**CHAPTER 1**

**AUDITING AND INTERNAL CONTROL**

**Review Questions**

1. **What is the purpose of an IT audit?**

Response: The purpose of an IT audit is to provide an independent assessment of some technology- or systems-related object, such as proper IT implementation, or controls over computer resources. Because most modern accounting information systems use IT, IT plays a significant role in a financial (external audit), where the purpose is to determine the fairness and accuracy of the financial statements.

2. **Discuss the concept of independence within the context of a financial audit. How is independence different for internal auditors?**

 Response: The auditor cannot be an advocate of the client, but must independently attest to whether GAAP and other appropriate guidelines have been adequately met. Independence for internal auditors is different because they are employed by the organization, and cannot be as independent as the external auditor. Thus internal auditors must use professional judgment and independent minds in performing IA activities.

 3. **What are the conceptual phases of an audit? How do they differ between general auditing and IT auditing?**

 Response: The three conceptual phases of auditing are:

 i. Audit planning,

 ii. Tests of internal controls, and

 iii. Substantive tests.

Conceptually, no difference exists between IT auditing and general auditing. IT auditing is typically a subset of the overall audit; the portion that involves computer technology is the subset.

 4. **Distinguish between the internal and external auditors**.

Response: External auditors represent the interests of third-party stakeholders in the organization, such as stockholders, creditors, and government agencies. External auditing is conducted by certified public accountants who are independent of the organization’s management. Internal auditors represent the interests of management. Internal auditing tasks include conducting financial audits, examining an operation’s compliance with legal obligations, evaluating operational efficiency, detecting and pursuing fraud within the firm, and conducting IT audits. External auditors also conduct IT audits as a subset of financial audits.

 5. **What are the four primary elements described in the definition of auditing?**

 Response:

 a. auditing standards

 b. systematic process

 c. management assertions and audit objectives

 d. obtaining evidence

6. **Explain the concept of materiality**.

Response: Materiality refers to the size of the effect of a transaction. From a cost-benefit point of view, a threshold is set above which the auditor is concerned with the correct recording and effects of transactions. Rather than using standard formulas, auditors use their professional judgment to determine materiality.

 7. **How does the Sarbanes-Oxley Act of 2002 affect management’s responsibility for internal controls**?

Response: The Sarbanes-Oxley Act (S-OX) specifically holds management responsible for internal controls. S-OX requires an annual report on internal controls that is the responsibility of management; external auditors must attest to the integrity of the report. Management must assess the effectiveness of the internal control structure and procedures for financial reporting as of the end of the most recent fiscal year and identify any control weaknesses. An attestation by external auditors reports on management’s assessment statement.

 8. **What are the four broad objectives of internal control?**

 Response:

 a. to safeguard the assets of the firm

 b. to ensure the accuracy and reliability of accounting records and information

 c. to promote efficiency in the firm’s operations

 d. to measure compliance with management’s prescribed policies and procedures

 9. **What are the four modifying assumptions that guide designers and auditors of internal control systems**?

 Response: Management responsibility, reasonable assurance, methods of data processing, and limitations.

 10. **Give an example of a preventive control**.

 Response: Locked doors, passwords, and data-entry controls for each field (e.g., range checks).

 11.  **Give an example of a detective control**.

 Response: A log of users, a comparison with computer totals and batch totals.

 12.  **Give an example of a corrective control**.

 Response: Manual procedures to correct a batch that is not accepted because of an incorrect social security number. A clerical worker would need to investigate and determine either the correct hash total or the correct social security number that should be entered. A responsible party is then needed to read exception reports and follow up on anomalies.

13. **What are the five internal control components described in the COSO framework**?

 Response:

 a. Control Environment

 b. Risk Assessment

 c. Information and Communication

 d. Monitoring

 e. Control Activities

14**. What are the six broad classes of control activities defined by COSO?**

 Response: The six broad classes of control activities defined by COSO are:

 a. transaction authorization,

 b. segregation of duties,

 c. supervision,

 d. accounting records,

 e. access control, and

 f. independent verification.

**15. Give an example of independent verification.**

 Response:

 a. the reconciliation of batch totals at periodic points during transaction processing

 b. the comparison of physical assets with accounting records

 c. the reconciliation of subsidiary accounts with control accounts

 d. reviews by management of reports that summarize business activity

 e. periodic audits by independent external auditors

 f. periodic audits by internal auditors

 16. **Differentiate between general and application controls. Give two examples of each**.

 Response: General controls apply to a wide range of exposures that systematically threaten the integrity of all applications processed within the IT environment. Some examples of general controls would be controls against viruses and controls to protect the hardware from vandalism. Application controls are narrowly focused on risks within specific systems. Some examples of application controls would be a control to make sure that each employee receives only one paycheck per pay period and a control to ensure that each invoice gets paid only once.

 17. **Distinguish between tests of controls and substantive testing**.

 Response: The tests of controls phase involves determining whether internal controls are in place and whether they function properly. The substantive testing phase involves a detailed investigation of specific account balances and transactions.

18. **Define audit risk.**

Response: Audit risk is the probability that the auditor will render an unqualified (clean) opinion on financial statements that are, in fact, materially misstated.

 19. **Distinguish between errors and irregularities. Which do you think concern auditors the most?**

 Response: Errors are unintentional mistakes whereas irregularities are intentional mis- representations to perpetrate a fraud or mislead the users of financial statements. Errors are a concern if they are numerous or sizable enough to cause the financial statements to be materially misstated. All processes that involve human actions are highly susceptible to some amount of human error. Computer processes should contain errors only if the programs are erroneous, if systems operating procedures are not being closely and competently followed, or if some unusual system malfunction has corrupted data. Errors are typically much easier to uncover than misrepresentations. Thus auditors typically are more concerned about whether they have uncovered any and all irregularities. Also, due to SAS No. 99 and Sarbanes-Oxley, auditors are much more concerned with fraud (irregularities) than before.

 20. **Distinguish between inherent risk and control risk. How do internal controls affect inherent risk and control risk, if at all? What is the role of detection risk?**

Response: Inherent risk is associated with the unique characteristics of the business or industry of the client. Firms in declining industries are considered to have more inherent risk than firms in stable or thriving industries. Auditors cannot reduce inherent risk, which is not affected by internal controls. Even in a system protected by excellent controls, financial data can be misstated.

Control risk is the likelihood that the control structure is flawed because internal controls are either absent or inadequate to prevent or detect errors in the accounts. Auditors assess the level of control risk by performing tests of internal controls. Internal control does, however, directly impact control risk. The more effective the internal controls that are in place, the lower the level of assessed control risk.

Detection risk is the risk that auditors are willing to take that errors not detected or prevented by the control structure will also not be detected by the auditors. Typically, detection risk will be lower for firms with higher inherent risk and control risk.

21. **What is the relationship between tests of controls and substantive tests?**

Response: The relationship between tests of controls and substantive tests is directly related to the auditor’s risk assessment. The stronger the internal controls, the less substantive testing the auditor must do.

22. **SOX contains many sections. Which sections does this chapter focus on**?

Response: This chapter concentrates on internal control and audit responsibilities pursuant to SOX Sections 302 and 404.

23. **What control framework does the PCAOB recommend**?

Response: The PCAOB recommends the use of COSO as the framework for control assessment.

24. **COSO identifies two broad groupings of information system controls. What are they**?

Response: The two broad groupings of information system controls identified by COSO are application controls and general controls.

25. **What are the objectives of application controls?**

Response: The objectives of application controls are to ensure the validity, completeness, and accuracy of financial transactions.

26. **Give three examples of application controls**?

 Response: Examples include:

a. A cash disbursements batch-balancing routing that verifies the total payments to vendors reconciles with the total postings to the accounts payable subsidiary ledger.

b. An account receivable check digit procedure that validates customer account numbers on sales transactions.

c. A payroll system limit check that identifies employee time card records with reported hours work in excess of the predetermined normal limit.

27. **Define general controls.**

Response: General controls apply to all systems. They are not application specific. General controls include controls over IT governance, the IT infrastructure, security and access to operation systems and databases, application acquisition and development, and program changes.

28. **What is the meaning of the term attest services**?

Response: The attest service is an engagement in which a practitioner is engaged to issue a written communication that expresses a conclusion about the reliability of a written assertion that is the responsibility of another party (SSAE No. 1, AT Sec. 100.01).

29. **List four general control areas**.

 Response: The following are examples of general control areas:

 a. It Governance controls,

 b. Security (data management controls),

 c. Security (operating system and network controls),

 d. Systems development and program change controls,

**DISCUSSION QUESTIONS**

1. **Discuss the differences between the attest function and advisory services**.

 Response: The attest service is defined as an engagement in which a practitioner is engaged

to issue, or does issue, a written communication that expresses a conclusion about the reliability of a written assertion that is the responsibility of another party. The following requirements apply to attestation services:

* Attestation services require written assertions and a practitioner’s written report.
* Attestation services require the formal establishment of measurement criteria or their description in the presentation.
* The levels of service in attestation engagements are limited to examination, review, and application of agreed-upon procedures.

Advisory services are professional services offered by public accounting firms to improve

their client organizations’ operational efficiency and effectiveness. The domain of

advisory services is intentionally unbounded so that it does not inhibit the growth of future

services that are currently unforeseen. As examples, advisory services include actuarial

advice, business advice, fraud investigation services, information system design and

implementation, and internal control assessments for compliance with SOX.

2. **A CPA firm has many clients. For some of its clients, it relies very heavily on the work of the internal auditors, while for others it does not. The amount of reliance affects the fees charged.**

**How can the CPA firm justify the apparent inconsistency of fees charged in a competitive marketplace?**

Response: The CPA firm’s reliance on the work of the internal auditors depends on the structure of the organization and to whom the internal auditors report. If they do not report directly to the board of directors, then their positions may be compromised. Further, the quality and type of work conducted by the internal auditors will affect external auditors reliance.

 3. **Accounting firms are very concerned that their employees have excellent communication skills, both oral and written. Explain why this requirement is so important by giving examples of where these skills would be necessary in each of the three phases of an audit.**

Response: During the planning phase of an audit, oral communication skills are used in interviews. Written communication skills are needed for recording the results of interviews and during observation and systems documentation reviews. In the tests of controls and substantive testing phases, oral communication skills are important when working with the client’s employees. Written communication skills are then vital in summarizing the results of tests.

4. **Explain the audit objectives of existence or occurrence, completeness, rights and obligations, valuation or allocation, and presentation and disclosure.**

 Response:

* The **existence or occurrence** assertion affirms that all assets and equities contained in the balance sheet exist and that all transactions in the income statement actually occurred*.*
* The**completeness**assertion declares that no material assets, equities, or transactions have been omitted from the financial statements.
* The **rights and obligations** assertion maintains that assets appearing on the balance sheet are owned by the entity and that the liabilities reported are obligations.
* The**valuation or allocation** assertion states that assets and equities are valued in accordance with generally accepted accounting principles and that allocated amounts such as depreciation expense are calculated on a systematic and rational basis.
* The **presentation and disclosure** assertion alleges that financial statement items are correctly classified (e.g., long-term liabilities will not mature within one year) and that footnote disclosures are adequate to avoid misleading the users of financial statements.

 5. **How has the Foreign Corrupt Practices Act of 1977 had a significant impact on organization management?**

 Response: The FCPA of 1977 requires that all companies registered with the Securities and

Exchange Commission maintain an appropriate system of internal controls. Internal controls typically directly impact the organizational structure and segregation of functions.

 6. **Discuss the concept of exposure and explain why firms may tolerate some exposure**.

Response: An exposure is the absence or weakness of an internal control. Sometimes cost- benefit analysis may indicate that the additional benefits of an internal control procedure may not exceed the costs. Thus, the firm may decide to tolerate some control risk associated with a particular exposure.

7. **If detective controls signal errors, why shouldn’t they automatically make a correction to the identified error? Why are separate corrective controls necessary?**

 Response: For any detected error, more than one feasible corrective solution may exist, and the best course of action may not always be obvious. Thus, linking an automatic response to a detective control may worsen a problem by applying an inappropriate corrective action.

 8. **Most accounting firms allow married employees to work for the firm. However, they do not allow an employee to remain working for them if he or she marries an employee of one of their auditing clients. Why do you think this policy exists?**

 Response: The accounting firm must retain its independence from its clients. The auditor must not have the opportunity to collude, in any fashion, with any employees of its client.

Having one spouse working for the client and the other working for the accounting firm would compromise the independence of the accounting firm.

 9. **Discuss whether a firm with fewer employees than there are incompatible tasks should rely more heavily on general authority then specific authority**.

 Response: Small firms with fewer employees than there are incompatible tasks should rely more heavily on specific authority. More approvals of decision by management and increased supervision should be imposed in order to compensate some for the lack of separation of duties.

 10. **An organization’s internal audit department is usually considered to be an effective control mechanism for evaluating the organization’s internal structure. The Birch Company’s internal auditing function reports directly to the controller. Comment on the effectiveness of this organizational structure.**

 Response: Having the internal auditing function report to the controller is unacceptable. If the controller is aware of/or involved in a fraud or defalcation, then he/she may give false or inaccurate information to the auditors. The possibility that the auditors may lose their jobs if they do not keep certain matters quiet also exists. Further, the fraud may be occurring at a level higher than the controller, and the controller may fear losing his/her job if the matter is pursued. The best route is to have the internal auditing function report directly to the audit committee.

 11. **According to COSO, the proper segregation of functions is an effective internal control procedure. Comment on the exposure (if any) caused by combining the tasks of paycheck preparation and distribution to employees**.

 Response: If a payroll employee were to prepare a paycheck for a nonexistent employee (perhaps under an alias or in the name of a relative), which is known as “ghost employee” fraud, and this employee also has the task of distributing the checks, then no one would be the wiser. On the other hand, if the checks go directly to another person, who then distributes the paychecks, the extra check should be discovered.

12. **Discuss the key features of Section 302 of SOX**.

Response: Section 302 requires that corporate management (including the CEO) certify quarterly and annually their organization’s internal controls over financial reporting. The certifying officers are required to:

 a. have designed internal controls, and

b. disclose any material changes in the company’s internal controls that have occurred during the most recent fiscal quarter.

13. **Discuss the key features of Section 404 of SOX**.

Response: Section 404 requires the management of public companies to assess the effectiveness of their organization’s internal controls over financial reporting and provide an annual report addressing the following points:

a. a statement of management’s responsibility for establishing and maintaining adequate internal control,

b. an assessment of the effectiveness of the company’s internal controls over financial reporting,

c. a statement that the organization’s external auditors has issued an attestation report on management’s assessment of the company’s internal controls,

d. an explicit written conclusion as to the effectiveness of internal control over financial reporting, and

 e. a statement identifying the framework used by management to conduct their assessment of internal controls.

14**. Section 404 requires management to make a statement identifying the control framework used to conduct its assessment of internal controls. Discuss the options in selecting a control framework.**

Response: The SEC has made specific reference to the Committee of the Sponsoring Organizations of the Treadway Commission (COSO) as a recommended control framework. Furthermore, the PCAOB’s Auditing Standard No. 5 endorses the use of COSO as the framework for control assessment. Although other suitable frameworks have been published, according to Standard No. 5, any framework used should encompass all of COSO’s general themes.

15. **Explain how general controls impact transaction integrity and the financial reporting process.**

 Response: Consider an organization with poor database security controls. In such a situation, even data processed by systems with adequate built-in application controls may be at risk. An individual who can circumvent database security may then change, steal, or corrupt stored transaction data. Thus, general controls are needed to ensure accurate financial reporting.

16. **Prior to SOX, external auditors were required to be familiar with the client organization’s internal controls, but not test them. Explain**.

 Response: Prior to SOX, auditors had the option of not relying on internal controls in the conduct of an audit and therefore did not need to test them. Instead, auditors could focus primarily on substantive tests. Under SOX, management is required to make specific assertions regarding the effectiveness of internal controls. To attest to the validity of these assertions, auditors are required to test the controls.

**17. Does a qualified opinion on management’s assessment of internal controls over the financial reporting system necessitate a qualified opinion on the financial statements? Explain**.

 Response: No. Auditors are permitted to simultaneously render a qualified opinion on management’s assessment of internal controls and render an unqualified opinion on the financial statements. Therefore, it is technically possible for auditors to determine that internal controls over financial reporting are weak, but conclude through substantive tests that the weaknesses do not cause the financial statements to be materially misrepresented.

18. **The PCAOB Standard No. 5 specifically requires auditors to understand transaction flows in designing their tests of controls. What steps does this entail?**

 Response: In order to be in compliance with PCAOB Standard No. 5 auditors must do the following:

 a. select the financial accounts that have material implications for financial reporting,

 b. identify the application controls related to those accounts, and

 c. identify the general controls that support the application controls.

19. **What fraud detection responsibilities (if any) does SOX impose on auditors?**

Response: Standard No. 2 places new responsibility on auditors to detect fraudulent activity. The standard emphasizes the importance of controls designed to prevent or detect fraud that could lead to material misstatement of the financial statements. Management is responsibility for implementing such controls and auditors are expressly required to test them.

**Multiple Choice Questions**

1. d
2. b
3. a
4. d
5. c
6. a
7. a
8. b
9. b
10. a

**Problems**

1. Segregation of Functions

Comment on the specific risks (if any) that are caused by the following combination of tasks.

a. A sales manager, who works on commission based on gross sales, approves credit and has the authority to write off uncollectible accounts.

b. The warehouse clerk, who has custodial responsibility over inventory in the warehouse, updates the inventory subsidiary ledger and prepares an inventory summary for the general ledger department.

c. The billing clerk bills customers and records sales in the sales journal

d. The shop foreman approves and submits time cards to timekeeping and distributes paychecks to employees.

e. The accounting clerk posts to individual account receivable subsidiary accounts and performs the reconciliation of the subsidiary ledger and the general ledger control account.

 Response:

 a. This situation is in violation because the sales manager has the power of credit authorization as well as accounts receivable record keeping. The potential risk is that the manager may approve credit to a friend’s or relative’s business and then write off the account as bad.

b.This situation is in violation because the warehouse clerk has custodial responsibility as well as record keeping responsibility. The potential risk is that the clerk may steal inventory and use his record keeping authority to adjust the inventory records to hide the theft.

c. No risks due to combining these tasks. The billing clerk is responsible for recording sales in the sales journal after they have been shipped to the customer

d. This situation is in violation because the foreman has authority to authorize time cards and also has asset custody (the employee pay check). The potential risk is that the supervisor may submit a false time card for a terminated or non-existent employee and then keep the paycheck that results.

e. This situation is in violation because the accounting clerk both records transactions and verifies the accuracy of the recording. The purpose of reconciliation is to verify that the two sets of records are equivalent. The risk is that the accounting clerk may conceal errors or cover up balances that do not equal because of embezzlement of funds.

2. Segregation of Duties

Explain why each of the following combinations of tasks should, or should not, be separated to achieve adequate internal control.

a. Recording cash receipts in the journal and posting to the account receivable subsidiary ledger.

b. Preparation of accounts payable and distribution of payroll checks to employees (paymaster).

c. Posting of amounts from both the cash receipts and the cash disbursements journals to the general ledger.

d. Distribution of payroll checks to employees and approval of time cards.

e. Approval of bad debt write-offs and the reconciliation of accounts payable subsidiary ledger and the general ledger control account.

 Response:

 a. These two tasks need to be separated because the individual has asset custody and recordkeeping responsibility.

 b. These two tasks do not need to be separated because they are independent of one another. AP clerks do not prepare payroll checks.

 c. In neither case does the employee have access to the assets; therefore no danger exists.

 d. These tasks should be separated. The potential risk is that the individual may submit a false time card for a terminated or non-existent employee and then keep the paycheck that results.

 e. These tasks need not be separated because they are independent tasks.

3. Role of Internal Audit Function

Nano Circuits Inc., is a publicly traded company that produces electronic control circuits, which are used in many products. In an effort to comply with SOX, Nano is in the process of establishing an in-house internal audit function, which previously had been outsourced. The company began this process by hiring a Director of Internal Audits. Nano Circuits’ CEO recently called a planning meeting to discuss the roles of key corporate participants regarding the implementation and maintenance of internal controls. Central to this decision is the organizational placement of the future internal audit function and to whom the new Director of Internal Audit should report. In addition, Nano Circuits considered the need to reconstitute its Board of Directors Audit Committee. Participants at the meeting included the company president, the chief financial officer, a member of the audit committee, a partner from Nano Circuits external audit firm, and the Director of Internal Audits. Expectations and concerns presented by the meeting participants are summarized below.

**CEO:** The CEO expressed concern that Nano Circuits complies with SOX and PCAOB requirements and recommendations. The internal audit function should strengthen the organization’s internal control system by developing control policies and procedures and by detecting violations of policies and procedures.

**CFO:** The CFO saw the role of the internal audit function as one that should be focused primarily on financial issues and therefore, the director of Internal Audits should report to the CFO.

**Audit committee member:** The committee member felt strongly that the Audit Committee as currently constituted is appropriate and no changes need to be made. Although none of the committee members are trained accountants they all have extensive industry experience, they have all been associated with Nano Circuits in various capacities for many years, and are well qualified to fulfill their policy-oversight responsibilities.

**External audit partner:** The external audit partner pointed out that the internal audit function should be organized such that it supports a close working relationship with the external auditors. This would include monitoring internal control systems on a continuing basis to provide a body of evidence on which the external auditor can rely.

**Director of Internal Audits:** The Director of Internal Audits argued that the new IA function should focus more on operational auditing issues, but it also should play a role in the review of internal controls over financial reporting.

Required:

a. Describe the role that each of the following areas has in the establishment, maintenance, and evaluation of internal control:

i. Management

ii. External auditor

iii. Internal audit

b. To whom should the Director of Internal Audits report. Explain your answer.

c. Comment on the audit committee member’s perspective as to the committee’s current composition.

Response:

a.

i. SOX requires management of public companies to implement an adequate system of internal controls over their financial reporting process. This includes controls over transaction processing systems that feed data to the financial reporting systems. In addition, Section 404 of SOX requires the management of public companies to assess the effectiveness of their organization’s internal controls. This entails providing an annual report addressing the following points:

 **1.** Understand the flow of transactions, including IT aspects, in sufficient detail to identify points at which a misstatement could arise.

 **2.** Using a risk-based approach, assess both the design and operating effectiveness of selected internal controls related to material accounts.

 **3.** Assess the potential for fraud in the system and evaluate the controls designed to prevent or detect fraud.

 **4.** Evaluate and conclude on the adequacy of controls over the financial statement reporting process.

 **5.** Evaluate entity-wide (general) controls that correspond to the components of the COSO framework.

ii. The external auditor reviews the organization’s control structure per the COSO internal control model. This includes the control environment, risk assessment, information and communications, monitoring, and control procedures. The auditor issues an opinion on control adequacy and identifies any material weaknesses in internal controls.

iii. Internal auditors perform a wide range of activities on behalf of the organization, including conducting financial audits, examining an operation’s compliance with organizational policies, reviewing the organization’s compliance with legal obligations, evaluating operational efficiency, and detecting and pursuing fraud within the firm. For cost reduction and efficiency purposes internal auditors often cooperate with and assist external auditors in performing aspects of financial audits including tests of controls. For example, a team of internal auditors can perform tests of computer controls under the supervision of a single external auditor.

b. The Director of Internal Audits should report to the Board of Directors Audit Committee.

When an internal audit department reports directly to a department, the internal auditor’s independence is compromised, and the external auditor is prohibited by professional standards from relying on evidence provided by the internal auditors. In contrast, external auditors can rely in part on evidence gathered by internal audit departments that are organizationally independent and report to the board of directors’ audit committee.

c. The audit committee probably needs to be reconstituted to be in compliance with SOX. The audit committee serves as an independent “check and balance” for the internal audit function and liaison with external auditors. The audit committee must be willing to challenge the internal auditors as well as management, when necessary. To be effective:

* The audit committee should consist of people who outsiders (not associated with the families of executive management nor former officers, etc.).
* With the advent of the Sarbanes-Oxley Act, at least one member of the audit committee must be a “financial expert.”

4. Internal Auditor Independence

Technical Solutions, Inc. is expanding and reorganizing its Internal Audit (IA) function. Currently the Director of Internal Audit, Sharon Kalafut, reports to the corporate controller, who receives and reviews all internal audit reports. Kalafut forwards copies of the internal audit reports to the audit committee of the board of directors and to the manager directly responsible for the function being audited.

An issue of contention among the management team pertains to which department or function the Director of Internal Audits should report. Martin Stevens the CEO wants to ensure that Technical Solutions complies with the SOX and that the internal audit department is structured such that it strengthens the company’s internal control system. Also, an overarching objective for the reorganized audit function is that the external auditors are able to rely on the work performed by the internal audit department to a substantial degree. Arguments put forth by interested parties as to where the IA department should be organizationally located are presented below:

* **Chief Operations Officer (COO).** John Sweeney, the COO of Technical Solutions, believes that the Director of IA should report to him. Under this arrangement the IA staff members would be involved in the preparation of policy statements on internal control regarding safeguarding of assets and in the design of business processes.
* **Chief Information Officer (CIO)**. Larry Rich, the CIO, has pushed hard to have the IA function report to him and take on an active role in the design, installation, and initial operation of a new computerized systems. IA staff will be primarily concerned with the design and implementation of internal accounting controls and conduct the evaluation of these controls during the test runs and audits.
* **Corporate Controller**. The controller, Linda Johnson, believes the IA group should remain within her functional area. Currently the IA staff performs a number of controller related tasks. These include:
* Internal auditors reconcile bank statements of the corporation each month. The controller believes this strengthens the internal control function because the internal auditor is not involved in either the receipt or the disbursement of cash.
* Internal auditors review the annual budget each year for relevance and reasonableness before the budget is approved. At the end of each month, the controller’s staff analyzes the variances from budget and prepares explanations of these variances. These variances and explanations are then reviewed by the internal audit staff.
* Finally, the internal auditors make accounting entries for complex transactions when employees of the accounting department are not adequately trained to handle such transactions. The controller believes this gives an added measure of assurance to the accurate recording of such transactions.

Required:

a. Define independence as it relates to the internal audit function.

b. For each of the proposed tasks to be performed by the IA function, explain whether Technical Solutions’ internal audit independence will be materially impaired. Consider each manager’s arguments independently.

c. To maintain independence, where should the Director of Internal Audits report? Explain your answer.

Response:

 a. Internal auditor independence implies no subordination of judgment to another and arises from an independent mental attitude that views events on a factual basis without influence from organizational units to which IA is subordinate.

b. i. The internal auditor’s independence is not impaired by the preparation of policy statements on internal control. The preparation of policy statements to guide others in the development and implementation of internal controls is a responsibility of the internal audit staff.

 ii. Auditor independence is impaired to the extent that the internal auditor is involved

 in the design and installation of computerized internal accounting controls being

 tested. Little confidence can be placed in audit findings issued by the individual who designed and installed the system being audited.

 iii. The internal auditor’s independence is impaired by reconciling bank statements.

 To maintain independence, the auditor should not perform operational assignments

 that are included as part of the independent evaluation and verification of a proper

 system of internal control. Separation of duties must be maintained.

 iv. Objectivity is not impaired in the review of the budget for relevance and

 reasonableness if the internal auditor has no responsibility for establishing or

 implementing the budget. However, the review of variances and explanations would

 impair objectivity as this is an area that would normally be reviewed during an

 operational audit.

 v. The preparation of complex accounting transactions will materially impair the

 internal auditor’s objectivity by involving the auditor in day-to-day operations.

c. The Director of Internal Audits should report to the Board of Directors Audit Committee.

The independence and competence of the internal audit staff determine the extent to which external auditors may cooperate with and rely on work performed by internal auditors. When the internal audit department reports directly to a department, such as the controller, the internal auditor’s independence is compromised, and the external auditor is prohibited by professional standards from relying on evidence provided by the internal auditors. In contrast, external auditors can rely in part on evidence gathered by internal audit departments that are organizationally independent and report to the board of directors’ audit committee.

5. Assessing Internal Control

The following describes the cash receipts procedures for a medium-sized online and catalogue-based retailer.

Customer payments come directly to the general mail room along with other mail items. The customer payments mail constitutes about 20 percent of the total mail received each day. The mailroom clerks sort through the mail, open the customer payment envelopes, remove the customer checks and remittance advices, and reconcile the two documents. The mailroom supervisor then sends the reconciled checks and remittance advices to the Accounts Receivable clerk, who posts the amounts received to the customer AR subsidiary ledger and the cash receipts journal from her computer terminal. The AR clerk then manually prepares a remittance list of all checks received, endorses the checks “for deposit only” and sends the checks and remittance list to the Treasurer. Finally, the clerk files the remittance advices in the AR department.

Once the checks and remittance list arrive at the Treasury department, the treasurer reconciles the documents, and manually prepares three hard copies of the deposit slip. Next, he sends the checks and two copies of the deposit slip to the bank. Finally, he files the third copy of the deposit slip and the remittance list in the department.

Required:

a) Identify the internal control weaknesses in the cash receipts process.

b) For each weakness, describe the associated risks.

c) For each weakness provide a possible control activity.

Response:

1.

a) Weakness: Mailroom clerks have access to checks and remittance advices.

b) Risk: The mailroom clerks who open the mail could steal the check and destroy the remittance advice and thus leave no record of the transaction.

c) Control: Mixing general mail and cash receipts mail in this way creates a chaotic environment that is difficult to control. The company should require the cash receipts to be sent to a separate PO Box, which could be a separate room or location. This smaller amount of similar mail can be better controlled though supervision.

2.

a) Weakness: The AR clerk receives checks and remittance advices from the mailroom supervisor.

b) Risk: The AR clerk has access to both asset and records. The clerk could steal the check and destroy the remittance advice to eliminate any record of the cash receipt. (See skimming in chapter 12 for details).

c) Control: A remittance list should be prepared in the mailroom to control the checks and remittance advices. Any loss or theft of checks after they are recorded on the remittance list would result in a discrepancy between the remittance list and the checks that are deposited in the bank.

3.

a) Weakness: The AR clerk has responsibility for recording cash and updating the customer accounts.

b) Risk: The clerk could engage in a lapping fraud. (See chapter 12 for details).

c) Control: Segregations of duties is needed to separate the tasks of recording accounts receivable and receiving cash receipts.

6**. Assessing Internal Control**

The following describes the cash disbursement procedures for a wholesale building supply company.

When the accounts payable clerk receives the supplier’s invoice she records the purchase in the purchases journal, records the liability in the AP subsidiary ledger, and sets a due date based on the terms specified on the invoice. The clerk then updates the inventory control and accounts payable control accounts in the general ledger. The invoice is then filed in the department.

Each day, the clerk visually searches the AP subsidiary ledger from her terminal for invoices that are due to be paid. From her computer terminal, the clerk prepares the check and records it in the check register. The negotiable portion of the check is mailed to the vendor and a check copy is filed. The clerk then closes the liability in the AP subsidiary ledger and updates the accounts payable control and cash accounts in the general ledger.

Required:

a) Identify the internal control weaknesses in the cash receipts process.

b) For each weakness, describe the associated risks.

c) For each weakness provide a possible control activity.

Response:

1.

a) Weakness: Clerk sets up a liability based solely on the vendors invoice.

b) Risk: The company may be paying for things it did not order, did not receive, or is paying too high a price.

c) Control: The clerk should perform a three-way-match of the purchase order, receiving report, and invoice to verify that the liability is legitimate and correctly stated.

2.

a) Weakness: AP clerk authorizes the liability and writes the check to pay it.

b) Risk: The clerk could create a false vendor, set up a liability and disburse funds (see payments to fictitious vendors, chapter 12),

c) Control: Segregation of duties between the tasks of authorizing a liability and check writing.

3.

a) Weakness: AP clerk has access to both the AP subsidiary ledger and the general ledger.

b) Risk: Balancing general ledger control accounts with corresponding subsidiary ledgers can help detect certain types of errors and irregularities. This ability is lost when the same individual is responsible for updating both accounts.

c) Control: Segregation of duties between the general ledger function and other accounting functions.

**7. Evaluation of Controls**

 Gaurav Mirchandaniis is the warehouse manager for a large office supply wholesaler. Mirchandaniis receives two copies of the customer sales order from the sales department. He elects the goods from the shelves and sends them and one copy of the sales order to the shipping department. He then files the second copy in a temporary file. Mirchandaniis retrieves the sales orders from the temporary file and updates the inventory subsidiary ledger from a terminal in his office. At that time, he identifies items that have fallen to low levels, selects a supplier, and prepares three copies of a purchase order. Once copy is sent to the supplier, one is sent to the accounts payable clerk, and one is files in the warehouse. When the goods arrive from the supplier, Mirchandaniis reviews the attached packing slip, counts and inspects the goods, places them on the shelves, and updates the inventory ledger to reflect the receipt. He then prepares a receiving report and sends it to the accounts payable department.

***Required:***

a. Prepare a systems flowchart of the procedures previously described.

b. Identify any control problems in the system.

c. What sorts of fraud are possible in this system?

Responses:

a. See following flowchart

b. The following segregation of functions problems exist:

 1. Mirchandaniis is the warehouse manager (asset custody) and is responsible for updating the inventory subsidiary ledger (record keeping).

 2. Mirchandaniis determines what should be ordered (authorization) and the places the order (transaction processing).

c. The following frauds could result from these control weaknesses:

 i. Kickback fraud—Since Mirchandaniis selects the supplier and also places the order, he could order inventory that is not needed or that is above market price from a supplier with whom he has a personal fraudulent arrangement. In exchange, the supplier pays a kickback to the warehouse manager.

 ii. Vendor fraud—Mirchandaniis authorizes, orders, and receives the goods; he could establish himself as a vendor and process fraudulent transactions.

 iii. Theft of inventory—Mirchandaniis can simply remove the assets from the warehouse, sell them, and adjust the inventory records. A reconciliation between the physical inventory on hand and the records would indicate no discrepancies.

**8. Evaluation of Controls**

Matt Demko is the loading dock supervisor for a dry cement packaging company. His work crew is composed of unskilled workers who load large transport trucks with bags of cement, gravel, and sand. The work is hard, and the employee turnover rate is high. Employees record their attendance on separate time cards. Demko authorizes payroll payments each week by signing the time cards and submitting them to the payroll department. Payroll then prepares the paychecks and gives them to Demko, who distributes them to his work crew.

***Required:***

a. Prepare a systems flowchart of the procedures described here.

b. Identify any control problems in the system.

c. What sorts of fraud are possible in the system?

a.



b. The following segregation of functions problem exists:

Demko authorizes the transaction (signs and submits timecards) and has asset custody (he distributes the checks to employees).

c. The following frauds could result from these control weaknesses:

i. Kickback fraud—Demko permits employees to inflate the hours worked and approves payment. The employee then splits the excess pay with the supervisor as a kickback.

ii. Nonexistent employee fraud—After an employee leaves the company, the supervisor continues to submit timecard for him. When the paychecks are distributed to Demko, he keeps the ones for the terminated employees and cashes them by forging their names.