**Integrated Auditing**

Match the following definitions (or partial definitions) to the appropriate term. Each term may be used once or not at all.

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| **Definition (or Partial Definition)** | **Term** |
| 1. A control deficiency, or a combination of control 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. 2. A weakness in the design or operation of a control that does not allow management or employees, in the normal course of performing their functions, to prevent or detect misstatements on a timely basis. 3. An account for which there is a reasonable possibility that it could contain misstatements that individually or, when aggregated with others, could have a material effect on the financial statements. 4. The primary section of Sarbanes-Oxley Act dealing with management and auditor reporting on internal control over financial reporting. 5. Those transaction flows that have meaningful bearing on the totals accumulated in the company’s significant accounts and, therefore, have a meaningful bearing on relevant assertions. 6. Tracing a transaction from origination through the company’s information systems until it is reflected in the company’s financial reports. | 1. Control deficiency 2. Detective controls 3. Major classes of transactions 4. Material weakness 5. Nonroutine transaction 6. Routine transaction 7. Section 243 8. Section 404 9. Significant account 10. Significant deficiency 11. Substantive procedure 12. Walk-through |

During audit of internal control over financial reporting of various issuers, the auditors encountered the independent situations below. For each situation, *a* through *e* select from the following list the appropriate audit responses. Each reply may be used once, more than once, or not at all.

1. Assess control risk as low for the purpose of the financial statement audit.
2. Consult legal counsel to explore reducing auditor liability.
3. Determine if the control deficiency is a material weakness by obtaining further evidence.
4. Disclose in the notes to the financial statements that there are material weaknesses.
5. Express an adverse opinion on internal control.
6. Express an unqualified opinion internal control.
7. Express an unqualified opinion on internal control and a paragraph on whether a previously reported material weakness in internal control continues to exist.
8. Insist that management’s assessment of internal control includes a description of the significant deficiency.
9. Issue a disclaimer of opinion.
10. Issue a report on internal control stating that no deficiencies were noted.
11. Issue a separate report on the client’s internal control.
12. Modify the opinion in the report on internal control for significant deficiencies.
13. Report matter only to board of directors.

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| **Situation** | **Response** |
| 1. The client did not furnish adequate evidence for the auditors to evaluate internal control over inventory. All other evidence was provided. 2. 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 the potential omission of cash receipts. 3. The auditors concluded that the ineffectiveness of the design controls over accounts payable and cash disbursements represents a material weakness in internal control even though the financial statements are not materially misstated. 4. The auditors concluded that a significant deficiency in internal control exists in the payroll function, but not material weakness. 5. 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. | **9.**  **3.**  **5.**  **13 & 6** |

For each of the following independent cases, state the highest level of deficiency that you believe the circumstances present-a control deficiency, a significant deficiency, or a material weakness. Explain your decisions in each case.

**Case 1**: The company processes a significant number of routine intercompany transactions. Individual intercompany transactions are not material and primarily relate to balance sheet activity-for example, cash transfers between business units to finance normal operations. A formal management policy requires monthly reconciliations of intercompany accounts and confirmation of balances between business units. However, there is not a process in place to ensure performance of these procedures. As a result detailed reconciliations of the intercompany accounts are not performed on a timely basis. Management does perform monthly procedures to investigate selected large-dollar intercompany account differences. In addition, management prepares a detailed monthly variance analysis of operating expenses to assess their reasonableness.

* Non-material doesn’t relate to income statement.
* Management has monthly procedure to detect.
* No process in place to ensure performance of these detection of these procedures.
* RESULT: **Significant deficiency.** The controls are not working.

**Case 2**: During its assessment of internal control over financial reporting, management identified the following deficiencies. Based on context in which the deficiencies occur, management and the auditors agree that these deficiencies individually represent significant deficiencies:

* Inadequate segregation of duties over certain information system access controls.
  + People can access things they’re not allowed to.
* Several instances of transactions that were not properly recorded in the subsidiary ledgers; the transactions involved were not material, either individually or in aggregate.
* No timely reconciliation of the account balances affected by the improperly recorded transactions.
* RESULT: **Material weakness**

**Case 3**: The company uses a standard sales contract for most transactions, although sales personnel are allowed to modify sales contract terms as necessary to make a profitable sale. Individual sales transactions are not material to the entity. The company’s accounting personnel review significant or unusual modifications to the sales contract terms. The changes in the standard shipping terms could require a delay in the timing of revenue recognition. Management reviews gross margins on a monthly basis and investigates any significant or unusual relationships. In addition, management reviews the reasonableness of inventory levels at the end of each accounting period. The company has experienced limited situations in which revenue has been inappropriately recorded in advance of the shipment, but amounts have not been material.

**Case 4**: The company has standard sales contract, but sales personnel frequently modify the terms of the contract. Sales personnel frequently grant unauthorized and unrecorded sales discounts to customers without the knowledge of the accounting department. These amounts are deducted by customers in paying their invoices and are recorded as outstanding balances in the accounts receivable aging. Although these amounts are individually insignificant, they are material in the aggregate and have occurred consistently over the past few years.

**Case 5**: The company has found it necessary to restate its financial statements for the past two years due to material overstatement of revenues two years ago (and an equal understatement last year). The errors are **due to sales of certain software that allowed the purchasers extremely lenient rights of return**. The errors were discovered shortly following the end of the current accounting year. Members of management indicated that the misstatements occurred because they simply did not know the accounting rules. Now they know the rules and they won’t let it happen again.

* RESULT: Significant deficiency.
* How much do you believe in management? No deficiency.

**Case 6**: Assume that same facts exist as in Case 5 except that you, the auditor, have identified the misstatements at the end of June of the year currently under audit. Members of management acknowledged that the misstatements occurred because they simply did not know the rules at the time, and now they know the rules. Management, within the last six months of the year under audit, hired a new financial accounting new expert and believes that the control weakness has been corrected as of year-end. Management believes that it is extremely unlikely that such a misstatement could occur again with the new expert reviewing the matters.

**Case 7**: Assume the same facts exist as in Case 6, except that the management has informed the CFO that she must watch over these matters much more carefully. She has attended several CPE courses on accounting and seems to be caught up in the area in which the misstatements occurred.

**Case 8**: Subsequent to year-end, the auditors have determined that they believe that management has understated its warranty obligations. The auditors know that, according to the Professional Standards, they should consider the difference between the management’s estimate and closes reasonable estimate as “likely misstatement.” The CFO has argued that this amount is reasonable. Yet, in fact, neither the CFO nor the auditors know which amount is right. The CFO is under no particular pressure to meet an earnings forecast; he just thinks that the warranty obligations for many of the products will expire and will not be exercised. Still, the CFO can’t convince the auditors. Likewise, the auditors can’t convince the CFO their position. The CFO finally agrees to a material adjustment to get to the auditors’ amount and “keep the peace.”

* CFO’s way of estimating amount is not correct.
* Internal control weakness
* Warranties are a contingent liability
* Disclosure on financials are based on probable outcome.
* Payments or replacements to honor warranty claims do not affect the income statement or net income. Reduce the warranty payable.