Question 1 of 39

Each of the following questions is appropriate to ask internal audit personnel, **except**

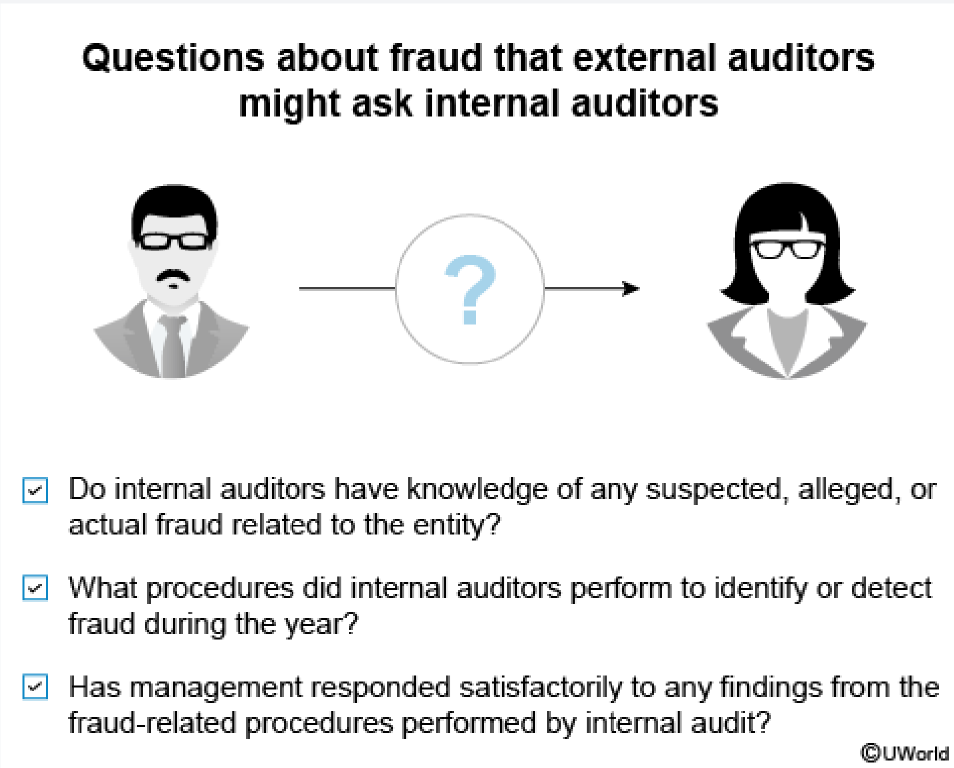
A. "How did you communicate to employees your views on business practices and ethical behavior?" ✓

B. "Do you have knowledge of any fraud or suspected fraud affecting the entity?"

C. "What procedures did you perform to identify or detect fraud during the year?"

D. "Has management responded satisfactorily to any findings from the fraud-related procedures you performed?"

Explanation:



Communication with an entity's internal audit team can help external auditors identify and assess the risk of material misstatement in the entity's F/S. Internal auditors may bring relevant matters to the external auditors' attention, and these details can be considered in the risk assessment process. Additionally, if such information indicates a heightened risk of material misstatement or fraud, the external auditors can incorporate those details into the risk assessment in accordance with relevant standards.

Some questions the external auditors might ask internal audit personnel include:

- "Do you have knowledge of any suspected, alleged, or actual fraud related to the entity?" **(Choice B)**
- "What procedures did you perform to identify or detect fraud during the year?" **(Choice C)**

- "Has management responded satisfactorily to any findings from the fraud-related procedures you performed?" **(Choice D)**

The external auditors would ask management, not internal auditors, **questions** about communicating views on **business practices** and **ethical behavior**. Furthermore, external auditors would make these inquiries during an assessment of the control environment, not during an internal audit.

Things to remember:
External auditors' communications with internal auditors may bring relevant matters to the external auditors' attention, and this information could be considered in the risk assessment process. To this end, the external auditors may ask internal auditors questions about fraud, fraud detection procedures, and management's response to the internal auditors' findings.

Question 2 of 39

To determine whether purchase orders were correctly filled by a supplier, the internal auditor most likely would review a sample of

A. Purchase requisitions.

B. Purchase invoices.

C. Receiving reports. ✓

D. Sales invoices.

Explanation:

RECEIVING REPORT

DATE RECEIVED	RECEIVING REPORT NO.
DATE PREPARED	PURCHASE ORDER NO.
WAREHOUSE LOCATION	SUPPLIER NO.

Item or Part No.	Item Description	Qty Received	Acceptance	
			Accept	Reject

Receiving Information
Received by (signature)
Checked by (signature)
EXCEPTIONS

The **spending cycle**, also called the **expenditure cycle**, is a series of recurring activities that revolves around purchasing and paying for inventory. The cycle consists of six business processes: purchase orders, receiving, inventory control, accounts payable, purchase returns, and cash disbursements.

The *supplier* is the entity that ships goods to the company to fulfill customer sales. Some of the documents in this cycle include:

- **Purchase requisition**: the internal request for goods (eg, materials needed to produce inventory) to be ordered from the supplier by the purchasing department **(Choice A)**
- **Purchase order**: the form *transmitted to the supplier* requesting goods be delivered to the company

- **Receiving report**: the document generated by the company warehouse for goods received from the supplier (see image above)
- **Purchase (vendor) invoice**: the document received from the supplier indicating the goods that were actually shipped to the company and the amount due **(Choice B)**

To determine whether purchase orders were **correctly filled** by the supplier, the internal auditor would review a sample of **receiving reports**. These reports are generated by the warehouse when the goods are delivered from the supplier. A receiving report can be a paper document or an electronic file issued from a barcode scanner.

(Choice D) Reviewing sales invoices would determine if supplier invoices were correct (ie, invoice was for shipped goods only). It does not determine if the correct items were shipped.

Things to remember:
The spending cycle revolves around purchasing and paying for inventory. To determine whether inventory orders from a supplier are being correctly filled, the internal auditor would review a sample of receiving reports.

Question 3 of 39

Which of the following statements is correct concerning internal control matters identified in a nonissuer financial statement audit?

A. An auditor is required to search for internal control matters that require communication to client management.

B. All identified internal control matters are considered material weaknesses and must be communicated to the client's management.

C. All internal control matters must be communicated orally to those charged with governance.

D. An auditor may report, in writing, that no material weaknesses were noted during an audit. ✓

Explanation:

Communication on I/C for audit of nonissuer F/S
• Provided in writing within 60 days of audit report date • Addressed to and restricted for use by client management and those charged with governance • Defines and explains identified significant deficiencies and material weaknesses • States audit was not designed to identify all significant deficiencies or material weaknesses • Specifically expresses no opinion on I/C effectiveness

The purpose of a nonissuer financial statement audit (ie, financial audit) is to express an opinion on the fairness of the financial statements only. To assess the risk of material misstatement, the auditor must gain an understanding of internal control (I/C) over financial reporting.

In a nonisser financial audit, the auditor is *not required* to search for I/C matters **(Choice A)**. However, when I/C matters are identified, the auditor must evaluate their severity and determine whether either significant deficiencies or material weaknesses exist. If **no material weaknesses** are noted, the **auditor may issue** a **written report** indicating such. However, this written report cannot indicate a lack of significant deficiencies because other I/C matters the auditor deems less significant may exist.

(Choice B) Not all I/C matters are material weaknesses. However, all identified material weaknesses and significant deficiencies must be reported in writing to those charged with governance.

(Choice C) An auditor must formally communicate I/C matters, specifically significant deficiencies and material weaknesses, to the client *in writing*, not orally.

Things to remember:
When performing a nonissuer financial audit, the auditor must gain an understanding of the internal controls over financial reporting but does not need to search for control

matters. If the auditor determines that significant control deficiencies or material weaknesses exist, they must be reported, in writing, to those charged with governance. The auditor may also report that no material weaknesses were noted if that is the case.

Question 4 of 39

Which of the following is **not** a component of internal control?

A. Control environment.

B. Control activities.

C. **Inherent risk.** ✓

D. Monitoring.

Explanation:

Components of internal control (CRIME)

Control activities	• Ensure achievement of objectives • Develop general controls over IT
Risk assessment	• Identify risk and consideration of fraud through clear objectives • Assess impact on internal control
Information and communication	• Generate relevant, high-quality information • Establish internal/external communication processes
Monitoring	• Conduct ongoing and/or separate evaluations • Report internal control deficiencies for corrective action
Environment	• Establish independent governance • Commit to competence, integrity, ethics, accountability

Most U.S. companies use COSO's *Internal Control – Integrated Framework* as a benchmark for internal controls. This framework starts out with five control components (ie, CRIME) and provides further descriptions and examples of controls in each component.

Control environment, control activities, and monitoring *are* COSO framework components **(Choices A, B, and D)**. **Inherent risk**, however, is **not** a COSO **control component**. Inherent risks are things that cannot be controlled (eg, economic downturns, management judgment errors). The COSO risk assessment component considers both control risk and inherent risk when determining risk levels and implementing risk controls. However, inherent risks will still exist even in the most well-designed control situation.

Things to remember:
Most U.S. companies use COSO's *Internal Control – Integrated Framework* as a benchmark against which to evaluate internal controls. This framework has five main components: environment, risk assessment, control activities, information and communication, and monitoring. Inherent risks are identified and addressed as part of the risk assessment component.

Question 5 of 39

Which of the following controls should prevent an invoice for the purchase of merchandise from being paid twice?

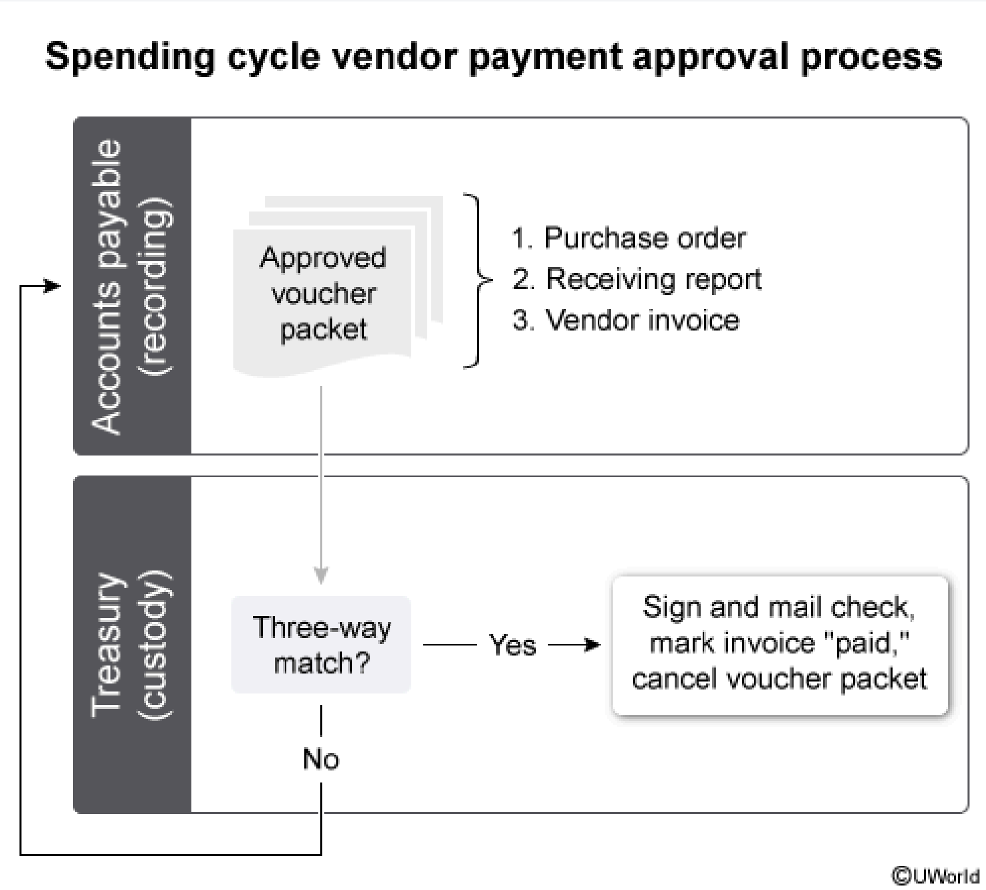
A. The check signer accounts for the numerical sequence of receiving reports used in support of each payment.

B. An individual independent of cash operations prepares a bank reconciliation.

C. The check signer reviews and cancels the voucher packets. ✓

D. Two check signers are required for all checks over a specified amount.

Explanation:



In the spending cycle, the accounts payable department records transactions and the treasury department signs checks. To increase speed and accuracy, businesses may use a paperless system, receiving documents, checking for errors, and processing payments with automated software. Internal controls and approval workflows are built into the enterprise resource planning (ERP) system design.

When requesting payment for **merchandise purchases**, accounts payable creates a voucher packet, which is a paper or electronic file containing the supporting purchase order, receiving report, and vendor invoice. If the quantities and prices match, the packet is forwarded to the treasury with the unsigned check or Automated Clearing House (ACH) payment request. The check signer reviews the documents, then manually or electronically **cancels the voucher packet** to **prevent duplicate payment**. ERP systems may also automate this control.

(Choice A) The entire voucher packet must be canceled to prevent duplicate payment. Checking the numerical sequence of receiving reports is only *part* of the process.

(Choice B) An independent party performing bank reconciliations may detect but cannot prevent duplicate payments because the party's work occurs after payment is issued.

(Choice D) Requiring two signers for checks that exceed a specified amount would not provide additional internal control for checks of other amounts.

Things to remember:
For merchandise purchases, a voucher packet containing the supporting purchase order, receiving report, and vendor invoice is attached to the payment request. The check signer reviews the documents and cancels the voucher packet to prevent duplicate payment.

Question 6 of 39

A standard audit report on a nonissuer's financial statements would be inappropriate if it referred to

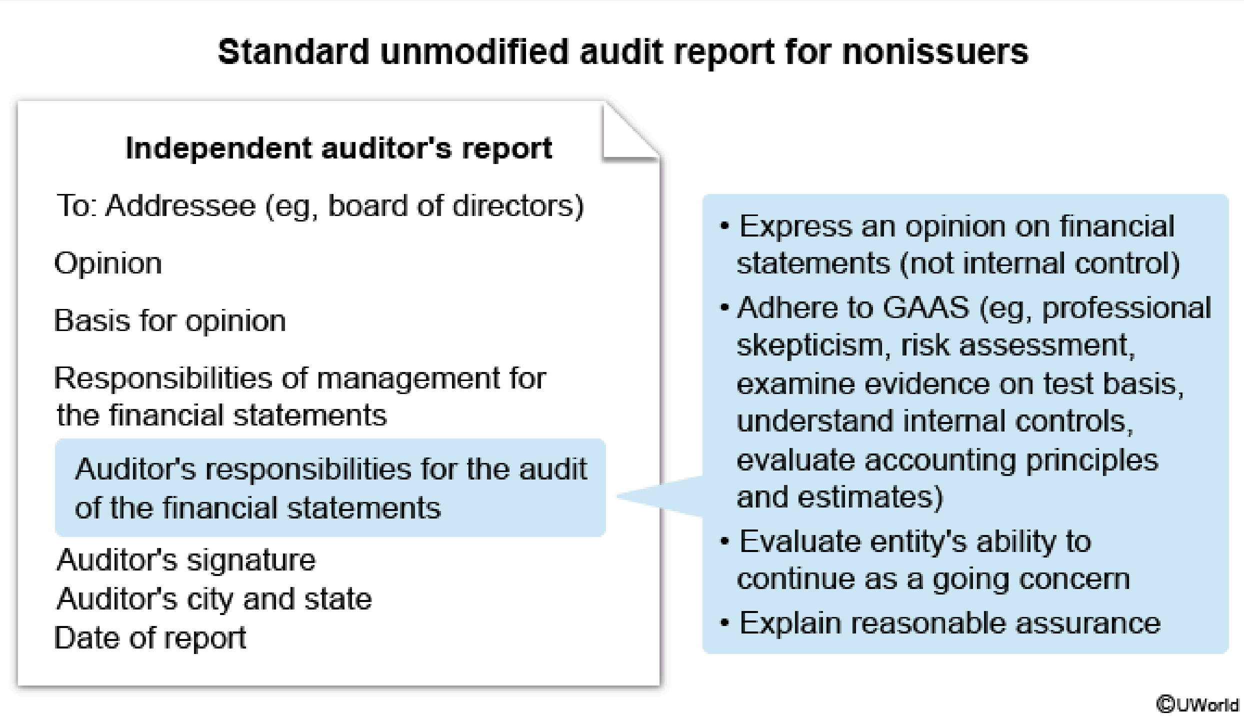
A. The examination of evidence on a test basis.

B. The evaluation of the entity's accounting policies.

C. The evaluation of significant estimates made by management.

D. The assessment of sampling risk factors. ✓

Explanation:



GAAS outlines the structure of a standard audit report for nonissuers. The order and content are regimented so that readers can better interpret them. The standard report consists of the opinion, basis for opinion, management's responsibilities, and auditor's responsibilities sections.

The section titled "Auditor's Responsibilities for the Audit of the F/S" includes a general description of an audit. The description indicates that the auditor evaluated the appropriateness of management's accounting policies, the reasonableness of its significant accounting estimates, and the overall presentation of the F/S **(Choices B and C)**. It also includes references to tests performed in all F/S audits, including risk assessment, understanding I/C, and the examination of evidence on a test basis **(Choice A)**.

Although this section **describes** the nature of procedures performed, it does so at a very **general** level. Because the auditor, not the reader, is in a position to interpret the results of **specific** tests or decisions made in conducting those tests (eg, assessment of sampling risk factors), they are **not described** in the audit report.