CHAPTER 18

Integrated Audits of Public Companies

Review Questions

18–1 Section 404a requires that each annual report filed with the Securities and Exchange Commission include an internal control report prepared by management in which management acknowledges its responsibility for establishing and maintaining adequate internal control and an assessment of internal control effective as of the end of the most recent fiscal year. Section 404b requires that the CPA firm attest to and report on the assessment made by management as well as provide its own opinion on internal control.

18–2 As operationalized by the Securities and Exchange Commission, management’s four overall responsibilities relating to internal control over financial reporting (hereafter, internal control):

- Accept responsibility for the effectiveness of internal control.
- Evaluate the effectiveness of internal control using suitable control criteria.
- Support the evaluation with sufficient evidence.
- Provide a report on internal control.

18–3 The following information must be included in management’s report on internal control over financial reporting:

- State that it is management’s responsibility to establish and maintain adequate internal control.
- Identify management’s framework for evaluating internal control.
- Include management’s assessment of the effectiveness of the company’s internal control over financial reporting as of the end of the most recent fiscal period, including a statement as to whether internal control over financial reporting is effective.
- Include a statement that the company’s auditors have issued an attestation report on management’s assessment.

18–4 A material weakness is considered more serious. A material weakness is a deficiency, or a combination of deficiencies, in internal control over financial reporting, such that there is a reasonable possibility that a material misstatement of the company’s annual or interim financial statements will not be prevented or detected on a timely basis. A significant deficiency is a deficiency, or a combination of deficiencies, in internal control over financial reporting that is less severe than a material weakness, yet important enough to merit attention by those responsible for oversight of the company’s financial reporting.
18–5 While the first part is correct (both significant deficiencies and material weaknesses must be communicated to the audit committee), there is an important distinction between the two. Material weaknesses result in adverse internal control audit reports, while significant deficiencies do not. Considering definitions, a material weakness is a deficiency, or a combination of deficiencies, in internal control over financial reporting, such that there is a reasonable possibility that a material misstatement of the company’s annual or interim financial statements will not be prevented or detected on a timely basis. A significant deficiency is a deficiency, or a combination of deficiencies, in internal control over financial reporting that is less severe than a material weakness, yet important enough to merit attention by those responsible for oversight of the company’s financial reporting.

18–6 When reporting on internal control over financial reporting, the opinion is on whether internal control is effective “as of” a particular date, ordinarily the last day of the client’s fiscal year. This is in contrast to reporting on the effectiveness of internal control over the entire year.

18–7 A compensating control limits the exposure to misstatements that exists due to deficiencies in other controls. It “compensates” for the deficiency in other controls, that is, it addresses the objective that is not being met by the deficient control. Compensating controls are ordinarily controls performed to detect, rather than prevent, a misstatement from occurring. For example, a reconciliation of the bank account performed by an individual otherwise independent of the cash function serves to detect a variety of possible misstatements (both errors and fraud) that may have occurred in the processing of cash receipts and disbursements.

18–8 Antifraud programs (three required) include effective:

- Management accountability.
- Audit committee.
- Code of conduct/ethics.
- “Whistleblower program.”
- Hiring and promotion procedures.
- Remediation of significant deficiencies material weaknesses, and fraud.

Students may include additional programs and elements.

18–9 A walk-through involves literally tracing a transaction through the entire information system from inception to financial reporting. Although generally an effective approach, walk-throughs are not required during an audit of internal control over financial reporting. They may be performed by the auditors or by the client personnel under proper supervision of the auditors.

18–10 Although any number of inquiries may be made, inquiries such as the following are suggested (three required):

- Can you describe the part of the processing of the transaction with which you are involved?
- What do you do when you find an error?
- What kind of errors have you found?
- What happened as a result of finding the errors, and how were the errors resolved?
- Have you ever been asked to override the process or controls? If yes, why did it occur and what happened?
18–11 Walk-throughs provide the auditors with evidence to:
- Verify that they have identified points at which a significant risk of misstatement to a relevant assertion exists.
- Verify their understanding of the design of controls, including those related to the prevention or detection of fraud.
- Evaluate the effectiveness of the design of controls.
- Confirm whether controls have been place in operation (implemented).

18–12 Routine transactions are for recurring activities, such as sales, purchases, cash receipts and disbursements, and payroll. Nonroutine transactions occur only periodically, such as the taking of physical inventory, calculating depreciation expense or adjusting for foreign currencies; nonroutine transactions generally are not a part of the routine flow of transactions. Estimation transactions (sometimes referred to as nonsystematic transactions) are activities involving management’s judgments or assumptions, such as determining the allowance for doubtful accounts, establishing warranty reserves, and assessing assets for impairment.

18–13 An account is significant if there is more than a remote likelihood that it could contain misstatements that individually, or when aggregated with others, could have a material effect on the financial statements.

Factors that should be considered in deciding whether an account is significant include its:
- Size and composition.
- Susceptibility of loss due to errors or fraud.
- Volume of activity, complexity and homogeneity of individual transactions.
- Nature of the account.
- Accounting and reporting complexity.
- Exposure to losses.
- Likelihood of significant contingent liabilities.
- Existence of related party transactions.
- Changes from the prior period.

18–14 Whether the auditors must perform tests at each location depends upon the individual importance of each location. Tests need only be performed at locations (or business units) that, individually or when aggregated, could create a material misstatement of the financial statements.

18–15 The statement is incorrect because auditors must first test design effectiveness, and if the design seems appropriate, test operating effectiveness to determine whether it is functioning properly. It is not a choice of one versus the other, although tests of operating effectiveness will not ordinarily be performed when the design is ineffective.

18–16 Any number of possible examples may be given in response to the question. One example is when a control is designed to require two individuals to open each day’s cash receipts. It may not operate effectively when the company allows one person to perform the function on days in which the second person is needed to perform another function. Also, such a control may not operate effectively if the two individuals simply divide the job in half and perform the function independently of one another.

18–17 The statement is correct. Standard No. 5 requires that additional evidence beyond inquiry alone be gathered. Thus, the auditors should substantiate inquiry results to the extent possible by performing other procedures such as inspecting reports or other documentation relating to the inquiry.
18–18 The statement is incorrect in that some controls may be tested after the “as of date” (year-end). Good examples are controls over the period-end financial reporting process in that they often function after year-end when the financial statements are being prepared.

18–19 The auditors may use the work of others as a part of an audit of internal control. One would ordinarily expect that the work of others would involve testing more low-risk, routine transactions rather than pervasive and control environment controls. In all cases in which the work of others is going to be used, the auditors should evaluate the competence and objectivity of those individuals and test the work they have performed.

18–20 When a substantive procedure identifies a misstatement, this will ordinarily indicate that controls have not operated effectively. Accordingly, this may lead to a consideration of the circumstances and whether a breakdown in controls indicates the existence of a significant deficiency or a material weakness. Indeed, identification of a material misstatement in the current year financial statements that was not initially identified by the company’s internal control is considered at least a significant deficiency and a strong indicator of a material weakness.

18–21 The performance of substantive tests may be affected by tests of controls in circumstances in which a control deficiency is identified. Substantive procedures may be increased to identify any possible material misstatement.

18–22 Entity-level controls have a pervasive effect on the achievement of overall control objectives (e.g., tone at the top) rather than a specific control objective.

18–23 The following represents transactions that are indicators of material weaknesses in internal control (three required):

- Identification of fraud, whether or not material, on the part of senior management
- Restatement of previously issued financial statements to reflect the correction of a material misstatement.
- Identification by the auditor of a material misstatement in circumstances that indicate that the misstatement would not have been detected by the company’s internal control.
- Ineffective oversight of the company’s external financial reporting and internal control by the company’s audit committee.

18–24 The opinion paragraph concludes directly on internal control.

18–25 A management imposed scope limitation is most likely to result in a disclaimer of opinion on the company’s internal control over financial reporting, or possibly withdrawal from the engagement.

18–26 Yes, although a material weakness exists related to internal control, the financial statements may still follow generally accepted accounting principles and an unqualified audit report may be appropriate. For example, a material weakness may have been identified, but one that the auditors’ substantive tests determined did not lead to a material misstatement during the year under audit. Or, if a material misstatement did occur during the year under audit and management has corrected it, an unqualified audit report on the financial statements would also be appropriate.

18–27 Auditors must communicate both significant deficiencies and material weaknesses to the audit committee.

18–28 When the auditors are engaged to report on whether a previously reported material weakness continues to exist, they plan and perform an engagement that focuses on controls that are relevant to
the particular weakness. If they determine that the controls are now effective, the auditors may issue an unqualified report indicating that the material weakness no longer exists.

Questions Requiring Analysis

18–29 Figure 18.7 presents the various links between identifying significant accounts and the controls to be tested. That sequence involves the following steps:

1. **Identify significant accounts and disclosures.** Significant accounts and disclosures are those in which there is more than a remote likelihood that it could contain misstatements that individually, or when aggregated with others, could have a material effect on the financial statements.

2. **Identify relevant financial statement assertions.** The financial statement assertions for significant accounts are: (1) existence or occurrence; (2) completeness; (3) valuation or allocation; (4) rights and obligations; (5) presentation and disclosures. The relevant assertions are those that have a meaningful bearing on whether the account is presented fairly.

3. **Identify significant processes and major classes of transactions.** The auditors identify each significant process over each major class of transactions. Major classes of transactions are those groupings of transactions that are significant to the financial statements. Consider a company whose sales may be initiated by customers either through the Internet, or in a retail store. These types of sales represent two major classes of transactions within the sales processes. Also, for a company with a significant amount of fixed assets, recording depreciation is a process that creates a major class of transactions. When auditors consider the major classes of transactions it is helpful to classify them by what Standard No. 5 refers to as transaction type—routine, nonroutine, or estimation.

   For each significant process, the auditors should:
   
   - Understand the flow of transactions (initiation, authorization, recording processing, reporting).
   - Identify points at which a misstatement could arise.
   - Identify controls to address potential misstatements.
   - Identify controls to prevent or timely detect unauthorized acquisition, use or disposition of the company’s assets.

4. **Identify control objectives.** The control objectives relate to the specific process in question. Figure 18.9 provides an illustration for accounts receivable. The control objectives include:

   - Ensure that all goods shipped are accurately billed in the proper period.
   - Accurately record all authorized shipments and only such shipments.
   - Accurately record all authorized sales returns and allowances and only such returns and allowances.
   - Ensure continued completeness and accuracy of accounts receivable.
   - Safeguard accounts receivable records.

5. **Identify controls to test.** The auditors identify the controls to be tested by considering the:
Points at which errors or fraud could occur.
Nature of the controls implemented by management.
Significance of each control in achieving the objectives of the control criteria.
Risk that controls might not be operating effectively.

18–30  a. The objective of tests of controls in an audit of internal control is to obtain evidence about the effectiveness of controls to support the auditors’ opinion on whether management’s assessment of the effectiveness of internal control is fairly stated as of a point in time and taken as a whole. Accordingly, to express this opinion the auditors must obtain evidence about the effectiveness of controls over all relevant assertions for all significant accounts and disclosures in the financial statements. This results in both testing controls not ordinarily tested for a financial statement and emphasizing tests that bear on their effectiveness as of a point in time—year-end.

b. The objectives of tests of controls for financial statement audits are to assist the auditors in planning the audit and to assess control risk. To assess control risk at less than the maximum, the auditors are required to obtain evidence that the relevant controls operated effectively during the entire period upon which the auditors plan to place reliance on those controls. However, the auditors are not required to assess control risk at less than the maximum for all assertions.

c. To reconcile these approaches, Standard No. 5, for purposes of the internal control audit, allows the auditors to obtain evidence about operating effectiveness at different times throughout the year—provided that the auditors update those tests or obtain other evidence that the controls still operated effectively at the end of the year. Thus, although the timing for issuing the internal control report would often not require tests throughout the year, the integrated nature of the two audits suggests a degree of testing throughout the year.

18–31  a. The management of Alexandria must gather sufficient evidence to demonstrate that hiring the controller has eliminated the material weakness, document the evidence, and provide a written assertion that the material weakness no longer exists.

b. Webster, Warren & Webb should plan and perform an engagement that focuses on whether the new controller has sufficient expertise to eliminate the material weakness. If they determine that hiring the controller has mitigated the weakness, the auditors may issue an unqualified report indicating that the material weakness no longer exists.

c. If the audit team discovers another weakness during the course of the audit, it will not affect the auditors’ report. However, they should make sure that the audit committee of Alexandria is notified about the weakness.

Objective Questions
18–32  Multiple Choice Questions

a. (1) PCAOB Standard No. 5 requires the auditors to communicate both material weaknesses and significant deficiencies to the audit committee.

b. (2) An audit report on internal control is modified for material weaknesses, not significant deficiencies.
c. (1) Management must communicate both material weaknesses and significant deficiencies to the audit committee.

d. (1) PCAOB Standard No. 5 includes ineffective oversight of financial reporting by the audit committee is considered an indicator of a material weakness in internal control.

e. (2) A material weakness involves a reasonable possibility of a material misstatement.

f. (3) An unqualified opinion with no explanatory language is appropriate when the material weakness has been eliminated (remediated) prior to the “as of date,” year-end.

g. (4) Management’s report on internal control under Section 404a of the Sarbanes-Oxley Act of 2002 need not state that it has a responsibility to establish and maintain internal control that detects all significant deficiencies.

h. (2) Management’s documentation must include information on controls designed to prevent fraud, but not on controls designed to ensure employee personal integrity.

i. (4) A material weakness involves a material amount.

j. (4) A walk-through involves tracing a transaction from origination through a company’s information systems until it is reflected in the financial reporting system.

k. (3) Auditors will not ordinarily ask what was the largest fraudulent transaction an individual ever processed. The other three replies are recommended questions.

l. (1) An audit of internal control over financial reporting ordinarily assess internal control at an “as of date”—ordinarily the last day of the fiscal period.

18–33 1. (A) The function of a credit department is to follow the company’s credit policies to make decisions on the granting of credit.

2. (B) Sales returns should be presented to the receiving clerk (not a sales department clerk) who should prepare a receiving report (not a shipping report).

3. (A) Sending monthly statements to customers represents a control strength as errors and fraud may be discovered.

4. (B) Write-offs of accounts receivable should be approved by a management official independent of the recordkeeping function, not by the controller who is responsible for recordkeeping. Frequently, the treasurer approves write-offs.

5. (C) While requiring two signatures on large checks is a good control over expenditures, it relates much more directly to the purchases/disbursements cycle than to the revenue cycle.

6. (A) Mailed cash receipts should be received by an individual with no recordkeeping responsibility—a secretary with no recordkeeping responsibility is appropriate. That individual should open the mail and prepare a list of the receipts. The cash should be forwarded with a copy of the listed receipts to a cashier (or the individual who makes deposits) and the remittance advices should be forwarded with another copy of the listed receipts to the accounting department.

7. (B) As indicated in the answer explanation to item 6, the cash receipts should be opened by an individual with no recordkeeping responsibility. The cash should be forwarded
with a copy of the listed receipts to a cashier (or the individual who makes deposits) and the remittance advices should be forwarded with another copy of the listed receipts to the accounting department.

8. \( (B) \) The cash receipts journal should be prepared by the department responsible for recordkeeping—accounting—under the authority of the controller.

9. \( (B) \) Cash should ordinarily be deposited daily.

10. \( (C) \) This control relates to the purchases/disbursements cycle.

11. \( (A) \) Bank reconciliations should be prepared by individuals independent of cash receipts (and cash disbursements) recordkeeping.

18–34 Task-Based Simulation

\( a. \) Agree. Voided checks should be saved so there is no question as to whether it is voided or outstanding.

\( b. \) Disagree. Each bank account ordinarily has its own series.

\( c. \) Agree. Purchasing, which authorizes purchase, should not also sign checks, which in essence disburse funds related to those purchases.

\( d. \) Disagree. This is a control in that it makes it more difficult for an inappropriate person to cash a check.

\( e. \) Agree. Authorized check signers disburse funds and effective oversight of the disbursement function requires reconciliation by another individual.

\( f. \) Disagree. Cash receipts should be so prelisted to establish control over total receipts.

\( g. \) Disagree. A policy of restrictively endorsing receipt (e.g., endorsing them “pay only to Zabling Co.”) is a control that makes it more difficult for another individual to cash the checks for personal use.

\( h. \) Disagree. This policy eliminates the possibility of the support inappropriately being used to support an improper second disbursement using those documents.

18–35 Task-Based Simulation

<table>
<thead>
<tr>
<th>Situation</th>
<th>Response</th>
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<tbody>
<tr>
<td>a. The client did not furnish adequate evidence for the auditors to evaluate internal control over inventory. All other evidence was provided.</td>
<td>9. Issue a disclaimer of opinion.</td>
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<tr>
<td>b. The auditors examined the client’s internal control over cash receipts and concluded that they are operating exactly as designed. However, the design of the controls does not include control procedures to prevent misstatements and he potential omission of cash receipts.</td>
<td>3. Determine if the control deficiency is a material weakness by obtaining further evidence.</td>
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<td>c. The auditors concluded that the ineffectiveness of the design of controls over accounts payable and cash disbursements represents a material weakness in internal control, even though the financial statements are not materially misstated.</td>
<td>5. Express an adverse opinion on internal control.</td>
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<tr>
<td>d. The auditors concluded that a significant deficiency in internal control exists in the payroll function, but no material weakness.</td>
<td>6. Express an unqualified opinion on internal control.</td>
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</table>
e. The auditor’s prior-year report on internal control included an adverse opinion. The client has since modified internal control and no material weaknesses were found in the current year.

6. Express an unqualified opinion on internal control.

18–36 Definitions

a. 4 Material weakness
b. 1 Control deficiency
c. 9 Significant account
d. 8 Section 404
e. 3 Major classes of transactions
f. 12 Walk-through

Problem

18–37 SOLUTION: Slingsdale Building Supplies, Inc. (Estimated time: 30 minutes)

a. The following deficiencies exist in Slingsdale’s cash receipts and billing functions:

   • Credit manager:
     
     o Ability to approve credit without external credit check or reference to established credit limits.

   • AR supervisor:
     
     o Billing without independent manual or computer verification.
     o Ability to alter details of charge forms and to use altered details in preparing invoices.
     o No check that daily totals of charge forms equal daily totals of invoices.
     o May write off accounts because there is no independent verification of the AR subsidiary ledger or reconciliation of it with the control account.
     o Long overdue accounts may remain on books and additional credit granted by omitting them from monthly report.

   • Cashier:
     
     o Incompatible duties of receiving cash receipts, depositing cash, and recording receipts on remittance advices.
     o No independent verification of cash receipts with deposit slips or lists of checks.
     o Reconciling bank statements is incompatible with receiving and depositing cash.

   • Bookkeeper:
     
     o Authorizes write-offs without investigating reasons for them.
     o Established criterion for write-offs is too inflexible and does not prevent granting additional credit at earlier date.
     o Can indirectly grant additional credit by not notifying credit manager of write-off.
     o Incompatible duties of authorizing and recording write-offs.
b. Material weaknesses result in an adverse opinion.

c. All material weaknesses and significant deficiencies must be reported both to management and to the audit committee.

In-Class Team Cases

18–38 SOLUTION: Control Deficiencies, Significant Deficiencies, and Material Weaknesses (Estimated time: 30 minutes)

Case 1

The auditors would generally determine that this deficiency represents a significant deficiency because while an immaterial amount is likely to be involved, it does seem large enough as to merit informing those responsible for oversight of the company’s financial reporting.

Case 2

The auditors are most likely to determine that the combination of these significant deficiencies represents a material weakness for the following reasons:

- Individually, these deficiencies were evaluated as representing significant deficiencies.
- Each of these significant deficiencies affects the same set of accounts and taken together may represent a more than remote likelihood that a material misstatement could occur and not be prevented or detected.

Therefore, in combination, these significant deficiencies may represent a material weakness.

Case 3

The auditors are most likely to determine a significant deficiency for the following reasons:

- The magnitude of a financial statement misstatement resulting from this deficiency would reasonably be expected to be less than material, although at a level that might merit the attention of those responsible for oversight of the company’s financial reporting.
- The risk of material misstatement is limited to revenue recognition errors related to shipping terms as opposed to broader sources of error in revenue recognition. However, the compensating detective controls are only designed to detect material misstatements.

Case 4

Based on only these facts, the auditors should determine that this deficiency represents a material weakness for the following reasons:

- The magnitude of a financial statement misstatement resulting from this deficiency would reasonably be expected to be material, because the frequency of occurrence allows insignificant amounts to become material in the aggregate.
• The likelihood of material misstatement of the financial statements resulting from this internal control deficiency is reasonably possible (even assuming that the amounts were fully reserved for in the company's allowance for uncollectible accounts) due to the likelihood of material misstatement of the gross accounts receivable balance.

Therefore, this internal control deficiency meets the definition of a material weakness.

Case 5

A restatement of previously issued financial statements to reflect the correction of a misstatement should be regarded as at least a significant deficiency and a strong indicator that a material weakness in internal control over financial reporting exists. If the auditors believe that management now knows the rules this may be considered only a significant deficiency—assuming the auditors don’t believe that this lack of accounting knowledge is a general problem in other areas.

Case 6

The auditor’s identification of a material misstatement is an indicator of a material in internal control. Yet, the hiring of the financial accounting expert seems to indicate that the deficiency does not exist at year-end. It seems clear that a material weakness in internal control does not exist at year-end.

Case 7

The question here relates to whether the auditor believes that the chief financial officer’s knowledge and ability is sufficient to indicate that neither a material weakness nor a significant deficiency exists at year-end. The auditors would need to determine whether the chief financial officer is likely to be able to effectively monitor matters. If not, a material weakness would seem to exist.

Case 8

PCAOB Standard No. 5 states that identification by the auditor of a material misstatement in financial statements in the current period that was not initially identified by the company’s internal control over financial reporting is a strong indicator of a material weakness. Because the auditors believe that the controller’s estimate is not reasonable, this would appear to be a strong indicator that a material weakness in internal control over financial reporting exists.