

# CPA REVIEW SCHOOL OF THE PHILIPPINES

Manila

## AUDITING THEORY

### INTERNAL CONTROL

*Related PSAs/PAPSSs: PSA 400, 402 and 315*

The auditor should obtain an understanding of the accounting and internal control systems sufficient to plan the audit and develop an effective audit approach.

Accounting system means the series of tasks and records of an entity by which transactions are processed as a means of maintaining financial records. Such systems identify, assemble, analyze, calculate, classify, record, summarize and report transactions and other events.

Internal Control System means all the policies and procedures (internal controls) adopted by the management of an entity to assist in achieving management's objective of ensuring, as far as practicable,:

- orderly and efficient conduct of its business, including adherence to management policies;
- safeguarding of assets;
- prevention and detection of fraud and error;
- accuracy and completeness of the accounting records; and
- timely preparation of reliable financial information.

The internal control system extends beyond those matters which relate directly to the functions of the accounting system.

#### Internal Control Components (PSA 315)

- (a) The control environment;
- (b) The entity's risk assessment process;
- (c) The information system, including the related business processes, relevant to financial reporting, and communication;
- (d) Control activities; and
- (e) Monitoring of controls.

#### *Control environment*

The control environment includes the attitudes, awareness, and actions of management and those charged with governance concerning the entity's internal control and its importance in the entity. The control environment also includes the governance and management functions and sets the tone of an organization, influencing the control consciousness of its people. It is the foundation for effective internal control, providing discipline and structure.

The control environment encompasses the following elements:

- Communication and enforcement of integrity and ethical values.
- Commitment to competence.
- Participation by those charged with governance.
- Management's philosophy and operating style.
- Organizational structure.
- Assignment of authority and responsibility.
- Human resource policies and practices.

#### *Entity's risk assessment process*

An entity's risk assessment process is its process for identifying and responding to business risks and the results thereof. For financial reporting purposes, the entity's risk assessment process includes how management identifies risks relevant to the preparation of financial statements that are presented fairly, in all material respects in accordance with the entity's applicable financial reporting framework, estimates their significance, assesses the likelihood of their occurrence, and decides upon actions to manage them.

Risks can arise or change due to circumstances such as the following:

- *Changes in operating environment.* Changes in the regulatory or operating environment can result in changes in competitive pressures and significantly different risks.
- *New personnel.* New personnel may have a different focus on or understanding of internal control.
- *New or revamped information systems.* Significant and rapid changes in information systems can change the risk relating to internal control.
- *Rapid growth.* Significant and rapid expansion of operations can strain controls and increase the risk of a breakdown in controls.
- *New technology.* Incorporating new technologies into production processes or information systems may change the risk associated with internal control.
- *New business models, products, or activities.* Entering into business areas or transactions with which an entity has little experience may introduce new risks associated with internal control.
- *Corporate restructurings.* Restructurings may be accompanied by staff reductions and changes in supervision and segregation of duties that may change the risk associated with internal control.
- *Expanded foreign operations.* The expansion or acquisition of foreign operations carries new and often unique risks that may affect internal control, for example, additional or changed risks from foreign currency transactions.
- *New accounting pronouncements.* Adoption of new accounting principles or changing accounting principles may affect risks in preparing financial statements.

*Information system, including the related business processes, relevant to financial reporting, and communication*

An information system consists of infrastructure (physical and hardware components), software, people, procedures, and data. Infrastructure and software will be absent, or have less significance, in systems that are exclusively or primarily manual.

The information system relevant to financial reporting objectives, which includes the financial reporting system, consists of the procedures and records established to initiate, record, process, and report entity transactions (as well as events and conditions) and to maintain accountability for the related assets, liabilities, and equity.

Accordingly, an information system encompasses methods and records that:

- 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.
- 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.
- Present properly the transactions and related disclosures in the financial statements.

Communication involves providing an understanding of individual roles and responsibilities pertaining to internal control over financial reporting. It includes the extent to which personnel understand how their activities in the financial reporting information system relate to the work of others and the means of reporting exceptions to an appropriate higher level within the entity. Open communication channels help ensure that exceptions are reported and acted on.

*Control activities*

Control activities are the policies and procedures that help ensure that management directives are carried out, for example, that necessary actions are taken to address risks that threaten the achievement of the entity's objectives.

Generally, control activities that may be relevant to an audit may be categorized as policies and procedures that pertain to the following:

- Performance reviews.
- Information processing.
- Physical controls.
- Segregation of duties.

#### *Monitoring of controls*

Management's monitoring of controls includes considering whether they are operating as intended and that they are modified as appropriate for changes in conditions. Monitoring of controls may include activities such as management's review of whether bank reconciliations are being prepared on a timely basis, internal auditors' evaluation of sales personnel's compliance with the entity's policies on terms of sales contracts, and a legal department's oversight of compliance with the entity's ethical or business practice policies.

#### Inherent Limitations of Internal Controls

1. Management's usual requirement that the cost of an internal control does not exceed the expected benefits to be derived.
2. Most internal controls tend to be directed at routine transactions rather than non-routine transactions.
3. The potential for human error due to carelessness, distraction, mistakes of judgment and the misunderstanding of instructions.
4. The possibility of circumvention of internal controls through the collusion of a member of management or an employee with parties outside or inside the entity.
5. The possibility that a person responsible for exercising an internal control could abuse that responsibility, for example, a member of management overriding an internal control.
6. The possibility that procedures may become inadequate due to changes in conditions, and compliance with procedures may deteriorate.

#### Accounting and Internal Control Assessment

- |                 |   |
|-----------------|---|
| 1 <sup>st</sup> | Understanding of accounting and internal control system |
| 2 <sup>nd</sup> | Plan the assessed level of control risk                 |
| 3 <sup>rd</sup> | Performance of tests of controls (if appropriate)       |
| 4 <sup>th</sup> | Reassessment of control risk                            |
| 5 <sup>th</sup> | Final assessment of control risk                        |

#### (1<sup>st</sup>) Understanding of Accounting and Internal Control Systems

In the audit of financial statements, the auditor is only concerned with those policies and procedures within the accounting and internal control systems that are relevant to the financial statement assertions. The understanding of relevant aspects of the accounting and internal control systems, together with the inherent and control risk assessments and other considerations, will enable the auditor to:

- (a) identify the types of potential material misstatements that could occur in the financial statements;
- (b) consider factors that affect the risk of material misstatements; and
- (c) design appropriate audit procedures.

The nature, timing and extent of the procedures performed by the auditor to obtain an understanding of the accounting and internal control systems will vary with, among other things:

- The size and complexity of the entity and of its computer system.
- Materiality considerations.
- The type of internal controls involved.
- The nature of the entity's documentation of specific internal controls.
- The auditor's assessment of inherent risk.
- Experience gained from prior audits.

#### *Procedures in Obtaining Understanding*

1. Make inquiries of appropriate company personnel
2. Inspect documents and records
3. Observe the company's activities and operations
4. Walk-through

*Documentation of Understanding*

The auditor should document his understanding of internal control. The extent of documentation is a matter of the CPA's judgment and the form of documentation depends upon his preference and skills.

1. Narrative descriptions

2. Internal control questionnaires (ICQ)
3. Flowcharts

4. Checklists

(2<sup>nd</sup>) Preliminary Assessment of Control Risk

The preliminary assessment of control risk is the process of evaluating the effectiveness of an entity's accounting and internal control systems in preventing or detecting and correcting material misstatements. There will always be some control risk because of the inherent limitations of any accounting and internal control system.

After obtaining an understanding of the accounting and internal control systems, the auditor should make a preliminary assessment of control risk, at the assertion level, for each material account balance or class of transactions.

The auditor ordinarily assesses control risk at a high level for some or all assertions when:

- (a) the entity's accounting and internal control systems are not effective; or
- (b) evaluating the effectiveness of the entity's accounting and internal control systems would not be efficient.

The preliminary assessment of control risk for a financial statement assertion should be high unless the auditor:

- (a) is able to identify internal controls relevant to the assertion which are likely to prevent or detect and correct a material misstatement; and
- (b) plans to perform tests of control to support the assessment.

(3<sup>rd</sup>) Test of Controls

If appropriate, tests of control are performed to obtain audit evidence about the effectiveness of the:

- (a) **design** of the accounting and internal control systems, that is, whether they are suitably designed to prevent or detect and correct material misstatements; and
- (b) **operation** of the internal controls throughout the period.

*Procedures for Performing Tests of Controls*

1. Inspection

2. Inquiry
3. Observation

4. Reperformance
5. Walk-through

*Required Documentation*

	<u>Assessed Control Risk</u>	
	<u>High (Maximum)</u>	<u>Less than high (Below Maximum)</u>
Understanding of ICS	Required	Required
Tests of Controls	Required	Required
Assessment of Control Risk	Required	Not required
Reason for assessment	Not required	Required

(4<sup>th</sup>) Reassessment of control risk

Based on the results of the tests of control, the auditor should evaluate whether the internal controls are designed and operating as contemplated in the preliminary assessment of control risk. The evaluation of deviations may result in the auditor concluding that the assessed level of control risk needs to be revised. In such cases, the auditor would modify the nature, timing and extent of planned substantive procedures.

(5<sup>th</sup>) Final Assessment of Control Risk

Before the conclusion of the audit, based on the results of the substantive procedures and other audit evidence obtained by the auditor, the auditor should consider whether the assessment of control risk is confirmed.

### Communication of Weaknesses

As a result of obtaining an understanding of the accounting and internal control systems and tests of control, the auditor may become aware of weaknesses in the systems. The auditor should make management aware, as soon as practical and at an appropriate level of responsibility, of material weaknesses in the design or operation of the accounting and internal control systems, which have come to the auditor's attention. The communication to management of material weaknesses would ordinarily be in writing. However, if the auditor judges that oral communication is appropriate, such communication would be documented in the audit working papers. It is important to indicate in the communication that only weaknesses which have come to the auditor's attention as a result of the audit have been reported and that the examination has not been designed to determine the adequacy of internal control for management purposes.

### MULTIPLE CHOICE QUESTIONS

1. According to PSA 400, which of the following is correct regarding internal control system?
  - a. Internal control system refers to all the policies and procedures adopted by the auditor to assist in achieving management's objective.
  - b. A strong environment, by itself, ensure the effectiveness of the internal control system.
  - c. In the audit of financial statements, the auditor is only concerned with those policies and procedures within the accounting and internal control systems that are relevant to the financial statements.
  - d. The internal control system is confined to those matters which relate directly to the functions of the accounting system.
2. Which of the following is correct about internal control?
  - a. Accounting and internal control systems provide management with conclusive evidence that objectives are reached.
  - b. One of the inherent limitations of accounting and internal control systems is the possibility that the procedures may become inadequate due to changes in conditions, and compliance with procedures may deteriorate.
  - c. Most internal controls tend to be directed at non-routine transactions.
  - d. Management does not consider costs of the accounting and internal control systems.
3. Corporate directors, management, external auditors, and internal auditors all play important roles in creating a proper control environment. Top management is primarily responsible for
  - a. Establishing a proper environment and specifying overall internal control.
  - b. Reviewing the reliability and integrity of financial information and the means used to collect and report such information.
  - c. Ensuring that external and internal auditors adequately monitor the control environment.
  - d. Implementing and monitoring controls designed by the board of directors.
4. Which of the following best describe the interrelated components of internal control?
  - a. Organizational structure, management philosophy, and planning.
  - b. Control environment, risk assessment, control activities, information and communication systems, and monitoring.
  - c. Risk assessment, backup facilities, responsibility accounting and natural laws.
  - d. Legal environment of the firm, management philosophy, and organizational structure.
5. In an audit of financial statements, an auditor's primary consideration regarding a control is whether it
  - a. Reflects management's philosophy and operating style.
  - b. Affects management's financial statement assertions.
  - c. Provides adequate safeguards over access to assets.
  - d. Enhances management's decision-making processes.
6. Effective internal control
  - a. Eliminates risk and potential loss to the organization.
  - b. Cannot be circumvented by management.
  - c. Is unaffected by changing circumstances and conditions encountered by the organization.
  - d. Reduces the need for management to review exception reports on a day-to-day basis.

7. Which of the following statements about internal control is correct?
  - a. Properly maintained internal controls reasonably assure that collusion among employees cannot occur.
  - b. Establishing and maintaining internal control is the internal auditor's responsibility.
  - c. Exceptionally strong control allows the auditor to eliminate substantive tests.
  - d. **The cost-benefit relationship should be considered in designing internal control.**
8. The ultimate purpose of assessing control risk is to contribute to the auditor's evaluation of the risk that
  - a. Tests of controls may fail to identify controls relevant to assertions.
  - b. **Material misstatements may exist in the financial statements.**
  - c. Specified controls requiring segregation of duties may be circumvented by collusion.
  - d. Entity policies may be overridden by senior management.
9. A proper understanding of the client's internal control is an integral part of the audit planning process. The results of the understanding
  - a. Must be reported to the shareholders and the SEC.
  - b. Bear no relationship to the extent of substantive testing to be performed.
  - c. Are not reported to client management.
  - d. **May be used as the basis for withdrawing from an audit engagement.**
10. An entity should consider the cost of a control in relationship to the risk. Which of the following controls best reflects this philosophy for a large peso investment in heavy machine tools?
  - a. Conducting a weekly physical inventory.
  - b. Placing security guards at every entrance 24 hours a day.
  - c. **Imprinting a controlled identification number on each tool.**
  - d. Having all dispositions approved by the vice president of sales.
11. Audit evidence concerning segregation of duties ordinarily is best obtained by
  - a. Performing tests of transactions that corroborate management's financial statement assertions
  - b. **Observing the employees as they apply specific controls.**
  - c. Obtaining a flowchart of activities performed by available personnel.
  - d. Developing audit objectives that reduce control risk.
12. Which of the following statements about preliminary assessment of control risks is correct?
  - a. After obtaining an understanding of the accounting and internal control systems, the auditor should make a preliminary assessment of control risks, at the assertion level, for all accounts or transaction classes.
  - b. The preliminary assessment of control risk can be done only after completing tests of controls.
  - c. The preliminary assessment of control risk for a financial assertion is normally low, unless the auditor is able to identify weaknesses that may indicate ineffectiveness of accounting and internal control system.
  - d. **The auditor ordinarily assesses control risk at high level for some or all assertions when it is not cost efficient to do tests of controls.**
13. Which of the following statements concerning control risk is correct?
  - a. When control risk is at the maximum level, an auditor is required to document the basis for that assessment.
  - b. Control risk may be assessed sufficiently low to eliminate substantive testing for significant transaction classes.
  - c. When assessing control risk, an auditor should not consider evidence obtained in prior audits about the operation of controls.
  - d. **Assessing control risk and obtaining an understanding of an entity's internal control may be performed concurrently.**
14. Based on a consideration of internal control completed at an interim date, the auditor assessed control risk at a low level and performed interim substantive tests. The records and procedures would most likely be tested again at year-end if
  - a. Tests of controls were not performed by the internal auditor during the remaining period.
  - b. Internal control provides a basis for limiting the extent of substantive testing.
  - c. The auditor used nonstatistical sampling during the interim period testing of controls.
  - d. **Inquiries and observations lead the auditor to believe that conditions have changed.**

15. Although substantive tests may support the accuracy of underlying records, these tests frequently provide no affirmative evidence of segregation of duties because
  - a. Substantive tests rarely guarantee the accuracy of the records if only a person who performs incompatible functions.
  - b. The records may be accurate even though they are maintained by a person who performs incompatible functions.
  - c. Substantive tests relate to the entire period under audit, but tests of controls ordinarily are confined to the period during which the auditor is on the client's premises.
  - d. Many computerized procedures leave no audit trail of who performed them, so substantive tests may necessarily be limited to inquiries and observation of office personnel.
16. After obtaining an understanding of internal control and assessing control risk, an auditor decided not to perform additional tests of controls. The auditor most likely concluded that the
  - a. Additional evidence to support a further reduction in control risk was not cost-beneficial to obtain.
  - b. Assessed level of inherent risk exceeded the assessed level of control risk.
  - c. Internal control was properly designed and justifiably may be relied on.
  - d. Evidence obtainable through tests of controls would not support an increased assessment of control risk.
17. The objective of tests of details of transactions performed as tests of controls is to
  - a. Monitor the design and use of entity documents such as prenumbered shipping form
  - b. Determine whether controls have been placed in operation.
  - c. Detect material misstatements in the account balances of the financial statements.
  - d. Evaluate whether controls operated effectively.
18. An auditor wishes to perform tests of controls on a client's cash disbursements procedures. If the controls leave no audit trail of documentary evidence, the auditor most likely will test the procedures by
  - a. Confirmation and observation.
  - b. Observation and inquiry.
  - c. Analytical procedures and confirmation.
  - d. Inquiry and analytical procedures
19. Which of the following would not be a method used to conduct tests of controls?
  - a. Inquiry
  - b. Walkthrough
  - c. Confirmation
  - d. Observation
20. The auditor is examining copies of sales invoices only for the initials of the person responsible for checking the extensions. This is an example of a
  - a. Test of controls
  - b. Substantive test
  - c. Dual purpose test
  - d. Test of balances
21. Which of the following types of evidence would an auditor most likely examine to determine whether controls are operating as designed?
  - a. Confirmations of receivables verifying account balances.
  - b. Letters of representations corroborating inventory pricing.
  - c. Attorneys' responses to the auditor's inquiries.
  - d. Client records documenting the use of computer programs.
22. Which of the following procedures concerning accounts receivable is an auditor most likely to perform to obtain evidential matter in support of an assessed level of control risk below the maximum level?
  - a. Sending confirmation requests to an entity's principal customers to verify the existence of accounts receivable.
  - b. Inspecting an entity's analysis of accounts receivable for unusual balances.
  - c. Comparing an entity's uncollectible accounts expense to actual uncollectible accounts receivable.
  - d. Observing an entity's employee prepare the schedule of past due accounts receivable.
23. An auditor is least likely to test controls that provide for
  - a. Classification of revenue and expense transactions by product line
  - b. Approval of the purchase and sale of trading securities
  - c. Segregation of the functions of recording disbursements and reconciling the bank account
  - d. Comparison of receiving reports and vendors' invoices with purchase orders

24. In a small company that doesn't employ an adequate number of employees to permit proper division of responsibilities, effective internal control can be strengthened by
- Direct participation by the owner of the business in the record keeping activities of the business.
  - Employment of temporary personnel to aid in the separation of duties.
  - Delegation of full, clear-cut responsibility to each employee for the functions assigned to each.
  - Engaging a CPA to perform monthly "write up" work.
25. Which of the following is true of the communication to management of material weaknesses in accounting and internal control?
- Communication must be in writing.
  - Oral communication of material weaknesses, when appropriate, would be documented in the audit working papers.
  - The communication should indicate that the auditor had extensively examined the accounting and internal control system of the client.
  - The auditors should indicate in the communication that the examination is primarily designed to determine whether the accounting and internal control is adequate.

### QUIZZERS

- Transaction authorization within an organization may be either specific or general. An example of specific transaction authorization is the
  - Approval of a construction budget for a new warehouse
  - Setting of automatic reorder points
  - Establishment of a customer's credit limits
  - Establishment of sales prices
- Internal control should provide reasonable (but not necessarily absolute) assurance which means that:
  - The cost of control activities should not exceed the benefits.
  - Internal control is management's, not auditor's, responsibility.
  - An attestation engagement about management's internal control assertions may not necessarily detect all reportable conditions.
  - There is always a risk that reportable conditions may result in material misstatements.
- Which of the following statements is an example of an inherent limitation of internal control.
  - Errors may arise from mistakes in judgments.
  - The effectiveness of control procedures depends on segregation of duties.
  - Procedures are designed to assure that transactions are executed as management authorities.
  - Computers process large numbers of transactions.
- Proper segregation of functional responsibilities calls for separation of the functions of
 

<ol style="list-style-type: none"> <li>Authorization, execution, and recording.</li> <li>Authorization, execution, and payment.</li> </ol>	<ol style="list-style-type: none"> <li>Custody, execution, and reporting.</li> <li>Authorization, payment, and recording.</li> </ol>
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- Which of the following is a responsibility that should not be assigned to only one employee?
  - Access to securities in the company's safe deposit box.
  - Custodianship of the cash working fund.
  - Reconciliation of bank statement.
  - Custodianship of tools and small equipment.
- Which of the following activities would be least likely to strengthen a company's internal control?
  - Maintaining insurance for fire and theft.
  - Separating accounting from other financial operations.
  - Fixing responsibility for the performance of employee duties.
  - Carefully selecting and training employees.
- As generally conceived, the "audit committee" of a publicly held company should be made up of
  - Members of the board of directors who are not officers or employees.
  - Representatives of the major equity interests (bonds, preferred stock, common stock).
  - The audit partner, the chief financial officer, the legal counsel, and at least one outsider.
  - Representatives from the client's management, investors, suppliers, and customers.



8. When considering internal control, the auditor's primary concern is to determine
- a. **The reliability of the accounting information system.**
  - b. The possibility of fraud occurring.
  - c. Compliance with policies, plans, and procedures.
  - d. The type of an opinion he will issue.
9. Of the following, the best statement of the CPA's primary objective in considering internal control is that the review is intended to provide
- a. **A basis for reliance on the system and determining the scope of other auditing procedures.**
  - b. Reasonable protection against client fraud and defalcations by client employees.
  - c. A basis for constructive suggestions to the client for improving his internal control system.
  - d. A method for ensuring that there is reasonable assurance that the financial statements are reliable.
10. When an auditor assesses control risk below the maximum level, the auditor is required to document the auditor's
- |    | <u>Basis for concluding that control Risk is below the maximum level</u> | <u>Understanding of the entity's internal control structure elements</u> |
|----|--|--|
| a. | <b>Yes</b>   | <b>Yes</b>   |
| b. | No   | No   |
| c. | Yes  | No   |
| d. | No   | Yes  |
11. The sequence of steps in gathering evidence as the basis of the auditor's opinion is
- a. Substantive tests, documentation of control structure, and tests of controls
  - b. **Documentation of control structure, tests of controls, and substantive tests**
  - c. Documentation of control structure, substantive tests, and tests of controls
  - d. Tests of controls, documentation of control structure, and substantive tests
12. In obtaining an understanding of an entity's internal control structure, an auditor is required to obtain knowledge about the
- |    | <u>Operating effectiveness of Policies and procedures</u> | <u>Design of policies and procedures</u> |
|----|---|--|
| a. | Yes   | Yes                                      |
| b. | <b>No</b>   | <b>Yes</b>                               |
| c. | Yes   | No                                       |
| d. | No  | No                                       |
13. Which of the following audit techniques most likely would provide an auditor with the most assurance about the effectiveness of the operation on an internal control procedure?
- a. Confirmation with outside parties
  - b. **Observation of client personnel**
  - c. Recomputation of account balance
  - d. Inquiry of client personnel
14. Which of the following is the correct order for performing the auditing procedures A through C below
- A = Tests of Controls  
B = Preparation of a flowchart depicting the client's internal control structure  
C = Substantive tests
- a. ABC
  - b. **BAC**
  - c. ACB
  - d. BCA
15. After considering a client's internal control, an auditor has concluded that the system is well designed and is functioning as anticipated. Under these circumstances, the auditor would most likely
- a. Cease to perform further substantive tests
  - b. **Not increase the extent of planned substantive tests**
  - c. Increase the extent of anticipated analytical procedures
  - d. Perform all tests of controls to the extent outlined in the preplanned audit program
16. After considering internal control, an auditor might decide to
- a. Increase the extent of tests of controls and substantive tests in areas where internal control is strong
  - b. **Increase the extent of substantive tests in areas where internal control is weak**
  - c. Reduce the extent of tests of controls in areas where internal control is strong

- d. Reduce the extent of both substantive tests and tests of controls in areas where internal control is strong
17. To obtain an understanding of the relevant policies and procedures of internal control, the auditor performs all of the following except:
- a. Make inquiries
  - b. **Design substantive tests**
  - c. Make observations
  - d. Inspect documents and records
18. In an auditor's consideration of internal control, the completion of a questionnaire is most closely associated with which of the following?
- a. Separation of duties
  - b. **Understanding the system**
  - c. Flowchart accuracy
  - d. Tests of controls
19. Before relying on the system of internal control, the auditor obtains a reasonable degree of assurance that the internal control procedures are in use and operating as planned. The auditor obtains this assurance by performing planned
- a. Substantive tests
  - b. **Tests of controls**
  - c. Transaction tests
  - d. Tests of trends and ratios
20. After obtaining an understanding of a client's controls, an auditor may decide to omit tests of the controls. Which of the following is not an appropriate reason to omit tests of controls?
- a. The controls duplicate other controls.
  - b. **The controls appear adequate.**
  - c. Reportable conditions preclude assessing control risk below the maximum.
  - d. The effort to test controls exceeds the effort saved by not performing substantive tests.
21. In general, a material weakness in internal control may be defined as a condition in which material errors or irregularities may occur and not be detected within a timely period by
- a. An independent auditor during tests of controls.
  - b. Management when reviewing interim financial statements and reconciling account balances.
  - c. **Employees in the normal course of performing their assigned functions.**
  - d. Outside consultants who issue a special-purpose report on internal control structure.
22. Internal control procedures are not designed to provide reasonable assurance that
- a. Transactions are executed in accordance with management's authorization.
  - b. Access to assets is permitted only in accordance with management's authorization.
  - c. **Irregularities will be eliminated.**
  - d. The recorded accountability for assets is compared with the existing assets at reasonable intervals.
23. A secondary purpose of the auditor's consideration of internal control is to provide
- a. A basis for assessing control risk.
  - b. An assurance that the records and documents have been maintained in accordance with existing company policies and procedures.
  - c. **A basis for constructive suggestions about improvements in internal control structure.**
  - d. A basis for the determination of the resultant extent of the tests to which auditing procedures are to be restricted.
24. The auditor's review of the client's internal control is documented in order to substantiate
- a. Conformity of the accounting records with GAAP.
  - b. Adherence to requirements of management.
  - c. **Compliance with generally accepted auditing standards.**
  - d. The fairness of the financial statement presentation.
25. A consideration of internal control made during an audit is usually not sufficient to express an opinion on an entity's controls because
- a. Weaknesses in the system may go unnoticed during the audit engagement.
  - b. A consideration of internal control is not necessarily made during an audit engagement.
  - c. **Only those controls on which an auditor intends to rely are reviewed, tested, and evaluated.**
  - d. Controls can change each year.

26. The accountant's report expressing an opinion on an entity's internal controls should state that the
- Objectives of the client's internal controls are being met.
  - Consideration of the internal controls was conducted in accordance with generally accepted auditing standards.
  - Establishment and maintenance of internal control is the responsibility of management.**
  - Inherent limitations of the client's internal controls were examined.
27. The primary objective of procedures performed to obtain an understanding of internal control is to provide an auditor with
- Evidential matter to use in reducing detection risk.
  - A basis from which to modify tests of controls.
  - Knowledge necessary to plan the audit.**
  - Information necessary to prepare flowcharts.

#### PSA 400 – Risk Assessments and Internal Control

28. Which of the following is not part of the control environment?
- Management philosophy and operating style.
  - Organizational structure and methods of assigning authority and responsibility.
  - Information and communication systems.**
  - The function of the board of directors and its committees.
29. When obtaining an understanding of the accounting and internal control system the auditor may trace a few transactions through the accounting system. This technique is:
- Reperformance test
  - Test of transactions
  - Walk-through test**
  - Validity test
30. Which of the following least likely affects the nature, timing, and extent of the procedures performed by the auditor to obtain an understanding of the accounting and internal control systems of an audit client?
- Materiality considerations
  - The auditor's assessment of inherent risk
  - The level of acceptable detection risk**
  - The size and complexity of the entity and of its computer system
31. The evaluation of deviations that were observed upon completing tests of controls
- May require the need for doing more extensive understanding of control.
  - May require more extensive tests of controls.
  - Always requires documentation of the basis of assessment of control risk.
  - May require modification of the nature, timing, and extent of planned substantive procedures.**
32. The following statements are true about observation when used as tests of control procedures, except.
- The auditor may supplement his observations with other tests of control capable of providing audit evidence.
  - Audit evidence obtained by doing observation pertains only to the point in time at which the procedure was applied.
  - Observation of who applies a control procedure is useful as a test of control procedures when evaluating control effectiveness of both computerized and manual system
  - Ordinarily, making inquiries provides more reliable audit evidence than doing observation when testing segregation of functional responsibilities.**
33. Tests of controls may include the following, except:
- Reperformance of internal control procedures
  - Inquiries about, and observation of, internal controls which leave no audit trail.
  - Inspection of documentary support for transactions evidencing authorization
  - Analytical procedures involving comparison of operating expenses with budgeted amount.**
34. Tests of controls are performed to obtain audit evidence about the effectiveness of the
- Operation of the internal controls at the time the tests are being applied.
  - Operations of the internal controls in eliminating fraud and errors.
  - Design of the internal controls in eliminating fraud and errors.
  - Design of the accounting and internal controls systems.**

35. The auditor should consider whether the assessment of control risk is confirmed
- Upon completion of understanding of internal control.
  - Upon completion of tests of controls
  - Before the final audit program is completed.
  - Upon the conclusion of the audit, based on the results of substantive procedures and other audit evidence obtained.

PSA 402 – Audit Considerations Relating to Entities Using Service Organizations

36. Which of the following is least likely considered by the auditor in determining the significance of service organization activities to the client and the relevance to the audit?
- Terms of contract and relationship between the client and the service organization.
  - The material financial statement assertions that are affected by the use of the service organization.
  - Client's internal controls that are applied to the transactions processed by the service organization.
  - The control policies and procedures of the client of requiring that all payments for goods and services be supported by receiving reports.
37. When the auditor considers that the service organization activities are significant to the client and relevant to the audit and he concludes that it would be efficient to obtain audit evidence from tests of control to support an assessment of control risk at a lower level. Such evidence may be obtained by, except
- Performing tests of the client's controls over activities of the service organization.
  - Obtaining a service organization auditor's report that expresses an opinion as to the operating effectiveness of the service organization's accounting and internal control systems for the processing applications relevant to the audit.
  - Visiting the service organization and performing tests of control.
  - Review the service contract between the client and the service organization.
38. Which statement is incorrect regarding the client auditor's use of service organization auditor's report?
- When using a service organization auditor's report, the client auditor should consider the nature of and content of that report.
  - The client auditor should consider the scope of work performed by the service organization auditor and should assess the usefulness and appropriateness of reports issued by the service organization auditor.
  - When a Type B report is to be used as evidence to support a lower control risk assessment, a client auditor would consider whether the controls tested by the service organization auditor are relevant to the client's transactions (significant assertions in the client's financial statements) and whether the service organization auditor's tests of control and the results are adequate.
  - Since Type A reports may be useful to a client auditor in gaining the required understanding of the accounting and internal control systems, an auditor may use such reports as a basis for reducing the assessment of control risk.
39. Which of the following is the least concern of the client auditor in reviewing the report of service organization auditor on suitability of internal control design of the service organization?
- The accuracy of description of the service organization's accounting and internal control systems, ordinarily prepared by the management of the service organization.
  - The systems' controls have been placed in operation.
  - The accounting and internal control systems are suitably designed to achieve their stated objectives.
  - The type of documentation of the understanding of the service organization's control system.
40. Which of the following is least likely entitled to the report of the service organization auditor on the suitability of the design and operating effectiveness of the service organization?
- Service organization's management
  - Service organization's customers
  - Client's auditors
  - Service organization's stockholders

True or False

1. As part of understanding internal, an auditor is not required obtain knowledge about the operating effectiveness of internal control.
2. A CPA's consideration of internal control in a financial statement audit is usually more limited than that made in connection with an engagement to report on management's written assertion as to the effectiveness of internal control.
3. Proper segregation of duties reduces the opportunities for persons to be in positions to perpetrate and conceal errors or fraud.
4. Management's aggressive attitude toward financial reporting and its emphasis on meeting projected profit goals most likely would significantly influence an entity's control environment when management is dominated by one individual who is also a shareholder.
5. It is important for the auditor to consider the competence of the audit client's employees, because their competence bears directly and importantly upon the achievement of the objectives of internal control.
6. When obtaining an understanding of an entity's internal control, an auditor should concentrate on the substance of controls rather than their form because management may establish appropriate controls but not act on them.
7. In obtaining an understanding of an entity's internal control in a financial statement audit, an auditor is not obligated to search for significant deficiencies in the operation of internal control.
8. An independent auditor might consider the procedures performed by the internal auditors because they are employees whose work may affect the nature, timing, and extent of audit procedures.
9. Internal control procedures are not designed to provide reasonable assurance that irregularities will be eliminated.
10. When considering internal control, an auditor must be aware of the concept of reasonable assurance, which recognizes that cost of internal control procedures should not exceed the benefits expected to be derived from the control.
11. The auditor's review of the client's internal control is documented in order to substantiate compliance with generally accepted auditing standards.
12. After obtaining an understanding of an entity's internal controls, an auditor may assess control risk at the maximum for some assertions because the auditor believes internal control activities are unlikely to be effective.
13. The primary purpose of the auditor's consideration of internal control is to provide a basis for determining the nature, timing, and extent of audit tests to be applied.
14. After consideration of a client's internal control, an auditor might decide to increase the extent of substantive testing in areas where the controls are weak.
15. A consideration of internal control made during an audit is usually not sufficient to express an opinion on an entity's controls because only those controls on which an auditor intends to rely are reviewed, tested, and evaluated.
16. Evidence about segregation of duties is best obtained by direct personal observation of employees who perform control activities.
17. An auditor's flowchart of a client's accounting system is a diagrammatic representation that depicts the auditor's understanding of the internal control system.
18. The purpose of tests of controls is to provide reasonable assurance that the control procedures are functioning as intended.
19. After documenting internal control in an audit engagement, the auditor may perform tests on those controls that the auditor plans to rely on.
20. The auditor observes client employees in order to corroborate the information obtained during the initial review of the system.

- end of AT-5910 -