internal control framework; COSO

Diff: Moderate

Objective: LO 10-3

AACSB: Reflective thinking skills

28) Discuss what is meant by the term "control environment" and identify four control environment subcomponents that the auditor should consider.

Answer: 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 control and its importance to the entity. Subcomponents include integrity and ethical values, commitment to competence, board of directors or audit committee participation, management's philosophy and operating style, organizational structure, assignment of authority and responsibility and human resource policies and practices.

Terms: Control environment

Diff: Moderate

Objective: LO 10-3

AACSB: Reflective thinking skills

29) Adequate separation of duties is an important control activity. Discuss the four general guidelines for separation of duties to prevent both intentional and unintentional misstatements that are of significance to auditors.

Answer: The general guidelines are:

- Custody of assets should be separated from accounting,
- Authorizing transactions should be separated from custody of related assets,
- Operational responsibility should be separated from record-keeping, and
- IT duties should be separated from user departments.

Terms: Separation of duties

Diff: Challenging

Objective: LO 10-3

AACSB: Reflective thinking skills

30) As a client's information system becomes more complex, it is likely that an auditor will increase reliance on controls and decrease substantive tests to support a control risk assessment.

A) True

B) False

Answer: A

Terms: Complex information system

Diff: Easy

Objective: LO 10-3

AACSB: Analytic skills

31) *Adequate documents and records* is a subcomponent of the *control environment*.

A) True

B) False

Answer: B

Terms: Control environment

Diff: Easy

Objective: LO 10-3

AACSB: Reflective thinking skills

32) The chart of accounts is a control and is closely related to the controls related to adequate documents and records.

A) True

B) False

Answer: A

Terms: Chart of accounts

Diff: Easy

Objective: LO 10-3

AACSB: Reflective thinking skills

33) Auditing standards prohibit reliance on the work of internal auditors due to the lack of independence of the internal auditors.

A) True

B) False

Answer: B

Terms: Auditing standards; internal auditors

Diff: Moderate

Objective: LO 10-3

AACSB: Reflective thinking skills

34) If an auditor wishes to rely on the work of internal auditors (IA), the auditor must obtain satisfactory evidence related to the IA's competence, integrity, and objectivity.

A) True

B) False

Answer: A

Terms: Internal auditors

Diff: Moderate

Objective: LO 10-3

AACSB: Reflective thinking skills

Learning Objective 10-4

1) When the auditor attempts to understand the operation of the accounting system by tracing a few transactions through the accounting system, the auditor is said to be:

A) tracing.

B) vouching.

C) performing a walk-through.

D) testing controls.

Answer: C

Terms: Tracing transactions through accounting system

Diff: Easy

Objective: LO 10-4

AACSB: Analytic skills

2) The purpose of phase 3 in the "process for understanding internal control and assessing control risk" is to:

- A) design, perform and evaluate tests of controls.
- B) obtain and document an understanding of internal control design an operation.
- C) assess control risk.
- D) decide planned detection risk and substantive tests.

Answer: A

Terms: Process for understanding internal control and assessing risk

Diff: Moderate

Objective: LO 10-4

AACSB: Reflective thinking skills

3) Narratives, flowcharts, and internal control questionnaires are three common methods of:

- A) testing the internal controls.
- B) documenting the auditor's understanding of internal controls.
- C) designing the audit manual and procedures.
- D) documenting the auditor's understanding of a client's organizational structure.

Answer: B

Terms: Narratives, flowcharts, and internal control questionnaires

Diff: Easy

Objective: LO 10-4

AACSB: Reflective thinking skills

4) Audit evidence concerning proper segregation of duties normally is best obtained by:

- A) direct personal observation of the employee who applies control procedures.
- B) making inquiries of co-workers about the employee who applies control procedures.
- C) preparation of a flowchart of duties performed and available personnel.
- D) inspection of third-party documents containing the initials of who applied control procedures.

Answer: A

Terms: Evidence of proper segregation of duties

Diff: Moderate

Objective: LO 10-4

AACSB: Reflective thinking skills

5) Audit evidence regarding the separation of duties is normally best obtained by:

- A) preparing flowcharts of operational processes.
- B) preparing narratives of operational processes.
- C) observation of employees applying control activities.
- D) inquiries of employees applying control activities.

Answer: C

Terms: Audit evidence of separation of duties

Diff: Moderate

Objective: LO 10-4

AACSB: Reflective thinking skills

6) Section 404 requires auditors to perform walkthroughs to assist in understanding internal control.

A) True

B) False

Answer: A

Terms: Walkthroughs; understanding internal control

Diff: Easy

Objective: LO 10-4

AACSB: Reflective thinking skills

Topic: Public

7) Procedures used to obtain an understanding of internal control are normally performed on fewer transactions than procedures used to test controls.

A) True

B) False

Answer: A

Terms: Understanding internal controls

Diff: Moderate

Objective: LO 10-4

AACSB: Reflective thinking skills

8) For most uses, flowcharts are superior to narratives as a method of communicating the characteristics of internal control.

A) True

B) False

Answer: A

Terms: Flowcharts

Diff: Moderate

Objective: LO 10-4

AACSB: Reflective thinking skills

9) When documenting their understanding of a client's internal controls, auditors are required to use narratives.

A) True

B) False

Answer: B

Terms: Understanding internal controls; narratives

Diff: Moderate

Objective: LO 10-4

AACSB: Reflective thinking skills

Learning Objective 10-5

1) The person responsible for reconciling sales invoices to customer orders does not access to the company's master price list in order to correctly compute sales. This is an example of a(n):

- A) operating deficiency.
- B) design deficiency.
- C) training deficiency.
- D) management deficiency.

Answer: B

Terms: Reconciling sales invoices to correctly compute sales

Diff: Moderate

Objective: LO 10-5

AACSB: Analytic skills

2) You are performing the audit of internal control for Clifton Company. Which of the following would represent a material weakness in internal control?

- A) The company's audit committee has experienced unusual turnover of members.
- B) The company's CFO was indicted for embezzling from the company.
- C) Bank reconciliations are done monthly.
- D) The CEO was forced to resign due to an inappropriate relationship with an outside vendor.

Answer: B

Terms: Material weaknesses in internal control

Diff: Moderate

Objective: LO 10-5

AACSB: Analytic skills

Topic: Public

3) The employee in charge of authorizing credit to the company's customers does not fully understand the concept of credit risk. This lack of knowledge would constitute:

- A) a deficiency in operation of internal controls.
- B) a deficiency in design of internal controls.
- C) a deficiency of management.
- D) not constitute a deficiency.

Answer: A

Terms: Lack of knowledge

Diff: Moderate

Objective: LO 10-5

AACSB: Ethical understanding and reasoning abilities

4) Section 404 requires auditors to evaluate the effectiveness of the audit committee's oversight of the company's:

A)

External financial reporting	Efficiency of operations	Internal control over financial reporting
Yes	No	Yes

B)

External financial reporting	Efficiency of operations	Internal control over financial reporting
No	No	Yes

C)

External financial reporting	Efficiency of operations	Internal control over financial reporting
Yes	Yes	No

D)

External financial reporting	Efficiency of operations	Internal control over financial reporting
No	Yes	No

Answer: A

Terms: Effectiveness of audit committee's oversight

Diff: Moderate

Objective: LO 10-5

AACSB: Reflective thinking skills

Topic: Public

5) Once auditors determine that entity level controls are designed and placed in the operation they:

A) make a preliminary assessment for each transaction-related audit objective for each major type of transaction.

B) make a preliminary assessment of control risk.

C) obtain an understanding of the design and implementation of internal control.

D) prepare audit documentation in order to opine on the company's internal control system.

Answer: A

Terms: Entity level controls

Diff: Moderate

Objective: LO 10-5

AACSB: Analytic skills

6) Which of the following is the correct definition of "control deficiency"?

- A) 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.
- B) A control deficiency exists if one or more deficiencies exist that adversely affect a company's ability to prepare external financial statements reliably.
- C) A control deficiency exists if the design or operation of controls results in a more than remote likelihood that controls will not prevent or detect misstatements.
- D) A control deficiency exists if the design or operation of controls results in a more than probable likelihood that controls will prevent or detect misstatements.

Answer: A

Terms: Control deficiency

Diff: Moderate

Objective: LO 10-5

AACSB: Reflective thinking skills

7) Which of the following deficiency exists if a necessary control is missing or not properly formulated?

- A) control
- B) significant
- C) design
- D) operating

Answer: C

Terms: Control deficiency

Diff: Moderate

Objective: LO 10-5

AACSB: Reflective thinking skills

8) To determine if significant internal control deficiencies are material weaknesses, they must be evaluated on their:

A)

Likelihood	Significance
Yes	Yes

B)

Likelihood	Significance
No	No

C)

Likelihood	Significance
Yes	No

D)

Likelihood	Significance
No	Yes

Answer: A

Terms: Internal control deficiencies are material weaknesses

Diff: Moderate

Objective: LO 10-5

AACSB: Reflective thinking skills

9) Significant deficiencies need to be communicated to the company's audit committee because:

- A) they represent material weaknesses that allow fraud to be perpetrated.
- B) they represent significant design flaws in internal controls.
- C) they represent falsification of accounting records.
- D) they represent disclosure of information related to issuance of a "going-concern" opinion.

Answer: B

Terms: Significant deficiencies

Diff: Moderate

Objective: LO 10-5

AACSB: Reflective thinking skills

10) Before making the final assessment of internal control at the end of an integrated audit, the auditor must:

A)

Test controls	Perform substantive tests of details
Yes	Yes

B)

Test controls	Perform substantive tests of details
No	No

C)

Test controls	Perform substantive tests of details
Yes	No

D)

Test controls	Perform substantive tests of details
No	Yes

Answer: A

Terms: Final assessment of internal control for integrated audit

Diff: Moderate

Objective: LO 10-5

AACSB: Analytic skills

Topic: Public

11) Significant deficiencies and material weaknesses in internal control of a public company must be reported in writing to which of the following?

- A) the Public Company Accounting Oversight Board
- B) members of management who are responsible for the related area of the company
- C) audit committee of the company's board of directors
- D) the AICPA

Answer: C

Terms: Internal controls; significant deficiencies; material weaknesses

Diff: Moderate

Objective: LO 10-5

AACSB: Reflective thinking skills

Topic: Public

12) Significant deficiencies are matters that come to an auditor's attention and should be communicated to an entity's audit committee because they represent:

- A) material frauds perpetrated by high-level management.
- B) internal control deficiencies that could adversely affect a company's ability to initiate, record, process, or report external financial statements reliably.
- C) flagrant violations of the entity's documented conflict-of-interest policies.
- D) intentional attempts by client personnel to limit the scope of the auditor's field work.

Answer: B

Terms: Significant deficiencies; audit committee

Diff: Moderate

Objective: LO 10-5

AACSB: Analytic skills

13) How must significant deficiencies and material weaknesses be communicated to those charged with governance?

- A) Either oral or written communication is acceptable.
- B) Oral communication is required.
- C) Written communication is required.
- D) Written communication is required for material weaknesses, but oral communication is allowed for significant deficiencies.

Answer: C

Terms: Significant deficiencies and material weaknesses; governance

Diff: Moderate

Objective: LO 10-5

AACSB: Reflective thinking skills

14) When considering internal control, an auditor should be aware of the concept of reasonable assurance, which recognizes that the:

- A) segregation of incompatible functions is necessary to ascertain that internal control is effective.
- B) employment of competent personnel provides assurance that the objectives of internal control will be achieved.
- C) establishment and maintenance of internal control is an important responsibility of the management and not of the auditor.
- D) concept allows for only a remote likelihood that material misstatements will not be prevented or detected on a timely basis.

Answer: D

Terms: Internal control; reasonable assurance

Diff: Challenging

Objective: LO 10-5

AACSB: Analytic skills

15) When planning an audit, the auditor's assessed level of control risk is:

- A) determined by using actuarial tables.
- B) calculated by using the audit risk model.
- C) a judgment issue, based on auditor knowledge.
- D) calculated by using the formulas provided in the AICPA's auditing standards.

Answer: C

Terms: Assessed level of control risk

Diff: Challenging

Objective: LO 10-5

AACSB: Reflective thinking skills

16) When a compensating control exists, the absence of a key control:

- A) is no longer a concern because there is no longer a significant deficiency or material weakness.
- B) is still a major concern to the auditor.
- C) could cause a material loss, so it must be tested using substantive procedures.
- D) is magnified and must be removed from the sampling process and examined in its entirety.

Answer: A

Terms: Compensating control; key control

Diff: Challenging

Objective: LO 10-5

AACSB: Analytic skills

17) You are the audit manager for a new audit client. Your staff auditors are unsure of what constitutes a control deficiency. Discuss the definition of control deficiency. In your response include at least two examples of control deficiencies.

Answer: 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 assigned functions.

Design Deficiency exists if a necessary control is missing or not properly designed.

Operating Deficiency exists if a well-designed control does not operate as designed or if the person performing the control is insufficiently qualified or authorized.

Terms: Control deficiency; Design deficiency; Operating deficiency

Diff: Moderate

Objective: LO 10-5

AACSB: Reflective thinking skills

18) Define the following terms: control deficiency, significant deficiency, and material weakness.

Answer:

- 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 significant deficiency exists if 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 statements.
- 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.

Terms: Control deficiency; Significant deficiency; Material weakness

Diff: Moderate

Objective: LO 10-5

AACSB: Reflective thinking skills

19) Describe the auditor's responsibilities related to required communications between the auditor and those charged with governance (remove auditor committee) regarding internal control.

Answer: The auditor must communicate significant deficiencies and material weaknesses in writing to those charged with governance as soon as they become 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.

Terms: Control activities

Diff: Challenging

Objective: LO 10-5

AACSB: Reflective thinking skills

20) The text suggested a five-step approach to identify deficiencies, significant deficiencies, and material weaknesses. Describe this approach.

Answer:

1. *Identify existing controls.* Because deficiencies and material weaknesses are the absence of adequate controls, the auditor must first know which controls exist.
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.
3. *Consider the possibility of compensating controls.* A compensating control is one elsewhere in the system that offsets the absence of a key control. 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.

Terms: Required communications between auditor and those charged with governance

Diff: Challenging

Objective: LO 10-5

AACSB: Reflective thinking skills; Analytic skills

21) The most important component of internal control is risk assessment.

A) True

B) False

Answer: B

Terms: Internal control risk assessment

Diff: Moderate

Objective: LO 10-5

AACSB: Reflective thinking skills

Learning Objective 10-6

1) If the results of tests of controls support the design and operations of controls as expected, the auditor uses _____ control risk as the preliminary assessment.

A) a lower

B) the same

C) a higher

D) either a lower or higher

Answer: B

Terms: Control risk as preliminary assessment

Diff: Moderate

Objective: LO 10-6

AACSB: Analytic skills

2) An auditor is likely to use four types of procedures to support the operating effectiveness of internal controls. Which of the following would generally NOT be used?

- A) make inquiries of appropriate client personnel
- B) examine documents, records, and reports
- C) reperform client procedures
- D) inspect design documents

Answer: D

Terms: Operating effectiveness of internal controls

Diff: Moderate

Objective: LO 10-6

AACSB: Reflective thinking skills

3) After considering a client's internal controls, an auditor has concluded that it is well designed and is functioning as intended. Under these circumstances the auditor would most likely:

- A) perform tests of controls to the extent outlined in the audit program.
- B) determine the control procedures that should prevent or detect errors and irregularities.
- C) not increase the extent of predetermined substantive tests.
- D) determine whether transactions are recorded to permit preparation of financial statements in conformity with generally accepted accounting principles.

Answer: C

Terms: Internal control design and functioning

Diff: Challenging

Objective: LO 10-6

AACSB: Analytic skills

4) In evaluating the operational effectiveness of internal controls the auditor is likely to use four types of audit procedures. List the procedures below.

Answer:

- Make inquiries of appropriate client personnel
- Examine documents, records, and reports
- Observe control-related activities
- Reperform client procedures

Terms: Operational effectiveness; internal controls; audit procedures

Diff: Challenging

Objective: LO 10-6

AACSB: Reflective thinking skills

5) When internal controls are highly effective in processing accounting transactions, the extent of substantive tests should be reduced.

- A) True
- B) False

Answer: A

Terms: Processing accounting transactions; substantive tests

Diff: Easy

Objective: LO 10-6

AACSB: Analytic skills

6) When internal controls over a given financial statement account are assessed as highly effective, the auditor need not obtain audit evidence for that account beyond testing the controls.

A) True

B) False

Answer: B

Terms: Internal controls highly effective

Diff: Moderate

Objective: LO 10-6

AACSB: Analytic skills

Learning Objective 10-7

1) In performing an audit of internal control over financial reporting which of the following is the auditor required to do?

A) Test routine and nonroutine transactions equally.

B) Form an opinion on the effectiveness of internal for financial reporting.

C) Rely on the work on internal auditors in order to promote audit efficiency.

D) Use the audit conclusions before starting the audit of financial statements.

Answer: B

Terms: Internal control audit requirements of auditor

Diff: Easy

Objective: LO 10-7

AACSB: Reflective thinking skills

Topic: SOX

2) The criterion that is most likely to be used as a framework in evaluating a company's internal control over financial reporting under Section 404 of the Sarbanes-Oxley Act is the *Enterprise Risk Management* framework.

A) True

B) False

Answer: B

Terms: Section 404 of the Sarbanes-Oxley Act

Diff: Challenging

Objective: LO 10-7

AACSB: Reflective thinking skills

Topic: SOX

3) To issue an unqualified opinion on internal control over financial reporting, there must be no identified material weaknesses and no restrictions on the scope of the audit.

A) True

B) False

Answer: A

Terms: Unqualified opinion on internal control

Diff: Moderate

Objective: LO 10-7

AACSB: Reflective thinking skills

Topic: Public

Learning Objective 10-8

1) A control available in a small company, which may be necessitated because of lack of competent personnel, is:

- A) a wider segregation of duties.
- B) a voucher system.
- C) fewer transactions to process.
- D) the owner-manager's direct involvement in the control process.

Answer: D

Terms: Control; smaller company; competent personnel

Diff: Easy

Objective: LO 10-8

AACSB: Ethical understanding and reasoning abilities

2) When auditing a private company, the auditor should obtain an understanding of internal control sufficient to:

- A) provide reasonable protection against client fraud and defalcations by client employees.
- B) assess control risk.
- C) provide a basis for suggestions to the client for improving the accounting system.
- D) provide a method for safeguarding assets, checking the accuracy and reliability of accounting data, promoting operational efficiency, and encouraging adherence to prescribed managerial policies.

Answer: B

Terms: Internal control understanding; Private company

Diff: Easy

Objective: LO 10-8

AACSB: Reflective thinking skills

3) In the audit of a private company, the auditor will test internal controls when control risk is initially assessed at:

A)

Low	Moderate	High
Yes	No	Yes

B)

Low	Moderate	High
No	No	Yes

C)

Low	Moderate	High
Yes	Yes	No

D)

Low	Moderate	High
No	Yes	No

Answer: C

Terms: Control risk

Diff: Moderate

Objective: LO 10-8

AACSB: Analytic skills

4) The auditor's consideration of a private company's internal control is:

A) required by GAAP.

B) required by GAAS.

C) required by the IRS.

D) recommended by the SEC.

Answer: B

Terms: Private company's internal control

Diff: Moderate

Objective: LO 10-8

AACSB: Reflective thinking skills

5) Which of the following may represent the biggest challenge smaller public companies face in implementing effective internal control?

A) a lack of expertise

B) reduced importance

C) limited resources

D) limited available guidance

Answer: C

Terms: Internal control biggest challenge

Diff: Moderate

Objective: LO 10-8

AACSB: Reflective thinking skills

Topic: Public

6) Which of the following is most correct for audits of non-public companies?

- A) an audit of internal control is required
- B) an audit of internal control is not required
- C) an audit of the design of internal controls is required
- D) an audit of the operational effectiveness of internal controls is required

Answer: B

Terms: Audits of non-public companies

Diff: Moderate

Objective: LO 10-8

AACSB: Reflective thinking skills

7) Match seven of the terms (a-i) with the definitions provided below (1-7):

- a. Control environment
- b. Control activities
- c. Independent checks on performance
- d. Internal control
- e. Monitoring
- f. Separation of duties
- g. General authorization
- h. Specific authorization
- i. Risk assessment

_____ 1. 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.

_____ 2. Company-wide policies for the approval of all transactions within stated limits.

_____ 3. 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.

_____ 4. Segregation of the following activities in an organization: custody of assets, accounting, authorization, and operational responsibility.

_____ 5. Management's identification and analysis of risks relevant to the preparation of financial statements in accordance with an applicable accounting framework.

_____ 6. Policies and procedures that help ensure that necessary actions are taken to address risks in the achievement of the entity's objectives.

_____ 7. 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.

Answer:

- 1. E
- 2. G
- 3. A
- 4. F
- 5. I
- 6. B
- 7. D

Terms: Control environment; Control activities; Internal control; Monitoring; Separation of duties; General authorization; Risk assessment

Diff: Moderate

Objective: LO 10-1 through LO 10-8

AACSB: Reflective thinking skills

8) If, when obtaining an understanding of control activities of a relatively small client, the auditor identified no control activities, the auditor would probably set a high assessment of control risk.

A) True

B) False

Answer: A

Terms: Control activities; control risk

Diff: Easy

Objective: LO 10-8

AACSB: Analytic skills

9) If, when obtaining an understanding of control activities of a relatively small client, the auditor identified no control activities, the auditor would probably reassess whether the client is auditable.

A) True

B) False

Answer: A

Terms: Control activities

Diff: Easy

Objective: LO 10-8

AACSB: Analytic skills

10) Auditors of private companies may rely on prior periods' tests of controls.

A) True

B) False

Answer: A

Terms: Private companies; test of controls

Diff: Easy

Objective: LO 10-8

AACSB: Reflective thinking skills

11) In an audit of a non-public company, the less control risk there is, the smaller the amount of planned substantive evidence that is required.

A) True

B) False

Answer: A

Terms: Non-public company; control risk; substantive evidence

Diff: Easy

Objective: LO 10-8

AACSB: Analytic skills

12) For proper internal control, there should be adequate separation of duties. However, the extent of separation of duties considered "adequate" does not depend on the size of the organization.

A) True

B) False

Answer: B

Terms: Separation of duties

Diff: Moderate

Objective: LO 10-8

AACSB: Reflective thinking skills

13) In an audit of a non-public company, the auditor's assessment of control risk and the extent of tests of controls are inversely related.

A) True

B) False

Answer: A

Terms: Non-public companies; control risk

Diff: Moderate

Objective: LO 10-8

AACSB: Reflective thinking skills

14) Smaller companies usually have less extensive internal controls than larger companies which result in more frauds being committed at small companies.

A) True

B) False

Answer: A

Terms: Internal controls for smaller companies

Diff: Moderate

Objective: LO 10-8

AACSB: Reflective thinking skills