ACCOUNTING 412
Chapter 6 Homework Solutions

6-1 From management's perspective, the internal control provides a way to meet its stewardship or agency responsibilities. Management also needs a control system that generates reliable information for decision-making purposes.

The importance of internal control to the auditor is rooted in the second standard of fieldwork. The controls that are relevant to the entity's ability to initiate, record, process, and report financial data consistent with management's assertions are the auditor's main concern. The auditor needs assurances about the reliability of the data generated within the entity's internal control system in terms of how it affects the fairness of the financial statements and how well the assets and records of the entity are safeguarded.

6-2 Internal control structure is composed of five components:

1. **Control environment**: The control environment sets the tone of the organization, influencing the control consciousness of its people. It is the foundation of all other components of internal control, providing discipline and structure.

2. **The entity’s risk assessment process**: The process for identifying and responding to business risks and the results thereof. For financial reporting purposes, the entity’s risk assessment process includes how management identifies risks relevant to the preparation of financial statements that are fairly presented in conformity with generally accepted accounting principles, estimates their significance, assesses the likelihood of their occurrence, and decides upon actions to manage them.

3. **The Entity’s Information System and Related Business Processes Relevant to Financial Reporting, and Communication**: The information system relevant to financial reporting objectives, which includes the accounting system, consists of the procedures, whether automated or manual, and records established to initiate, record, process, and report entity transactions and to maintain accountability for the related assets, liabilities, and equity. Communication involves providing an understanding of individual roles and responsibilities pertaining to internal control over financial reporting.

4. **Control Procedures**: Control procedures are the policies and procedures that help ensure that management directives are carried out, for example, that necessary actions are taken to address risks to achievement of the entity's objectives. Control procedures, whether automated or manual, have various objectives and are applied at various organizational and functional levels.

5. **Monitoring of Controls**: It is a process to assess the quality of internal control performance over time. It involves assessing the design and operation of controls on a timely basis and taking necessary corrective actions.

6-5 A substantive audit strategy means that the auditor has made a decision not to rely on the entity's controls and to audit the related financial statement accounts directly. Control risk is set at the maximum when a substantive audit strategy is followed. With a reliance strategy, the auditor relies on the entity's controls and sets control risk below the maximum. The reliance strategy requires a more detailed understanding and documentation of internal control than does
the substantive strategy. The auditor also plans and performs tests of controls to support the lower assessed level of control risk.

6-6 In addition to planning the audit of the financial statements, the auditor's understanding of the entity's internal control is used to (1) identify the types of potential misstatements, (2) consider factors that affect the risk of material misstatement, (3) design tests of controls, and (4) design of substantive tests.

6-7 The concept of reasonable assurance recognizes that the cost of an entity's internal control system should not exceed the benefits that are expected to be derived. Thus, an internal control system will not detect every error that might occur because it would be too costly to design such a system. Management override of internal control, personnel errors or mistakes, and collusion are inherent limitations of internal control.

6-9 Auditing standards state that the auditor should document the basis of the conclusions about the achieved level of control risk. The auditor should also document the achieved level of control risk so that the audit risk model can be used.

6-11 For private companies, auditing standards require that the auditor report any reportable conditions to the audit committee or to a similar level of authority when the entity does not have an audit committee. See Chapter 7 for the auditor’s reporting responsibility for reporting on internal control over reporting for public companies.

6-26 a. Internal control is design and effected by an entity’s board of directors, management, and other personnel that is designed to provide reasonable assurance about the achievement of the entity’s objectives in the following categories: (1) reliability of financial reporting, (2) effectiveness and efficiency of operations, and (3) compliance with applicable laws and regulations.

b. In planning an audit, the auditor should obtain an understanding of each of the components of internal control sufficient to plan the audit by performing procedures to understand the design of controls relevant to the preparation of financial statements and whether they have been placed in operation.

c. An auditor may set control risk at the maximum level for some or all assertions because the auditor believes controls are unlikely to pertain to an assertion, or are unlikely to be effective, or because evaluating their effectiveness would be inefficient.

d. An auditor should document the understanding of the internal control components obtained to plan the audit. The auditor should also document the basis of the auditor's conclusion about the assessed level of control risk. If control risk is assessed at the maximum level, the auditor should document that conclusion but is not required to document the basis of that conclusion. However, if the assessed level of control risk is below the maximum level, the auditor should document the basis of the conclusion
that the effectiveness of the design and operation of internal controls supports that assessed level.

6-27 The control environment factors that establish, enhance, or mitigate the effectiveness of specific controls, and their components, are:

**Communication and Enforcement of Integrity and Ethical Values**

The effectiveness of an entity’s controls is influenced by the integrity and ethical values of the individuals who create, administer, and monitor the controls. Integrity and ethical values are essential elements of the control environment, affecting the design, administration, and monitoring of the other components. Integrity and ethical behavior are the product of the entity’s ethical and behavioral standards, how they are communicated, and how they are reinforced in practice.

**A Commitment to Competence**

Management must specify the competence level for a particular job and translate it into the required level of knowledge and skill. Management must then hire employees who have the appropriate competence for a job.

**Participation of Board of Directors and Audit Committee**

The board of directors and audit committee significantly influence the control consciousness of the entity. Factors that affect the effectiveness of the board and audit committee include the following: its independence from management, the experience and stature of its members, the extent of its involvement with and scrutiny of the entity's activities, the appropriateness of its actions, the degree to which difficult questions are raised and pursued with management, and its interaction with the internal and external auditors.

**Managements’ Philosophy and Operating Style**

Management’s philosophy and operating style can significantly affect the quality of internal control. Characteristics that may indicate important information to the auditor about management’s philosophy and operating style include: (1) management’s approach to taking and monitoring risks, (2) management’s attitudes and actions towards financial reporting, and (3) management’s attitudes toward information processing and accounting functions and personnel.

**Organizational Structure**

The organizational structure defines how authority and responsibility are delegated and monitored. Establishing a relevant organizational structure includes considering key areas of authority and responsibility and appropriate lines of reporting. It provides a framework for planning, executing, and monitoring operations. An entity develops an organizational structure that depends on its size and the nature of its business.

**Assignment of Authority and Responsibility**

This factor includes how authority and responsibility for operating activities are assigned and how reporting relationships and authorization hierarchies are established.
This includes policies regarding acceptable business practices, the knowledge and experience of key personnel, and the resources provided for carrying out duties. It also includes policies and communications directed toward ensuring that all personnel understand the entity's objectives, know how their individual actions interrelate and contribute to those objectives, and recognize how and for what they will be held accountable.

**Human Resource Policies and Procedures**

The quality of internal control is a direct function of the quality of the personnel operating the system. The entity should have personnel policies for hiring, training, evaluating, counseling, promoting, compensating, and taking remedial action.

6-30  

a. Before applying principal substantive procedures to balance sheet accounts at April 30, 2005, the interim date, Cook should assess the difficulty in controlling incremental audit risk. Cook should consider whether

- Cook's experience with the reliability of the accounting records and management's integrity has been good.
- Rapidly changing business conditions or circumstances may predispose General's management to misstate the financial statements in the remaining period.
- The year-end balances of accounts selected for interim testing will be predictable.
- General's procedures for analyzing and adjusting its interim balances and for establishing proper accounting cutoffs will be appropriate.
- General's accounting system will provide sufficient information about year-end balances and transactions in the final two months of the year to permit investigation of unusual transactions, significant fluctuations, and changes in balance compositions that may occur between the interim and balance sheet dates.
- The cost of the substantive tests necessary to cover the final two months of the year and provide the appropriate audit assurance at year-end is substantial.

Assessing control risk at below the maximum would not be required to extend the audit conclusions from the interim date to year-end. However, if Cook assesses control risk at the maximum during the final two months, Cook should consider whether the effectiveness of the substantive tests to cover that period will be impaired.

b. Cook should design the substantive procedures so that the assurance from those tests and the tests to be applied as of the interim date, and any assurance provided from the assessed level of control risk, will achieve the audit objectives at year-end. Such tests should include the comparison of year-end information with comparable interim information to identify and investigate unusual amounts. Other analytical procedures and/or substantive procedures should be performed to extend Cook's conclusions relative to the assertions tested at the interim date to the balance sheet date.

6-32  

a. Preview Company's control environment has the following strengths:

- Corporate management has high integrity.
- Preview has a code of conduct.
- Preview hires competent people.
- Management is conservative in its use of accounting principles and practices.
• The external auditors review controls at each division.

The control environment has the following weaknesses:
• Divisions operate autonomously with limited monitoring (management intervenes only when planned results are not obtained).
• The board of directors and audit committee are not very active.
• There is limited monitoring of employee compliance with the corporate code of conduct.
• Employee compensation is dependent on performance. This in and of itself is not a weakness. However, with the presence of the other weaknesses, it represents a source of concern for the auditor.
• Preview does not have an internal audit department.

b. The following factors lead to and facilitate Harris's manipulation of inventory:
• As a general manager, Harris has a high incentive to "look good." His division has had seven years of increasing profits, and his salary and bonus depend on the division's performance.
• Competition in the industry is fierce, and sales prices are declining.
• Inventory represents a large portion of the balance sheet, and controls over inventory are weak.
• There is limited monitoring by corporate management, and there is no internal audit department.