AUDIT

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Table of Contents

Introduction .................................................................................................................. 1

AUDIT-1
Audit Standards & Planning .......................................................................................... 2

AUDIT-2
Internal Control ............................................................................................................ 3

AUDIT-3
Audit Evidence .............................................................................................................. 4

AUDIT-4
Audit Sampling ............................................................................................................ 5
Audit Reports ................................................................................................................ 6

AUDIT-5
Compilations and Reviews (SSARS) .......................................................................... 7
Other Services and Reports .......................................................................................... 8
Information Technology (IT) ....................................................................................... 9

Appendix
AICPA Released Questions ........................................................................................ Appendix
The following is an excerpt from the Roger CPA Review Text books, which are included with purchase of the Roger CPA Review course. Written and updated by your instructor, Roger Philipp, CPA, the textbooks are the perfect companion to our dynamic lectures.
Internal Control

The *second* standard of fieldwork states:

“The auditor *must* obtain a sufficient understanding of the entity and the environment, including its internal control, to assess the risk of material misstatement (RMM) of the financial statements whether due to error or fraud, and to design the nature, timing, and extent of further audit procedures.”

For Financial Statement audits, the auditor expresses an opinion on the client's financial statements, not on their internal control structure. The reason the auditor is interested in the client’s internal control structure is the inverse relationship between Control risk and Detection risk: the stronger the internal control structure, the less substantive testing the auditor will have to perform. The auditor cannot finalize the audit program until the level of Control Risk has been assessed and an acceptable level of detection risk determined. To assess control risk for specific financial statement assertions at less than the maximum, the auditor is required to obtain evidence that the relevant controls operated effectively during the entire period upon which the auditor plans to place reliance on those controls.

For Audits of Public Companies, The Sarbanes-Oxley Act of 2002 created a requirement for an integrated audit of SEC registrants that provides assurance about the fairness of financial statements and about the effectiveness of internal control over financial reporting. The financial statement audit portion of the “integrated audit” is similar to any other financial statement audit, but its integrated nature means that auditors rely much more on internal control and less on substantive procedures. The objective of the tests of controls in an audit of internal control over financial reporting is to obtain evidence about the effectiveness of controls to support the auditor's opinion on the company's internal control over financial reporting. The auditor's opinion relates to the effectiveness of the company's internal control over financial reporting as of a point in time (the last day of the fiscal period, it is this date on which the auditor concludes as to the effectiveness of internal control) and taken as a whole.

As a result, the auditor is looking for the presence of useful controls: the strengths in the system. These will primarily involve those controls designed by management that relate to the financial statement assertions and are meant to produce accurate financial records and safeguarding of assets. Those controls designed to enable adherence to laws and regulations and promote efficiency in the organization are usually not relevant to the financial statement assertions.

**10 GAAS** (Measure of Quality of Auditor – TIPPICANOE)

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Integrity
Predecessor Auditor
Audit Committee
Engagement Letter
(FACSIMILE)

Internal Control – Rely ↑

C- Appropriate Evidence – Sub ↓

Inverse Relationship
Management is responsible for the establishment and maintenance of Internal controls. We want Reasonable assurance that Internal controls are achieving certain Objectives (ACE):

- Accurate & Reliable financial reporting
- Compliance with laws and regulations
- Effectiveness and efficiency of operations

The mnemonic ACE will remind management that it should try to establish a strong internal control structure so as to have an ACE in the hole.

The primary interest of the outside auditor is in the first objective, accurate and reliable financial reporting which relate to the fair presentation of the financial statements being audited. The second goal, compliance with laws and regulations, is primarily relevant to compliance auditing, which may occur in connection with audits under government auditing standards. The third goal, promoting effectiveness and efficiency of operations, is of little interest to an outside auditor except in the case of rarely-performed operational audits.

The auditor should obtain an understanding of the 5 components of internal control in order to evaluate the design of relevant controls and determine whether they have been implemented, assess the risk of material misstatement and design the nature, timing and extent of further audit procedures.

Elements of internal control: (CRIME)

- **Control activities**
  - Policies and procedures that help ensure that management directives are carried out.
    - Performance reviews – actual vs. budget, P/Y, financial to non-financial
    - Information processing – (IT) General vs. Application controls
    - Physical controls – Access to assets
    - Segregation of duties includes assigning different people the responsibilities of authorizing transactions, recording transactions, maintaining custody of assets, and performing comparisons. It is intended to reduce the opportunities to allow any person to be in a position to both perpetrate and conceal errors or irregularities in the normal course of their duties.
      - Authorization of transactions
      - Recording (posting) of transactions
      - Custody of assets
      - Comparisons

- **Risk assessment**
  - An entity’s risk assessment for financial reporting purposes is its identification, analysis, and management of risks relevant to the preparation of financial statements that are fairly presented in conformity with GAAP. Risk assessment includes risks that may affect an entity’s ability to properly record, process, summarize, and report financial data. Risk assessment, for example, may address how the entity considers the possibility of unrecorded transactions or identifies and analyzes significant estimates recorded in the financial statements.
Risks relevant to financial reporting include external and internal factors such as the following:

- Changes in operating environment
- New personnel
- New or revamped information systems
- Rapid growth
- New technology
- New lines of business, products or activities
- Corporate restructurings
- Foreign operations
- Accounting pronouncements

**Information and communication**

- Refers to the I.D, retention, and transfer of information in a timely manner allowing personnel to perform their responsibilities.
  - **Info system** consists of the methods and records used to record, process, summarize and report Co.’s transactions and to maintain accountability for the related accounts
  - **Communication** involves establishing individual duties and responsibilities relating to internal control and making them known to involved personnel.

**Monitoring**

- An important management responsibility is to establish and maintain internal control. Management monitors controls to consider whether they are operating as intended and that they are modified as appropriate for changes in conditions. Monitoring is a process that assesses the quality of internal control performance over time.

**Control Environment (CHOPPER)**

The control environment sets the tone of an organization, influencing the control consciousness of its people. It is the foundation for all other components of internal control, providing discipline and structure. Control environment factors include the following:

- **Commitment to competence** - Effective control requires a sincere interest on the part of the employees in performing good work.
- **Human resource policies & practices** - A company can minimize the control difficulties created by new employees by sound hiring and training policies for employees.
- **Organizational structure** - A company that operates all over the world has different internal control problems than one operating entirely within a single building.
- **Participation of those charged with Governance** - An audit committee of the board of directors that actively monitors the internal audit function produces a more attentive management on such matters.
- **Philosophy of management & operating style** - The belief (or lack of it) in the importance of internal control by management will affect the seriousness with which it is taken by the rest of the employees. This is especially the case when decision-making in the company is dominated by a single individual.
- **Ethical values & Integrity** - Honest employees will be less likely to cause internal control difficulties related to fraud and improve the opportunity for those resulting from errors to be effectively detected.
Responsibility assignment - The manner in which authority, responsibility and accountability is assigned to different employees determines the controls that will be needed. Again, the domination of decision-making by a single individual holds significance, since such power makes it extremely difficult for internal control to be trusted.

The mnemonic CRIME reminds management that it would be a crime not to consider all of the internal control elements when designing the system.

Understanding the internal control structure
An auditor performs the following procedures to obtain an understanding of internal control:

- Step 1 - Obtain an understanding of the design of internal control (perform risk assessment procedures - CRIME)
- Step 2 - Document the understanding of Internal Control
- Step 3 - Assess Risk of Material Misstatement (RMM = IR x CR)
- Step 4 - Perform tests of controls
- Step 5 - Reassess risk of Material Misstatement and evaluate results.
- Step 6 –Document conclusions and complete the planned substantive procedures

1. Understand the design of CRIME (perform Risk Assessment Procedures) (what is the form?)

Have the controls been IMPLEMENTED (put into use?). To evaluate the implementation of a control means to determine whether a control is actually being used by the entity. The auditor first considers the design of the control. If the control is improperly designed, it may represent a material weakness in the entity’s internal control.

Risk assessment procedures are used to obtain an understanding of the entity and its environment, including its internal control (CRIME), in order to assess the risk of material misstatement (RMM) and to design the nature, timing and extent of further audit procedures. Risk assessment procedures to obtain an Understanding include:

- Analytical procedures (Using high-level data)
- Inquiries of management and staff
- Inspection of documents and records
- Observing the applications of specific controls

The knowledge obtained through risk assessment procedures is used to:

- Identify the types of potential misstatements (Errors or Fraud).
- Consider factors that affect the risk of material misstatements.
- Design tests of controls and Substantive procedures
  - As part of obtaining an understanding of internal control sufficient to plan the audit, the auditor should evaluate whether the client’s programs and controls that address the identified risks of material misstatement due to fraud have been suitably designed and implemented.
  - Determine if these have been Implemented (Placed into operation).
    - Understanding doesn’t require evaluating their operating effectiveness.
The goal of this understanding is to identify those controls that might reduce the risk of misstatements. If these controls can be relied on, the auditor will be able to reduce substantive testing.

Notice, however, that the auditor is only trying to determine what controls have been implemented (being used), and is not determining whether the controls have been operating effectively. The latter is only necessary in a financial statement audit if the auditor plans to rely on the controls. The auditor’s main concern is whether, and how, a specific control prevents, detects, and corrects material misstatements in relevant assertions. Once the auditor has gained an understanding of the internal control structure, they may decide to assess the Risk of Material Misstatement high (not rely on internal control), in which case there is no point in determining whether the controls are effective.

The techniques available to the auditor to gain information about a client’s internal control structure include:

- **Prior audits** - Reviewing audit documentation that document the internal control structure of the client in prior years.
- **Inquiry** - Asking management and other client personnel to describe the controls that they are currently using.
- **Inspection** - Examining documents that are used in internal control, such as authorization forms and procedures manuals.
- **Observation** - Watching employees perform their jobs.

Keep in mind that the auditor is interested in the **substance** of the controls, not the form. Often, inquiry and inspection will provide the auditor with information about controls that have been designed, but **observation** will reveal that these controls aren't actually being enforced by management. Observation is especially critical in determining whether controls involving **segregation of duties** are being implemented in practice, and not just in theory.

2. **Document understanding of Internal Control**

The auditor’s documentation of their understanding of internal control should include the key elements of the understanding obtained regarding the 5 components of I/C (CRIME), the sources of information from which the understanding was obtained, and the risk assessment procedures performed. The form is influenced by the size and complexity of the entity. There are different techniques for documenting the auditor’s understanding of the internal control structure:

- **Memorandum** - The auditor provides a detailed written description of the internal control structure. This approach is extremely cumbersome and provides the auditor with no structure or guidance, so it is not commonly used, and it is virtually never tested on the CPA exam. It is sometimes called the **narrative** approach.

- **Flowchart** - The auditor prepares a visual depiction of the internal control structure. This requires knowledge of specialized symbols but does the best job of giving the auditor a sense of the flow and sequence of transactions in the client entity. Testing on the CPA exam has been limited to reading flowcharts and then answering conventional questions about strengths and weaknesses in the internal control structure, and has never involved their preparation. Historically, exam questions have been written so
that the candidate could understand flowcharts provided even if they had no prior knowledge of the standard meaning of the various symbols, and we do not suggest using your valuable study time in an attempt to learn the symbols.

- **Questionnaire** - A series of yes/no questions are prepared and answered by the auditor regarding the internal control structure. Each question is designed to identify a potentially useful internal control element that might be relied upon if it is operating effectively. This is the most structured of the approaches, is easiest for an inexperienced staff member in an audit to utilize, and is a very popular area of testing on the CPA exam.

Parts of an internal control structure may require a client employee to choose from several alternative actions depending on the conditions faced, and documenting such activities may best be accomplished by preparing a **decision table** that lists each possible condition and the actions that will result from each (depicts the logic of an operation or process). This is, however, a limited tool that cannot effectively document the entire structure.

3. **Assessing Risk of Material Misstatement (RMM)**

The auditor should perform the risk assessment to identify and assess the risks of material misstatement at the financial statement level and at the relevant assertion level for classes of transactions, account balances, and disclosures.

The auditor may use either a **substantive approach**, in which substantive procedures are emphasized, or a **combined approach**, in which both tests of controls and substantive procedures are used.

- The auditor needs to
  - Identify the risks
  - Relate the identified risks to the types of potential misstatements that could occur at the relevant assertion level
  - Consider whether the risks are so significant that they could result in a material misstatement of the financial statements
  - Consider the likelihood (probability) that the identified risks could result in material misstatements on the financial statements.

If the risk assessment is based on an expectation that controls are operating effectively, the auditor should test the operating effectiveness of controls (T-of-C) that have been determined to be suitably designed to prevent or detect material misstatements.

- **Intend to Rely?**
  The risk assessment may **NOT** include an expectation that controls operate effectively when *(Substantive approach)*:
    - Controls appear **inadequate / ineffective/ weak**
    - Auditor believes that performing extensive substantive procedures is likely to be more **cost effective** than performing tests of controls. *(Cost/benefit – inefficient)*

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*NO – RMM ↑ (Sub Approach)*

*YES – RMM ↓ (Combined Approach)*
If the controls appear effective, tests of controls will be performed when (Combined approach):
  o the auditor’s risk assessment includes an expectation of operating effectiveness of controls because the likelihood of material misstatement is lower if the control operates effectively (Cost effective)
  or
  o When substantive procedures alone do not provide sufficient audit evidence.

Since tests of controls alone are not normally sufficient upon which to base an audit opinion, the further audit procedures will be composed of a combination of tests of controls and substantive procedures. Thus, the decision to perform tests of controls will be made when the auditor believes that a combination of tests of controls and a decreased scope of substantive procedures is likely to be more cost effective than performing more extensive substantive procedures. The overall approach here, as it relates to controls is to
  • Identify controls that are relevant to specific assertions that are likely to prevent or detect material misstatements, and
  • Perform tests of controls to evaluate the effectiveness of those controls.

4. Tests of controls – To test the effectiveness of the design and operation of a control (what is the substance?). The auditor must consider how the control was applied, the consistency with which it was applied and by whom it was applied.

  • Testing the Cycles for ARCC’s by doing RIIO

There are 4 Procedures for testing controls.

  • Reperformance - The auditor applies the control that the client personnel presumably performed earlier. For example, if the payables clerk was supposed to match vendor invoices with purchase orders and receiving reports before preparing a voucher for payment, the auditor might pull a sample of payment vouchers that were generated during the year and attempt to locate the appropriate supporting documents and match them.
  • Inspection - The auditor examines controls, documents and reports that provide documentary evidence. For example, the auditor might examine client records documenting the use of computer programs.
  • Inquiry - The auditor asks client personnel involved in controls to state how effectively certain controls were enforced. For example, the auditor might ask the accounting personnel if they handled any cash or signed checks in the course of the year.
  • Observation - The auditor watches client personnel performing their regular functions to see if they follow the controls that were designed and implemented. For example, the auditor might observe the distribution of pay checks to see if appropriate procedures for verifying employees are being followed.
If the auditor plans to use audit evidence about the operating effectiveness of controls obtained in prior audits and the controls have not changed since they were last tested, the auditor should test the operating effectiveness of such controls at least once in every three years.

5. **Reassess RMM to determine DR**

Based on the results of the tests of controls the auditor will determine whether it is necessary to modify the scope of substantive procedures. If tests of control reveal that the system operates as expected, there will generally be no need to change the scope of planned substantive procedures. Conversely, if the system does not operate as effectively as expected, the scope of substantive procedures for the relevant assertions involved will increase (thereby decreasing detection risk).

- DR tells you how much substantive testing to do
- Must do substantive testing (adjust Audit Program for Substantive tests)
- AR / (IR x CR) = DR

6. **Document Conclusions**

The auditor is required to communicate significant deficiencies and material weaknesses to management and those charged with governance. The basis for risk assessment must always be documented. The auditor needs to document:

- The assessment of the risks of material misstatement at the financial statement and relevant assertion levels;
- The basis for that assessment;
- Significant risks identified and related controls evaluated;
- Risks identified that require tests of controls to obtain sufficient audit evidence and the related controls evaluated.

**Sarbanes-Oxley Act (SOX)**

SOX created a variety of new regulations and eliminated a significant portion of the accounting profession’s system of self regulation. Some new issues include:

- Section 302 makes officers responsible for maintaining effective internal controls and requires signing officers to disclose all significant internal control deficiencies to issuer’s auditors and audit committee.
- Officers are also required to report any fraud (whether material or not) involving management or employees with role in internal controls.

**Basic concepts**

Regardless of the good intentions of management, even a strong control environment combined with excellent control activities is subject to certain inherent limitations (COCO):

- **Collusion** - Control activities that depend on segregation of duties will not be effective if those engaged in the segregated functions conspire together.

- **Override by management** - Since management designs and implements the system of internal control, it is in a position to override it, so that even an effective internal control structure cannot be expected to prevent intentional misbehavior by
management. This is one of the reasons the auditor must establish the integrity of management before accepting the engagement.

- **Competence** - If control procedures are erroneously applied, they will not be effective. Internal control cannot be expected to prevent mistakes in human judgment (misjudgment).

- **Obsolescence** - A good internal control structure may cease to be effective due to changes in the company's operations or size.

It is essential to keep in mind the concept of **reasonable assurance** as it relates to internal control. Even were it possible to design a perfect system of internal control, management would not do so, since there are costs involved in any action, and the costs of the internal control structure should not exceed the benefits. As a result, management may sometimes reasonably refuse to remedy a deficiency in internal control that it knows exists.

**SAS 99 requires the auditor to respond to management override of controls** – Because management is often in a position to override controls in order to commit financial-statement fraud, the standard includes procedures to test for management override of controls on every audit. It should be noted that SAS 99 states that even a properly planned and performed audit may not detect a material misstatement resulting from fraud because of (1) concealment aspects of fraudulent activity, including the fact that fraud often involves collusion or falsified documents, and (2) the need to apply professional judgment in the identification of evaluation of **fraud risk factors** and other conditions.
CLASS QUESTIONS:

1. Which of the following is not a component of an entity’s internal control?
   a. Control risk.
   b. Control activities.
   c. Monitoring.
   d. Control environment.

2. In obtaining an understanding of an entity’s internal control in a financial statement audit, an auditor is required to obtain knowledge about the operating effectiveness of controls and implementation of controls.
   
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3. When an auditor increases the assessed level of control risk (Risk of Material Misstatement) because certain control activities were determined to be ineffective, the auditor would most likely increase the
   a. Extent of tests of controls.
   b. Level of detection risk.
   c. Extent of tests of details.
   d. Level of inherent risk.

4. Which of the following is not a step in an auditor’s assessment of Control Risk (Risk of Material Misstatement)?
   a. Evaluate the effectiveness of internal control with tests of controls.
   b. Obtain an understanding of the entity’s information system and control environment.
   c. Perform tests of details of transactions to detect material misstatements in the financial statements.
   d. Consider whether controls can have a pervasive effect on financial statement assertions.

5. After obtaining an understanding of internal control and assessing the risk of material misstatement, an auditor decided to perform tests of controls. The auditor most likely decided that
   a. It would be efficient to perform tests of controls that would result in a reduction in planned substantive tests.
   b. Additional evidence to support a further reduction in the risk of material misstatement is not available.
   c. An increase in the assessed level of the risk of material misstatement is justified for certain financial statement assertions.
   d. There were many internal control weaknesses that could allow misstatements to enter the accounting system.

6. In assessing Risk of Material Misstatement, an auditor ordinarily selects from a variety of techniques, including
   a. Inquiry and recalculation.
   b. Reperformance and observation.
   c. Comparison and confirmation.
   d. Inspection and verification.
7. Which of the following most likely would **not** be considered an inherent limitation of the potential effectiveness of an entity’s internal control?

   a. Incompatible duties.
   b. Management override.
   c. Mistakes in judgment.
   d. Collusion among employees.
SOLUTIONS:

1. (a) The requirement is to identify the reply that is not a component of an entity’s internal control. Answer (a) is correct because while auditors assess control risk as a part of their consideration of internal control, it is not a component of an entity’s internal control. Answers (b), (c), and (d) are incorrect because the control environment, risk assessment, control activities, information and communication, and monitoring are the five components of an entity’s internal control (SAS 109).

2. (b) In obtaining an understanding of internal control, the auditor should perform procedures to provide sufficient knowledge of the design of the relevant controls and whether they have been implemented. Information on operating effectiveness need not be obtained unless the Control Risk (risk of material misstatement) is to be assessed at a level below the maximum.

3. (c) Increases in the assessed level of Control Risk (the risk of material misstatement) leads to decreases in the acceptable level of detection risk. Accordingly, the auditor will need to increase the extent of substantive tests such as tests of details. Answer (a) is incorrect because tests of controls are performed to reduce the assessed level of risk of material misstatement only when controls are believed to be effective. Answer (b) is incorrect because the level of detection risk must be decreased, not increased. Answer (d) is incorrect because the level of inherent risk pertains to the susceptibility of an account to material misstatement independent of related controls.

4. (c) The requirement is to identify the procedure that is not a step in an auditor’s assessment of control risk. Answer (c) is correct because performing tests of details of transactions to detect material misstatements pertains more directly to detection risk rather than inherent or control risk. Answer (a) is incorrect because auditors evaluate the effectiveness of internal control with tests of controls. Answer (b) is incorrect because obtaining an understanding of the entity’s information system and control environment is a preliminary step for considering control risk. Answer (d) is incorrect because auditors will consider the effect of internal control on the various financial statement assertions.

5. (a) The requirement is to identify a circumstance in which an auditor may decide to perform tests of controls. Answer (a) is correct because tests of controls will be performed when they are expected to result in a cost effective reduction in planned substantive tests. Answer (b) is incorrect because tests of controls are only performed when they are likely to support a further reduction in the assessed level of the risk of material misstatement. Answer (c) is incorrect because tests of controls are designed to decrease the assessed level of the risk of material misstatement, not increase it. Answer (d) is incorrect because internal control weaknesses normally result in more substantive testing and less tests of controls.

6. (b) The requirement is to identify the most appropriate procedures for assessing Control Risk (the risk of material misstatement). Auditors perform tests of controls to obtain evidence on the operating effectiveness of controls to assess risk of material misstatement. Answer (b) is correct because tests of controls include inquiries of appropriate entity personnel, inspection of documents and reports, observation of the application of the policy or procedure, and reperformance of the application of the policy or procedure.

7. (a) The requirement is to identify the reply that most likely would not be considered an inherent limitation of the potential effectiveness of an entity’s internal control. Answer (a) is correct because incompatible duties may generally be divided among individuals in such a manner as to control the problem. Answers (b), (c), and (d) are all incorrect because
management override, mistakes of judgment, and collusion among employees are all inherent limitations of internal control.
Simulation #1

The following flowchart (Flowchart tab) depicts part of a client's purchases and cash disbursements cycle. Some of the flowchart symbols are labeled to indicate operations, controls, and records. For each symbol numbered 1 through 12, select one response from the answer lists below. Each response in the lists may be selected once or not at all.

### Operations and controls
- A. Approve receiving report
- B. Prepare and approve voucher
- C. Prepare purchase order
- D. Prepare purchase requisition
- E. Prepare purchases journal
- F. Prepare receiving report
- G. Prepare sales journal
- H. Prepare voucher
- I. Sign checks and cancel voucher package documents

### Connectors, documents, departments, and files
- J. Accounts payable
- K. Canceled voucher package
- L. From purchasing
- M. From receiving
- N. From vouchers payable
- O. Purchase order No. 5
- P. Receiving report No. 1
- Q. Stores
- R. To vendor
- S. Treasurer
- T. Unpaid voucher file, filed by due date

The Professional Standards state that internal control provides reasonable and not absolute assurance of achieving a client’s control objectives. Relatedly, the Professional Standards acknowledge that internal control has certain limitations. Search the Professional Standards to find the location at which a number of limitations are discussed together. You may simply paste the appropriate material to your solution.

Internet controls either (1) prevent misstatements, or (2) detect material misstatements of financial statements. Write a memorandum to the audit staff describing these two types of controls.

To: Audit Staff
From: CPA Candidate
Re: Types of controls

**REMINDER:** Your response will be graded for both technical content and writing skills. Technical content will be evaluated for information that is helpful to the intended reader and clearly relevant to the issue. Writing skills will be evaluated for development, organization, and the appropriate expression of ideas in professional correspondence. Use a standard business memo or letter format with a clear beginning, middle, and end. Do not convey information in the form of a table, bullet point list, or other abbreviated presentation.
Simulation #2

An auditor’s working papers include the narrative description (situation tab) of the cash receipts and billing portions of Southwest Medical Center’s internal control.

Evaluate the information in the situation on the worksheet (internal control tab) as being either (1) a strength, (2) a weakness, (3) not a strength or a weakness.

Southwest is a health care provider that is owned by a partnership of five physicians. It employs eleven physicians, including the five owners, twenty nurses, five laboratory and X-ray technicians, and four clerical workers. The clerical workers perform such tasks as reception, correspondence, cash receipts, billing, accounts receivable, bank deposits, and appointment scheduling. These clerical workers are referred to in the situation as office manager, clerk #1, clerk #2, and clerk #3. Assume that the narrative is a complete description of the system.

About two-thirds of Southwest’s patients receive medical services only after insurance coverage is verified by the office manager and communicated to the clerks. Most of the other patients pay for services by cash or check when services are rendered, although the office manager extends credit on a case-by-case basis to about 5% of the patients.

When services are rendered, the attending physician prepares a prenumbered service slip for each patient and gives the slip to clerk #1 for pricing. Clerk #1 completes the slip and gives the completed slip to clerk #2 and a copy to the patient.

Using the information on the completed slip, clerk #2 performs one of the following three procedures for each patient:

- Clerk #2 files an insurance claim and records a receivable from the insurance company if the office manager has verified the patient’s coverage, or
- Clerk #2 posts a receivable from the patient on clerk #2’s PC if the office manager has approved the patient’s credit, or
- Clerk #2 receives cash or a check from the patient as the patient leaves the medical center, and clerk #2 records the cash receipt.

At the end of each day, clerk #2 prepares a revenue summary.

Clerk #1 performs correspondence functions and opens the incoming mail. Clerk #1 gives checks from insurance companies and patients to clerk #2 for deposit. Clerk #2 posts the receipt of patients’ checks on clerk #2’s PC patient receivable records and insurance companies’ checks to the receivables from the applicable insurance companies. Clerk #1 gives mail requiring correspondence to clerk #3.

Clerk #2 stamps all checks “for deposit only” and each day prepares a list of checks and cash to be deposited in the bank. (This list also includes the cash and checks personally given to clerk #2 by patients.) Clerk #2 keeps a copy of the deposit list and gives the original to clerk #3.

Clerk #3 personally makes the daily bank deposit and maintains a file of the daily bank deposits. Clerk #3 also performs appointment scheduling for all of the doctors and various correspondence functions. Clerk #3 also maintains a list of patients whose insurance coverage the office manager has verified.

When insurance claims or patient receivables are not settled within sixty days, clerk #2 notifies the office manager. The office manager personally inspects the details of each instance of nonpayment. The office manager converts insurance claims that have been rejected by insurance companies into patient receivables. Clerk #2 records these patient receivables on clerk #2’s PC and deletes these receivables from the applicable insurance companies. Clerk #2 deletes the patient receivables that appear to be uncollectible from clerk #2’s PC when authorized by the office manager. Clerk #2 prepares a list of patients with uncollectible balances and gives a copy of the list to clerk #3, who will not allow these patients to make appointments for future services.

Once a month an outside accountant posts clerk #2’s daily revenue summaries to the general ledger, prepares a monthly trial balance and monthly financial statements, accounts for prenumbered service slips, files payroll forms and tax returns, and reconciles the monthly bank statements to the general ledger. This accountant reports directly to the physician who is the managing partner.

All four clerical employees perform their tasks on PCs that are connected through a local area network. Each PC is accessible with a password that is known only to the individual employee and the managing partner.
Southwest uses a standard software package that was acquired from a software company and that cannot be modified by Southwest’s employees. None of the clerical employees have access to Southwest’s check writing abilities.

<table>
<thead>
<tr>
<th>Condition</th>
<th>Strength</th>
<th>Weakness</th>
<th>Neither</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Southwest is involved only in medical services and has not diversified its operations.</td>
<td></td>
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<tr>
<td>2. Insurance coverage for patients is verified and communicated to the clerks by the office manager before medical services are rendered.</td>
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<td>3. The physician who renders the medical services documents the services on a prenumbered slip that is used for recording revenue and as a receipt for the patient.</td>
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<td>4. Cash collection is centralized in that Clerk #2 receives the cash (checks) from patients and records the cash receipt.</td>
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<td>8. Clerk #2 receives cash and checks and prepares the daily bank deposit.</td>
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<tr>
<td>9. Clerk #2 maintains the accounts receivable records and can add or delete information on the PC.</td>
<td></td>
<td></td>
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</tr>
<tr>
<td>10. Prenumbered service slips are accounted for on a monthly basis by the outside accountant who is independent of the revenue generating and revenue recording functions.</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>11. The bank reconciliation is prepared monthly by the outside accountant who is independent of the revenue generating and revenue recording functions.</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>12. Computer passwords are only known to the individual employees and the managing partner who has no duties in the revenue recording functions.</td>
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<td></td>
<td></td>
</tr>
<tr>
<td>13. Computer software cannot be modified by Southwest’s employees.</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>14. None of the employees who perform duties in the revenue generating and revenue recording are able to write checks.</td>
<td></td>
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<td></td>
</tr>
</tbody>
</table>

Research Directions

An auditor may discover certain audit adjustments, material and immaterial, that relate to the financial statements. Search the Professional Standards to determine auditor responsibility for communicating these adjustments to the audit committee. You may simply paste the appropriate material to your solution.
Assume that in your audit of Southwest you assessed control risk at a low level for accounts receivable. However, your substantive procedures have detected a large number of errors in the accounts. Write a memorandum to the audit working papers describing the implications of this situation.

**To:** Audit Working Papers  
**From:** CPA Candidate  
**Re:** Implications of errors discovered in accounts receivable

---

**REMINDER:** Your response will be graded for both technical content and writing skills. _Technical content_ will be evaluated for information that is helpful to the intended reader and clearly relevant to the issue. _Writing skills_ will be evaluated for development, organization, and the appropriate expression of ideas in professional correspondence. Use a standard business memo or letter format with a clear _beginning, middle, and end_. _Do not convey_ information in the form of a table, bullet point list, or other abbreviated presentation.
## Simulation #3

<table>
<thead>
<tr>
<th>Situation</th>
<th>Internal Control Evaluation</th>
<th>Purpose of Internal Control</th>
<th>Research and Communication</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>PURCHASING</strong></td>
<td>From Dept. Head</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Verifies Advancy of Vendor's Past Record &amp; Prepares 4-Copy Purchase Order</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>From Purchasing</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Prepares 4-Copy Receiving Report</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>To Receiving Dept.</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>To Accounts Payable</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>To Dept. Head</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>To Vendor</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>RECEIVING</strong></td>
<td>From Vendor</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Receiving Report</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>To Accounts Payable</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>To General Ass't</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>To Vendor</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>ACCOUNTS PAYABLE</strong></td>
<td>From Vendor</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Voucher</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>To Accounts Payable</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>To Vendor</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

The following flowchart depicts the activities relating to the purchasing, receiving, and accounts payable departments of Model Company, Inc. Assume that you are a supervising assistant assigned to the Model Company audit.

Erlich Larsen, a beginning assistant, analyzed the flowchart and has supplemented the flowchart by making certain inquiries of the controller. He has concluded that the internal control over purchasing, receiving, and accounts payable is strong and has provided the following list of what he refers to as internal control strengths. Review his list and for each internal control strength indicate whether you agree or disagree that each represents a strength. For those in which you disagree briefly explain why.
Internal Control Strengths  
Prepared by Erich Larsen

### Purchasing

1. The department head of the requisitioning department selects the appropriate supplier.  
   - Agree: ☐  
   - Disagree: ☐

2. Proper authorization of requisitions by department head is required before purchase orders are prepared.  
   - Agree: ☐  
   - Disagree: ☐

3. Purchasing department makes certain that low-cost supplier is always chosen.  
   - Agree: ☐  
   - Disagree: ☐

4. Purchasing department assures that requisitions are within budget limits before purchase orders are prepared.  
   - Agree: ☐  
   - Disagree: ☐

5. The adequacy of each vendor’s past record as a supplier is verified.  
   - Agree: ☐  
   - Disagree: ☐

### Receiving

6. Secure facilities limit access to the goods during the receiving activity.  
   - Agree: ☐  
   - Disagree: ☐

7. Receiving department compares its count of the quantity of goods received with that listed on its copy of the purchase order.  
   - Agree: ☐  
   - Disagree: ☐

8. A receiving report is required for all purchases, including purchases of services.  
   - Agree: ☐  
   - Disagree: ☐

9. The requisitioning department head independently verifies the quantity and quality of the goods received.  
   - Agree: ☐  
   - Disagree: ☐

10. Requisitions, purchase orders, and receiving reports are matched with vendor invoices as to quantity and price.  
    - Agree: ☐  
    - Disagree: ☐

### Accounts Payable

11. Accounts payable department recomputes the mathematical accuracy of each invoice.  
    - Agree: ☐  
    - Disagree: ☐

12. The voucher register is independently reconciled to the control accounts monthly by the originators of the related vouchers.  
    - Agree: ☐  
    - Disagree: ☐

13. All supporting documentation is marked “paid” by accounts payable immediately prior to making it available to the treasurer.  
    - Agree: ☐  
    - Disagree: ☐

14. All supporting documentation is required for payment and is made available to the treasurer.  
    - Agree: ☐  
    - Disagree: ☐

15. The purchasing, receiving, and accounts payable functions are segregated.  
    - Agree: ☐  
    - Disagree: ☐

<table>
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<tr>
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</table>

Another assistant has been working in the revenue cycle area and has compiled a list of possible errors and fraud that may result in the misstatement of Model Company’s financial statements, and a corresponding list of controls that, if properly designed and implemented, could assist in preventing or detecting the errors and fraud.

For each possible error and fraud numbered 1 through 15, select one internal control from the answer list below that, if properly designed and implemented, most likely could assist management in preventing or detecting the errors and fraud. Each response in the list of controls may be selected once, more than once, or not at all.
Controls

A. Shipping clerks compare goods received from the warehouse with the details on the shipping documents.
B. Approved sales orders are required for goods to be released from the warehouse.
C. Monthly statements are mailed to all customers with outstanding balances.
D. Shipping clerks compare goods received from the warehouse with approved sales orders.
E. Customer orders are compared with the inventory master file to determine whether items ordered are in stock.
F. Daily sales summaries are compared with control totals of invoices.
G. Shipping documents are compared with sales invoices when goods are shipped.
H. Sales invoices are compared with the master price file.
I. Customer orders are compared with an approved customer list.
J. Sales orders are prepared for each customer order.
K. Control amounts posted to the accounts receivable ledger are compared with control totals of invoices.
L. Sales invoices are compared with shipping documents and approved customer orders before invoices are mailed.
M. Prenumbered credit memos are used for granting credit for goods returned.
N. Goods returned for credit are approved by the supervisor of the sales department.
O. Remittance advices are separated from the checks in the mailroom and forwarded to the accounting department.
P. Total amounts posted to the accounts receivable ledger from remittance advices are compared with the validated bank deposit slip.
Q. The cashier examines each check for proper endorsement.
R. Validated deposit slips are compared with the cashier's daily cash summaries.
S. An employee, other than the bookkeeper, periodically prepares a bank reconciliation.
T. Sales returns are approved by the same employee who issues receiving reports evidencing actual return of goods.

Possible Errors and Fraud

1. Invoices for goods sold are posted to incorrect customer accounts.
2. Goods ordered by customers are shipped, but are not billed to anyone.
3. Invoices are sent for shipped goods, but are not recorded in the sales journal.
4. Invoices are sent for shipped goods and are recorded in the sales journal, but are not posted to any customer account.
5. Credit sales are made to individuals with unsatisfactory credit ratings.
6. Goods are removed from inventory for unauthorized orders.
7. Goods shipped to customers do not agree with goods ordered by customers.
8. Invoices are sent to allies in a fraudulent scheme and sales are recorded for fictitious transactions.
9. Customers' checks are received for less than the customers' full account balances, but the customers' full account balances are credited.
10. Customers' checks are misappropriated before being forwarded to the cashier for deposit.
11. Customers' checks are credited to incorrect customer accounts.
12. Different customer accounts are each credited for the same cash receipt.
13. Customers' checks are properly credited to customer accounts and are properly deposited, but errors are made in recording receipts in the cash receipts journal.
14. Customers' checks are misappropriated after being forwarded to the cashier for deposit.
15. Invalid transactions granting credit for sales returns are recorded.

Assume that in Internal Control Evaluation you have identified some circumstances that may be considered deficiencies in internal control—indeed some might be considered significant deficiencies or even material weaknesses. Write a memorandum addressed to Bill Jones, the job's senior, that abstracts from the professional standards the following:

1. Definition of material weakness and significant deficiency.
2. Whether a preference exists in the standards on whether any communication need be in writing versus presented orally to the audit committee.
3. Whether deficiencies of which an audit committee is already aware must be communicated to the audit committee.

Assume that this is the audit of a nonpublic company for which no overall public reporting responsibility relating to internal control is required under the requirements of the Sarbanes-Oxley Act of 2002. Also, include an exact citation to the professional standards paragraph(s) in which you find the guidance.

NOTE: If you do not have access to professional standards indicate the keywords or section numbers that you would use to do your search. Then, go to the solution which has excerpts for professional standards to complete the requirement.

To: Mr. Bill Jones
From: CPA Candidate
Re: Reporting on internal control

REMINDER: Your response will be graded for both technical content and writing skills. Technical content will be evaluated for information that is helpful to the intended reader and clearly relevant to the issue. Writing skills will be evaluated for development, organization, and the appropriate expression of ideas in professional correspondence. Use a standard business memo or letter format with a clear beginning, middle, and end. Do not convey information in the form of a table, bullet point list, or other abbreviated presentation.
Simulation Solution #1

1. (C) **Prepare purchase order**—A trapezoid represents a manual operation. Here, a purchase order enters the flowchart after this step; accordingly, a purchase order is being prepared.

2. (R) **To vendor**—A circle represents a connector, a symbol indicating that a document is entering or leaving that portion of the flowchart. Here a copy of the purchase order is sent to the vendor to order the goods. This must be the case because, otherwise, the vendor would not be informed of the order.

3. (F) **Prepare receiving report**—A trapezoid represents a manual operation. Here, a receiving report enters the flowchart after this step; accordingly, a receiving report is being prepared. Also, note above this step that goods are received, the point at which one would expect preparation of a receiving report.

4. (L) **From purchasing**—A circle represents a connector, a symbol indicating that a document is entering or leaving that portion of the flowchart. The document here is from purchasing because below the connector is requisition No. 1, which purchasing has sent with the purchase order No. 5 to vouchers payable, as evidenced by the connector in the bottom far right under purchasing.

5. (M) **From receiving**—A circle represents a connector, a symbol indicating that a document is entering or leaving that portion of the flowchart. The document here is from receiving because under the receiving portion of the flowchart, approximately 3/4 of the way down, we see a connector indicating that receiving report No. 1 is being sent to vouchers payable. Also, toward the bottom under the vouchers payable portion of the flowchart, we see that receiving report No. 1 is indeed in the system.

6. (O) **Purchase order No. 5**—We know from item 4 that this document was sent from purchasing, and we know that purchasing has sent to vouchers payable requisition No. 1 and purchase order No. 5. Since requisition No. 1 is labeled on the flowchart, this must be purchase order No. 5.

7. (P) **Receiving report No. 1**—We know from item 5 that this document was sent from receiving, and since we know that receiving has sent receiving report No. 1 to vouchers payable this must be that document.

8. (B) **Prepare and approve voucher**—A trapezoid represents a manual operation. Here, an approved voucher enters the flowchart after this step; accordingly, a voucher is being prepared and approved in this step.

9. (T) **Unpaid voucher file, filed by due date**—The triangle symbol represents a file. Entering this file are the approved but unpaid vouchers with the support of their invoices, receiving reports, purchase orders and purchase requisitions. Because these vouchers are sent to the treasurer in order of due date (the bottom, right symbol under vouchers payable) this file is the unpaid voucher file, filed by due date.

10. (S) **Treasurer**—Because the unpaid vouchers (the “voucher package”) was sent from vouchers payable to the treasurer, this is the treasurer.

11. (I) **Sign checks and cancel voucher package documents**—A trapezoid represents a manual operation. Here, the operation prior to 11 involves a review of documents and preparation of a check and a remittance advice. After this operation the documents changed are a “canceled voucher package file” and a “signed check”; accordingly, checks are being signed and the voucher package is being canceled.

12. (K) **Canceled voucher package**—After step 11, the check copy, remittance advice No. 1, the signed check, and remittance advice No. 2 exit on the far right. Accordingly, item 12 is the voucher package, now canceled as evidenced by the description below the triangular file symbol.
Limitations of an Entity’s Internal Control

64. Internal control, no matter how well designed and operated, can provide an entity with reasonable assurance, but not absolute assurance, about achieving an entity’s objectives. The likelihood of achievement is affected by limitations inherent to internal control. These include the realities that human judgment in decision making can be faulty and that breakdowns in internal control can occur because of human failures such as simple errors or mistakes. For example, if an entity’s information system personnel do not sufficiently understand how an order entry system processes sales transactions, they may design changes to the system that will erroneously process sales for a new line of products. On the other hand, such changes may be correctly designed but misunderstood by individuals who translate the design into program code. Errors also may occur in the use of information produced by IT. For example, automated controls may be designed to report transactions over a specified amount for management review, but individuals responsible for conducting the review may not understand the purpose of such reports and, accordingly, may fail to review them or investigate unusual items.

65. Additionally, controls, whether manual or automated, can be circumvented by the collusion of two or more people or inappropriate management override of internal control. For example, management may enter into undisclosed agreements with customers that alter the terms and conditions of the entity’s standard sales contracts which may result in improper revenue recognition. Also, edit checks in a software program that are designed to identify and report transactions that exceed specified credit limits may be overridden or disabled.

66. Smaller entities often have fewer employees, which may limit the extent to which segregation of duties is practicable. However, for key areas, even in a very small entity, it can be practicable to implement some degree of segregation of duties or other form of unsophisticated but effective controls. The potential for override of controls by the owner-manager depends to a great extent on the control environment and, in particular, the owner-manager’s attitudes about the importance of internal control.
To: Audit Working Papers  
From: CPA Candidate  
Re: Implications of errors discovered in accounts receivable

The memorandum is designed to document the implications of the errors discovered in accounts receivable. In the course of performing our substantive audit procedures for the audit of Southwest’s accounts receivable, we detected a large number of errors. Having assessed control risk at a low level, we should reassess control risk for the assertions regarding accounts receivable and then reevaluate the sufficiency of our substantive procedures. This will allow us to control audit risk at the appropriate level.

If you have any additional questions about the implications of this matter, please contact me.
## Simulation Solution #2

<table>
<thead>
<tr>
<th>Condition</th>
<th>Strength</th>
<th>Weakness</th>
<th>Neither</th>
</tr>
</thead>
<tbody>
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<td>○</td>
<td>○</td>
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<tr>
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<td>○</td>
<td>○</td>
</tr>
<tr>
<td>3. The physician who renders the medical services documents the services on a prenumbered slip that is used for recording revenue and as a receipt for the patient.</td>
<td>●</td>
<td>○</td>
<td>○</td>
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<td>4. Cash collection is centralized in that Clerk #2 receives the cash (checks) from patients and records the cash receipt.</td>
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<td>●</td>
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<td>8. Clerk #2 receives cash and checks and prepares the daily bank deposit.</td>
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<tr>
<td>9. Clerk #2 maintains the accounts receivable records and can add or delete information on the PC.</td>
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<td>○</td>
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<td>●</td>
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</tr>
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<td>●</td>
<td>○</td>
<td>○</td>
</tr>
<tr>
<td>12. Computer passwords are only known to the individual employees and the managing partner who has no duties in the revenue recording functions.</td>
<td>●</td>
<td>○</td>
<td>○</td>
</tr>
<tr>
<td>13. Computer software cannot be modified by Southwest’s employees.</td>
<td>●</td>
<td>○</td>
<td>○</td>
</tr>
<tr>
<td>14. None of the employees who perform duties in the revenue generating and revenue recording are able to write checks.</td>
<td>●</td>
<td>○</td>
<td>○</td>
</tr>
</tbody>
</table>
AU 380.09-.10 provides requirements with respect to communication of audit adjustments to the audit committee as follows:

Audit Adjustments

**AU380.09**

The auditor should inform the audit committee about adjustments arising from the audit that could, in his judgment, either individually or in the aggregate, have a significant effect on the entity’s financial reporting process. For purposes of this section, an audit adjustment, whether or not recorded by the entity, is a proposed correction of the financial statements that, in the auditor’s judgment, may not have been detected except through the auditing procedures performed. Matters underlying adjustments proposed by the auditor but not recorded by the entity could potentially cause future financial statements to be materially misstated, even though the auditor has concluded that the adjustments are not material to the current financial statements.

**AU380.10**

The auditor also should inform the audit committee about uncorrected misstatements aggregated by the auditor during the current engagement and pertaining to the latest period presented that were determined by management to be immaterial, both individually and in the aggregate, to the financial statements taken as a whole.

To: Audit Working Papers

From: CPA Candidate

Re: Implications of errors discovered in accounts receivable

In the course of performing our substantive audit procedures for the audit of Southwest’s accounts receivable, we detected a large number of errors. Having assessed control risk at a low level, we should reassess control risk for the assertions regarding accounts receivable and then reevaluate the sufficiency of our substantive procedures.
Simulation Solution #3

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<tr>
<td>1.</td>
<td>Disagree. Someone independent of requisitioning should select the supplier.</td>
<td></td>
<td></td>
</tr>
<tr>
<td>2.</td>
<td>Agree.</td>
<td></td>
<td></td>
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<tr>
<td>3.</td>
<td>Disagree. Often, factors in addition to cost are considered (e.g., quality, dependability).</td>
<td></td>
<td></td>
</tr>
<tr>
<td>4.</td>
<td>Agree.</td>
<td></td>
<td></td>
</tr>
<tr>
<td>5.</td>
<td>Agree.</td>
<td></td>
<td></td>
</tr>
<tr>
<td>6.</td>
<td>Agree.</td>
<td></td>
<td></td>
</tr>
<tr>
<td>7.</td>
<td>Disagree. A comparison of quantities is not possible because quantity is blacked out on the purchase order provided to receiving.</td>
<td></td>
<td></td>
</tr>
<tr>
<td>8.</td>
<td>No receiving report is ordinarily necessary for purchases of services.</td>
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<td></td>
</tr>
<tr>
<td>10.</td>
<td>Agree.</td>
<td></td>
<td></td>
</tr>
<tr>
<td>11.</td>
<td>Agree.</td>
<td></td>
<td></td>
</tr>
<tr>
<td>12.</td>
<td>Disagree. The reconciliation should be performed by an independent party.</td>
<td></td>
<td></td>
</tr>
<tr>
<td>13.</td>
<td>Disagree. Documentation should be marked “paid” by the individual making the payment.</td>
<td></td>
<td></td>
</tr>
<tr>
<td>15.</td>
<td>Agree.</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

1. (C) Invoices posted to incorrect customer accounts will be detected by analyzing customer responses to monthly statements that include errors, particularly statements with errors not in favor of the customer.

2. (G) The comparison of shipping documents with sales invoices will detect goods that have been shipped but not billed when no sales invoice is located for a particular shipping document.

3. (F) To provide assurance that all invoiced goods that have been shipped are recorded as sales, daily sales summaries should be compared with invoices. For example, a sale that has not been recorded will result in a sales summary that does not include certain sales invoices.

4. (K) A comparison of the amounts posted to the accounts receivable ledger with the control total for invoices will provide assurance that all invoices have been posted to a customer account.

5. (I) Comparing customer orders with an approved customer list will provide assurance that credit sales are made only to customers that have been granted credit.

6. (B) Requiring an approved sales order before goods are released from the warehouse will provide assurance that goods are not removed for unauthorized orders.

7. (D) A comparison by shipping clerks of goods received from the warehouse with the approved sales orders will provide assurance that goods shipped to customers agree with goods ordered by customers.

8. (L) A comparison of sales invoices with shipping documents and approved sales orders will detect invoices that do not have the proper support. Accordingly, it will help prevent the recording of fictitious transactions.

9. (P) Comparing amounts posted to the accounts receivable ledger with the validated bank deposit will detect improper postings to accounts receivable since any differences in amounts will be investigated.

10. (C) Misappropriations of customers’ checks will be detected when customers indicate that they have made payments for items shown as payable on their monthly statement. Note that replies O and P will only detect this misappropriation in the unlikely event that the perpetrator does not dispose of the remittance advice.

11. (C) Mispostings of payments made will be detected when customers indicate that they have made payments for items shown as payable on their monthly statement.

12. (P) Crediting more than one account for a cash receipt will be detected when the total of amounts posted to the accounts receivable ledger is compared with the validated bank deposit slip.
13. (S) An independent reconciliation of the bank account will reveal improper total recording of receipts in the cash receipts journal because unlocated differences between bank and book balances will occur and be investigated.

14. (P) Comparing total amounts posted to the accounts receivable ledger with the validated bank deposit slip will detect a difference between total cash receipts and the amount credited to the accounts receivable ledger.

15. (N) Requiring the approval of the supervisor of the sales department for goods received will provide assurance that invalid transactions granting credit for sales returns are not recorded. Note that using prenumbered credit memos (reply M) will only be effective if the sequence is accounted for and if credit memos may be compared in some form to actual returns.

The first step is to determine the manner in which the candidate wishes to identify the pertinent research in the area. If a keyword or index search is to be used, words such as “internal control report” or “significant deficiency” may be helpful. But internal control is a difficult area to research in that the term occurs frequently throughout the standards. Concerning internal control it is probably best to memorize the fact that the auditor’s responsibility for reporting on internal control significant deficiencies is included in AU 325 (also, know that other communications to the audit committee are included in AU 380). Attest reports on internal control over financial reporting (not an issue in this question) are in AT 501.

1. AU 325 includes the following definition for a significant deficiency and a material weakness:

   A **significant deficiency** is a deficiency, or combination of deficiencies, in internal control that is *less severe than a material weakness*, yet important enough to merit attention by those charged with governance.

   A **material weakness** is a deficiency, or combination of deficiencies, in internal control such that there is a reasonable possibility (or probable) that a material misstatement of the entity’s financial statements will not be prevented, or detected and corrected on a timely basis.

2. AU 325 establishes a presumptively mandatory requirement that the communication be in writing.

3. AU 325 also establishes a presumptively mandatory requirement that such matters be recommunicated.

Given the above information, one may write a memorandum as follows:

To: Mr. Bill Jones  
From: CPA Candidate  
Re: Reporting on internal control  
Date: [Today’s date]  

At your request, I researched the Professional Standards on the following three issues:

a. Definitions of material weaknesses and significant deficiencies.
b. Whether a communication on significant deficiencies must be in writing.
c. Whether a significant deficiency must be communicated when the audit committee is already aware of it.

The guidance for all three of these matters is included in AU section 325.

**Definitions of material weaknesses and significant deficiencies**

The definitions for a significant deficiency and a material weakness are presented in AU section 325 as

A **significant deficiency** is a deficiency, or combination of deficiencies, in internal control that is *less severe than a material weakness*, yet important enough to merit attention by those charged with governance.

A **material weakness** is a deficiency, or combination of deficiencies, in internal control such that there is a reasonable possibility (or probable) that a material misstatement of the entity’s financial statements will not be prevented, or detected and corrected on a timely basis.

**Must a communication on significant deficiencies be in writing?**

Yes. Control deficiencies noted by the auditor that are considered to be significant deficiencies or material weaknesses should be communicated in writing to management, and those charged with
governance as a part of each audit, even if they previously have been communicated to these parties in connection with previous audits.

**Must a significant deficiency of which the audit committee is aware be communicated?**

Yes. As indicated above, even if previously communicated, it should again be communicated.

If you have additional questions about internal control, please contact me.
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