1. The Committee of Sponsoring Organizations of the Treadway Commission (COSO) broadly defines internal control as:

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

   - Effectiveness and efficiency of operations.
   - Reliability of financial reporting.
   - Compliance with applicable laws and regulations.

   The Canadian Institute of Chartered Accountants (CoCo) defines internal control as:

   Those elements of an organization that support people and offer reasonable assurance in the achievement of the organization's objectives in the following categories:

   - Effectiveness and efficiency of operations.
   - Reliability of internal and external reporting.
   - Compliance with laws and regulations and internal policies.

   According to the Turnbull Report (*Internal Control Guidance for Directors on the Combined Code*), internal control:

   Encompasses the policies, processes, tasks, behaviors and other aspects of a company that offer reasonable assurance in facilitating its effective and efficient operation, enabling it to respond appropriately to significant business, operational, financial, compliance, and other risks to achieving the company's objectives relative to:

   - Safeguarding assets.
   - Managing liabilities.
   - The quality of reporting.
   - Compliance with laws and regulations.

2. The five components of internal control are: Control Environment, Risk Assessment, Control Activities, Information and Communication, and Monitoring.

3. The CEO and senior management own internal control, the board of directors provides governance and oversight, internal auditors provide independent assessment of operating effectiveness, and other associates produce or monitor elements of an organization's system of internal controls. While independent outside auditors do not have responsibility for the organization's internal control, they do contribute independence and objectivity through their opinions covering the fairness of the financial statements and the effectiveness of internal control over financial reporting.

4. The CEO of an organization owns and has ultimate responsibility for internal control, however, everybody has some level of responsibility for internal control. The CEO has primary responsibility due to the nature of the position and because the CEO is the individual who most directly sets the "tone at the top" which is the ethical climate of the organization. There is a direct relationship

between the integrity of the CEO and the overall ethical environment of the organization, which in turn affects the effectiveness of the system of internal controls.

5. Limits of internal control are the confines that relate to the limits of human judgment, resource constraints and the need to consider the cost of controls in relation to expected benefits, the reality that breakdowns can occur, and the possibility of collusion or management override. Examples include faulty human judgment in decision-making, human error or mistakes, circumvention of controls by individuals acting in collusion with others, management override of controls, and cost/benefit assessments.

6. Entity-level controls are very broadly focused and deal with the organizational environment or atmosphere. They are designed to directly mitigate risks that exist at the organization-wide level. Process-level and transaction-level controls, on the other hand, are more detailed in focus and are designed by process owners to mitigate risks that threaten processes, activities, tasks, and transactions.

7. Key controls and secondary controls differ in terms of their importance. Key controls are designed to reduce risks associated with critical business objectives, while secondary controls are designed to either reduce risks associated with business objectives that are not critical to the organization's survival or success or serve as backup to a key control.

8. If key controls do not fully operate effectively, a compensating control may help reduce the related risk. A complementary control is one that, when taken together with other controls, contributes to the overall effective mitigation of risk.

9. Whereas a directive control gives explicit direction regarding what actions need to take place to cause or encourage a desirable event to occur, a corrective control is one in which detected errors or omissions are corrected.

10. General computing controls and application controls are the two broad types of information systems controls.

11. Initially, management performs the primary assessment, testing, and certification of internal controls, and then the internal audit function independently validates management's results. Additionally, a report is typically submitted to the board audit committee by either senior management or the chief audit executive (CAE), outlining the results of management's self assessment regarding the proper design and efficacy of the organization's internal controls.

    As indicated in The IIA's *International Standards for the Professional Practice of Internal Auditing* (*Standards*), the internal audit function is responsible for assessing and reporting on an organization's controls (either elements of, or the entirety of, the system of internal controls) as outlined in Practice Advisory 2130-1: Assessing the Adequacy of Control Processes:

    Three key considerations in reaching an evaluation of [conclusion on] the overall effectiveness of the organization's risk management and control processes are:

    - Were significant discrepancies or weaknesses [deficiencies] discovered from the audit work performed and other assessment information gathered?
    - If so, were corrections or improvements made after the discoveries?
    - Do the discoveries and their consequences lead to the conclusion that a pervasive condition exists resulting in an unacceptable level of business risk [or operating effectiveness]?

1. **C** is the best answer. Answer A is incorrect because it is a purpose of audit planning. Answer B is incorrect because correcting control weaknesses is a function of management, not of the internal auditor. Answer D is incorrect because it is a basic objective from a financial accounting and auditing perspective, but is not broad enough to cover the internal auditor's entire purpose for review.
2. **C** is the best answer. Residual risk is that risk left over after all controls and risk management techniques have been applied. Answer A is incorrect because the impact of risk is its consequence. Answer B is incorrect because risk that is under control is managed risk. Answer D is incorrect because the underlying risk is the absolute risk.
3. **A** is the best answer. Preventive controls are actions taken prior to the occurrence of transactions with the intent of stopping errors from occurring. Use of an approved vendor list is a control to prevent the use of unacceptable suppliers. Answer B is incorrect because a detective control identifies errors after they have occurred. Answer C is incorrect because corrective controls correct the problems identified by detective controls. Answer D is incorrect because monitoring controls are designed to ensure the quality of the control system's performance over time.
4. **B** is the best answer. A good system of internal controls is likely to expose a fraud if it is perpetrated by one employee without the aid of others. Answer A is incorrect because a group has a better chance of successfully perpetrating an irregularity than does an individual employee. Answers C and D are incorrect because management can often override controls, singularly or in groups.
5. **A** is the best answer. A tailored program will be more relevant to an operation than will a generalized program. Answer B is incorrect because a generalized program cannot take into account variations resulting from changing circumstances and varied conditions. Answer C is incorrect because a generalized program cannot take into account variations in circumstances and conditions. Answer D is incorrect because every aspect of an operation need not be examined — only those likely to conceal problems and difficulties.
6. **C** is the best answer. The employee's supervisor would be in the best position to ensure payment of the proper amount. Answer A is incorrect because employees may be properly included on payroll, but the amounts paid may be unauthorized. Answer B is incorrect because undelivered checks provide no evidence regarding validity of the amounts. Answer D is incorrect because witnessing a payroll distribution would not assure that amounts paid are authorized.
7. **C** is the best answer. Although this might be informational, there is no need to develop a comparison of investment returns with other organizations. Indeed, some financial investment scandals show that such comparisons can be highly misleading because high returns were due to taking on a high level of risk. Also, this is not a test of the adequacy of the controls. Answer A is incorrect because new financial instruments are very risky and the first step of such an engagement should be to determine the nature of policies established for the investments. Answer B is incorrect because oversight by a management committee is an important control. Therefore, the auditor should determine the nature of the oversight set up to monitor and authorize such investments. Answer D is incorrect because a fundamental control concept over cash-like assets is that someone establishes a mechanism to monitor the risks.
8. **A** is the best answer. Independent reconciliation of bank accounts is necessary for good internal control. Answer B is incorrect because it is not an important internal control consideration. Answer C

is incorrect because foreign currency translation rates are not computed, but instead verified. Having two employees in the same department perform the same task will not significantly enhance internal control. Answer D is incorrect because it is not an important internal control consideration.

9. **C** is the best answer. The organization's management has primary responsibility for the monitoring component of internal control. Answer A is incorrect because independent outside auditors perform financial statement audits to ensure that organizations meet their financial reporting obligations. Answer B is incorrect because the internal audit function performs an independent assessment of the system of internal controls. Answer D is incorrect because the organization's board of directors is responsible for governance and oversight, but not monitoring.

1. B and D would most likely indicate the existence of control weaknesses over safeguarding of assets. Failure to perform background checks on associates is a symptom of weak controls for safeguarding of assets because it could result in the hiring of an associate with prior convictions for theft or fraud committed at a past employer. These individuals may be more likely to commit fraud against their current employer. Additionally, management's failure to take corrective action on past engagement observations, which, related to safeguarding of assets, is a weakness related to safeguarding of assets. The poor location of a service department, on the other hand, is a symptom of weak controls for achieving organizational goals and objectives, but not for the safeguarding of assets. The same is true of management's lack of access to reports that profile overall performance in relation to other benchmarked organizations.
2. Yes, analytical results are the criteria for the decision to discharge the wastewater, which, in conjunction with other controls, helps management achieve the objective of preventing the release of wastewater that does not meet permit limits or other conditions.
3. The control requiring a review of all purchase requisitions by a supervisor in the user department prior to submitting them to the purchasing department is superior because it is a means of control over the number of items ordered. Conversely, the control requiring agreement of the receiving report and packing slip would be more appropriate for the risk of receiving an amount other than that ordered.
4. a. Yes, an organization's internal audit function is part of the organization's overall system of internal controls. Through their independent assessment of management's assertions regarding the design adequacy and operating effectiveness of internal controls, the internal audit function provides an extra level of assurance upon which the board of directors, audit committee, and external parties such as regulators, external auditors, and shareholders can rely. While management's assessment of the adequate design and operating effectiveness of the organization's system of internal controls should be sufficient to stand on its own, the independent positioning of the internal audit function, reporting directly to the board, can be relied upon to supplement management's assessment.

   Or,

   No, an organization's internal audit function is not part of the organization's system of internal controls. Management's assessment of the adequate design and operating effectiveness should stand alone and the internal audit function should not be relied upon in any way to reinforce or support management's assessment. However, internal audit functions that are appropriately positioned within the organization, with direct reporting lines to the audit committee, contribute to overall governance

by providing an extra level of assurance upon which the board of directors, audit committee, and external parties such as regulators, external auditors, and shareholders can rely.

b. Yes, by definition, the internal audit function is an independent monitoring function according to COSO. Monitoring is most effective when a layered approach is taken with monitoring embedded in the day-to-day activities management performs in their areas of responsibilities and also performed separately to evaluate, on a regular basis, the effectiveness of internal controls. If appropriately positioned within the organization, the internal audit function can remain independent and add value while serving in this monitoring role.

Or,

No, it is not appropriate for the internal audit function to perform day-to-day monitoring activities, which is management's responsibility. If it is necessary for management to rely on monitoring activities performed by the internal audit function for there to be confidence in the organization's system of internal controls, then management is not appropriately performing monitoring activities and the system of internal controls cannot accurately be assessed as adequately designed or operating effectively. However, by definition, the internal audit function is an independent monitoring function according to COSO. The internal audit function can contribute to overall governance by providing an additional, independent layer of monitoring that can give external parties added confidence in the organization's system of internal controls.

The following grading guide will assist in assigning points for the case study. The following three items provide a basis for evaluating that the necessary components are present for each of the five photographed controls required in the case study.

1. Photographs of five *different* controls.

   1.   2.   3.   4.   5.

2. Clear indication of whether each control is designed to mitigate the threat of bad things happening or the threat of good things not happening.

   1.

   2.

   3.

   4.

   5.

   The objective(s) each control is designed to address.

   1.

   2.

   3.

   4.

   5.

   How each control is meant to operate (that is, how the control works).

   1.

   2.

   3.

   4.

   5.

   How the control would be tested to determine whether it is operating effectively.

   1.

   2.

   3.

   4.

   5.

3. Form:
   - Typed, proper grammar and spelling, good sentence structure, etc.
   - Objective, operation, and test separately described (for example, outline format).