

Chapter 3: Internal Control over Financial Reporting: Management's Responsibilities and Importance to the External Auditors

Student: _____

1. Internal control is a process designed to guarantee the achievement of the objectives of reliable financial reporting, compliance with laws and regulations and ineffective and inefficient operations.

True False

2. Internal control is a process, effected by an entity's board of directors, management, and other personnel, designed to provide reasonable assurance regarding the achievement of objectives relating to operations, reporting, and compliance.

True False

3. The quality of an organization's internal control will affect both the audit approach and the amount of testing needed for an engagement.

True False

4. Control activities are the component of internal control that includes control actions that have been established by policies and procedures

True False

5. Control activities implemented to mitigate transaction processing risk that typically affect only certain processes, transactions, accounts, and assertions are referred as transaction or application controls.

True False

6. Internal controls are considered to be part of corporate governance.

True False

7. Effective control not only identifies risk but also responds to these risks appropriately.

True False

8. Investors and lenders are not concerned with internal control of the companies in which they invest.

True False

9. Preventative controls are designed to prevent the occurrence of a misstatement.
True False
10. Internal control are needed for all activities of the organization
True False
11. The better the quality of the internal controls, the more an auditor can rely on the controls.
True False
12. The five major components of an organization's internal control are: the control environment, risk assessment, control activities, information and communication, and monitoring.
True False
13. A company's internal auditing function should not be considered when assessing the effectiveness of internal controls.
True False
14. An organization's control environment is established and maintained by the internal auditing department.
True False
15. A material weakness in internal control 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.
True False
16. Physical controls are necessary to protect and safeguard assets from accidental or intentional destruction and theft.
True False
17. Monitoring of the internal controls involves assessment by appropriate personnel of the design and operation of controls on a timely basis and taking necessary actions.
True False
18. An auditor is not required to obtain evidence about the design and operation of the internal controls to conclude the controls are effective at preventing material misstatements from occurring.
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19. Segregation of duties is a control activity that is designed to protect against the risk that an individual could both perpetrate and cover up a fraud.
- True False
20. In addition to controls being specific, they may be broad, such as policies regarding a code of ethics.
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31. One of the advantages of a computerized accounting system is that the computerized system eliminates the need for internal controls.
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32. A transaction trail includes the documents and records that allow an auditor to trace a transaction from its origination through to its final disposition, or vice versa.
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35. Managers must use professional judgment to determine whether identified control deficiencies rise to the level of a significant deficiency or material weakness.
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36. Walkthroughs and inquiries are often used to obtain an understanding of internal controls.
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37. A deficiency in design of internal controls exists when an existing control is not properly designed so that, even if the control operates as designed, the control objective would not be met.
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38. The PCAOB's requirement is that documentation must be able to be interpreted by an auditor not connected to the engagement.
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39. A well-controlled organization has an appropriate structure and clearly defined lines of responsibility and authority where everyone in the organization has equal responsibility for the effective operation of internal control.
- True False
40. Transaction oriented controls are designed to operate on every transaction throughout the year.
- True False
41. All organizations should evaluate and communicate internal control deficiencies in a timely manner to those parties responsible for taking corrective action, including senior management and the board of directors, as appropriate.
- True False
42. Preventive controls are designed to provide reasonable assurance that the correct program is used for processing, all transactions are processed, and the transactions update appropriate files.
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43. One of the components of internal control, monitoring, refers to the process of identifying, capturing, and exchanging information in a timely fashion to enable accomplishment of the organization's objectives.
- True False
44. One of the components of internal control, the control environment, is considered pervasive and the auditor should start the evaluation of controls at this level.
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45. Control activities may be implemented at the organizational level and at the transactional level.
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46. The quality of an organization's internal controls affect which of the following?
- A. The reliability of financial data.
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 - D. All of the above.
47. Internal control is a process designed to achieve objectives in which one of the following categories?
- A. Reliability of financial reporting.
 - B. Compliance with applicable laws.
 - C. Ineffectiveness of operations.
 - D. Both A and B.

48. Which of the following is **not** a reason that the auditor must gain an understanding of the client's internal control system?
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 - B. Assess control risk and identify the types of financial statement misstatements that are most likely to occur.
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49. Which one of the following groups is interested in an organization's control structure?
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- A. Control risk assessment.
 - B. Control environment.
 - C. Information and communication.
 - D. Monitoring.

54. Which of the following is not part of the control environment?
- A. Management philosophy and operating style.
 - B. Methods of assigning authority and responsibility.
 - C. Personnel policies and practices.
 - D. Control activities.
55. Which of the following is **not** one of the underlying principles of an effective control environment as developed by COSO?
- A. The organization demonstrates a commitment to integrity and ethical values.
 - B. The board of directors demonstrates independence from management and exercises oversight for the development and performance of internal control.
 - C. Management establishes, with board oversight, structures, reporting lines, and appropriate authorities and responsibilities in pursuit of objectives.
 - D. The organization considers the potential for fraud in assessing risks to the achievement of objectives.
56. Which of the following is a major component of an organization's internal control structure?
- A. Major new financing.
 - B. The financial environment.
 - C. Risk assessment.
 - D. Telecommunication equipment.
57. What is the component of COSO's internal control system that concerns the process of identifying, capturing, and exchanging information in a timely fashion to enable accomplishment of the organization's objective called?
- A. Control activities.
 - B. Information and communication.
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58. Which of the following services does the PCAOB require auditors of public companies to perform?
- A. A financial statement audit and an attest audit.
 - B. A financial statement audit and an assurance audit.
 - C. A financial statement audit and agreed upon procedures.
 - D. A financial statement audit and an examination of the effectiveness of internal controls.
59. The information and communication component of internal control includes which of the following?
- A. The organization deploys control activities through policies that establish what is expected and in procedures that put policies into action.
 - B. The organization obtains or generates and uses relevant, quality information to support the functioning of other components of internal control.
 - C. The organization identifies and assesses changes that could significantly impact the system of internal control.
 - D. All of the above.

60. Which of the following best describes the purpose of personnel policies and procedures?
- A. Ensure the organization hires the right people.
 - B. Ensure the organization complies with federal and state laws in its hiring and retention decisions.
 - C. Ensure the organization has employees that are properly trained and supervised.
 - D. Ensure the organization performs all of the above.
61. Which of the following is not part of management's report on internal controls?
- A. Management responsibility for control of financial reporting.
 - B. The framework used to evaluate internal control.
 - C. An assessment of the effectiveness of the company's internal control.
 - D. A statement that the company is not required to have an audit on internal control.
62. Which one of the following represents a control deficiency?
- A. A missing control that is required for achievement of objectives.
 - B. A control that operates as designed.
 - C. A control that ensures the reliability of financial reporting.
 - D. A control that does not prevent immaterial errors.
63. The PCAOB's AS No. 5 states that internal controls may be preventive or detective. Which of the following controls is preventive?
- A. Requiring two persons to open mail containing payments.
 - B. Reconciling the accounts receivable subsidiary file with the control account.
 - C. Using batch totals.
 - D. Preparing bank reconciliations.
64. Which of the following is an inherent limitation of internal controls?
- A. Lack of auditor independence.
 - B. Collusion.
 - C. Separation of duties.
 - D. Employee peer review.
65. When obtaining an understanding of internal controls, what is the independent external auditor primary concerned with?
- A. Detecting all errors.
 - B. Determining the effectiveness of operations.
 - C. Determining whether the internal controls can be relied upon.
 - D. Determining whether the controls promote efficiency.

66. What is the auditor's responsibility for testing internal controls when the auditor believes that the internal controls are effective and intends to rely upon them?
- A. The auditor is required to test the controls.
 - B. The auditor may test the controls.
 - C. The auditor does need not to test the controls.
 - D. The auditor never has any responsibility for testing internal controls.
67. To support an assessment that controls are effective, what must an auditor do?
- A. Achieve the same conclusion after appropriately testing internal control.
 - B. Achieve the opposite conclusion after appropriately testing internal control.
 - C. Perform increased substantive procedures.
 - D. Perform limited substantive procedures as the assessment is justified.
68. Which of the following is an example of a test of controls?
- A. Examining the reasonableness of interest accrued on notes payable.
 - B. Verify that cash surrender value of life insurance is classified as a long-term asset.
 - C. Using a spreadsheet to create a pivot table for the summarization of accounts receivable.
 - D. Reviewing management's monthly bank reconciliations.
69. Requiring the mail clerk to prepare a listing of all checks received, with copies of the list going to the cashier and to accounting, is an example of which type of control?
- A. Preventive.
 - B. Corrective.
 - C. Detective.
 - D. Directive.
70. Which of the following best represents a walkthrough?
- A. The controller reviews the bank reconciliation prepared by the accountant and its resulting journal entries.
 - B. The auditor walks the production line to find inefficiencies in the inventory process and reports them to management.
 - C. The controller takes a sample of write-offs to ensure they have been adequately documented and recorded.
 - D. The auditor traces three purchasing transactions from the purchase order to the financial statement for observation and understanding.
71. Which one of the following is considered effective documentation of an internal control system?
- A. Electronically pre-numbered records.
 - B. A cathode ray screen used in input.
 - C. Verbal authorization.
 - D. The financial statements.

72. Which of the following facts would result in an auditor issuing an adverse report over internal control?
- A. The controls are believed to be effective.
 - B. The tests of controls support the documented understanding of controls.
 - C. There is a material weakness in the design or operation of controls.
 - D. A confirmation is not returned by a customer timely.
73. Which of the following is an example of a physical control to safeguard assets?
- A. Hiring only trustworthy cashiers.
 - B. Separation of duties.
 - C. Locks on the warehouse doors.
 - D. Safety audits on the production-line.
74. A financial statement auditor concludes that internal controls over cash are not functioning as designed. She believes that material misstatements to the cash accounts are possible because of the deficiencies. What course of action is the auditor most likely to take?
- A. Report the audit to the regulatory agencies of the IRS and SEC.
 - B. Develop specific tests for cash balances to determine the extent of misstatement.
 - C. Explain to the client that the audit firm will not be able to complete the audit.
 - D. Test the internal control over cash.
75. Which one of the following is **not** a control activity implemented in most accounting systems?
- A. Segregation of duties.
 - B. Competent, trustworthy employees.
 - C. Authorization procedures.
 - D. All of these activities are normally implemented.
76. What is the typical outcome when an auditor discovers a material weakness in the design or operation of controls?
- A. An adverse opinion unless management corrects the defect before year-end.
 - B. An adverse opinion even if management corrects the defect before year-end.
 - C. The firing of the auditors.
 - D. Adjusting audit journal entries.
77. Which of the following is not a way an auditor obtains evidence regarding the effectiveness of internal control over the accounting system?
- A. Performing a walkthrough of the accounting system.
 - B. Making inquiries of banks and attorneys.
 - C. Reviewing system flowcharts.
 - D. Taking plant and operational tours.

78. Which of the following procedures will an auditor use to better understand a client's internal control over accounting systems?
- A. An auditor will look over subsequent year working papers.
 - B. An auditor will review previous year working papers.
 - C. An auditor will copy previous year working papers.
 - D. An auditor will re-draft subsequent year working papers.
79. Internal control is a process affected by the organization's board of directors, management, and other personnel to provide reasonable assurance of achieving certain objectives. Which of the following does not fit into one of these categories of objectives?
- A. Reliability of financial reporting.
 - B. Compliance with laws and regulations.
 - C. Continuing existence.
 - D. Effectiveness and efficiency of operations.
80. Which of the following documents will an auditor use to demonstrate an understanding of internal control?
- A. Checklists, disclosures and procedures.
 - B. The audit report, internal control opinions and confirmations.
 - C. Workpapers, engagement letters and management representation letters.
 - D. Questionnaires, narratives and flowcharts.
81. Which of the following is clearly a test of controls?
- A. Walk-through of the expense cycle from performance of the service to the reporting in the balance sheet.
 - B. Examination of a sample of purchase order records for electronic, authenticated, authorization.
 - C. Observing the controller's use of company owned equipment.
 - D. Sending a letter to the client's attorney to determine litigation that is pending between plaintiff and the defendant.
82. Which of the following is an example of a control environment deficiency??
- A. A low level of control consciousness within the organization.
 - B. An audit committee that does not have independent members.
 - C. An audit committee that is not viewed as the client of the external auditor.
 - D. All of the above.
83. Which of the following types of evidence is an auditor most likely to consider in determining whether internal controls are operating as designed?
- A. A letter from management corroborating inventory pricing.
 - B. Questionnaires completed by employees in the receiving department concerning their duties and responsibilities.
 - C. Attorneys' responses to the auditor's inquiries.
 - D. Direct confirmations of receivables verifying account balances.

84. How can an auditor use inquiry to gain a better understanding of internal controls?
- A. By interviewing key employees to gain further insight into the internal control environment.
 - B. By observing the safeguarding of assets by checking locked doors and safes.
 - C. By tracing a transaction from the boundary of the organization through to the final reporting.
 - D. By documenting thoroughly the internal control through the use of narratives.
85. In a large company, who usually monitors the internal control?
- A. Internal auditors.
 - B. PCAOB.
 - C. CFO.
 - D. External auditors.
86. Which of the following is **not** true of internal control as defined by COSO?
- A. It is narrower than internal control over financial reporting.
 - B. It is a process that includes all elements of internal control working together.
 - C. It includes all the people in the organization.
 - D. It starts at the top of the organization in setting a tone.
87. Which of the following is **not** true of the concepts that are embodied in the COSO framework of internal controls?
- A. Internal controls relate to the organization's objectives.
 - B. The six components of internal control are logically and operationally intertwined.
 - C. Internal controls apply across all activities of the organization.
 - D. All of the above are true.
88. Which of the following is not a major components of an organization's internal controls?
- A. Risk assessment.
 - B. Control environment.
 - C. Control activities.
 - D. Control risk.
89. Which of the following is **not** part of the control environment of an organization?
- A. Management's philosophy and operating style.
 - B. Organizational structure.
 - C. Human resources.
 - D. Both A and B.
 - E. All of the above are part of the control environment.

90. Which of the following is an example of a detective control in an information system?
- A. Automated reports to management that specifically identify delinquent receivable.
 - B. A requirement that salaried employees submit written requests to work overtime.
 - C. Assurance from top management that computer centers are kept locked.
 - D. The employment of trustworthy people to enter data into the information system.
91. Which of the following is a detective control?
- A. Access controls.
 - B. Edit controls.
 - C. Reconciliations.
 - D. All of the above are detective controls.
92. Which component of COSO's internal control system concerns the process that provides feedback on the effectiveness of the other four components of internal control?
- A. Information and communication.
 - B. Monitoring.
 - C. Control activities.
 - D. Risk assessment.
93. Which of the following is the most severe?
- A. Material weaknesses in internal control.
 - B. Significant deficiencies in internal control.
 - C. Operational deficiencies in internal control.
 - D. Each is equally severe because it could result in inaccuracies in financial reporting.

94. **Internal control**

Define the term "internal control" and identify the major components of an internal control system.

95. Control environment

One of the elements of an organization's control system is the "control environment." Identify at least four factors that the auditor should consider when reviewing the control environment and discuss how the auditor would relate this review to the assessment of control risk.

96. Internal control components and principles

For each of the five components of internal control, list at least two related principles of internal control. In gathering the information and briefly describe each one.

97. Internal Control Principles

Identify and briefly describe the two principles that should govern the monitoring function.

98. Integrated audit

Explain the application of an integrated audit as it relates to regulation. Discuss the reasons that this integrated approach may occur.

99. Internal Control Principles

The fourth internal control principles requires organizations demonstrate a commitment to attract, develop, and retain competent individuals in alignment with objectives. Discuss how this can be done?

100. COSO: A Framework for Internal Control

What is internal control as defined by COSO? Also explain, the other elements of the definition that are important to internal control

101. Pervasive control activities

Discuss what pervasive control activities are and provide an example of at least three.

102. Management Evaluation of Internal Controls

What are the steps in management's evaluation of internal control over financial reporting?

103. IT Controls Integrated into Internal Control Evaluations

Explain input controls.

104. Relationship of the five internal control components

The five components of the COSO internal control system are conceptually and logically integrated. List the five components of the model and describe how they are integrated with each other in the internal control process.

Use the following format:

	Components	Description
1		
2		
3		
4		
5		

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 - B. The framework used to evaluate internal control.
 - C. An assessment of the effectiveness of the company's internal control.
 - D.** A statement that the company is not required to have an audit on internal control.
62. Which one of the following represents a control deficiency?
- A.** A missing control that is required for achievement of objectives.
 - B. A control that operates as designed.
 - C. A control that ensures the reliability of financial reporting.
 - D. A control that does not prevent immaterial errors.
63. The PCAOB's AS No. 5 states that internal controls may be preventive or detective. Which of the following controls is preventive?
- A.** Requiring two persons to open mail containing payments.
 - B. Reconciling the accounts receivable subsidiary file with the control account.
 - C. Using batch totals.
 - D. Preparing bank reconciliations.
64. Which of the following is an inherent limitation of internal controls?
- A. Lack of auditor independence.
 - B.** Collusion.
 - C. Separation of duties.
 - D. Employee peer review.

65. When obtaining an understanding of internal controls, what is the independent external auditor primary concerned with?
- A. Detecting all errors.
 - B. Determining the effectiveness of operations.
 - C.** Determining whether the internal controls can be relied upon.
 - D. Determining whether the controls promote efficiency.
66. What is the auditor's responsibility for testing internal controls when the auditor believes that the internal controls are effective and intends to rely upon them?
- A.** The auditor is required to test the controls.
 - B. The auditor may test the controls.
 - C. The auditor does need not to test the controls.
 - D. The auditor never has any responsibility for testing internal controls.
67. To support an assessment that controls are effective, what must an auditor do?
- A.** Achieve the same conclusion after appropriately testing internal control.
 - B. Achieve the opposite conclusion after appropriately testing internal control.
 - C. Perform increased substantive procedures.
 - D. Perform limited substantive procedures as the assessment is justified.
68. Which of the following is an example of a test of controls?
- A. Examining the reasonableness of interest accrued on notes payable.
 - B. Verify that cash surrender value of life insurance is classified as a long-term asset.
 - C. Using a spreadsheet to create a pivot table for the summarization of accounts receivable.
 - D.** Reviewing management's monthly bank reconciliations.
69. Requiring the mail clerk to prepare a listing of all checks received, with copies of the list going to the cashier and to accounting, is an example of which type of control?
- A.** Preventive.
 - B. Corrective.
 - C. Detective.
 - D. Directive.
70. Which of the following best represents a walkthrough?
- A. The controller reviews the bank reconciliation prepared by the accountant and its resulting journal entries.
 - B. The auditor walks the production line to find inefficiencies in the inventory process and reports them to management.
 - C. The controller takes a sample of write-offs to ensure they have been adequately documented and recorded.
 - D.** The auditor traces three purchasing transactions from the purchase order to the financial statement for observation and understanding.

71. Which one of the following is considered effective documentation of an internal control system?
- A. Electronically pre-numbered records.
 - B. A cathode ray screen used in input.
 - C. Verbal authorization.
 - D. The financial statements.
72. Which of the following facts would result in an auditor issuing an adverse report over internal control?
- A. The controls are believed to be effective.
 - B. The tests of controls support the documented understanding of controls.
 - C. There is a material weakness in the design or operation of controls.
 - D. A confirmation is not returned by a customer timely.
73. Which of the following is an example of a physical control to safeguard assets?
- A. Hiring only trustworthy cashiers.
 - B. Separation of duties.
 - C. Locks on the warehouse doors.
 - D. Safety audits on the production-line.
74. A financial statement auditor concludes that internal controls over cash are not functioning as designed. She believes that material misstatements to the cash accounts are possible because of the deficiencies. What course of action is the auditor most likely to take?
- A. Report the audit to the regulatory agencies of the IRS and SEC.
 - B. Develop specific tests for cash balances to determine the extent of misstatement.
 - C. Explain to the client that the audit firm will not be able to complete the audit.
 - D. Test the internal control over cash.
75. Which one of the following is **not** a control activity implemented in most accounting systems?
- A. Segregation of duties.
 - B. Competent, trustworthy employees.
 - C. Authorization procedures.
 - D. All of these activities are normally implemented.
76. What is the typical outcome when an auditor discovers a material weakness in the design or operation of controls?
- A. An adverse opinion unless management corrects the defect before year-end.
 - B. An adverse opinion even if management corrects the defect before year-end.
 - C. The firing of the auditors.
 - D. Adjusting audit journal entries.

77. Which of the following is not a way an auditor obtains evidence regarding the effectiveness of internal control over the accounting system?
- A. Performing a walkthrough of the accounting system.
 - B.** Making inquiries of banks and attorneys.
 - C. Reviewing system flowcharts.
 - D. Taking plant and operational tours.
78. Which of the following procedures will an auditor use to better understand a client's internal control over accounting systems?
- A. An auditor will look over subsequent year working papers.
 - B.** An auditor will review previous year working papers.
 - C. An auditor will copy previous year working papers.
 - D. An auditor will re-draft subsequent year working papers.
79. Internal control is a process affected by the organization's board of directors, management, and other personnel to provide reasonable assurance of achieving certain objectives. Which of the following does not fit into one of these categories of objectives?
- A. Reliability of financial reporting.
 - B. Compliance with laws and regulations.
 - C.** Continuing existence.
 - D. Effectiveness and efficiency of operations.
80. Which of the following documents will an auditor use to demonstrate an understanding of internal control?
- A. Checklists, disclosures and procedures.
 - B. The audit report, internal control opinions and confirmations.
 - C. Workpapers, engagement letters and management representation letters.
 - D.** Questionnaires, narratives and flowcharts.
81. Which of the following is clearly a test of controls?
- A. Walk-through of the expense cycle from performance of the service to the reporting in the balance sheet.
 - B.** Examination of a sample of purchase order records for electronic, authenticated, authorization.
 - C. Observing the controller's use of company owned equipment.
 - D. Sending a letter to the client's attorney to determine litigation that is pending between plaintiff and the defendant.
82. Which of the following is an example of a control environment deficiency??
- A. A low level of control consciousness within the organization.
 - B. An audit committee that does not have independent members.
 - C.** An audit committee that is not viewed as the client of the external auditor.
 - D. All of the above.

83. Which of the following types of evidence is an auditor most likely to consider in determining whether internal controls are operating as designed?
- A. A letter from management corroborating inventory pricing.
 - B.** Questionnaires completed by employees in the receiving department concerning their duties and responsibilities.
 - C. Attorneys' responses to the auditor's inquiries.
 - D. Direct confirmations of receivables verifying account balances.
84. How can an auditor use inquiry to gain a better understanding of internal controls?
- A.** By interviewing key employees to gain further insight into the internal control environment.
 - B. By observing the safeguarding of assets by checking locked doors and safes.
 - C. By tracing a transaction from the boundary of the organization through to the final reporting.
 - D. By documenting thoroughly the internal control through the use of narratives.
85. In a large company, who usually monitors the internal control?
- A.** Internal auditors.
 - B. PCAOB.
 - C. CFO.
 - D. External auditors.
86. Which of the following is **not** true of internal control as defined by COSO?
- A.** It is narrower than internal control over financial reporting.
 - B. It is a process that includes all elements of internal control working together.
 - C. It includes all the people in the organization.
 - D. It starts at the top of the organization in setting a tone.
87. Which of the following is **not** true of the concepts that are embodied in the COSO framework of internal controls?
- A. Internal controls relate to the organization's objectives.
 - B.** The six components of internal control are logically and operationally intertwined.
 - C. Internal controls apply across all activities of the organization.
 - D. All of the above are true.
88. Which of the following is not a major components of an organization's internal controls?
- A. Risk assessment.
 - B. Control environment.
 - C. Control activities.
 - D.** Control risk.

89. Which of the following is **not** part of the control environment of an organization?
- A. Management's philosophy and operating style.
 - B. Organizational structure.
 - C. Human resources.
 - D. Both A and B.
 - E.** All of the above are part of the control environment.
90. Which of the following is an example of a detective control in an information system?
- A.** Automated reports to management that specifically identify delinquent receivable.
 - B. A requirement that salaried employees submit written requests to work overtime.
 - C. Assurance from top management that computer centers are kept locked.
 - D. The employment of trustworthy people to enter data into the information system.
91. Which of the following is a detective control?
- A. Access controls.
 - B. Edit controls.
 - C.** Reconciliations.
 - D. All of the above are detective controls.
92. Which component of COSO's internal control system concerns the process that provides feedback on the effectiveness of the other four components of internal control?
- A. Information and communication.
 - B.** Monitoring.
 - C. Control activities.
 - D. Risk assessment.
93. Which of the following is the most severe?
- A.** Material weaknesses in internal control.
 - B. Significant deficiencies in internal control.
 - C. Operational deficiencies in internal control.
 - D. Each is equally severe because it could result in inaccuracies in financial reporting.

94. **Internal control**

Define the term "internal control" and identify the major components of an internal control system.

Internal control is a process, effected by an entity's board of directors, management, and other personnel, designed to provide reasonable assurance regarding the achievement of objectives relating to operations, reporting, and compliance.

The major components of internal control are:

1. control environment;
2. risk assessment;
3. control activities;
4. information and communication; and
5. monitoring.

95. **Control environment**

One of the elements of an organization's control system is the "control environment." Identify at least four factors that the auditor should consider when reviewing the control environment and discuss how the auditor would relate this review to the assessment of control risk.

The factors that an auditor should consider when reviewing the control environment would include:

- management's philosophy and operating style.
- the entity's organization structure.
- the functioning of the board of directors and its committees.
- methods of assigning authority and responsibility.
- management's control methods for monitoring and following up on performance, including internal auditing.
- personnel policies and practices.
- external influences such as bank regulatory agencies.

The auditor would examine his or her findings relating to each of the listed factors in determining whether control risk was high, medium or low. For example, if the philosophy of management placed little priority on internal controls the auditor would be concerned about control risk.

96. **Internal control components and principles**

For each of the five components of internal control, list at least two related principles of internal control.

n gathering the information and briefly describe each one.

Internal Control Components and Principles

COMPONENTS	PRINCIPLES
CONTROL ENVIRONMENT	1. The organization demonstrates a commitment to integrity and ethical values. 2. The board of directors demonstrates independence of management and exercises oversight for the development and performance of internal control. 3. Management establishes, with board oversight, structures, reporting lines, and appropriate authorities and responsibilities in the pursuit of objectives. 4. The organization demonstrates a commitment to attract, develop, and retain competent individuals in alignment with objectives. 5. The organization holds individuals accountable for their internal control responsibilities in the pursuit of objectives.
RISK ASSESSMENT	6. The organization specifies objectives with sufficient clarity to enable the identification and assessment of risks relating to objectives. 7. The organization identifies risks to the achievement of its objectives across the entity and analyzes risks as a basis for determining how the risks should be managed. 8. The organization considers the potential for fraud in assessing risks to the achievement of objectives. 9. The organization identifies and assesses changes that could significantly impact the system of internal control.
CONTROL ACTIVITIES	10. The organization selects and develops control activities that contribute to the mitigation of risks to the achievement of objectives to acceptable levels. 11. The organization selects and develops general control activities over technology to support the achievement of objectives. 12. The organization deploys control activities as manifested in policies that establish what is expected and in relevant procedures to effect the policies.
INFORMATION AND COMMUNICATION	13. The organization obtains or generates and uses relevant, quality information to support the functioning of other components of internal control. 14. The organization internally communicates information, including objectives and responsibilities for internal control, necessary to support the functioning of other components of internal control. 15. The organization communicates with external parties regarding matters affecting the functioning of other components of internal control.
MONITORING	16. The organization selects, develops, and performs ongoing and/or separate evaluations to ascertain whether the components of internal control are present and functioning. 17. The organization evaluates and communicates internal control deficiencies in a timely manner to those parties responsible for taking corrective action, including senior management and the board of directors, as appropriate.

97. **Internal Control Principles**

Identify and briefly describe the two principles that should govern the monitoring function.

1. The organization selects, develops, and performs ongoing and/or separate evaluations to ascertain whether the components of internal control are present and functioning.

Ongoing evaluation are procedures built into the normal recurring activities of an entity. Separate evaluations are conducted periodically, typically by objective management personnel, internal auditors, or external consultants.

2. The organization evaluates and communicates internal control deficiencies in a timely manner to those parties responsible for taking corrective action, including senior management and the board of directors, as appropriate.

Control deficiencies identified through monitoring or other activities need to be communicated to appropriate personnel such as management or the board of directors so that appropriate corrective action can be taken.

98. **Integrated audit**

Explain the application of an integrated audit as it relates to regulation. Discuss the reasons that this integrated approach may occur.

The Sarbanes-Oxley Act of 2002 requires reporting by management of publicly-held companies on the effectiveness of internal control over financial reporting. The Public Company Accounting Oversight Board (PCAOB) requires the external auditor to perform an **integrated audit** of the effectiveness of internal controls and financial reporting. In other words, the same auditor must attest to both the financial statements and management's assertions regarding the effectiveness of internal controls over financial reporting.

Because of the above mentioned regulatory requirements, auditors will perform an audit on both financial statements and internal controls for all public clients.

99. **Internal Control Principles**

The fourth internal control principles requires organizations demonstrate a commitment to attract, develop, and retain competent individuals in alignment with objectives. Discuss how this can be done?

Commitment to competence includes management 's consideration of the competence levels for particular jobs and how those levels translate into requisite skills and knowledge. This commitment is demonstrated through policies and procedures to attract, train, mentor, evaluate, and retain employees

100. **COSO: A Framework for Internal Control**

What is internal control as defined by COSO? Also explain, the other elements of the definition that are important to internal control

COSO defines internal control as a process, effected by an entity's board of directors, management, and other personnel, designed to provide reasonable assurance regarding the achievement of objectives in the following categories:

- (1) reliability of financial reporting,
- (2) compliance with applicable laws and regulations, and
- (3) effectiveness and efficiency of operations.

Other elements of the definition that are important:

- * Is a process designed to accomplish the organization's objectives.
- * Starts at the top of the organization with the board of directors and management creating and reinforcing a structure and a tone for controls in the organization.
- * Directly or indirectly includes all people in the organization, ranging from the shipping clerk to the internal auditor to the chief financial officer.
- * Is broader than internal control over financial reporting.

101. **Pervasive control activities**

Discuss what pervasive control activities are and provide an example of at least three.

Pervasive control activities are those controls activities whose implementation affects almost all accounting systems.

Some examples of pervasive control activities include:

- *segregation of duties
- *authorization procedures
- *documented transaction trail
- *physical controls to safeguard assets
- *reconciliation of control accounts with subsidiary ledgers, of transactions recorded with transactions submitted for processing, and of physical counts of assets with recorded assets
- *competent, trustworthy employees

102. **Management Evaluation of Internal Controls**

What are the steps in management's evaluation of internal control over financial reporting?

Integrated audit process includes the following steps:

1. Identify financial reporting risks.
2. Identify control that mitigate financial reporting risk
3. Assess design effectiveness
4. Select and perform testing procedures to evaluate operating effectiveness
5. Document operating effectiveness
6. Evaluate control deficiencies
7. Provide public disclosure of management report

103. **IT Controls Integrated into Internal Control Evaluations**

Explain input controls.

The control procedures designed to assure that the organization fully captures all the transactions between itself and another entity, and to properly record those transactions, are referred to as input controls.

Input controls are designed to ensure that authorized transactions are correct, complete, and recorded in a timely fashion and that only authorized transactions exist. They include:

- * Input validation tests
- * Self-checking digits

104. **Relationship of the five internal control components**

The five components of the COSO internal control system are conceptually and logically integrated. List the five components of the model and describe how they are integrated with each other in the internal control process.

Use the following format:

	Components	Description
1		
2		
3		
4		
5		

1. Control environment

The component of internal control that includes the set of standards, processes, and structures that provides the basis for carrying out internal control across the organization.

2. Risk assessment

The component of internal control that is the process for identifying and assessing the risks that may affect an organization from achieving its objectives.

3. Control activities

The component of internal control that includes control actions that have been established by policies and procedures.

4. Information and communication

The component of internal control that refers to the process of identifying, capturing, and exchanging information in a timely fashion to enable accomplishment of the organization's objectives.

5. Monitoring

The component of internal control that determines whether the controls, including all five components, are present and continuing to function effectively.