CHAPTER 7

Internal Control

Review Questions

7–1 Internal control is a process, affected by the entity’s board of directors, management and other personnel, designed to provide reasonable assurance regarding the achievement of objectives in the categories of (1) effectiveness and efficiency of operations, (2) reliability of financial reporting, and (3) compliance with applicable laws and regulations.

7–2 The five basic components of an organization’s internal control are (1) control environment, (2) risk assessment, (3) control activities, (4) (accounting) information and communication, and (5) monitoring.

7–3 The control environment is composed of integrity and ethical values, commitment to competence, board of directors or audit committee, management’s philosophy and operating style, organizational structure, human resource policies and practices, and assignment of authority and responsibility.

7–4 Separating recordkeeping from custody of the related assets provides an independently maintained record that may periodically be reconciled with assets on hand. This independent record holds the personnel of a custodial department accountable for assets entrusted to their care. If the custodial department maintained the accounting records, opportunity would exist for that department to conceal its errors or shortages by manipulating the records.

7–5 Key factors in protecting a business against losses through embezzlement include adequate internal control, fidelity bonds, and regular audits by independent public accountants.

7–6 The risk assessment component of internal control relates to the factors that affect the risk that the organization’s financial reporting objectives will not be achieved. An awareness of this component contributes to internal control because management’s consideration of the possibility that financial statements may be misstated decreases the likelihood of misstatement.

7–7 The two types of monitoring are (1) ongoing monitoring activities, and (2) separate evaluations. Examples of ongoing monitoring activities include continuous monitoring of customer complaints and reviewing the reasonableness of management reports. Separate evaluations include periodic audits by the internal auditors.

7–8 The four types of control activities are (1) performance review, (2) information processing, (3) physical controls and (4) segregation of duties. Performance reviews contribute to internal control by providing management with an overall indication of whether personnel at various levels are effectively pursuing the objectives of the organization. Information processing controls are performed to check the accuracy, completeness, and authorization of transactions. Physical controls
contribute by assuring physical security over both records and other assets. Segregation of duties reduces the opportunities for any one person to both perpetuate and conceal errors or irregularities.

7–9 Assuming that the general category of transaction has already been authorized by top management, at least three employees or departments should usually participate in each transaction to achieve strong internal control. One employee approves the transaction after determining that the details conform to company policies, another employee records the transaction in the accounting records, and the third employee executes the transaction by releasing and/or taking custody of the related assets. (Note: The approval function may be omitted in an extremely simple transaction such as a cash sale not involving a check.)

7–10 The primary objective of the internal auditor is to aid corporate management in efficient administration by investigating and reporting upon compliance with company policies, reliability of accounting and statistical records and reports, adequacy of internal control, efficiency of operating procedures, and effectiveness of performance in all areas of operation.

The primary objective of the independent auditors is to determine whether the financial statements fairly reflect the financial position, operating results, and cash flows of the business. The independent auditors have a responsibility to stockholders, creditors, and the public, as well as to management.

7–11 The independent auditors should consider the work of the internal auditors as a portion of the control environment of internal control. After evaluating the competence and relative independence of the internal auditors, the independent auditors will determine the extent to which the work of the internal auditors may be relied upon in determining the nature, timing, and extent of their testing.

7–12 Internal control is a process, effected by the entity’s board of directors, management, and other personnel, designed to provide reasonable assurance regarding the achievement of objectives in the following categories:
- Reliability of financial reporting.
- Effectiveness and efficiency of operations.
- Compliance with applicable laws and regulations.

The concept of corporate governance is broader than internal control in that it is not only concerned with the effectiveness of financial reporting, but it also encompasses ethical treatment of all major stakeholders, compliance with laws, regulations, customary business practices, and effective risk management. Since management plays the major role in determining how various stakeholders are treated, corporate governance is primarily concerned with controlling management and providing incentives for appropriate management behavior.

7–13 Auditors consider internal control because its quality has a major effect on the nature, timing, and extent and nature of the audit procedures necessary to complete the audit. More specifically, the auditors’ understanding of the entity and its environment, including internal control allows them to (1) assess the risks of material misstatements of the financial statements and (2) design the nature, timing, and extent of further audit procedures.

7–14 If the safeguarding of company assets were the only objective of internal control, then some basis might exist for the argument that the bonding of employees was an acceptable substitute for good internal control practices. However, internal control has such other important objectives as assuring the reliability of accounting data and other types of information needed by management for effective direction of the business. When internal controls are weak or absent, the losses from waste and inefficiency are apt to be far greater than losses from dishonest acts by employees.
An assessment of internal control by the auditors is a prerequisite to the determination of the nature, timing, and extent of the further audit procedures necessary to express an opinion on the financial statements. Under normal circumstances, the assessment of internal control significantly reduces the cost of an audit, because a reduction in the assessed level of control risk permits the auditors to perform much less substantive procedures than would otherwise be necessary.

7–15 Among the sources of information that auditors may use in preparing a working paper description of internal control are organization charts, charts of accounts, job descriptions, interviews and discussions with officers and employees, reports of internal auditors, accounting reports and records, inspection of facilities, and working papers and reports from prior examinations.

7–16 No. Designing audit programs involves complex judgments, resulting in the possibility of inconsistencies in these judgments by auditors in the field. CPA firms attempt to reduce inconsistencies in judgments by developing firm policies, and “decision aids” or guides, that assist auditors in gathering relevant information or combining the information to make decisions about the nature, timing, and extent of substantive procedures.

7–17 Tests of controls are efficient auditing procedures when the reduction in the substantive procedures that results from a lower assessed level of control risk exceeds the amount of work involved in performing the tests of controls.

7–18 Documentation is usually in the form of flowcharts, questionnaires, or written narratives of the system.

7–19 During their consideration of internal control, the auditors will inevitably encounter some deficiencies that should be brought to the attention of management. A management letter is the written report to the client describing such deficiencies, along with the auditors’ recommendations for corrective action. This report serves as a useful reference document for management in implementing improvements in internal control and may also serve to limit the auditors’ liability to the client in the event the control deficiencies subsequently give rise to defalcations or other losses.

7–20 The COSO Enterprise Risk Management Framework includes the following components:

1. **Internal environment**—The internal environment encompasses the tone of the organization, and sets the basis for how risk is viewed and addressed by the organization’s personnel.
2. **Objective setting**—This activity involves setting the goals that should be aligned with the organization’s mission. By setting objectives the organization can identify critical risk factors that allow the organization to meet its objectives.
3. **Event identification**—This activity involves identifying events that may be negative (risks), positive (opportunities), or both. Events may result from external or internal factors.
4. **Risk assessment**—This activity involves analyzing risks in terms of likelihood and impact.
5. **Risk response**—This activity involves selecting the appropriate responses to the identified risks. Responses may include avoidance, reduction, sharing, or acceptance.
6. **Control activities**—Include the policies and procedures that ensure that the risk responses are effectively carried out.
7. **Information and communication**—Includes activities to ensure that relevant information is identified, captured, and communicated to enable people to carry out their responsibilities.
8. **Monitoring**—Involves management activities and separate evaluations designed to determine whether needed modifications should be made to the enterprise risk management system.
7–21 You should explain to the president that auditing standards require the auditors to report significant deficiencies and material weaknesses to the audit committee of the board of directors. Failure to submit such a report to the board would be a violation of generally accepted auditing standards.

7–22 The two subsections of Section 404 of the Sarbanes-Oxley Act are 404a and 404b. Section 404a requires each annual report filed with the SEC to include a report in which management (1) acknowledges its responsibility for establishing and maintaining adequate internal control over financial reporting, and (2) provides an assessment of internal control effectiveness as of the end of the most recent fiscal year.

Section 404b requires auditors of certain companies to attest to, and report on, internal control over financial reporting.

7–23 The five stages of an audit of internal control performed in accordance with PCAOB requirements are:
(1) Plan the engagement.
(2) Obtain an understanding of internal control over financial reporting (internal control).
(3) Test and evaluate design effectiveness of internal control.
(4) Test and evaluate operating effectiveness of internal control.
(5) Form an opinion on the effectiveness of internal control over financial reporting.

Questions Requiring Analysis

7–24 a. (1) The effectiveness of internal control depends directly on the integrity and ethical values of the personnel responsible for creating, administering, and monitoring control of the organization.
(2) Control is more effective if the employees are competent in performing their duties.
(3) The board of directors or audit committee oversees the quality of the organization’s financial reports, and acts as a deterrent to management override of controls and management fraud.

b. Through risk assessment, management can determine when new controls are needed because of changes in the organization’s operations or economic environment. This process includes an assessment of financial reporting risk, which is the risk of presenting materially misstated financial statements.

Among the factors that result in increased financial reporting risk are (only four required):

- Changes in the organization’s regulatory or operating environment.
- Changes in personnel.
- Implementation of as a new or modified information system.
- Rapid growth of the organization.
- Changes in technology affecting production processes or information systems.
- Introduction of new lines of business, products, or processes.
- Corporate restructurings.
- Expansion or acquisition of foreign operations.
- Adoption of new accounting principles or changing accounting principles.

c. The five major objectives of an accounting system include:

- Identify and record all valid transactions.
- Describe on a timely basis the transactions in sufficient detail to permit proper classification of transactions for financial reporting.
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- Measure the value of transactions in a manner that permits recording their proper monetary value in the financial statements.
- Determine the time period in which transactions occurred to permit recording of transactions in the proper accounting period.
- Properly present the transactions and related disclosures in the financial statements.

d. (1) Performance reviews provide management with an overall indication of whether personnel at various levels are effectively pursuing the objectives of the organization.
(2) Information processing controls are designed to check the accuracy, completeness, and authorization of transactions.

e. The two types of monitoring activities are (1) ongoing monitoring activities and (2) separate evaluations. Ongoing monitoring activities include regularly performed supervisory and management activities, such as continuous monitoring of customer complaints, or reviewing the reasonableness of management reports. Separate evaluations are monitoring activities that are performed on a nonroutine basis, such as periodic audits by the internal auditors.

7–25 a. Internal control is defined as a process, effected by the entity’s board of directors, management, and other personnel, designed to provide reasonable assurance regarding the achievement of objective regarding (1) reliable financial reporting, (2) effectiveness and efficiency of operations, and (3) compliance with applicable laws and regulations.

b. The definition includes the following concepts:
(1) Internal control is as a process—as a means to an end.
(2) The process is effected by individuals not merely policy manuals, documents, and forms.
(3) Internal control can only provide reasonable assurance, which means that the cost of internal control should not exceed the benefits derived.
(4) Internal control is designed to achieve objectives in the three areas of reliable financial reporting, effectiveness and efficiency of operations, and compliance with laws and regulations.

c. The five components of internal control include:
(1) The control environment.
(2) Risk assessment.
(3) The accounting information and communication system.
(4) Control activities.
(5) Monitoring.

d. The major limitations of internal control include:
(1) Mistakes may be made in the performance of controls as a result of misunderstanding of instructions, mistakes of judgments, carelessness, distraction, or fatigue.
(2) Top management can override internal control.
(3) Control activities dependent upon separation of duties may be circumvented by collusion among employees.

7–26 a. The planned assessed level of control risk is the level the auditors intend to use in performing the audit for a particular financial statement assertion. For example, after obtaining the understanding of internal control, the auditors will determine a planned assessed level of control risk based on their understanding of internal control and risk assessment procedures. The revised assessed level of control risk is the level of risk based on
the additional tests of controls performed to evaluate control risk for an assertion. **Control risk** is the actual, but unknown, level of risk pertaining to an assertion.

**b.** While obtaining an understanding of internal control, the auditors may determine a **planned assessed level of control risk** for the existence of accounts receivable that requires them to test as a sample of sales transactions. Based on the results of the tests of controls for sales, the auditors may arrive at an **revised assessed level of control risk** that is either higher or lower than the level planned. The **actual** level of control risk for existence of receivables is, as always, at an unknown level.

7–27  **a.** After or during obtaining an understanding of the client and its environment, including internal control, the auditors perform their risk assessment procedures. Then they document this understanding and the risk assessment procedures. At this point they may or may not have performed some tests of controls as a part of the risk assessment procedures. When they believe that a lower level of assessed control risk may be possible, and that the related reduction of substantive procedures may be cost justified, the auditors will assess risk based on the assumption that these controls are operating effectively. They will then design further audit procedures, including tests of controls and substantive tests. Finally, when the additional tests of controls and substantive tests have been performed, the auditors will evaluate whether risk has been appropriately restricted.

**b.** Obtain an understanding.  
- Inquire of client personnel.
- Inspect various documents and records.
- Observe control activities and operations.
- Perform walk-through of transactions.
- Perform some tests of controls.

Document the understanding.  
- Prepare flowchart.
- Prepare checklists.
- Prepare questionnaires.

Assess the risks of material misstatement (develop planned assessed level of control risk).  
- Evaluate risk based on the understanding.

Design and perform further audit procedures (tests of controls and substantive procedures).  
- Analyze information obtained above.
- Perform inquiry procedures.
- Inspect documents for performance.
- Observe application of procedures.
- Reperform application of procedures.
- Perform substantive procedures.
Reassess control risk  
(or the risk of material  
misstatement) and modify  
substantive procedures.

Document the results of the risk  
assessment process.  

Analyze results obtained.

Overall responses to risks  
Nature, timing, and extent of procedures  
The linkage of procedures to assertion-level  
risk risks  
The results of audit procedures  
The conclusions regarding the use of  
evidence about the operating effectiveness  
of controls obtained in prior periods

7–28 Since Bailey’s consideration of internal control shows that controls are very weak, he may omit  
performing tests of controls. He must, however, have an adequate understanding of internal control  
to assess the risks of material misstatement. At a minimum, Bailey should obtain a basic  
understanding of the control environment, risk assessment, information and communication,  
monitoring, and important control activities. He should document this understanding, and also  
document that control risk is assessed at the maximum level.

7–29  a. (1) The primary advantage of the internal control questionnaire is that control  
weaknesses, including the absence of controls, are prominently identified by the “no”  
answers. Another advantage of the questionnaire is its simplicity. If the questions  
have been predetermined, as is usual, the auditors’ responsibility includes the  
completion of the questionnaire with yes-or-no answers, and written explanations are  
required only for the “no” or unfavorable answers. Also, the comprehensive list of  
questions provides assurance of complete coverage of significant control areas.

(2) An advantage of the written narrative approach in reviewing internal control is that  
the description is designed to explain the precise controls applicable to each  
examination. In this sense, the working paper description is tailor-made for each  
engagement and thus offers flexibility in its design and application. A second  
advantage is that its preparation normally requires a penetrating analysis of the  
client’s system. In requiring a written description of the flow of transactions, records  
maintained, and the division of responsibilities, the memorandum method minimizes  
the tendency to perform a perfunctory review.

(3) The use of a flowchart in documenting internal control offers the advantage of a  
graphic presentation of a system or a series of sequential processes. It shows the  
steps required and the flow of forms or other documents from person to person in  
carrying out the function depicted. Thus, the tendency to overlook the controls  
existing between functions or departments is minimized. Another advantage is that  
the flowchart method avoids the detailed study of written descriptions of procedures  
without sacrificing the CPAs’ ability to appraise the effectiveness of controls under  
review. An experienced auditor can gain a working understanding of the system  
much more readily by reviewing a flowchart than by reading questionnaires or  
lengthy narratives. Information about specific procedures, documents, and  
accounting records can also be located more quickly in a flowchart. Because of these  
advantages, flowcharting has become the most widely used method of describing  
internal control in audit working papers.
b. Even though internal control appears to be strong, the auditors are required to conduct tests of controls. Just because controls are prescribed does not mean that the client’s personnel are adhering to those requirements. Employees may not understand their assigned duties, or may perform those duties in a careless manner, or other factors may cause the controls actually in place to differ from those prescribed.

Through tests of controls the CPAs obtain reasonable assurance that controls are in use and are operating as planned, and they may detect material errors of types not susceptible to effective internal control. In addition, such testing enables the CPAs to comply with the third standard of fieldwork that calls for obtaining sufficient competent evidential matter to provide a reasonable basis for an opinion.

Note to instructor—Auditors may forego tests of controls if they conclude that controls are so weak as to provide no basis for assessing control risk at a level lower than the maximum.

7–30 a. The following categories of measures and underlying measures are included in the AICPA document on Antifraud Programs and Control Measures:

1. Create and maintain a culture of honesty and high ethics.
   - Set tone at the top.
   - Create a positive workplace environment.
   - Hire and promote appropriate employees.
   - Properly train employees.
   - Discipline.
2. Evaluate the risks of fraud and implement processes, procedures, and controls to mitigate those risks.
   - Identify and measure fraud risks.
   - Mitigate fraud risks.
   - Implement and monitor controls and other measures.
3. Develop an appropriate oversight process.

b. Examples of measures that create a positive workplace environment include (only two required):
   - Encourage and empower employees to help create a positive workplace.
   - Allow employees to participate in developing and updating the code of conduct.
   - Encourage employees and give them the means to communicate concerns about potential violations of the code of conduct without fear of retribution.

Examples of factors that detract from a positive workplace environment include (only two required):
   - Top management that does not seem to care about or reward appropriate behavior
   - Negative feedback and lack of recognition for job performance
   - Perceived inequities in the organization
   - Autocratic rather than participate management
   - Low organizational loyalty or feelings of ownership
   - Unreasonable budget expectations or other financial targets
   - Fear of delivering “bad news” to supervisors and/or management
   - Less than competitive compensation
   - Poor training and promotion opportunities
   - Lack of clear organizational responsibilities
   - Poor communication practices or methods within the organization

7–31 The required documentation related to internal control in a financial statement audit include:
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(1) Documentation of understanding of internal control (flowcharts, written narratives, questionnaires, etc.).
(2) The overall responses to address the risks of material misstatement at the financial statement level.
(3) The nature, timing, and extent of further audit procedures (including additional tests of controls and substantive procedures).
(4) The linkage of further audit procedures with assessed risks at the relevant assertion level.
(5) The results of audit procedures (including tests of controls).
(6) The conclusions reached with regard to the use of the current audit evidence about the operating effectiveness of controls that was obtained in prior audits.

7–32 The client’s plan of organization is entirely unsatisfactory from the standpoint of establishing internal control. He has ignored the basic control principle that two or more employees should participate in every transaction. When one person has complete control over a certain type of transaction or a certain phase of operations, it is usually possible for the individual to conceal any accidental errors or wasteful acts as well as to cover up any fraudulent activities.

Placing the functions of purchasing, receiving, and storing of goods under one employee would enable that employee to conceal inefficiency and losses from such causes as duplicate orders, shortages in quantities received, excessive stockpiling, and “kickbacks” from suppliers.

The employee who has been given full responsibility for accounts receivable records and for collections from customers would be able to abstract cash receipts and to conceal this theft by falsification of customers’ accounts.

The employee responsible for all aspects of the payroll could overstate the amounts owing to employees or place fictitious names on the payroll.

Cash handling should be separated from recordkeeping. Duties should be divided so that the work of one employee serves as proof of the accuracy of the work of other employees.

7–33

a. (1) The primary auditing objective of the independent auditors is to obtain sufficient appropriate evidence to express an opinion as to the fairness of the financial statements in accordance with generally accepted accounting principles. A secondary objective is to determine that the client recognizes the objectives (listed below) of the internal auditors and that suitable progress is being made toward their achievement.

The overall auditing objective of the internal auditors is to assist management in achieving the most efficient administration of the operations of organization. This total objective entails the protection of the interests of the organization, including pointing out existing deficiencies to provide a basis for appropriate corrective action, and the furtherance of the interests of the organization, including the recommendation of changes for the improvement of the various phases of the operations. The internal auditors are also a monitoring control that serves as the eyes and ears of the audit committee of the board of directors. They help assure that management does not override other internal controls.

(2) In conducting audits, internal auditors appraise company policies, organization, records, and performance, whereas independent auditors are essentially concerned with the verification of data affecting the financial statements. Internal auditors are charged with the responsibility of seeing that company accounting policies are being followed; they are vitally interested in the cost of prescribed procedures and their effect upon customers and company personnel. By reason of the nature of their work, internal auditors undertake more exhaustive detailed inquiries than do the outside auditors.

For audit purposes, independent auditors are interested primarily in the end result of the accounting processes, but internal auditors are interested in the processes
themselves. CPAs propose correction of misstatements disclosed by their audits, whereas internal auditors try to prevent occurrence or recurrence of misstatements. Both auditors are concerned with the verification of the accuracy of the accounting records. Because they must form an opinion on the company’s financial statements, independent auditors are primarily concerned that the statements follow generally accepted accounting principles. Internal auditors are aware of this aspect of auditing managerial decisions, but principally concern themselves with determining that the decisions promote administrative efficiency and have been compiled with.

b. The independent auditors should consider the work of the internal auditors because the latter are an integral part of internal control. Such consideration is necessary by the outside auditors because its results determine the extent of their remaining auditing procedures.

7–34 The weaknesses and suggested improvements are as follows:

<table>
<thead>
<tr>
<th>Weakness</th>
<th>Recommended Improvement</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. The audit committee is not made up of all outside directors. Howard Kress, the chief financial officer, is a member.</td>
<td>The audit should be made up of only outside members of the board of directors. That is, directors who are not officers or employees of the company.</td>
</tr>
<tr>
<td>2. Howard Kress, the chief financial officer, reviews and approves related party transactions.</td>
<td>The audit committee or the complete board of directors should review and approve related party transactions.</td>
</tr>
<tr>
<td>3. The internal auditor reports to Laura Howe, the chief operating officer.</td>
<td>The internal auditor should report to the audit committee of the board of directors to help ensure objectivity.</td>
</tr>
<tr>
<td>4. While the company has a written code of conduct, employees are only exposed to it upon employment.</td>
<td>The code of conduct should be distributed at least annually and employees should be required to recommit to adherence to the code at that time.</td>
</tr>
<tr>
<td>5. The hotline for reporting unethical behavior is staffed by the corporate controller.</td>
<td>The hotline should be staffed by an objective function, such as internal auditing.</td>
</tr>
</tbody>
</table>

Objective Questions

7–35 Multiple Choice

a. (2) Detecting management fraud is generally not considered to be an objective of internal control. In fact, one of the inherent limitations of internal control is that it is subject to override by management. All of the other answers represent valid objectives of internal control.

b. (4) Management review of weekly performance reports is an ongoing monitoring activity that may detect errors or fraud. Answer (1) is incorrect because while periodic audits by internal audit represent a monitoring activity, they best classified as separate
evaluations, and not ongoing monitoring activities. Answer (2) is incorrect because the audit of the annual financial statements is the function of the external auditors. Answer (3) is incorrect because approvals of cash disbursements represent a control activity.

c. (1) Because the auditors’ purposes are for considering internal control to obtain the necessary knowledge to (a) assess the risks of material misstatement, and (b) to determine the nature, timing, and extent of the tests to be performed, answer (1) is correct.

d. (3) An increase in the substantive procedures will decrease detection risk, and thereby compensate for the increased level of control risk due to a weakness in internal control. Answer (1) is incorrect because if the weakness exists, increasing the extent of tests will only provide more evidence on the weakness—not evidence that compensates for the weakness. Answers (2) and (4) are incorrect because a decrease in detection risk or inherent risk, not an increase, would compensate. Also, in the case of inherent risk, it may not be possible to change the assessment since it is a function of the firm’s environment.

e. (3) Preparing bank reconciliations will detect a variety of misstatements related to cash and is a detective control in the sense that it does not prevent the misstatement from occurring, but may detect it. Answers (1) and (2) are incorrect because segregating duties and requiring approvals are primarily designed to prevent misstatements. Answer (4) is incorrect because the primary purpose of keeping backup copies of key transactions (or all transactions) is preventing loss of information in the event of an information system failure.

f. (4) The symbol on the left indicates a manual function; the symbol on the right represents a file.

g. (1) The internal auditors’ objectivity refers to their relative independence from the organizational units they have been evaluating. This may best be determined by considering the organizational level to which the internal auditors report. The other answers address the issues of the internal auditors’ competence, not objectivity.

h. (2) Involvement of the owner in key control functions should be a major step toward preventing material errors or defalcations. Answer (1) would not be cost-effective. Answer (3) would provide some measure of control, but not as much as would daily participation by the owner. If it were feasible to hire additional employees, it would be cheaper to hire permanent employees rather than temporary. The need for internal control is permanent. Answer (4) would weaken, not strengthen internal control.

i. (3) An enterprise risk management system cannot eliminate all risks.

j. (1) Hedging the risk is an example of risk sharing in that it involves reducing risk likelihood or impact by transferring or sharing a portion of the risk.

k. (1) Management may issue a report on internal control regardless of whether the system has a material weakness.

l. (3) In an audit of internal control performed under PCAOB standards, the auditors must test controls for all significant accounts.
7–36 The types of controls are as follow:

a. D. The annual physical inventory is a detective control because it would serve to detect misstatements of inventory after they have occurred.

b. D. The monthly reconciliation of bank accounts is a detective control because it would serve to detect misstatements of cash after they have occurred.

c. P. Segregation of duties over purchasing would serve to prevent errors and fraud relating to purchase transactions. Segregation of duties prevents individuals from perpetrating errors and fraud and covering them up in the course of performing their assigned duties.

d. P. Supervisory approval of time cards is a preventative control because it would serve to prevent errors and fraud with respect to payroll transactions. The supervisor approval would help to prevent errors or fraud in the time records.

e. P. Requiring dual signatures for checks is a preventative control because it would serve to prevent errors and fraud with respect to cash disbursements.

f. C. Adjustments of perpetual inventory records to physical counts would serve to correct the inventory records.

g. D. Management review of budget versus actual performance would serve to highlight potential errors and fraud after they have occurred. Therefore, it is a detective control.

h. D. Internal audits of payroll would serve to detect errors and fraud in payroll after they have occurred. Therefore, it is a detective control.

7–37

1. Monitoring—ongoing
2. Control environment—human resource policies and procedures
3. Control activities—application controls
4. Risk assessment
5. Monitoring—separate evaluations
6. Control environment—integrity and ethical values
7. Control activities—performance reviews
8. Accounting information and communication system
9. Control activities—physical controls
10. Control environment—organizational structure

7–38 SOLUTION:

1. c 6. c
2. c 7. d
3. d 8. e
4. g 9. f
5. h 10. i

7–39

a. 3
b. 2
c. 1
d. 7
e. 5
f. 11
g. 10

7–40

a. (2) Auditors are not in general concerned with how controls originated.

b. (3) While tests of controls involve, inquiry, inspection, observation, and reperformance, “observation of confirmations” doesn’t have a clear meaning.

c. (4) Tests of controls address operating effectiveness of controls.

d. (2) The planned assessed level of control risk is determined during planning.

e. (3) The auditors never know the exact control risk involved—they always simply have an estimate of it.

Problems

7–41 SOLUTION: Orange Corporation (Estimated time: 25 minutes)

ORANGE CORPORATION

Raw Materials Recording and Transferring System Flowchart

December 31, 20__
SOLUTION: Island Trading Co. (Estimated time: 25 minutes)

a. Undesirable combinations are as follows:

(1) Cash receipts and accounts receivable
(2) Cash receipts and credit memos on sales returns and allowances
(3) Cash disbursements and accounts payable
(4) Cash receipts and bank reconciliation
(5) Cash disbursements and bank reconciliation
(6) General ledger and cash receipts
(7) Accounts receivable and credit memos on sales returns and allowances

b. Assignment of functions

Employee No. 1:

(1) Maintain general ledger
(2) Issue credit memos on sales returns and allowances
(6) Reconcile bank account

Employee No. 2:

(4) Maintain cash disbursements journal and prepare checks for signature
(7) Handle and deposit cash receipts

Employee No. 3:

(2) Maintain accounts payable ledger
(3) Maintain accounts receivable ledger
7–43 SOLUTION: Prospect Corporation Inc. (Estimated time: 55 minutes)

a. PROSPECT CORPORATION INC.
Sales System Flowchart
December 31, 20__
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7–44 SOLUTION: Church Cash Receipts (Estimated time: 0 minutes)

Part (a)

<table>
<thead>
<tr>
<th>Weakness</th>
<th>Recommended Improvement</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Financial secretary exercises too much control over collections.</td>
<td>To extent possible, finance secretary’s responsibilities should be confined to recordkeeping.</td>
</tr>
<tr>
<td>2. Finance committee is not exercising its assigned responsibility for collections.</td>
<td>Finance committee should assume a more active supervisory role.</td>
</tr>
<tr>
<td>3. The internal auditing function has been assigned to the finance committee, which also has responsibility for the administration of the cash function. Also, the finance committee has not performed the internal auditing function.</td>
<td>An audit committee should be appointed to perform periodic internal auditing procedures or outside auditors should be engaged.</td>
</tr>
<tr>
<td>4. The head usher has sole access to cash during the period of the count. One person should not be left alone with the cash until the amount has been recorded or control established in some other way.</td>
<td>The number of cash counters should be increased to at least two, and cash should remain under joint control until counted and recorded.</td>
</tr>
<tr>
<td>5. The collection is vulnerable to robbery while it is being counted and from the church safe prior to its deposit in the bank.</td>
<td>The collection should be deposited in the bank’s night depository immediately after the count. Physical safeguards, such as locking and bolting the door during the period of the count should be instituted. Increasing the number of cash counters will also reduce vulnerability to robbery.</td>
</tr>
<tr>
<td>6. The head usher’s count lack usefulness from a control standpoint because he or she surrenders custody of both the cash and the record of the count.</td>
<td>The finance secretary should receive a copy of the collection report for posting to the finance records. The head usher should maintain a copy of the report for use by the audit committee.</td>
</tr>
<tr>
<td>7. Contributions are not deposited intact daily. There is no assurance that amounts withheld by the finance secretary for expenditure will be properly accounted for.</td>
<td>Contributions should be deposited intact daily. If it is considered necessary for the financial secretary to make cash expenditures, he or she should be provided with a cash working fund. The fund should be replenished by check based upon a properly approved reimbursement request and satisfactory support.</td>
</tr>
<tr>
<td>8. No mention is made of bonding.</td>
<td>Key employees and members involved in receiving and disbursing cash should be bonded.</td>
</tr>
<tr>
<td>9. Written instructions for handling cash collections apparently have not been prepared.</td>
<td>Particularly because much of the work involved in cash collections is performed by unpaid, untrained church members, often on a short-term basis, detailed instructions should be written.</td>
</tr>
</tbody>
</table>
Part (b)

<table>
<thead>
<tr>
<th>Weakness</th>
<th>Recommended Improvement</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. The envelope system has not been encouraged. Control features that it could provide have been ignored.</td>
<td>The envelope system should be encouraged. Donors should indicate on the outside of each envelope the amount contributed. Envelope contributions should be reported separately and supported by the empty collection envelopes. Prenumbered envelopes will permit ready identification of the donor by authorized persons without general loss of confidentiality.</td>
</tr>
<tr>
<td>2. The church maintains no permanent record of amounts pledged and contributed. These records are needed to (1) provide valid support for tax deductibility of members’ contributions, (2) permit better planning for fund drives, and (3) provide a basis for direct confirmation of amounts contributed.</td>
<td>A member’s contribution record should be prepared by the financial secretary from the pledge cards and collection envelopes.</td>
</tr>
<tr>
<td>3. No investigation is made of differences between the amounts pledged and contributed.</td>
<td>All members should be furnished with periodic written advice of the amounts pledged and contributed. If properly handled by the audit committee, this procedure can be combined with direct confirmation of the amount contributed. Not only will control be better, but also members more likely will fulfill their pledges.</td>
</tr>
<tr>
<td>4. Letters certifying to amounts contributed are being furnished to members based upon the amounts shown on pledge cares. This is improper because actual contributions may not equal pledges.</td>
<td>The maintenance of members’ contribution record and the furnishing of periodic advices to members will correct this weakness.</td>
</tr>
<tr>
<td>5. No provision is made for the receipt of contributions by mail. This method of giving should be encouraged, but the financial secretary should not handle mail receipts.</td>
<td>A church employee other than the financial secretary should open mail. This employee should list the receipts, maintain a copy of this listing, and deposit the receipts. Checks should be stamped with the restrictive endorsement when received.</td>
</tr>
</tbody>
</table>
In-Class Team Case

7–45 SOLUTION: Willington, CPA  (Estimated time: 50 minutes)

<table>
<thead>
<tr>
<th></th>
<th>Case A—Controls Appear Strong; Auditor Decides to Test Controls to Extent Possible*</th>
<th>Case B—Controls Appear Strong, but Auditor Does Not Test*</th>
<th>Case C—Controls Appear Weak*</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. At what level is planned assessed level of control risk?</td>
<td>Low</td>
<td>Maximum</td>
<td>Maximum</td>
</tr>
<tr>
<td>of control risk? (low; moderate; maximum)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>2. Describe the scope of tests of control that will be performed.</td>
<td>Tests performed</td>
<td>None</td>
<td>None</td>
</tr>
<tr>
<td>(none; tests performed)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Results of Tests of Controls</td>
<td>A(1)—Controls strong (operated effectively)</td>
<td>A(2) Controls moderately effectively</td>
<td>A(3) Controls ineffective</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>N/A</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>N/A</td>
</tr>
<tr>
<td>3. At what level is the assessed level of control risk?</td>
<td>Low</td>
<td>Moderate</td>
<td>Maximum</td>
</tr>
<tr>
<td>(low; moderate; maximum)</td>
<td></td>
<td></td>
<td>Maximum</td>
</tr>
<tr>
<td>4. (a) What is the acceptable level of detection risk?</td>
<td>Moderate</td>
<td>Low</td>
<td>Lowest</td>
</tr>
<tr>
<td>(lowest; low; moderate; high; highest)</td>
<td></td>
<td></td>
<td>Lowest</td>
</tr>
<tr>
<td>5. (b) Describe the scope (nature, timing, and extent) of substantive tests. (highest; high; moderate; low; lowest)</td>
<td>Moderate Scope</td>
<td>High Scope</td>
<td>Highest Scope</td>
</tr>
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<td></td>
<td></td>
<td></td>
<td>Highest Scope</td>
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<td>Highest Scope</td>
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<td></td>
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<td></td>
</tr>
</tbody>
</table>
| *Inherent risk is assessed at the maximum level; evaluation of controls is based on management’s description.