

**PART-1(UNIT-1)**

1. Which of the following concurrent occupations could appear to subvert the ethical behavior of an internal auditor?

A. Internal auditor and adjunct faculty member of a local business college that educates potential employees.

B. Internal auditor and a well-known charitable organization's local in-house chairperson.

C. Internal auditor and part-time business insurance broker.

D. Internal auditor and landlord of multiple housing that publicly advertises for tenants in a local community newspaper listing monthly rental fees.

**Answer (C) is correct**

Rule of Conduct 2.1 under the objectivity principle states, "Internal auditors shall not participate in any activity or relationship that may impair or be presumed to impair their unbiased assessment. This participation includes those activities or relationships that may be in conflict with the interests of the organization." As a business insurance broker, the internal auditor may lose his or her objectivity because (s)he might benefit from a change in the employer's insurance coverage.

A. Teaching is compatible with internal auditing.

B. The activities of a charity are unlikely to be contrary to the interests of the organization.

D. Whereas dealing in commercial properties might involve a conflict, renting residential units most likely does not.

2. A review of an organization's code of conduct revealed that it contained comprehensive guidelines designed to inspire high levels of ethical behavior. The review also revealed that employees were knowledgeable of its provisions. However, some employees still did not comply with the code. What element should a code of conduct contain to enhance its effectiveness?

A. Periodic review and acknowledgment by all employees.

B. Employee involvement in its development.

C. Provisions for disciplinary action in the event of violations.

D. Public knowledge of its contents and purpose.

**Answer (C) is correct.**

Penalties for violations of a code of conduct should enhance its effectiveness. Some individuals will be deterred from misconduct if they expect it to be detected and punished.

A.Periodic review and acknowledgment would ensure employee knowledge and acceptance of the code, which are not at issue.

B.Employee involvement in development would encourage employee acceptance, which is not at issue.

D.Public knowledge might affect the behavior of some individuals, but not to the same extent as the perceived likelihood of sanctions for wrongdoing.

3.According to The IIA's Code of Ethics, which of the following principles is relevant to the establishment of trust?

A.Confidentiality.

B.Competency.

C.Integrity.

D.Objectivity.

**Answer (C) is correct.**

The principle of integrity states that the integrity of the internal auditors establishes trust and thus provides the basis for reliance on their judgment. The four Core Principles included in The IIA's Code of Ethics are integrity, objectivity, confidentiality, and competency.

A.The principle of confidentiality states that internal auditors do not disclose information without appropriate authority. It does not include the establishment of trust.

B.The principle of competency states that internal auditors apply the knowledge, skills, and experience needed in the performance of internal audit services. It does not include the establishment of trust

D.The principle of objectivity states that internal auditors are not unduly influenced by their own interests or by others in forming judgments. It does not include the establishment of trust.

4.In their communication of results, internal auditors are required by The IIA's Code of Ethics to

A.Obtain factual information within the established time and budget parameters.

B.Disclose all material information obtained as of the date of the final engagement communication.

C.Reveal material facts that could distort communications if not revealed.

D.Present sufficient factual information without revealing confidential information that could be detrimental to the organization.

**Answer (C) is correct.**

Internal auditors should disclose all material facts known to them that, if not disclosed, may distort the reporting of activities under review (Rule of Conduct 2.3).

- A. Obtaining information pertains to performing the engagement, not communicating results.
- B. Disclosures by the internal auditors are not limited to information obtained as of the date of the final engagement communication.
- D. The Code of Ethics does not prohibit communicating confidential information to appropriate parties within the organization, e.g., senior management and the board

5. An internal auditor has uncovered facts that could be interpreted as indicating unlawful activity on the part of an engagement client. The internal auditor decides not to inform senior management and the board of these facts because of lack of proof. The internal auditor, however, decides that, if questions are raised regarding the omitted facts, they will be answered fully and truthfully. In taking this action, the internal auditor

- A. Has violated The IIA's Code of Ethics because unlawful acts should have been reported to the appropriate regulatory agency to avoid potential "aiding and abetting" by the internal auditor.
- B. Has not violated The IIA's Code of Ethics or the Standards because the internal auditor is committed to answering all questions fully and truthfully.
- C. Has violated the Standards because the internal auditor should inform the appropriate authorities in the organization if fraud may be indicated.
- D. Has not violated The IIA's Code of Ethics or the Standards because confidentiality takes precedence over all other standards.

**Answer (C) is correct.**

The internal auditor should inform the appropriate authorities in the organization if the indicators of the commission of a fraud are sufficient to recommend an investigation. Thus, the internal auditor has a duty to act even though the available facts do not prove that an irregularity has occurred. Moreover, Rule of Conduct 2.3 states, "Internal auditors shall disclose all material facts known to them that, if not disclosed, may distort the reporting of activities under review."

- A. The possibility of unlawful activities should be reported to the appropriate personnel within the organization.
- B. The internal auditor has an affirmative duty to report the results of his or her work.
- D. Reporting a possible irregularity to the appropriate organizational authorities is not a breach of the duty of confidentiality owed to the organization.

6. Which Standards expand upon the other categories of Standards?

- A. Attribute Standards.
- B. Implementation Standards.
- C. Performance Standards.
- D. All of the choices are correct.

**Answer (B) is correct.**

Implementation Standards expand upon the Attribute and Performance Standards. They provide requirements applicable to assurance or consulting engagements.

A. Attribute Standards apply to all internal audit services

C. Performance Standards apply to all internal audit services.

D. Only Implementation Standards expand upon the standards in other categories.

7. The types of services provided by the internal audit activity can best be described as

A. Auditing and consulting.

B. Auditing and assurance.

C. Assurance and consulting.

D. Auditing and engagement.

**Answer (C) is correct.**

The internal audit activity provides independent, objective assurance and consulting services designed to add value and improve an organization's operations (Definition of Internal Auditing).

A. The IIA Glossary defines assurance and consulting, not auditing and consulting, as the types of services provided by the internal audit activity.

B. The IIA Glossary defines assurance and consulting, not auditing and assurance, as the types of services provided by the internal audit activity.

D. Engagement is not a type of internal audit service.

8. Which of the following is permissible under The IIA's Code of Ethics?

A. An auditor used audit-related information in a decision to buy stock issued by the employer corporation.

B. In response to a subpoena, an auditor appeared in a court of law and disclosed confidential, audit-related information that could potentially damage the auditor's organization.

C. An auditor did not report significant observations about illegal activity to the board because management indicated that it would resolve the issue.

D. After praising an employee in a recent audit engagement communication, an auditor accepted a gift from the employee.

**Answer (B) is correct.**

Rule of Conduct 1.2 under the integrity principle states, "Internal auditors shall observe the law and make disclosures expected by the law and the profession." Thus, auditors must comply with subpoenas.

A. Rule of Conduct 3.2 prohibits auditors from using audit information for personal gain

C. Rule of Conduct 1.3 prohibits auditors from knowingly being a party to any illegal or improper activity. Significant observations of illegal activity should be reported to the board.

D. Rule of Conduct 2.2 prohibits an auditor from accepting anything that might be presumed to impair the auditor's professional judgment.

9. During an engagement performed at a manufacturing division of a defense contractor, the internal auditor discovered that the organization apparently was inappropriately adding costs to a cost-plus governmental contract. The internal auditor discussed the matter with senior management, who suggested that the internal auditor seek an opinion from legal counsel. Upon review, legal counsel indicated that the practice was questionable but was not technically in violation of the government contract. Based on legal counsel's decision, the internal auditor decided to omit any discussion of the practice in the final engagement communication sent to senior management and the board. However, the internal auditor did informally communicate legal counsel's decision to senior management. Did the internal auditor violate The IIA's Code of Ethics?

A. No. The internal auditor followed up the matter with appropriate personnel within the organization and reached a conclusion that no fraud was involved.

B. Yes. Internal legal counsel's opinion is not sufficient. The internal auditor should have sought advice from outside legal counsel.

C. No. If a fraud is suspected, it should be resolved at the divisional level where it is taking place.

D. Yes. It is a violation because all important information, even if resolved, should be reported to the board.

**Answer (A) is correct.**

Although an argument can be made that the internal auditor should report the matter to the board and senior management, there is no indication that the internal auditor is deliberately withholding material facts that, if not disclosed, may distort reports of activities under review (Rule of Conduct 2.3). Hence, no violation of the Code occurred.

B. The internal auditor has gathered sufficient information. Internal legal counsel's opinion appears to be sufficient.

C. Material fraud, if suspected, should be brought to the attention of management. However, in this case, the internal auditor gathered sufficient information to dispel the suspicion of fraud.

D. The internal auditor did not deliberately withhold important information.

**10.**An internal auditor discovered some material inefficiencies in a purchasing function. The purchasing manager is the internal auditor's next-door neighbor and best friend. In accordance with The IIA's Code of Ethics, the internal auditor should

- A. Not report the incident because of loyalty to the friend.
- B. Include the facts of the case in a special communication submitted only to the friend.
- C. Objectively include the facts of the case in the engagement communications.
- D. Not report the friend unless the activity is illegal.

**Answer (C) is correct.**

Rule of Conduct 2.3 under the objectivity principle states, "Internal auditors shall disclose all material facts known to them that, if not disclosed, may distort the reporting of activities under review."

- A. This action is at variance with the internal auditor's duties.
- B. This action is at variance with the internal auditor's duties.
- D. This action is at variance with the internal auditor's duties.

**11.** Which of the following most likely constitutes a violation of The IIA's Code of Ethics?

- A. Auditor C is content as an internal auditor and has come to look at it as a regular 9-to-5 job. Auditor C has not engaged in continuing professional education or other activities to improve effectiveness during the last 3 years. However, Auditor C feels performance of quality work is the same as before.
- B. Auditor A has accepted an assignment to perform an engagement at the electronics manufacturing division. Auditor A has recently joined the internal audit activity. But Auditor A was senior auditor for the external audit of that division and has audited many electronics organizations during the past 2 years.
- C. Auditor B has been assigned to perform an engagement at the warehousing function 6 months from now. Auditor B has no expertise in that area but accepted the assignment anyway. Auditor B has signed up for continuing professional education courses in warehousing that will be completed before the assignment begins.
- D. Auditor D discovered an internal financial fraud during the year. The books were adjusted to properly reflect the loss associated with the fraud. Auditor D discussed the fraud with the external auditor when the external auditor reviewed working papers detailing the incident.

**Answer (A) is correct.**

Rule of Conduct 4.3 under the competency principle states, "Internal auditors shall continually improve their proficiency and the effectiveness and quality of their services."

**B.**No professional conflict of interest exists per se, especially given that the internal auditor was previously in public accounting. However, the internal auditor should be aware of potential conflicts.

**C.**An internal auditor must possess the necessary knowledge, skills, and competencies at the time an engagement is conducted, not the time it is accepted.

**D.**The information was disclosed as part of the normal process of cooperation between the internal and external auditor. Because the books were adjusted, the external auditor was expected to inquire as to the nature of the adjustment.

**12.Fact Pattern:** The chief audit executive (CAE) of a mid-sized internal audit activity was concerned that management might outsource the internal auditing function. Thus, the CAE adopted a very aggressive program to promote the internal audit activity within the organization. The CAE planned to present the results to senior management and the board and recommend modification of the internal audit activity's charter after using the new program. The following lists six actions the CAE took to promote a positive image within the organization:

Engagement assignments concentrated on efficiency. The engagements focused solely on cost savings, and each engagement communication highlighted potential costs to be saved. Negative observations were omitted. The focus on efficiency was new, but the engagement clients seemed very happy.

Drafts of all engagement communications were carefully reviewed with the engagement clients to get their input. Their comments were carefully considered when developing the final engagement communication.

The information technology internal auditor participated as part of a development team to review the control procedures to be incorporated into a major computer application under development.

Given limited resources, the engagement manager performed a risk assessment to establish engagement work schedule priorities. This was a marked departure from the previous approach of ensuring that all operations are evaluated on at least a 3-year interval.

To save time, the CAE no longer required that a standard internal control questionnaire be completed for each engagement.

When the internal auditors found that the engagement client had not developed specific criteria or data to evaluate operations, the internal auditors were instructed to perform research, develop specific criteria, review the criteria with the engagement client, and, if acceptable, use them to evaluate the engagement client's operations. If the engagement client disagreed with the criteria, a negotiation took place until acceptable criteria could be agreed upon. The engagement communication commented on the engagement client's operations in conjunction with the agreed-upon criteria.

Which of the following elements of Action 1 taken by the CAE would be considered inappropriate?

- The type of engagements was changed before modifying the internal audit activity's charter and going to the audit committee.
- Negative observations were omitted from the engagement communications.
- Cost savings and recommendations were highlighted in the engagement communication.

A.1 and 3.

B.1 and 2.

C.1 only.

D.2 and 3.

**Answer (B) is correct.**

The CAE dramatically changed internal audit's scope of work without consulting with the board. A second violation is the omission of negative observations. Under The IIA's Code of Ethics, the auditors must disclose all material facts known to them that, if not disclosed, may distort the reporting of activities under review (Rule of Conduct 2.3).

**A.** Highlighting potential cost savings is appropriate for an engagement communication, and material negative observations must not be omitted.

**C.** Omitting negative observations is also a violation.

**D.** The CAE dramatically changed internal audit's scope of work without consulting with the board. Moreover, highlighting potential cost savings is appropriate for an engagement communication.

**13.** The board of an organization has charged the chief audit executive (CAE) with upgrading the internal audit activity. The CAE's first task is to develop a charter. What item should be included in the statement of objectives?

**A.** Report all engagement results to the board every quarter.

**B.** Notify governmental regulatory agencies of unethical business practices by organization management.

**C.** Evaluate the adequacy and effectiveness of the organization's controls.

**D.** Submit budget variance reports to management every month.

**Answer (C) is correct.**

The charter establishes the internal audit activity's position within the organization, including the nature of the chief audit executive's functional reporting relationship with the board; authorizes access to records, personnel, and physical properties relevant to the performance of engagements; and defines the scope of internal audit activities (Inter. Std. 1000). Internal auditing brings a systematic, disciplined approach to evaluating and improving risk management, control, and governance processes (Definition of Internal Auditing).

**A.** Only significant engagement results are discussed with the board.

**B.** Internal auditors ordinarily are not required to report deficiencies in regulatory compliance to the appropriate agencies. However, they must observe the law and make disclosures expected by the law and profession (Rule of Conduct 1.2).

**D.** Submission of budgetary variance reports is not a primary objective of internal auditing. It is a budgetary control that management may require on a periodic basis.

**14.** An internal auditor is performing services in a division in which the chief financial officer is a close personal friend, and the internal auditor learns that the friend is to be replaced after a series of critical

labor negotiations. The internal auditor relays this information to the friend. Has a violation of The IIA's Code of Ethics occurred?

- A.No. The use of the confidential information resulted in no personal gain to the internal auditor.
- B.Yes. The internal auditor was not prudent in the use of information acquired in the course of his or her duties.
- C.No. The internal auditor was just being honest with his or her friend.
- D.Yes. The internal auditor had a conflict of interest with the organization.

**Answer (B) is correct.**

Rule of Conduct 3.1 under the confidentiality principle states, "Internal auditors shall be prudent in the use and protection of information acquired in the course of their duties." Rule of Conduct 3.2 states, "Internal auditors shall not use information for any personal gain or in any manner that would be contrary to the law or detrimental to the legitimate and ethical objectives of the organization." In this case, the decision whether to notify the financial officer of his or her replacement was properly the organization's. Accordingly, the internal auditor was bound not to tell his or her friend.

- A.The Rules of Conduct specifically prohibit using information in a manner that would be detrimental to the legitimate and ethical objectives of the organization.
- C.The Rules of Conduct specifically prohibit using information in a manner that would be detrimental to the legitimate and ethical objectives of the organization.
- D.The facts do not suggest that a conflict of interest existed. However, such a conflict would be present, for example, if the internal auditor used confidential information to seize a business opportunity that rightfully belonged to the organization.

**15.** Which situation is most likely a violation of The IIA's Code of Ethics?

- A.Immediately reporting a violent crime observed at work to local law enforcement agencies.
- B.Reporting apparent violations of antitrust statutes by officers to government regulators.
- C.Reporting apparent violations of antitrust statutes by officers to the board of directors.
- D.Cooperating with the government's criminal investigation of the organization.

**Answer (B) is correct.**

An internal auditor must (1) not knowingly be a party to any illegal activity (Rule of Conduct 1.3); (2) disclose all material facts known to him or her that, if not disclosed, might distort the reporting of activities under review (Rule of Conduct 2.3); and (3) respect and contribute to the legitimate and ethical objectives of the organization (Rule of Conduct 1.4). Thus, when apparent violations of antitrust statutes by officers come to the internal auditor's attention, (s)he should report to the board of directors rather than directly to the government regulators. An internal auditor also must observe the law and make any disclosures required by the law or by the profession (Rule of Conduct 1.2)

A. Everyone has a legal and moral obligation to report violent crimes immediately.

C. An internal auditor should report apparent improprieties to the board.

D. Everyone has a legal obligation to cooperate with a criminal investigation. An internal auditor must observe the law and make any disclosures required by the law or by the profession (Rule of Conduct 1.2).

**16.** During an engagement to evaluate the organization's accounts payable function, an internal auditor plans to confirm balances with suppliers. What is the source of authority for such contacts with units outside the organization?

A. The internal audit activity's charter.

B. The Standards.

C. Internal audit activity policies and procedures.

D. The Code of Ethics.

**Answer (A) is correct.**

The charter establishes the internal audit activity's position within the organization, including the nature of the chief audit executive's functional reporting relationship with the board; authorizes access to records, personnel, and physical properties relevant to the performance of engagements; and defines the scope of internal audit activities (Inter. Std. 1000). Thus, the charter prescribes the internal audit activity's relationships with other units within the organization and with those outside.

B. The internal audit activity's authority is defined in a charter approved by the board.

C. Policies and procedures guide the internal auditors in their consistent compliance with the internal audit activity's standards of performance.

D. The purpose of the Code of Ethics is to promote an ethical culture in the profession of internal auditing.

**17.** According to The IIA Code of Ethics, the principle of integrity requires internal auditors to do which of the following?

A. Not accept anything that may impair or be presumed to impair their professional judgment.

B. Respect and contribute to the legitimate and ethical objectives of the organization.

C. Continually improve their proficiency, effectiveness, and quality of services.

D. Be prudent in the use and protection of the information acquired in the course of their duties.

**Answer (B) is correct.**

Rule of Conduct 1.4 under the integrity principle states, “Internal auditors shall respect and contribute to the legitimate and ethical objectives of the organization.”

A. Rule of Conduct 2.2 under the objectivity principle states, “Internal auditors shall not accept anything that may impair or be presumed to impair their professional judgment.”

C. Rule of Conduct 4.3 under the competency principle states, “Internal auditors shall continually improve their proficiency and the effectiveness and quality of their services.”

D. Rule of Conduct 3.1 under the confidentiality principle states, “Internal auditors shall be prudent in the use and protection of information acquired in the course of their duties.”

18. The Core Principles for the Professional Practice of Internal Auditing are the basis for internal audit effectiveness. Which of the following is not a core principle?

A. Is objective and free from undue influence (independent).

B. Demonstrates quality and continuous improvement.

C. Eliminates risk management processes that are inadequate and ineffective.

D. Aligns with the strategies, objectives, and risks of the organization.

**Answer (C) is correct.**

It is the responsibility of management to eliminate risk management processes that are inadequate and ineffective. It is the responsibility of the internal auditor to evaluate whether risk management processes are effective. The internal audit function is effective if all core principles are present and operating effectively. The Core Principles for the Professional Practice of Internal Auditing are: “(1) demonstrates integrity, (2) demonstrates competence and due professional care, (3) is objective and free from undue influence (independent), (4) aligns with the strategies, objectives, and risks of the organization, (5) is appropriately positioned and adequately resourced, (6) demonstrates quality and continuous improvement, (7) communicates effectively, (8) provides risk-based assurance, (9) is insightful, proactive, and future-focused, and (10) promotes organizational improvement.”

A. “Is objective and free from undue influence (independent)” is one of the core principles for the professional practice of internal auditing. The Definition of Internal Auditing states “internal auditing is an independent, objective assurance and consulting activity.”

B. “Demonstrates quality and continuous improvement” is one of the core principles for the professional practice of internal auditing. As defined in the Definition of Internal Auditing, internal auditing is “designed to add value and to improve an organization’s operations.”

D. “Aligns with the strategies, objectives, and risks of the organization” is one of the core principles for the professional practice of internal auditing. According to the Definition of Internal Auditing, internal auditing is designed to “help an organization accomplish its objectives by bringing a systematic, disciplined approach to evaluate the effectiveness” of the organization’s processes.

19. The chief audit executive meets with the members of the internal audit activity at scheduled staff meetings. Which of the following is the most appropriate function of such a staff meeting?

- A.Revising travel, promotion, and compensation policies.
- B.Explaining administrative policies and obtaining suggestions from the staff.
- C.Developing the engagement work schedule.
- D.Developing long-range training programs that will meet the staff's needs.

**Answer (B) is correct.**

One reason for staff meetings is to explain routine administrative matters, to teach new techniques, and even to let off steam. For example, staff members should be able to raise questions about ineffective procedures, promotions, salaries, or other problems.

- A.Management of the internal audit activity should revise travel, promotion, and compensation policies.
- C.Management of the internal audit activity should develop engagement work schedules
- D.Developing long-range training programs that will meet the staff's needs should be done by management of the internal audit activity.

**20.**A new staff internal auditor was told to perform an engagement in an area with which the internal auditor was not familiar. Because of time constraints, no supervision was provided. The assignment represented a good learning experience, but the area was clearly beyond the internal auditor's competence. Nonetheless, the internal auditor prepared comprehensive working papers and communicated the results to management. In this situation,

- A.The internal audit activity violated the Standards by hiring an internal auditor without proficiency in the area.
- B.The internal audit activity violated the Standards by not providing adequate supervision.
- C.The Standards and The IIA's Code of Ethics were followed by the internal audit activity.
- D.The chief audit executive has not violated The IIA's Code of Ethics because it does not address supervision.

**Answer (B) is correct.**

Rule of Conduct 4.2 under the competency principle requires internal auditing services to be performed in accordance with the Standards. Attr. Std. 1200 requires engagements to be performed with proficiency and due professional care. They also should be properly supervised to ensure that objectives are achieved, quality is assured, and staff is developed (Perf. Std. 2340).

- A.All internal auditors need not be proficient in all areas. The internal audit activity as a whole should have an appropriate mix of skills.
- C.The Standards and the Code were not followed.
- D.The Code requires compliance with the Standards, and the Standards require proper supervision.

**21.**To prevent misunderstandings, engagement clients must

- A. Be informed of the internal audit activity's purpose, authority, and responsibility.
- B. Define the level of authority required by internal auditors for each engagement.
- C. Establish the internal audit activity's position within the organization.
- D. Authorize access to records, personnel, and physical properties relevant to the engagement.

**Answer (A) is correct.**

Engagement clients must be informed of the internal audit activity's purpose, authority, and responsibility to prevent misunderstandings about access to records and personnel. The CAE, senior management, and the board mutually agree upon the internal audit charter. The charter defines (1) the internal audit objectives and responsibilities and (2) the expectations for the internal audit activity.

**B.** The level of authority required for each engagement within the internal audit activity is mutually agreed upon by the CAE, senior management, and the board, and is defined in the internal audit charter.

**C.** The internal audit charter, not the engagement client, establishes the internal audit activity's position within the organization.

**D.** Engagement clients do not authorize the internal auditor's activity but must be informed of the internal auditor's authority. The internal audit charter authorizes access to records, personnel, and physical properties relevant to the performance of engagements. Final approval of the internal audit charter resides with the board.

**22.** Which of the following actions could be construed as a violation of The IIA's Code of Ethics?

- A. Including an internal control problem in a final engagement communication when it has been corrected prior to completion of the engagement.
- B. Turning a case over to the security department when an internal auditor suspects fraud but has no proof.
- C. Expressing an opinion on internal financial statements.
- D. Failing to report to management information that would be material to management's judgment.

**Answer (D) is correct.**

Rule of Conduct 2.3 under the objectivity principle states, "Internal auditors shall disclose all material facts known to them that, if not disclosed, may distort the reporting of activities under review."

**A.** Such reporting is routine.

**B.** Turning a case over to the security department is acceptable if the internal auditor is careful not to state any final conclusions that are not supported by factual information.

**C.** Expressing an opinion on internal financial statements is acceptable since it is for internal use only.

23. According to The IIA Code of Ethics, which of the following are four principles relevant to the professional care that internal auditors should apply in their practice of internal auditing?

- A. Integrity, objectivity, confidentiality, and competency.
- B. Trust, communication, value, and performance.
- C. Judgment, interest, authority, and experience.
- D. Reliance, evaluation, information, and service.

**Answer (A) is correct.**

The four principles of The IIA's Code of Ethics are integrity, objectivity, confidentiality, and competency.

- B. Trust, communication, value, and performance are not principles of The IIA's Code of Ethics.
- C. Judgment, interest, authority, and experience are not principles of The IIA's Code of Ethics.
- D. Reliance, evaluation, information, and service are not principles of The IIA's Code of Ethics.

24. An internal auditor has been assigned to an engagement at a foreign subsidiary. The internal auditor is aware that the social climate of the country is such that "facilitating payments" (bribes) are an accepted part of doing business. The internal auditor has completed the engagement and has found significant weaknesses relating to important controls. The subsidiary's manager offers the internal auditor a substantial "facilitating payment" to omit the observations from the final engagement communication with a provision that the internal auditor could revisit the subsidiary in 6 months to verify that the problem areas have been properly addressed. The internal auditor should

- A. Not accept the payment because such acceptance is in conflict with the Code of Ethics.
- B. Accept the offer because it is consistent with the ethical concepts of the country in which the subsidiary is doing business.
- C. Accept the payment because it has the effect of doing the greatest good for the greatest number; the internal auditor is better off, the subsidiary is better off, and the organization is better off because there is strong motivation to correct the deficiencies.
- D. Not accept the payment, but omit the observations as long as a verification visit is made in 6 months.

**Answer (A) is correct.**

Rule of Conduct 2.2 under the objectivity principle states, "Internal auditors shall not accept anything that may impair or be presumed to impair their professional judgment."

- B. The profession's standards, not the customs of individual countries or regions, should guide the internal auditor's conduct
- C. The action is explicitly prohibited by the Code of Ethics.

**D.**Rule of Conduct 2.3 requires internal auditors to “disclose all material facts known to them that, if not disclosed, may distort the reporting of activities under review.”

**25.**Objectivity is an ethical requirement for all persons engaged in the professional practice of internal auditing. One aspect of objectivity requires

- A.Refraining from using confidential information for unethical or illegal advantage.
- B.Performance of professional duties in accordance with relevant laws.
- C.Avoidance of conflict of interest.
- D.Maintenance of an appropriate level of professional expertise.

**Answer (C) is correct.**

Commitment to independence from conflicts of economic or professional interest is an aspect of objectivity.

- A.Not using confidential information for unethical or illegal advantage is an aspect of confidentiality.
- B.Observing the law is a component of integrity.
- D.Maintenance of an appropriate level of professional expertise is an aspect of competency

**26.**During an engagement, an employee with whom you have developed a good working relationship informs you that she has some information about senior management that is damaging to the organization and may concern illegal activities. The employee does not want her name associated with the release of the information. Which of the following actions is considered to be unethical?

- A.Inform the employee of other methods of communicating this type of information.
- B.Suggest that the employee consider talking to legal counsel.
- C.Inform the employee that you will attempt to keep the source of the information confidential and will look into the matter further.
- D.Assure the employee that you can maintain her anonymity and listen to the information.

**Answer (D) is correct.**

An internal auditor cannot assure anonymity. Information communicated to an internal auditor is not deemed to be privileged. Internal auditors shall disclose all material facts known to them that, if not disclosed, may distort the reporting of activities under review (Rule of Conduct 2.3).

- A.The employee could be directed to other methods of communicating the information in order to maintain her anonymity.
- B.Suggesting that the person seek expert legal advice from a qualified individual is appropriate.

C.Promising merely to attempt to keep the source of the information confidential is allowable. This promise is not a guarantee of confidentiality.

27.An auditor who shall observe the law and make disclosures expected by the law is following the IIA's Code of Ethics Core Principle of

A.Competency.

B.Objectivity.

C.Integrity.

D.Responsibility.

**Answer (C) is correct.**

The integrity of internal auditors establishes trust and thus provides the basis for reliance on their judgment. Rule of Conduct 1.2 under the integrity principle states, "Internal auditors shall observe the law and make disclosures expected by the law and the profession." Additionally, Rule of Conduct 1.3 states, "Internal auditors shall not knowingly be a party to any illegal activity or engage in acts that are discreditable to the profession of internal auditing or to the organization."

A.Competency is a core principle of The IIA's Code of Ethics. Competency refers to the knowledge, skills, and experience needed by the internal auditor in the performance of internal audit services.

B.Objectivity is a core principle of The IIA's Code of Ethics; however, objectivity relates to the internal auditor's commitment to make a balanced assessment of all the relevant circumstances and not be unduly influenced by self-interest or others in forming judgment. Objectivity does not include observation of laws and required disclosures expected by the law.

C.Responsibility is not a core principle of the IIA's Code of Ethics

28.An internal auditing team has made observations and recommendations that should significantly improve a division's operating efficiency. Out of appreciation of this work, and because it is the holiday season, the division manager presents the in-charge internal auditor with a gift of moderate value. Which of the following best describes the action prescribed by The IIA's Code of Ethics?

A.Not accept it, regardless of other circumstances, because its value is significant.

B.Not accept it if the gift is presumed to impair the internal auditor's judgment.

C.Accept it, regardless of other circumstances, because its value is insignificant.

D.Not accept it prior to submission of the final engagement communication.

**Answer (B) is correct.**

Rule of Conduct 2.2 under the objectivity principle states, "Internal auditors shall not accept anything that may impair or be presumed to impair their professional judgment."

A. According to Rule of Conduct 2.2, the decision whether to accept a gift should be based on the potential impairment of the auditor's judgment.

C. The decision to accept or reject the gift should be based on whether the internal auditor's professional judgment will be impaired or be presumed to be impaired..

D. The timing of the gift is irrelevant.

**29.** Internal auditors should be prudent in their relationships with persons and organizations external to their employers. Which of the following activities will most likely not adversely affect internal auditors' ethical behavior?

A. Discussing engagement plans or results with external parties.

B. Accepting compensation from professional organizations for consulting work.

C. Serving as consultants to suppliers.

D. Serving as consultants to competitor organizations.

**Answer (B) is correct.**

Professional organizations are unlikely to be employees, clients, customers, suppliers, or business associates of the organization. Thus, the consulting fees are not likely to impair or be presumed to impair the internal auditors' professional judgment (Rule of Conduct 2.2). Moreover, relationships with professional organizations are not likely to create a conflict of interest or impair or be presumed to impair internal auditors' unbiased judgment (Rule of Conduct 2.1). Also, the consulting engagement should not result in the improper use of information (Rule of Conduct 3.2).

A. Internal auditors should "be prudent in the use and protection of information acquired in the course of their duties" (Rule of Conduct 3.1). Furthermore, such discussion might be "detrimental to the legitimate and ethical objectives of the organization" (Rule of Conduct 3.2).

C. Serving as a consultant to suppliers might create a conflict of interest.

D. Serving as a consultant to competitors might create a conflict of interest.

**30.** All of the following activities would be considered consulting services except

A. Internal audit has been engaged to train employees on the new accounts receivable system.

B. The board has requested internal audit to provide an opinion on management's claim that the segment was profitable in the first quarter.

C. The director has engaged internal audit to review and recommend improvements for the adequacy of cash controls at an offsite selling location.

D. The CFO has requested internal audit to provide an estimation of the savings from outsourcing the payroll processing function.

**Answer (B) is correct.**

Assurance services involve the internal auditor's objective assessment of evidence to provide opinions or conclusions regarding a subject matter. The nature and scope of an assurance engagement are determined by the internal auditor. Assurance services include performing financial engagements. The engagement to provide an opinion on management's claim of profitability is an example of assurance services.

A. Training is considered a consulting service. Consulting services are intended to add value and improve the organization's processes. The engagement to train employees on the new accounts receivable system is an example of consulting services.

B. Consulting services are advisory in nature. The engagement to review and recommend improvements for the adequacy of cash controls is an example of consulting services.

C. Consulting services are generally performed at the specific request of the engagement client. Providing an estimation of the savings from outsourcing the payroll processing function is an example of consulting services.

**31.** The purposes of the Standards include all of the following except

A. Guiding adherence to the mandatory elements of the IPPF.

B. Establishing the basis for the measurement of internal audit performance.

C. Fostering improved organizational processes and operations.

D. Guiding the ethical conduct of internal auditors.

**Answer (D) is correct.**

Guiding the ethical conduct of internal auditors is the purpose of the Code of Ethics, not the Standards.

A. Guiding adherence to the mandatory elements of the IPPF is a stated purpose of the Standards.

B. Establishing the basis for the evaluation of internal audit performance is a stated purpose of the Standards.

C. Fostering improved organizational processes and operations is a stated purpose of the Standards.

**32.** The nature and scope of an assurance engagement are determined by the

A. Engagement client.

B. Senior management.

C. Board.

D. Internal auditor.

**Answer (D) is correct.**

The nature and scope of an assurance engagement are determined by the internal auditor. An assurance engagement involves the internal auditor's objective assessment of evidence to provide opinions or conclusions regarding an entity, operation, function, process, system, or other subject matter. Assurance services include performing financial, performance, compliance, system security, and due diligence engagements.

A. The nature and scope of an assurance engagement are not determined by the engagement client. However, the nature and scope of the consulting engagement are subject to agreement with the engagement client.

B. The nature and scope of an assurance engagement are not determined by senior management. Senior management is generally tasked with managing the day-to-day responsibilities of the organization.

C. The nature and scope of an assurance engagement are not determined by the board. As defined by The IIA Glossary, the board is "charged with the responsibility to direct and/or oversee the organization's activity."

**33.** Which of the following actions by an internal auditor is most likely a violation of The IIA's Code of Ethics?

A. Accepting payment for teaching auditing at a local university.

B. Allowing use of the Certified Internal Auditor designation in a context not involving his or her employment.

C. Accepting a moderate gift from a customer of his or her organization.

D. Having a material ownership interest in a competitor.

**Answer (C) is correct.**

Rule of Conduct 2.2 under the objectivity principle states, "Internal auditors shall not accept anything that may impair or be presumed to impair their professional judgment."

A. Teaching is compatible with internal auditing.

B. The IIA's Code of Ethics does not specifically mention use of the CIA designation. Acts discreditable to the profession or the organization are prohibited, but use of the CIA designation outside the employment context is not per se discreditable.

D. Having a material ownership interest in a competitor is more likely to cause a conflict for a director or officer than an internal auditor. An internal auditor would seldom be able during the course of his or her employment to take action that would enhance the value of the ownership interest.

**34.** An internal auditor, recently terminated by an organization due to downsizing, has found a job with another organization in the same industry. Which of the following disclosures made by the internal auditor to the new organization would constitute a violation of The IIA's Code of Ethics?

A. The new internal audit activity does not use PPS sampling, and the internal auditor believes PPS sampling has advantages for many of the engagements conducted by the new employer. The internal

auditor conducts training sessions and develops forms to implement sampling in the same manner as the previous employer.

B. While at the previous firm, the internal auditor conducted a great deal of research to identify “best practices” for the management of the treasury function. Because most of the research was done at home and during non-office hours, the internal auditor retained much of the research and plans to use it in conducting a review of the treasury function at the new employer.

C. The internal auditor used the risk assessment approach that was used by the internal auditor’s former employer in determining priorities in the new job.

D. None of the answers represent a violation of the Code.

**Answer (D) is correct.**

The former employer’s risk assessment approach may be viewed as general information about “best practices.” Hence, applying this approach on behalf of a new employer is acceptable. With regard to the former employer’s sampling methods, the internal auditor is applying knowledge of a commonly used engagement procedure. It is not confidential information. Moreover, gathering information about best practices of other organizations is part of the continuing education of the internal auditor. Thus, the listed responses are not violations of the Code.

A. Disclosing sampling methods does not violate the Code.

B. Disclosing information about best practices of other organizations does not violate the Code.

C. Disclosing the former employer’s risk assessment approach does not violate the Code.

**35.** The code of ethics of a professional organization sets forth

A. A basis for the measurement of internal audit performance.

B. Broad standards of conduct for the members of the organization.

C. The organizational details of the profession’s governing body.

D. A list of illegal activities that are proscribed to the members of the profession.

**Answer (B) is correct.**

An organization’s code of ethical conduct is the established general value system the organization wishes to apply to its members’ activities by communicating organizational purposes and beliefs and establishing uniform ethical guidelines for members, which include guidance on behavior for members in making decisions. A code establishes high standards against which individuals can measure their own performance and communicates to those outside the organization the value system from which the organization’s members must not be asked to deviate.

A. The Standards establish a basis for the measurement of internal audit performance.

C.The organizational details of the profession’s governing body are stated in the by-laws of the professional organization.

D.Certain actions may be legal but contrary to an organization’s code of ethics. For example, an internal auditor may not perform a service for which (s)he does not possess the necessary knowledge, skills, and experience.

36.The organizational position of the internal audit activity should be free from the effects of irresponsible policy changes by management. The most effective way to ensure that freedom is to

A.Have the internal audit charter approved by the board.

B.Develop written policies and procedures to serve as standards of performance for the internal audit activity.

C.Adopt policies for the functioning of the internal audit activity.

D.Establish an audit committee within the board.

**Answer (A) is correct.**

The internal audit charter is a formal document that defines the internal audit activity’s purpose, authority, and responsibility. Final approval of the internal audit charter resides with the board (Inter. Std. 1000).

B.Written policies and procedures serve to guide the internal auditor but have little effect on management.

C.Adoption of policies for the functioning of the internal audit activity does not protect its organizational position.

D.The establishment of an audit committee alone does not ensure the status of the internal audit activity.

37.Under The IIA’s Code of Ethics, an entity that provides internal auditing services is specifically required to

A.Maintain certain predetermined staffing requirements for engagements.

B.Participate in a formal continuing education program.

C.Comply with the International Standards for the Professional Practice of Internal Auditing.

D.Comply with organizational policy.

**Answer (C) is correct.**

The IIA’s Code of Ethics applies not only to individuals but also to entities that provide internal auditing services. Rule of Conduct 4.2 under the competency principle states, “Internal auditors shall perform internal audit services in accordance with the International Standards for the Professional Practice of Internal Auditing.”

A. Staffing requirements must be determined based on the circumstances of each engagement.

B. The Code requires compliance with the Standards, and the Standards require internal auditors to enhance their knowledge, skills, and other competencies through continuing professional development, but neither the Code nor the Standards require formal continuing education.

D. The Code requires internal auditors to respect and contribute to the legitimate and ethical objectives of the organization and not engage in acts discreditable to the organization. However, the Code does not specifically mention compliance with organizational policy.

**38.** Which of the following violates The IIA's Code of Ethics core principle of competency?

A. The internal auditor directed his brother to sell company stock during the company's blackout period.

B. The internal auditor failed to complete the required continuing education needed to obtain the skills necessary for the engagement.

C. The manager failed to disclose all revenues and sales taxes collected to the state's taxation department.

D. The internal auditor accepted gifts of material value from the engagement client.

**Answer (B) is correct.**

Rule of Conduct 4.1 under the competency principles states, "Internal auditors shall engage only in those services for which they have the necessary knowledge, skills, and experience." Failure to have the knowledge and skills necessary for the engagement violates the Code of Ethics core principle of competency.

A. A company's blackout period is the period of time before its earnings release to the public. During this time, employees (insiders) cannot buy or sell the company's stock. An internal auditor shall not use information for any personal gain. This is a violation of the Code of Ethics core principle of confidentiality. It would also be considered insider trading, which is illegal.

C. Failing to make disclosures required by law is a violation of the Code of Ethics core principle of integrity.

D. Acceptance of gifts of material value may impair the internal auditor's professional judgment. This is a violation of the Code of Ethics core principle of objectivity.

**39.** Which of the following is a violation of The IIA's Code of Ethics core principle of confidentiality?

A. Confidential information of the organization was released in response to a court order received by the organization.

B. Disclosure of the organization's trade secrets to a family member. The disclosure of the information resulted in no personal gain to the internal auditor or the family member.

C. During an engagement, the audit supervisor found that a control deficiency caused by management override created exposure to material risks. He reported the matter to the audit committee.

D. A loan officer at the local bank requested financial statements for the past two years. The CFO approved the request.

**Answer (B) is correct.**

Disclosure of the organization's trade secrets violates Rule of Conduct 3.2 under the confidentiality principle which states, "Internal auditors shall not use information for any personal gain or in any manner that would be contrary to the law or detrimental to the legitimate and ethical objectives of the organization." The internal auditor also violated Rule of Conduct 3.1 which states, "Internal auditors shall be prudent in the use and protection of information acquired in the course of their duties." Although there was no personal gain for the internal auditor or the family member, the internal auditor still violated the confidentiality principle.

A. The principle of confidentiality permits the disclosure of confidential information given a legal or professional obligation to do so.

C. Rule of Conduct 2.3 under the objectivity principle requires auditors to "disclose all material facts known to them that, if not disclosed, may distort the reporting of activities under review." Thus, the audit supervisor abided by the objectivity principle and did not violate the confidentiality principle.

D. The principle of confidentiality permits the disclosure of the company's information when given the appropriate authority and does not violate the core principle of confidentiality.

**40.** The purpose, authority, and responsibility of the internal audit activity are formally defined in

A. A formal, written charter.

B. The memorandum of understanding.

C. The corporate bylaws.

D. The records of the proceedings of the board of directors.

**Answer (A) is correct.**

The purpose, authority, and responsibility of the internal audit activity must be formally defined in a written charter, consistent with the Mission of Internal Audit and the mandatory elements of the IPPF (Core Principles), Definition of Internal Auditing, Code of Ethics, and Standards.

B. A memorandum of understanding is an agreement between parties expressing their common will that does not necessarily contain the elements of a contract

C. The corporate bylaws are not the appropriate place to define the purpose, authority, and responsibility of the internal audit activity.

D. While the records of board meetings do reflect discussions related to the internal audit charter, they are no substitute for an actual formal charter.

41. The Standards consist of three types of Standards. Which Standards apply to the characteristics of providers of internal auditing services?

- A. Attribute Standards.
- B. Implementation Standards.
- C. Performance Standards.
- D. Independence Standards.

**Answer (A) is correct.**

Attribute Standards describe the characteristics of organizations and parties providing internal auditing services.

B. Implementation Standards apply to specific types of engagements.

C. Performance Standards describe the nature of internal auditing and provide quality criteria for evaluation of internal audit performance.

D. The IPPF does not contain Independence Standards.

42. A newly hired CAE discovered the CFO is paying personal expenses through the organization. Upon further investigation, the CAE found that the CFO is submitting these expenses as research and development. The CFO has worked for the organization for 15 years. The CAE immediately notified the audit committee. The CAE

- A. Violated the Code of Ethics principle of objectivity.
- B. Upheld the Code of Ethics principle of integrity.
- C. Violated the Code of Ethics principle of integrity.
- D. Violated the Code of Ethics principle of confidentiality.

**Answer (B) is correct.**

Rule of Conduct 1.1 for integrity states, "Internal auditors shall perform their work with honesty, diligence, and responsibility." The audit committee has the role of governance and should take an active role in the prevention and deterrence of fraud. The CAE upheld the principle of integrity by notifying the audit committee timely.

A. The principle of objectivity is a commitment to providing stakeholders with unbiased information and a commitment to independence from conflicts of interest. Rule of Conduct 2.3 for objectivity states, "Internal auditors shall disclose all material facts known to them that, if not disclosed, may distort the reporting of activities under review." Reporting an issue of possible fraud upheld the principle of objectivity.

C. Integrity establishes trust. Rule of Conduct 1.4 for integrity states, "Internal auditors shall respect and contribute to the legitimate and ethical objectives of the organization." Reporting without delay an issue of possible fraud is not a violation of integrity.

**D.**The principle of confidentiality was not violated by the CAE reporting his/her discoveries to the audit committee. The communication was to those charged with governance of fraud and noncompliance with laws and regulations.

**43.**Which of the following would violate The IIA's Code of Ethics core principle of competency?

**A.**The organization has downsized and has a very lean staff. The board has recently approved the deferral of all continuing education for the next 12 months due to the staff's workload.

**B.**Bob recently completed continuing education courses in restaurant accounting and has been assigned to audit one of the organization's steakhouses next month.

**C.**The audit committee hired a new CAE to perform financial due diligence on a chain of hotels that the company is considering purchasing. The new CAE has extensive knowledge and years of experience in the hotel industry.

**D.**Carrie was recently promoted to supervise the audit of food and beverage accounting for the organization's banquet facilities. Carrie has audited several areas of the organization, including 6 months of shadowing audit supervisors in the hospitality area.

**Answer (A) is correct.**

The IIA's Rules of Conduct for competency state, "Internal auditors shall engage only in those services for which they have the necessary knowledge, skills, and experience, shall perform internal audit services in accordance with the International Standards for the Professional Practice of Internal Auditing and shall continually improve their proficiency and the effectiveness and quality of their services." The deferral of completing continued education, even though approved by the board, violates The IIA's Code of Ethics Rule of Conduct for competency.

**B.**Bob acquired the required knowledge and skills prior to the start of the upcoming audit. Additionally, by completing continuing education, he continued to improve his proficiency and other competencies. This satisfies the rule of conduct for competency.

**C.**The audit committee has hired a CAE for his or her knowledge and experience in the industry in which the company desires to invest. This satisfies the Rule of Conduct for competency.

**D.**Carrie has the knowledge, skills, and experience to supervise the food and beverage audit. This satisfies the Rule of Conduct for competency.

**44.**A CIA is working in a noninternal-auditing position as the director of purchasing. The CIA signed a contract to procure a large order from the supplier with the best price, quality, and performance. Shortly after signing the contract, the supplier presented the CIA with a gift of significant monetary value. Which of the following statements regarding the acceptance of the gift is true?

**A.**Because the contract was signed before the gift was offered, acceptance of the gift does not violate either The IIA's Code of Ethics or the organization's code of conduct.

**B.**Acceptance of the gift is prohibited only if it is not customary.

C. Because the CIA is no longer acting as an internal auditor, acceptance of the gift is governed only by the organization's code of conduct.

D. Acceptance of the gift violates The IIA's Code of Ethics and is prohibited for a CIA

**Answer (D) is correct.**

Members of The Institute of Internal Auditors and recipients of, or candidates for, IIA professional certifications are subject to disciplinary action for breaches of The IIA's Code of Ethics. Rule of Conduct 2.2 under the objectivity principle states, "Internal auditors shall not accept anything that may impair or be presumed to impair their professional judgment."

A. The timing of signing the contract is irrelevant.

B. Acceptance of the gift could easily be presumed to have impaired the CIA's professional judgment.

C. The CIA is still governed by The IIA's code of conduct.

**45. The IIA Rules of Conduct set forth in The IIA's Code of Ethics**

A. Describe behavior norms expected of internal auditors.

B. Apply only to particular conduct specifically mentioned.

C. Are guidelines to assist internal auditors in dealing with engagement clients.

D. Are interpreted by the Principles.

**Answer (A) is correct.**

The IIA's Code of Ethics extends beyond the definition of internal auditing to include two essential components: (1) Principles that are relevant to the profession and practice of internal auditing and (2) Rules of Conduct that describe behavior norms expected of internal auditors (Introduction)

B. The conduct may be unacceptable or discreditable although not mentioned in the Rules of Conduct.

C. The Rules of Conduct provide guidance to internal auditors in the discharge of their responsibility to all those whom they serve. Engagement clients are not the only parties served by internal auditing.

D. The Rules of Conduct are an aid in interpreting the Principles.

**46. An internal auditor was reviewing filed payroll tax reports with payroll records. Two months later, the auditor shared salaries of certain employees with the organization's Logistics Manager. Which core principle of The IIA's Code of Ethics was violated?**

A. Confidentiality.

B. Competency.

C. Objectivity.

D.Authority.

**Answer (A) is correct.**

According to the confidentiality principle of The IIA's Code of Ethics, "Internal auditors respect the value and ownership of information they receive and do not disclose information without appropriate authority unless there is a legal or professional obligation to do so." Rule of Conduct 3.1 further states, "Internal auditors shall be prudent in the use and protection of information acquired in the course of their duties." The auditor violated the principle of confidentiality by disclosing employees' salaries to a co-worker.

**B.**The principle of competency requires internal auditors to apply the knowledge, skills, and experience needed in the performance of internal audit services. Confidential information is not included under the principle of competency.

**C.**The principle of objectivity states that internal auditors exhibit the highest level of professional objectivity in gathering, evaluating, and communicating information about the activity or process being examined. It does not address disclosure of confidential information.

**D.**Authority is defined as the right to govern or rule. Authority is not one of the core principles of The IIA's Code of Ethics.

**47.**The Rule of Conduct requirement for internal auditors to "perform their work with honesty, diligence, and responsibility" falls under which core principle of The IIA's Code of Ethics?

A.Competency.

B.Confidentiality.

C.Integrity.

D.Objectivity.

**Answer (C) is correct.**

Rule of Conduct 1.1 under the integrity principle states, "Internal auditors shall perform their work with honesty, diligence, and responsibility."

**A.**The competency principle relates to the internal auditor's commitment to acquiring and maintaining an appropriate level of knowledge and skill

**B.**The confidentiality principle relates to the internal auditor's commitment to be prudent in the use and protection of information acquired in the course of their duties.

**C.**The objectivity principle relates to the internal auditor's commitment to independence from conflicts of economic or professional interest.

**48.**Which of the following is not appropriate for inclusion in the internal audit charter?

- A. Authorization of the board to approve the charter.
- B. Authorization of internal audit access to records, personnel, and physical properties.
- C. Definition of the scope of internal audit activities.
- D. The nature of the chief audit executive's functional reporting relationship with the board

**A. Answer (A) is correct.**

Final approval of the internal audit charter resides with the board. The board has this power inherently.

**B.** Authorization of internal audit access to records, personnel, and physical properties is one of the elements to be included in the internal audit charter.

**C.** Definition of the scope of internal audit activities is one of the elements to be included in the internal audit charter.

**D.** The nature of the chief audit executive's functional reporting relationship with the board is one of the elements to be included in the internal audit charter.

**49.** Which of the following best describes the purpose of the internal audit activity?

- A. To add value and improve an organization's operations.
- B. To assist management with the design and implementation of risk management and control systems.
- C. To examine and evaluate an organization's accounting system as a service to management.
- D. To monitor the organization's internal control system for the external auditors

**Answer (A) is correct.**

The Definition of Internal Auditing states, in part, "Internal auditing is an independent, objective assurance and consulting activity designed to add value and improve an organization's operations."

**B.** Performing the functions of design and implementation of risk management and control systems would impair the objectivity of the internal auditors. An internal auditor may, however, recommend control standards and review procedures prior to their implementation.

**C.** Internal auditing is much broader than examining and evaluating an organization's accounting system.

**D.** Internal auditing serves the organization, not the external auditors.

**50.**Internal auditing has planned an engagement to evaluate the effectiveness of the quality assurance function as it affects the receipt of goods, the transfer of the goods into production, and the scrap costs related to defective items. The engagement client argues that such an engagement is not within the scope of the internal audit activity and should come under the purview of the quality assurance department only. What is the most appropriate response?

A.Because quality assurance is a new function, seek the approval of management as a mediator to set the scope of the engagement.

B.Terminate the engagement because it will not be productive without the client's cooperation.

C.Refer to the internal audit activity's charter and the approved engagement plan that includes the area designated for evaluation in the current time period.

D.Indicate that the engagement will evaluate the function only in accordance with the standards set by, and approved by, the quality assurance function before beginning the engagement.

**Answer (C) is correct.**

The written charter, approved by the board, defines the scope of internal audit activities (Inter. Std. 1000).

A.The engagement client does not determine the scope of this type of assurance engagement. A scope limitation imposed by the client might prevent the internal audit activity from achieving its objectives.

B.The internal auditors must conduct the engagement and communicate any scope limitations to management and the board

D.Other objectives may be established by management and the internal auditors. The engagement is not limited to the specific standards set by the quality assurance department. It considers such standards in the development of the engagement program.

**51.**An internal auditor often faces special problems when performing an engagement at a foreign subsidiary. Which of the following statements is false with respect to the conduct of international engagements?

A.The IIA Standards do not apply outside of the United States.

B.The internal auditor should determine whether managers are in compliance with local laws.

C.It is preferable to have multilingual internal auditors conduct engagements at branches in foreign nations.

D.There may be justification for having different organizational policies in force in foreign branches.

**Answer (A) is correct.**

Pronouncements by The IIA have no geographic limits. Compliance with the concepts in the Standards is essential for the responsibilities of internal auditors to be met, regardless of the national environment.

**B.**The internal audit activity must evaluate the adequacy and effectiveness of controls, including those relating to compliance with laws, regulations, policies, procedures, and contracts.

**C.**The internal audit activity collectively must possess the knowledge, skills, and other competencies needed to perform its responsibilities.

**D.**Varying laws and customs and other environmental factors justify policy differences.

**52.**An internal auditor engages in the preparation of income tax forms during the tax season. For which of the following activities will the internal auditor most likely be in violation of The IIA's Code of Ethics?

A. Teaching an evening tax seminar, for a fee, at a local university.

B. Preparing tax returns for elderly citizens, regardless of their associations, as a public service.

C. Preparing the personal tax return, for a fee, for one of the organization's division managers.

D. Writing a tax guide intended for publication and sale to the general public.

**Answer (C) is correct.**

Rule of Conduct 2.2 under the objectivity principle states, "Internal auditors shall not accept anything that may impair or be presumed to impair their professional judgment." Preparing a personal tax return for a division manager for a fee falls under this prohibition.

**A.**Teaching an evening tax seminar is unlikely to impair the internal auditor's professional judgment.

**B.**Engaging in a public service separate from the interests and activities of the organization is unlikely to impair professional judgment.

**D.**Writing a tax guide for sale to the general public is unlikely to impair the internal auditor's professional judgment.

**53.**A chief audit executive (CAE) learned that a staff internal auditor provided confidential information to a relative. Both the CAE and staff internal auditor are CIAs. Although the internal auditor did not benefit from the transaction, the relative used the information to make a significant profit. The most appropriate way for the CAE to deal with this problem is to

A. Take no action because the internal auditor did not benefit from the transaction.

- B. Summarily discharge the internal auditor and notify The IIA.
- C. Verbally reprimand the internal auditor.
- D. Inform The IIA's Board of Directors and take the personnel action required by organizational policy

**Answer (D) is correct.**

The staff internal auditor has violated Rule of Conduct 3.2 regarding use of information. A violation of The IIA's Code of Ethics is the basis for a complaint to the International Ethics Committee, which is responsible for receiving, interpreting, and investigating all complaints against members or CIAs on behalf of the Board of Directors of The IIA and making recommendations to the Board on actions to be taken (Administrative Directive 5). In addition, organizational policy must be followed.

- A. The auditor improperly used information and violated The IIA's Code of Ethics. Some action is warranted
- B. Summary discharge may not be in accordance with company personnel policies.
- C. The internal auditor has violated Rule of Conduct 3.2 regarding use of information. The IIA should be notified.

**54.** Which of the following activities of an internal auditor is most likely to be acceptable under The IIA's Code of Ethics?

- A. Acceptance of a material gift from a supplier.
- B. Frequent luncheons and other socializing with major suppliers of the organization without the consent of senior management.
- C. Conducting an unrelated business outside of office hours.
- D. Late arrivals and early departures from work because this practice is common in the organization.

**Answer (C) is correct.**

Nothing in The IIA's Code of Ethics prohibits operating an unrelated business outside of regular office hours. The activity is not, in itself, (1) a conflict of interest, (2) a use of information for personal gain, or (3) an impairment of the internal auditor's unbiased assessment.

- A. Rule of Conduct 2.2 under the objectivity principle states, "Internal auditors shall not accept anything that may impair or be presumed to impair their professional judgment."
- B. Rule of Conduct 2.1 under the objectivity principle states, "Internal auditors shall not participate in any activity or relationship that may impair or be presumed to impair their unbiased assessment. This participation includes those activities or relationships that may be in conflict with the interests of the organization."
- D. Internal auditors should exercise diligence in performing their duties.

55.The internal audit activity’s scope of responsibilities includes

- A.Evaluating risk.
- B.Eliminating risk.
- C.Controlling risk.
- D.Managing risk.

**Answer (A) is correct.**

The internal audit activity helps an organization accomplish its objectives by bringing a systematic, disciplined approach to the evaluation and improvement of the effectiveness of risk management, control, and governance processes (Definition of Internal Auditing). Managing, controlling, and eliminating risk are responsibilities of management.

- B.Eliminating risk is a responsibility of management.
- C.Controlling risk is a responsibility of management
- D.Managing risk is a responsibility of management.

56.An internal auditor for a large regional bank was asked to serve on the board of directors of a local bank. The bank competes in many of the same markets as the regional bank but focuses more on consumer financing than on business financing. In accepting this position, the internal auditor

- Violates The IIA’s Code of Ethics because serving on the board may be in conflict with the best interests of the internal auditor’s employer
- Violates The IIA’s Code of Ethics because the information gained while serving on the board of directors of the local bank may influence recommendations regarding potential acquisitions

- A.2 only.
- B.1 only.
- C.Neither 1 nor 2.
- D.1 and 2.

**Answer (D) is correct.**

Rule of Conduct 2.1 under the objectivity principle states, “Internal auditors shall not participate in any activity or relationship that may impair or be presumed to impair their unbiased assessment. This participation includes those activities or relationships that may be in conflict with the

interests of the organization.” Accordingly, service on the board of the local bank constitutes a conflict of interest and may prejudice the internal auditor’s ability to carry out objectively his or her duties regarding potential acquisitions.

A.Serving on the board of the local bank may also be in conflict with the best interests of the auditor’s employer.

B.Serving on the board of the local bank creates a conflict of interest and may prejudice the internal auditor’s ability to perform his or her duties.

C.Serving on the board of the local bank creates a conflict of interest and may prejudice the internal auditor’s ability to perform his or her duties.

57.Which of the following is an element of authority that should be included in the internal audit activity’s charter?

A.Access to the external auditors’ engagement records.

B.Access to records, personnel, and physical properties relevant to the performance of engagements.

C.Identification of the organizational units in which engagements are to be performed.

D.Samples of the types of disclosures that should be made to the audit committee.

**Answer (B) is correct.**

According to the Interpretation of Standard 1000, “[t]he internal audit charter establishes the internal audit activity’s position within the organization, including the nature of the chief audit executive’s functional reporting relationship with the board; authorizes access to records, personnel, and physical properties relevant to the performance of engagements; and defines the scope of internal audit activities.”

A.Only access to the organization’s internal records is an element of authority included in the internal audit activity’s charter.

C.The internal audit charter does not identify the organizational units subject to audit.

D.Sampling of the types of disclosures that should be made to the audit committee is not an element of authority included in the internal audit activity’s charter.

58.The IIA’s Code of Ethics requires internal auditors to perform their work with

A.Knowledge, skills, and competencies.

B.Timeliness, sobriety, and clarity.

C.Punctuality, objectivity, and responsibility.

D.Honesty, diligence, and responsibility.

**Answer (D) is correct.**

Rule of Conduct 1.1 under the integrity principle states, “Internal auditors shall perform their work with honesty, diligence, and responsibility.”

A.Knowledge, skills, and competencies are mentioned in the Standards

B.Timeliness, sobriety, and clarity are not mentioned in the Code.

C.Punctuality is not mentioned in the Code.

**59.** Which one of the following must be included in the internal audit charter?

A.Internal audit responsibility.

B.Number of full-time internal audit employees deemed to be the necessary minimum.

C.Chief audit executive’s compensation plan.

D.Internal audit objectivity.

**Answer (A) is correct.**

The purpose, authority, and responsibility of the internal audit activity must be formally defined in an internal audit charter.

**B.** The staffing of the internal audit activity is determined by the CAE and the board; it is not an appropriate matter to include in the internal audit charter.

**C.** The CAE’s compensation plan is not an appropriate matter to include in the internal audit charter.

**D.** Objectivity is an attribute of individual auditors and is not included in the internal audit charter.

**60.** An engagement at a foreign subsidiary disclosed payments by the sales department to local government officials in return for orders. What action does The IIA’s Code of Ethics suggest for an internal auditor in such a case?

A.Report the incident to appropriate regulatory authorities.

B.Report the practice to the board of The Institute of Internal Auditors.

C.Refrain from any action that might be detrimental to the organization.

D.Inform appropriate organizational officials.

**Answer (D) is correct.**

Such payments may be illegal. Rule of Conduct 2.3 under the objectivity principle states, “Internal auditors shall disclose all material facts known to them that, if not disclosed, may distort the reporting of activities under review.”

- A. The Code does not require that the incident be reported to regulatory authorities.
- B. The Code of Ethics does not require reporting for these types of activities to The IIA.
- C. Informing organizational officials is not detrimental to the organization.

**61.** Which of the following statements is not appropriate to include in a manufacturer’s conflict of interest policy? An employee shall not

- A. Use organizational information for private purposes.
- B. Participate (directly or indirectly) in the management of a public agency.
- C. Borrow from or lend money to vendors.
- D. Accept money, gifts, or services from a customer.

**Answer (B) is correct.**

A prohibition on public service is ordinarily inappropriate. Public service is a right, if not a duty, of all citizens.

- A. A conflict of interest policy should prohibit the use of organization information for private gain
- C. A conflict of interest policy should prohibit financial dealings between an employee and those with whom the organization deals.
- D. A conflict of interest policy should prohibit the transfer of benefits between an employee and those with whom the organization deals.

**62** During the course of an engagement, an internal auditor discovers that a clerk is embezzling funds from the organization. Although this is the first embezzlement ever encountered and the organization has a security department, the internal auditor decides to interrogate the suspect. If the internal auditor is violating The IIA’s Code of Ethics, the rule violated is most likely

- A. Failing to comply with the law.
- B. Lack of loyalty to the organization.
- C. Lack of competence in this area.
- D. Failing to exercise due diligence.

**Answer (C) is correct.**

Rule of Conduct 4.1 under the competency principle states, "Internal auditors shall engage only in those services for which they have the necessary knowledge, skills, and experience." Internal auditors may not have, and are not expected to have, knowledge equivalent to that of a person whose primary responsibility is to detect and investigate fraud (Impl. Std. 1210.A2).

**A** .The internal auditor may violate the suspect's civil rights as a result of inexperience.

**B** Loyalty is better exhibited by consulting with professionals and knowing the limits of competence.

**D** .The requirement to perform work with diligence does not override the competency Rules of Conduct or the need to use good judgment.

**63** The chief audit executive (CAE) has been appointed to a committee to evaluate the appointment of the external auditors. The engagement partner for the external accounting firm wants the CAE to join her for a week of hunting at her private lodge. The CAE should

A.Refuse on the grounds of conflict of interest.

B.Accept, assuming both their schedules allow it.

C.Ask the comptroller whether accepting the invitation is a violation of the organization's code of ethics.

D.Accept as long as it is not charged to employer time.

**Answer (A) is correct.**

Rule of Conduct 2.1 under the objectivity principle states, "Internal auditors shall not participate in any activity or relationship that may impair or be presumed to impair their unbiased assessment. This participation includes those activities or relationships that may be in conflict with the interests of the organization." Furthermore, under Rule of Conduct 2.2, "Internal auditors shall not accept anything that may impair or be presumed to impair their professional judgment."

**B** . The auditor should not accept.

**C** . The auditor should know that accepting the invitation raises conflict of interest issues.

**D** .Not charging the time to the company is not sufficient to eliminate conflict-of-interest concerns.

**64** Support from which persons or combination of persons listed below is most important to the success of the internal audit activity?

A.The audit committee.

- B. Management and the board.
- C. The chief executive officer.
- D. The chief executive officer and chief financial officer.

**Answer (B) is correct.**

The support of management and the board is crucial when inevitable conflicts arise between the internal audit activity and the department or function under review.

**A** The support of management and the board is crucial when inevitable conflicts arise between the internal audit activity and the department or function under review.

**C** The support of management and the board is crucial when inevitable conflicts arise between the internal audit activity and the department or function under review.

**D** The support of management and the board is crucial when inevitable conflicts arise between the internal audit activity and the department or function under review.

**65** According to The IIA's International Professional Practices Framework, which of the following constitute mandatory guidance for implementing the Standards?

- A. Performance Standards.
- B. Implementation Guides.
- C. Practice Aids.
- D. Development Aids.

**Answer (A) is correct.**

The mandatory guidance portion of the IPPF consists of the Core Principles, Definition of Internal Auditing, the Code of Ethics, Attribute Standards, Performance Standards, and Implementation Standards.

**B** Implementation Guides are strongly recommended guidance.

**C** Practice Aids are not part of the IPPF.

**D** Development Aids are not part of the IPPF.

**66** A manufacturing organization often hires recent college graduates to fill entry level internal auditor positions. Which of the following would not support the organization's commitment to the Rule of Conduct for competency?

A. Annually, the organization holds a seminar and provides the professional employees with updates on changes to IIA standards and guidance.

B. The organization routinely brings in motivational speakers to inspire the employees.

C. The organization pays for and requires all professional employees to take continuing education classes.

D. The organization requires a training program for entry level auditors.

**Answer (B) is correct.**

Competency is the commitment to acquiring and maintaining an appropriate level of knowledge and skill. Rule of Conduct 4.3 under the competency principle states, "Internal auditors shall continually improve their proficiency and the effectiveness and quality of their services." While hearing motivational speakers may be uplifting and inspiring, it would not contribute to the auditors' knowledge and skill levels.

**A** Providing seminars on changes to IIA standards and guidance would contribute to an internal auditor's skill and knowledge. Rule of Conduct 4.3 under the competency principles states, "Internal auditors shall continually improve their proficiency." Holding a seminar and providing the professional employees with updates on changes to IIA standards and guidance demonstrates the organization's commitment to the Rule of Conduct for competency.

**C** Rule of Conduct 4.3 under the competency principles states, "Internal auditors shall continually improve their proficiency." Paying for and requiring all professional employees to take continuing education classes would support the organization's commitment to the Rule of Conduct for competency.

**D** Rule of Conduct 4.1 under the competency principle states, "Internal auditors shall engage only in those services for which they have the necessary knowledge, skills, and experience." A required training program for entry level auditors would help the auditors acquire the necessary knowledge to perform their work.

**67** During an examination of grants awarded by a not-for-profit organization, an internal auditor discovered a number of grants made without the approval of the grant authorization committee (which includes outside representatives), as required by the organization's charter. All the grants, however, were approved and documented by the president. The chair of the grant authorization committee, who is also a member of the board of directors, proposes that the committee meet and retroactively approve all the grants before the engagement communication is issued. If the committee meets and approves the grants before such issuance, the internal auditor should

A. Include the items in the communication as an override of the organization's controls. Details about each grant should be reported, and the internal auditor should investigate further for fraud.

B. Report the override of control to the board.

C. Discuss the matter with the chair of the grant committee to determine the rationale for not approving the grants earlier. If the grants are routine, discussion of the grant committee's inaction should be omitted from the engagement communication.

D. Not report the grants in question because they were approved before the issuance of the engagement communication.

**Answer (B) is correct.**

Rule of Conduct 2.3 under the objectivity principle states, “Internal auditors shall disclose all material facts known to them that, if not disclosed, may distort the reporting of activities under review.” The management override of an important control over approval of grants created a material risk exposure. The internal auditor is ethically obligated to report the matter to senior officials charged with performing the governance function.

A Details about each grant need not be included unless the internal auditor believes that fraud may have occurred. Moreover, the appropriate organizational authorities should be informed if wrongdoing is suspected.

C The routine nature of the grants is irrelevant to the issue of the violation of the charter.

D The control override should be reported.

**68** The IIA’s Code of Ethics extends beyond the Definition of Internal Auditing to include two essential components. Which item below is one of these components?

A. Principles that are relevant to the profession and practice of internal auditing.

B. Activities that provide the organization with assurance and consulting services.

C. Provision of quality criteria for evaluating the internal audit function’s performance.

D. Government of the responsibilities, attitudes, and actions of the organization’s internal audit activity.

**Answer (A) is correct.**

The IIA’s Code of Ethics includes two essential components: (1) Principles that are relevant to the profession and practice of internal auditing and (2) Rules of Conduct that describe behavior norms expected of internal auditors. A code of ethics is necessary and appropriate for the profession of internal auditing.

**B** As defined in The IIA Glossary, the purpose of the internal audit activity is to provide “independent, objective assurance and consulting services designed to add value and improve an organization’s operations.”

**C** Performance Standards govern the nature of internal auditing and provide quality criteria for evaluating the internal audit function’s performance.

**D** Attribute Standards govern the responsibilities, attitudes, and actions of the organization’s internal audit activity and the people who serve as internal auditors.

69“Internal auditors shall be prudent in the use and protection of information acquired in the course of their duties” is a Rule of Conduct under which core principle of The IIA’s Code of Ethics?

- A.Risk-based assurance.
- B.Competency.
- C.Disclosure.
- D.Confidentiality.

**Answer (D) is correct.**

The Rules of Conduct in The IIA’s Code of Ethics are organized based on the principles of integrity, objectivity, confidentiality, and competency. Rule of Conduct 3.1 under the confidentiality principle states, “Internal auditors shall be prudent in the use and protection of information acquired in the course of their duties.”

**A** Risk-based assurance is a core principle for the Professional Practice of Internal Auditing, not a core principle of The IIA’s Code of Ethics. The core principles in the Code of Ethics are integrity, objectivity, confidentiality, and competency.

**B** Competency is a core principle of The IIA’s Code of Ethics, but it is not the principle that contains the stated rule. Competency is a commitment to acquiring and maintaining an appropriate level of knowledge and skill.

**C** Disclosure is not a core principle of The IIA’s Code of Ethics.

70 In a review of travel and entertainment expenses, a certified internal auditor questioned the business purposes of an officer’s reimbursed travel expenses. The officer promised to compensate for the questioned amounts by not claiming legitimate expenses in the future. If the officer makes good on the promise, the internal auditor

- A.Should inform the tax authorities in any event.
- B.Can ignore the original charging of the nonbusiness expenses.
- C.Should still include the finding in the final engagement communication.
- D.Should recommend that the officer forfeit any frequent flyer miles received as part of the questionable travel.

**Answer (C) is correct.**

Rule of Conduct 2.3 under the objectivity principle states, “Internal auditors shall disclose all material facts known to them that, if not disclosed, may distort the reporting of activities under review.”

**A** Communication of results to parties outside the organization is not required in the absence of a legal mandate.

**B** The possibly fraudulent behavior of the officer is a material fact that should be reported regardless of whether the questioned expenses are reimbursed.

**D** Management should determine what constitutes just compensation.

**71** Which of the following violates The IIA's Code of Ethics core principle of confidentiality?

**A.** The company's internal audit charter states, "If independence is impaired in fact or appearance, the details of the impairment must be disclosed to appropriate parties."

**B.** The internal auditor purchased stock in the company after seeing a draft of the quarterly financial statements.

**C.** A first-year internal auditor sought help preparing workpapers from a third-year internal auditor on the same engagement.

**D.** The CAE began an investigation on submitted travel expense reports after hearing sales personnel were inflating their travel expenses.

**Answer (B) is correct.**

Rule of Conduct 3.2 under the confidentiality principle states, "Internal auditors shall not use information for any personal gain." The stock purchase is a violation of The IIA's Code of Ethics and is insider trading. Illegal insider trading is the trading of stock for personal gain by having access to confidential information that has not yet been made public.

**A** The internal audit charter is a formal document. If independence is impaired, it is a violation of the core principle of objectivity. Rule of Conduct 2.2 under the objectivity principle states, "Internal auditors shall not accept anything that may impair or be presumed to impair their professional judgment."

**C** Discussing workpapers with another team member on the same engagement is not a violation of the confidentiality principle. Rule of Conduct 3.1 under the confidentiality principle states, "Internal auditors shall be prudent in the use and protection of information acquired in the course of their duties."

**D** Investigating potential fraud is within the scope of the responsibilities of the internal audit charter. It is not a violation of the core principle of confidentiality.

**72** An organization has recently placed a former operating manager in the position of chief audit executive (CAE). The new CAE is not a member of The IIA and is not a CIA. Henceforth, the internal audit activity will be run strictly by the CAE's standards, not The IIA's. All four staff internal auditors are members of The IIA, but they are not CIAs. According to The IIA's Code of Ethics, what is the best course of action for the staff internal auditors?

- A.They must respect the legitimate and ethical objectives of the organization and ignore the Standards.
- B.They must resign their jobs to avoid improper activities.
- C.They should comply with the International Standards for the Professional Practice of Internal Auditing.
- D.The Code does not apply because they are not CIAs.

**Answer (C) is correct.**

Rule of Conduct 4.2 under the competency principle states, “Internal auditors shall perform internal audit services in accordance with the International Standards for the Professional Practice of Internal Auditing.” Because the internal auditors are members of The Institute, The IIA’s Code of Ethics is enforceable against them even though they are not CIAs.

**A** Internal auditors should respect and contribute to the legitimate and ethical objectives of the organization, but an IIA member, a holder of an IIA professional certification, or a candidate for certification may be liable for disciplinary action for failure to adhere to the Standards.

**B** The IIA’s Code of Ethics says nothing about resignation to avoid improper activities.

**D** The IIA’s Code of Ethics may be enforced against IIA members and recipients of, or candidates for, IIA professional certifications.

**73** The chief audit executive (CAE) is best defined as the

- A.Person responsible for the internal audit function.
- B.Outside provider of internal audit services.
- C.Person responsible for overseeing the contract with the outside provider of internal audit services.
- D.Inspector general.

**Answer (A) is correct.**

The CAE is a person in a senior position responsible for effectively managing the internal audit activity in accordance with the internal audit charter and the mandatory elements of the IPPF (The IIA Glossary).

**B** The internal audit activity may be insourced.

**C** The term “chief audit executive” is defined broadly because (1) the internal audit activity may be insourced or outsourced and (2) many different titles are used in practice.

**D** The specific job title of the chief audit executive may vary across organizations (The IIA Glossary).

**74** Company A recently acquired Company B. Company B is in a very different industry from Company A. Ten internal auditors have been assigned to review key areas of Company B's operations. The CAE has arranged for the auditors to receive industry training prior to the commencement of work. How should the CAE explain to the board why the industry training is needed?

A. Internal auditors will not know how to be prudent in the use and protection of the information acquired in the course of their duties.

B. Internal auditors will be unable to contribute to the legitimate and ethical objectives of the organization.

C. Internal auditors do not have the necessary knowledge, skills, or experience to complete the work.

D. Internal auditors may distort the reporting of activities if all material facts are not known to them.

**Answer (C) is correct.**

The Code of Ethics principle of competency states, "Internal auditors shall engage only in those services for which they have the necessary knowledge, skills, and experience." Because Company B's industry is very different than Company A's industry, the internal auditors must acquire the required knowledge and skills needed for the engagement. Failure to do so would be in violation of the Code of Ethics.

**A** The Code of Ethics principle of confidentiality states, "Internal auditors shall be prudent in the use and protection of information acquired in the course of their duties." Industry training would not be the correct training to teach the internal auditors confidentiality.

**B** The Code of Ethics principle of integrity states, "Internal auditors shall respect and contribute to the legitimate and ethical objectives of the organization." Industry training would not teach the internal auditors integrity.

**D** Disclosure by the internal auditors of all material facts known to them that, if not disclosed, may distort the reporting of activities under review is included in the principle of objectivity. Industry training would not provide the internal auditors with the material facts of Company B.

**75** The internal audit charter includes all of the following except

A. The organization's core values, mission, and vision statements.

B. The internal auditor's responsibility to provide assurance and consulting services.

C. A formal definition of the purpose, authority, and responsibility of the internal audit activity.

D. The nature of the chief audit executive's relationship with the board.

**Answer (A) is correct.**

The core values, mission, and vision statements of the organization are not included in the internal audit charter. The interpretation of Standard 1000, defines the internal audit charter as “a formal document that defines the internal audit activity’s purpose, authority, and responsibility. The internal audit charter establishes the internal audit activity’s position within the organization, including the nature of the chief audit executive’s functional reporting relationship with the board; authorizes access to records, personnel, and physical properties relevant to the performance of engagements; and defines the scope of internal audit activities. Final approval of the internal audit charter resides with the board.”

**B** The internal audit charter for the internal audit activity defines the internal audit activity’s purpose, authority, and responsibility. The internal audit activity’s responsibility to provide the organization with assurance and consulting services is defined in the internal audit charter.

**C** The internal audit charter includes a formal definition of the purpose, authority, and responsibility of the internal audit activity. The internal audit charter should be discussed among the CAE, senior management, and the board to mutually agree upon (1) the internal audit objectives and responsibilities and (2) the expectations for the internal audit activity.

**D** The nature of the chief audit executive’s functional reporting relationship with the board is defined in the internal audit charter. This includes the CAE’s functional and administrative reporting lines and the level of authority required for the internal audit activity to perform engagements and fulfill its agreed-upon objectives and responsibilities.

**76** A typical code of ethical conduct for financial managers or management accountants in an organization requires all of the following except

A. Independence from conflicts of professional interest.

B. Subjectivity in presenting information, preparing reports, and making analyses.

C. Integrity and a refusal to compromise professional values for the sake of personal goals.

D. Independence from conflicts of economic interest

**Answer (B) is correct.**

The code of ethical conduct for financial managers or management accountants in an organization should require objectivity in presenting information, preparing reports, and making analyses.

**A** A typical code of ethical conduct for financial managers or management accountants requires independence from conflicts of professional interest.

**C** A typical code of ethical conduct for financial managers or management accountants in an organization requires integrity and a refusal to compromise professional values for the sake of personal goals.

**D.** A typical code of ethical conduct for financial managers or management accountants requires independence from conflicts of economic interest.

77 The authority of the internal audit activity is limited to that granted by

- A. The board and the controller.
- B. Management and the board.
- C. Senior management and the Standards.
- D. The board and the chief financial officer.

**Answer (B) is correct.**

The purpose, authority, and responsibility of the internal audit activity must be formally defined in a charter. The CAE must periodically review and present the charter to senior management and the board for approval (Attr. Std. 1000).

- A The controller is not the only member of management.
- C The Standards cannot provide actual authority to an internal audit activity.
- D Management and the board, not a particular manager, give the internal audit activity its authority.

78 An internal auditor may receive which of the following without violating The IIA's Code of Ethics?

- A. A dinner and baseball tickets from the manager of a department that has never been reviewed and for which there are no plans for a future engagement. The tickets are usually made available to employees of that department.
- B. A bottle of whiskey from the organization's CFO.
- C. A dinner and baseball tickets from the manager of a department being reviewed. The tickets are usually made available to employees of that department.
- D. A pen received from the sales manager of a subsidiary with the imprinted name of the organization's product and a phone number.

**Answer (D) is correct.**

Rule of Conduct 2.2 under the objectivity principle states, "Internal auditors shall not accept anything that may impair or be presumed to impair their professional judgment." A small promotional item, such as a pen of minimal value, is unlikely to affect an auditor's judgment.

- A A gift from an employee whose department may be reviewed most likely violates Rule of Conduct 2.2.

**B** A gift from an employee whose department may be reviewed most likely violates Rule of Conduct 2.2.

**C** A gift from an employee whose department may be reviewed most likely violates Rule of Conduct 2.2.

**79** The best reason for establishing a code of conduct within an organization is that such codes

A. Provide a quantifiable basis for personnel evaluations.

B. Are typically required by governments.

C. Express standards of individual behavior for members of the organization.

D. Have tremendous public relations potential.

**Answer (C) is correct.**

An organization's code of ethical conduct is the established general value system the organization wishes to apply to its members' activities. It communicates organizational purposes and beliefs and establishes uniform ethical guidelines for members, which include guidance on behavior for members in making decisions. A code establishes high standards against which individuals can measure their own performance. It also communicates to those outside the organization the value system from which its members must not be asked to deviate.

**A** Codes of conduct provide qualitative, not quantitative, standards.

**B** Governments typically lack the power to impose ethical codes on nongovernment personnel (the Sarbanes-Oxley Act of 2002 contains a partial exception to this general rule).

**D** Other purposes of a code of conduct are much more significant.

**80** Which core principle of The IIA's Code of Ethics do the following actions violate?

- The internal auditor assumes operational duties on a temporary basis.
- The internal auditor performs an audit in a department managed by the auditor's father.
- The internal auditor managed the department being audited 6 months prior to the audit.
- The internal auditor receives a bonus based on the number of observations generated during an audit.

A. Integrity.

B. Competency.

C. Independence.

D. Objectivity.

**Answer (D) is correct.**

According to The IIA's Code of Ethics, "Internal auditors exhibit the highest level of professional objectivity in gathering, evaluating, and communicating information about the activity or process being examined. Internal auditors make a balanced assessment of all the relevant circumstances and are not unduly influenced by their own interest or by others in forming judgments." The auditor should not participate in any activity or relationship that may impair or appear to impair an unbiased assessment. Assuming management responsibilities and auditing an area in which the auditor had such responsibilities within 1 year violate the objectivity principle. Performing an audit in a department managed by a family member also violates this principle because of an actual or implied conflict of interest. Accepting a bonus based on work accomplished during an audit also may impair or be presumed to impair the auditor's objectivity.

**A** Integrity relates to the auditor's adherence to applicable laws and the organization's ethical values. It is the basis for reliance on the auditor's judgments.

**B** Competency pertains to the auditor's knowledge, skills, and experience in performing internal audit work.

**C** Independence is not one of the core principles of The IIA Code of Ethics.

**81** Which of the following statements is part of The IIA Rules of Conduct for competency?

**A.** Internal auditors shall disclose all material facts known to them that, if not disclosed, may distort the reporting of activities under review.

**B.** Internal auditors shall respect and contribute to the legitimate and ethical objectives of the organization.

**C.** Internal auditors shall engage only in those services for which they have the necessary knowledge, skills, and experience.

**D.** Internal auditors shall be prudent in the use and protection of information acquired in the course of their duties.

**Answer (C) is correct.**

Rule of Conduct for competency 4.1 states, "Internal auditors shall engage only in those services for which they have the necessary knowledge, skills, and experience."

**A** Rule of Conduct for objectivity 2.3 states, "Internal auditors shall disclose all material facts known to them that, if not disclosed, may distort the reporting of activities under review."

**B** Rule of Conduct for integrity 1.4 states, "Internal auditors shall respect and contribute to the legitimate and ethical objectives of the organization."

**D** Rule of Conduct for confidentiality 3.1 states, "Internal auditors shall be prudent in the use and protection of information acquired in the course of their duties."

**82** The degree of voluntary compliance with an organization's adopted code of ethics is a measure of the

- A. Organization's ethical culture.
- B. Integrity of the organization's professionals.
- C. Standards of competence of all members.
- D. Cohesion and professionalism of an organization.

**Answer (D) is correct.**

The mere existence of a code of ethical conduct does not ensure that ethical principles are followed or that those outside the organization will believe it is trustworthy. A measure of the cohesion and professionalism of an organization is the degree of voluntary compliance with its adopted code of ethics.

**A** The primary purpose of a code of ethical conduct for a professional organization is to promote an ethical culture among professionals who serve others. The purpose of the code is not to measure of the degree of voluntary compliance.

**B** Integrity is a core principle of The IIA's Code of Ethics. Integrity establishes trust and provides the basis for reliance on an internal auditor's judgment. Integrity does not measure the degree of an organization's voluntary compliance with the adopted code.

**C** A code of ethics or ethical conduct can help establish minimum standards of competence; however, it is not a measurement of voluntary compliance with an organization's adopted code.

**83** Which of the following activities would be considered an assurance service by the internal auditors?

- A. Internal auditing has agreed to work with the warehouse manager in examining organizational performance for the purpose of promoting change.
- B. The employee turnover in the tax department has been exceptionally high this year. The tax director has requested internal audit's assistance in preparing property tax returns.
- C. The director of inventory control has hired 20 temporary employees for the seasonal business. The director has requested internal audit to provide training on the importance of inventory control procedures.
- D. The board is in the due diligence phase of a new company acquisition. The CFO has asked for the internal auditor's opinion of the new company's debt structure.

**Answer (D) is correct.**

Assurance services involve the internal auditor's objective assessment of evidence to provide opinions or conclusions regarding an entity, operation, function, process, system, or other subject

matter. Generally, three parties are participants in assurance services: (1) the process owner (the new company), (2) the internal auditor, and (3) the user or group using the assessment (the board).

**A** According to The IIA, facilitation services are consulting engagements in which the “auditor guides management in identifying organizational strengths and opportunities for improvement.” Working with the warehouse manager to examine organizational performance for the purpose of promoting change would be considered a facilitation service.

**B** Bookkeeping, accounting, and tax services would not be considered assurance services. Assurance services provide an objective examination of evidence for the purpose of providing an independent assessment.

**C** Training would be considered a consulting service. The purpose of the internal audit activity is to provide “independent, objective assurance and consulting services.” Consulting services include providing counsel, advice, facilitation, and training.

**84** After the chief audit executive receives approval from the board to offer consulting services, what should be done?

A. The CAE should get approval from the internal auditors.

B. The internal audit charter should be amended.

C. The board should develop appropriate policies and procedures for conducting such engagements.

D. The CAE should begin performing consulting services.

**Answer (B) is correct.**

The purpose, authority, and responsibility of the internal audit activity must be formally defined in an internal audit charter (Attr. Std. 1000). The nature of consulting services must be defined in the internal audit charter (Impl. Std. 1000.C1).

**A** The CAE does not need to get additional approval from the internal auditors. Only board approval is required.

**C** The CAE must establish policies and procedures to guide the internal audit activity.

**D** After the CAE receives board approval, the internal audit charter must be amended and the CAE must establish policies and procedures.

**85** Which of the following situations is a violation of The IIA’s Code of Ethics?

A. Knowing that management was aware of the situation, an internal auditor purposely left a description of an unlawful practice out of the final engagement communication.

B. An internal auditor, with the knowledge and consent of management, accepted a token gift from a customer of the organization that was not presumed to impair and did not impair judgment.

C. An internal auditor shared techniques with internal auditors from another organization.

D. Based upon knowledge of the probable success of the employer's business, an internal auditor invested in a mutual fund that specialized in the same industry.

**Answer (A) is correct.**

Rule of Conduct 2.3 under the objectivity principle states, "Internal auditors shall disclose all material facts known to them that, if not disclosed, may distort the reporting of activities under review." Moreover, Rule of Conduct 1.3 under the integrity principle states, "Internal auditors shall not knowingly be a party to any illegal activity, or engage in acts that are discreditable to the profession of internal auditing or to the organization."

**B** Acceptance of anything from a customer is prohibited but only if it would impair or be presumed to impair professional judgment.

**C** Rule of Conduct 4.3 under the competency principle states, "Internal auditors shall continually improve their proficiency and the effectiveness and quality of their services."

**D** Although an internal auditor is prohibited from using confidential information for personal gain, and an investment in the organization's stock would be questionable, an investment in a mutual fund is acceptable.

**86** In their reporting, internal auditors are required by The IIA's Code of Ethics to

A. Disclose material facts known to the internal auditor that could distort the final engagement communication if not revealed.

B. Disclose all material information obtained by the auditor as of the date of the final engagement communication.

C. Obtain factual information within the established time and budget parameters.

D. Present sufficient factual information without revealing confidential matters that could be detrimental to the organization.

**Answer (A) is correct.**

Rule of Conduct 2.3 under the objectivity principle states, "Internal auditors shall disclose all material facts known to them that, if not disclosed, may distort the reporting of activities under review."

**B** The Code does not address disclosure this specifically.

**C** Time and budget parameters are not addressed in the Code.

**D** The Code requires only that internal auditors be prudent in the use and protection of information.

**87** The transportation department of a publicly held company has asked the internal audit activity to review the design specifications for a proposed new warehouse and repair facility. The best reason for the internal audit activity to decline the request is

A. The CEO and the head of the transportation department are neighbors and belong to the same social clubs.

B. Such a review does not fall within the authority granted in the internal audit charter.

C. The internal audit activity performed a thorough review of the transportation department the previous year.

D. The transportation department's budget is immaterial to the organization's total budget.

**Answer (B) is correct.**

The internal audit activity's purpose, authority, and responsibility are specifically granted in the form of a written charter approved by the board.

A An attitude of independence is required for internal auditors, not for auditees and management.

C Internal audit engagements are scheduled based on a risk assessment, not simply time elapsed since the last engagement.

D Internal audit engagements are scheduled based on a risk assessment, only one of the elements of which is monetary materiality.

**88** An internal auditor has discovered mathematical errors in their workpapers. Reporting the error would require an extensive amount of rework. The internal auditor decides to not say anything and leaves the errors. The internal auditor's actions are in violation of The IIA's Code of Ethics. What did the internal auditor fail to do?

A. Engage in services for which they have sufficient knowledge and experience.

B. Observe the law and report the disclosures expected by the law and the profession.

C. Protect the information acquired in the course of their duties.

D. Perform the work with honesty, diligence, and responsibility.

**Answer (D) is correct.**

Rule of Conduct 1.1 under the integrity principle states, "Internal auditors shall perform their work with honesty, diligence, and responsibility." The internal auditor failed to perform their work with honesty when they chose to not disclose errors in the workpapers.

**A** Discovering an error in the workpapers is not an indication of the internal auditor's competency, though one could question their judgment.

**B** Failure to report errors in the internal auditor's workpapers is not an indication that the internal auditor failed to observe the law.

**C** There is no indication that information the auditor acquired while performing their duties was not protected.

**89** Which of the following situations is a violation of The IIA's Code of Ethics?

**A.** During an engagement, an internal auditor learned that the organization was about to introduce a new product that would revolutionize the industry. Because of the probable success of the new product, the product manager suggested that the internal auditor buy an additional interest in the organization, which the internal auditor did.

**B.** An internal auditor gave a speech at a local IIA chapter meeting outlining the contents of a program the internal auditor had developed for engagements relating to electronic data interchange (EDI) connections. Several internal auditors from major competitors were in the audience.

**C.** An internal auditor for a manufacturer of office products recently completed an engagement to evaluate the marketing function. Based on this experience, the internal auditor spent several hours one Saturday working as a paid consultant to a hospital in the local area that intended to conduct an engagement to evaluate its marketing function.

**D.** An internal auditor was ordered to testify in a court case in which a merger partner claimed to have been defrauded by the internal auditor's organization. The internal auditor divulged confidential information to the court.

**Answer (A) is correct.**

Rule of Conduct 3.2 under the confidentiality principle states, "Internal auditors shall not use information for any personal gain or in any manner that would be contrary to the law or detrimental to the legitimate and ethical objectives of the organization."

**B** Giving a speech is not a violation of The IIA's Code of Ethics. In fact, The IIA's motto is "progress through sharing."

**C** The hospital is not a competitor or supplier of the internal auditor's employer. Hence, no conflict of interest is involved.

**D** The principle of confidentiality permits the disclosure of confidential information if there is a legal or professional obligation to do so.

**90** The Rules of Conduct in The IIA's Code of Ethics are

**A.** Organized based on the principles of integrity, authority, capability, and objectivity.

B.Intended to guide the ethical conduct of internal auditors.

C.Used to measure compliance with The IIA's Core Principles.

D.Used to approve decisions regarding the appointment and removal of the chief audit executive (CAE).

**Answer (B) is correct.**

The Rules of Conduct are an essential component of The IIA's Code of Ethics. There are Rules of Conduct for each of the core principles of integrity, objectivity, confidentiality, and competency. The rules describe behavior expected of internal auditors. "These rules are an aid to interpreting the Principles into practical applications and are intended to guide the ethical conduct of internal auditors."

**A** The Rules of Conduct are organized based on the core principles of integrity, objectivity, confidentiality, and competency. Authority and capability are not elements of the core principles of The IIA's Code of Ethics.

**C** The Rules of Conduct are an essential component of The IIA's Code of Ethics, but they are not used to measure compliance with The IIA's Core Principles.

**D** The board of directors approves decisions regarding the appointment and removal of the CAE. The CAE is responsible for effectively managing the internal audit activity in accordance with the internal audit charter and the mandatory elements of the International Professional Practices Framework.

**91** The purpose of the internal audit activity can be best described as

A.Expressing an opinion on the adequate design and functioning of the system of internal control.

B.Providing additional assurance regarding fair presentation of financial statements.

C.Assuring the absence of any fraud that would materially affect the financial statements.

D.Adding value to the organization.

**Answer (D) is correct.**

Internal auditing is an independent, objective assurance and consulting activity designed to add value and improve an organization's operations (Definition of Internal Auditing).

**A** Assessing internal control is one of many tasks of the internal audit activity, but it is not its primary purpose.

**B** Assisting the external auditors in their audit of the financial statements is one of many possible tasks of the internal audit activity, but it is not its primary purpose.

**C** Detecting fraud is one of many possible tasks of the internal audit activity, but it is not its primary purpose.

**92** An internal auditor, nearly finished with an engagement, discovers that the director of marketing has a gambling habit. The gambling issue is not directly related to the existing engagement, and the internal auditor is under pressure to complete it quickly. The internal auditor notes the problem and passes the information on to the chief audit executive but does no further follow-up. The internal auditor's actions

A. Are in violation of the Standards because the internal auditor did not properly follow up on a red flag that might indicate the existence of fraud.

B. Are in violation of The IIA's Code of Ethics for withholding meaningful information.

C. Are in violation of The IIA's Code of Ethics for withholding meaningful information and are in violation of the Standards because the internal auditor did not properly follow up on a red flag that might indicate the existence of fraud.

D. Are not in violation of either The IIA's Code of Ethics or the Standards.

**Answer (D) is correct.**

The IIA's Code of Ethics and the Standards were not violated. The internal auditor did not withhold information and properly followed up upon learning of the information.

**A** The internal auditor did not withhold information but properly followed up upon learning of the information.

**B** The internal auditor did not withhold information but properly followed up upon learning of the information.

**C** The internal auditor did not withhold information but properly followed up upon learning of the information.

**93** An accounting association established a code of ethics for all members. What is one of the association's primary purposes of establishing the code of ethics?

A. To provide a framework within which accounting policies could be effectively developed and executed.

B. To outline criteria that can be used in conducting interviews of potential new accountants.

C. To establish standards to follow for effective accounting practice.

D. To outline criteria for professional behavior to maintain standards of integrity and objectivity.

**Answer (D) is correct.**

The primary purpose of a code of ethical behavior for a professional organization is to promote an ethical culture among professionals who serve others.

**A** A code of ethics does not provide the framework within which accounting policies are developed.

**B** The primary purpose is not for interviewing new accountants.

**C** National standards-setting bodies, not codes of ethics, provide guidance for effective accounting practice.

**94** Every day, acts of integrity are seen in the workplace. Which workplace situation presented below most likely violates The IIA's Code of Ethics core principle of integrity?

**A.** An employee, hired to work full-time, has had to reduce work hours to help care for her elderly mother. The employee has kept her supervisor and human resources informed, is productive when in the office, and always punches out when not at work.

**B.** The director of internal auditing is quick to take responsibility for the department when his team fails to perform. The director also is quick to recognize and praise his team when the job is done well.

**C.** A first-year internal auditor was having difficulty completing assignments on time. The employee's supervisor arranged for the employee to have more training. Additionally, the supervisor developed a more structured work schedule with intermediary deadlines for the employee.

**D.** The internal audit manager is required to file work performance reports every morning. The manager continually comes in late and leaves work early. One of the manager's direct reports stays late every night to complete the performance reports on behalf of the manager.

**Answer (D) is correct.**

The IIA's Rule of Conduct integrity principle states, "Internal auditors (1.1) shall perform their work with honesty, diligence, and responsibility, and (1.4) shall respect and contribute to the legitimate and ethical objectives of the organization." The internal audit manager is not taking responsibility for the position or respecting the employee who is having to carry the workload. The manager has violated the principle of integrity.

**A** The employee has exhibited professionalism and has not violated the principle of integrity.

**B** The director understands the importance of teamwork and has not violated the principle of integrity.

**C** The supervisor, recognizing the employee's shortcomings, adapted their management style and is setting the employee up for success. Neither the supervisor nor the employee has violated the principle of integrity.

**95** Today's internal auditor will often encounter a wide range of potential ethical dilemmas, not all of which are explicitly addressed by The IIA's Code of Ethics. If the internal auditor encounters such a dilemma, the internal auditor should always

- A. Seek counsel from an independent attorney to determine the personal consequences of potential actions.
- B. Act consistently with the code of ethics adopted by the organization even if such action is not consistent with The IIA's Code of Ethics.
- C. Seek the counsel of the board before deciding on an action.
- D. Apply and uphold the principles embodied in The IIA's Code of Ethics.

**Answer (D) is correct.**

The Code includes Principles (integrity, objectivity, confidentiality, and competency) relevant to the profession and practice of internal auditing and Rules of Conduct that describe behavioral norms for internal auditors and that interpret the Principles. Internal auditors are expected to apply and uphold the Principles. Furthermore, that a particular conduct is not mentioned in the Rules does not prevent it from being unacceptable or discreditable.

- A Seeking the advice of legal counsel on all ethical decisions is impracticable.
- B** If the organization's standards are not consistent with, or as high as, the profession's standards, the internal auditor is held to the standards of the profession.
- C Seeking the advice of the board on all ethical decisions is impracticable. Furthermore, the advice might not be consistent with the profession's standards.

**96** Which of the following items is a violation by an internal auditor of The IIA's Code of Ethics?

- A. Information in the internal auditor's working papers that proved a criminal act was included in the internal auditor's draft communication. The comments were later removed by internal audit management.
- B.** A control system that had been recommended by the internal audit staff during the previous engagement was found to be defective. The internal auditor reported the defective function as an engagement client failure.
- C. Certain facts recorded in the internal auditor's working papers that helped to support the basic allegations made by the internal auditor regarding a case of fraud were not included in the final engagement communication.
- D. To keep the engagement effort within the budgeted time, the internal auditor was directed to and did curtail testing in an area that looked suspicious and later was proved to contain massive irregularities.

**Answer (B) is correct.**

Reporting the defective function as an engagement client failure is a violation of the internal auditor's ethical obligation to disclose all material facts known to him or her that, if not disclosed, may distort the reporting of activities under review (Rule of Conduct 2.3).

**A** The ethical transgression, if any, was not made by the internal auditor but by internal audit management.

**C** Immaterial facts need not be included.

**D** The ethical transgression, if any, was not made by the internal auditor but by internal audit management.

**97** A formal code of ethics should do all of the following except

**A.** Communicate the organization's value system to outsiders.

**B.** Provide a method of policing and disciplining members of the organization for violations.

**C.** Reflect only legal standards of conduct for individuals and the organization.

**D.** Effectively communicate acceptable values to all members.

**Answer (C) is correct.**

An ethical organization aspires to a higher standard of behavior than mere legality.

**A** A code of ethics should communicate the organization's value system to those outside the organization.

**B** A code of ethics should indeed provide a method of policing and disciplining members for violations.

**D** A code of ethics should effectively communicate acceptable values to all organization members.

**98** Which of the following best defines consulting services?

**A.** The policies, procedures, and activities designed and operated to ensure that risks are contained within the level that an organization is willing to accept.

**B.** The objective examination of evidence for the purpose of providing an independent assessment on governance, risk management, and control processes for the organization.

**C.** Activities intended to add value and improve an organization's governance, risk management, and control processes.

**D.** A systematic, disciplined approach to evaluate and improve the effectiveness of governance, risk management, and control processes.

**Answer (C) is correct.**

The IIA Glossary defines consulting services as "advisory and related client service activities that are intended to add value and improve an organization's governance, risk management, and

control processes without the internal auditor assuming management responsibility.” Generally, two parties are participants in consulting services: (1) the internal auditor and (2) the engagement client.

**A** The IIA Glossary defines control processes as “the policies, procedures, and activities designed and operated to ensure that risks are contained within the level that an organization is willing to accept.”

**B** The definition of assurance services from The IIA Glossary is “an objective examination of evidence for the purpose of providing an independent assessment on governance, risk management, and control processes for the organization.”

**D** To help “an organization accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of governance, risk management and control processes” is The IIA Glossary’s definition of the internal audit activity.

**99** When the internal audit activity performs an assurance engagement, how many parties are involved?

A.One.

B.Three.

C.Two.

D.The entire organization.

**Answer (B) is correct.**

Three parties are involved in an assurance engagement. They are the process owner (the party directly involved with the process or system), the internal auditor (the assessor), and the user of the assessment. For an assurance service, the internal audit activity determines the nature and scope of the engagement and objectively assesses the evidence gathered. The evidence and its evaluation form the basis for expressing an opinion or stating a conclusion about the subject matter of the engagement.

**A** Any type of engagement performed by the internal audit activity has more than one party involved.

**C** Consulting engagements ordinarily are provided at the client’s request. The nature and scope of this advisory service are agreed upon with the client. The two parties to a consulting service are the internal auditor (the advisor) and the client (the advisee).

**D** Only a certain number of parties, not the entire organization, are involved in an internal audit assurance engagement.

**100** In complying with The IIA’s Code of Ethics, an internal auditor should

- A. Primarily apply the competency principle in establishing trust.
- B. Use individual judgment in the application of the principles set forth in the Code.
- C. Respect and contribute to the objectives of the organization even if it is engaged in illegal activities.
- D. Go beyond the limitation of personal technical skills to advance the interest of the organization.

**Answer (B) is correct.**

The IIA's Code of Ethics includes principles that internal auditors are expected to apply and uphold. They are interpreted by the Rules of Conduct, behavior norms expected of internal auditors. That a particular conduct is not mentioned in the Rules of Conduct does not prevent it from being unacceptable or discreditable. Consequently, a reasonable inference is that individual judgment is necessary in the application of the principles and the Rules of Conduct.

**A** Applying and upholding the integrity principle is the means by which an internal auditor establishes trust as a basis for reliance on his or her judgment.

**C** An internal auditor "shall not knowingly be a party to any illegal activity." Furthermore, an internal auditor is bound to respect and contribute only to the legitimate and ethical objectives of the organization.

**D** Internal auditors "shall engage only in those services for which they have the necessary knowledge, skills, and experience."

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**PART-1(UNIT-2)**

**1** Which of the following facts, by themselves, could contribute to a lack of independence of the internal audit activity?

1. The CEO accused the new auditor of not operating "in the best interests of the organization."
2. The majority of audit committee members come from within the organization.
3. The internal audit activity's charter has not been approved by the board.

- A.1 only.
- B.2 only.
- C.2 and 3 only.
- D.1, 2, and 3.

**Answer (D) is correct.**

The CEO's statement suggests that the internal audit activity lacks the support of senior management and the board. Furthermore, the lack of outside audit committee members may contribute to a loss of independence. The board's failure to approve the charter may have the same effect. The charter enhances the independence of the internal audit activity. By specifying the purpose, authority, and responsibility of the internal audit activity, it establishes the position of internal audit in the organization, including the nature of the chief audit executive's functional reporting relationship with the board (Inter. Std. 1000).

- A The other facts listed could also contribute to a lack of independence.
- B Lack of support by the CEO and lack of a charter weaken the internal audit activity's position.
- C Lack of support by the CEO weakens the internal audit activity's position.

**2** To avoid being the apparent cause of conflict between an organization's senior management and the board, the chief audit executive should

- A. Communicate all engagement results to both senior management and the board.
- B. Strengthen the independence of the internal audit activity through organizational position.
- C. Discuss all reports to senior management with the board first.
- D. Request board approval of policies that include internal audit activity relationships with the board.

**Answer (D) is correct.**

To achieve the degree of independence necessary to effectively carry out the responsibilities of the internal audit activity, the chief audit executive has direct and unrestricted access to senior management and the board. This can be achieved through a dual-reporting relationship (Inter. Std. 1100).

- A Receipt of all engagement results by senior management and the board is unnecessary and inefficient.
- B Organizational position helps the internal audit activity to achieve independence but is not, by itself, enough to avoid conflict.
- C The board essentially has an oversight rather than an operational role.

**3** A medium-sized publicly owned organization operating in Country X has grown to a size that the governing authority believes warrants the establishment of an internal audit activity. Country X has legislated internal audit requirements for government-owned organizations. The organization changed the bylaws to reflect the establishment of the internal audit activity. The governing authority decided that the chief audit executive (CAE) must be a certified internal auditor and will report directly to the newly established audit committee. Which of the items discussed above will contribute the most to the new CAE's independence?

- A. The establishment of the internal audit activity is documented in the bylaws.
- B. Country X has legislated internal auditing requirements.
- C. The CAE will report to the audit committee.
- D. The CAE is to be a certified internal auditor.

**Answer (C) is correct.**

Independence is effectively achieved when the CAE reports functionally to the board (Inter. Std. 1110). The audit committee is a subset of the board.

- A Documentation in the bylaws does little to promote independence.
- B Legislated internal audit requirements in Country X do not promote independence.
- D Independence requires support from senior management and the board.

**4** An external quality assessment team was evaluating the independence of an internal audit activity. The internal audit activity performs engagements concerning all of the elements included in its scope. Which of the following reporting responsibilities is most likely to threaten the internal audit activity's independence? Reporting to the

- A. President.
- B. Chief financial officer.
- C. Executive vice president.
- D. Audit committee.

**Answer (B) is correct.**

The CAE must report to a level within the organization that allows the internal audit activity to fulfill its responsibilities (Attr. Std. 1110). The higher the level to which the internal audit activity reports, the more likely that independence will be assured. Reporting to the chief financial officer limits the influence and independence of the internal audit activity.

**A** Being responsible to the president helps preserve the internal audit activity's independence by enhancing its position in the organization.

**C** The executive vice president is higher ranking than the CFO.

**D** Because the audit committee is a subset of the board, independence is enhanced when the internal audit activity reports to the audit committee.

**5** To determine the organizational placement of internal audit, the CAE

I. Works with the board

II. Works with senior management

III. Has discretion to independently determine placement

A.I only.

B.II only.

C.I and II only.

D.III only.

**Answer (C) is correct.**

The CAE cannot solely determine the organizational independence and placement of internal audit. The CAE works with the board and senior management to determine the organizational placement of internal audit.

**A** The CAE also must work with senior management.

**B** The CAE also must work with the board.

**D** The CAE does not have discretion to independently determine the organizational placement of the internal audit function.

**6** The CAE should report functionally to the board. The board is responsible for which of the following activities?

1. Internal communication and information flows

2. Approval of the internal audit risk assessment and related audit plan

3. Approval of annual compensation and salary adjustments for the CAE

A.1 and 2 only.

B.2 and 3 only.

C.1 and 3 only.

D.1, 2, and 3

**Answer (B) is correct.**

Organizational independence is effectively achieved when the CAE reports functionally to the board. Examples of functional reporting to the board involve the board

- Approving the internal audit charter
- Approving the risk-based internal audit plan
- Receiving communications from the CAE on the internal audit activity's performance
- Approving decisions regarding the appointment and removal of the CAE
- Making appropriate inquiries of management and the CAE to determine whether there are inappropriate scope or resource limitations (Inter. Attr. Std. 1110)

**A** Internal communication and information flows are administrative reporting items. Administrative reporting is the reporting relationship within the management structure. Furthermore, functional reporting also involves the board's approval of annual compensation and salary adjustments for the CAE.

**C** Internal communication and information flows are administrative reporting items. Moreover, functional reporting also involves the board's approval of the internal audit risk assessment and related audit plan.

**D** Internal communication and information flows are administrative reporting items.

7 The optimal administrative reporting line of the CAE is to

- A. The audit committee.
- B. Line management.
- C. Board of directors.
- D. CEO or equivalent.

**Answer (D) is correct.**

The CAE should report administratively to the CEO or an equivalent so that the CAE (1) is clearly in a senior position and (2) has authority to perform duties unimpeded.

**A** Functional reporting is to the board.

**B** Administrative reporting preferably is to the CEO.

**C** The CAE must communicate and interact directly with the board. Functional reporting is to the board.

8. Independence permits internal auditors to render impartial and unbiased judgments. The best way to achieve independence is through

- A. Individual knowledge and skills.
- B. A dual-reporting relationship.
- C. Supervision within the organization.
- D. Organizational knowledge and skills.

**Answer (B) is correct.**

Independence is the freedom from conditions that threaten the ability of the internal audit activity to carry out internal audit responsibilities in an unbiased manner. To achieve the degree of independence necessary to effectively carry out the responsibilities of the internal audit activity, the CAE has direct and unrestricted access to senior management and the board. This can be achieved through a dual-reporting relationship (Inter. Std. 1100).

- A. Individual knowledge and skills allow individual auditors to achieve professional proficiency.
- C. Supervision ensures that engagement objectives are achieved, quality is assured, and staff is developed.
- D. Organizational knowledge and skills allow the internal audit activity collectively to achieve professional proficiency.

9. When evaluating the independence of an internal audit activity, a quality assurance review team performing an external assessment considers several factors. Which of the following factors has the least amount of influence when judging an internal audit activity's independence?

- A. Criteria used in making internal auditors' assignments.
- B. The extent of internal auditor training in communications skills.
- C. Relationship between engagement records and engagement communications.
- D. Impartial and unbiased judgments.

**Answer (B) is correct.**

Training in communication relates to the knowledge, skills, and other competencies needed to perform engagements, not to independence.

- A. How individual internal auditors are assigned relates to independence. The auditor's personal relationships with operating personnel, work experience with the engagement client, etc., affect independence.

C.If significant engagement observations found in the engagement records are omitted from the engagement communications, independence becomes an issue.

D.Unbiased judgment is an aspect of independence.

10.Which action is not consistent with functional reporting?

A.Organizational independence is effectively achieved when the CAE reports functionally to the board.

B.The CAE should meet with the board, with management present, to reinforce the independence of the internal audit activity.

C.The board should have the final authority to approve the internal audit risk assessment.

D.The board should approve the CAE's performance evaluation.

**Answer (B) is correct.**

Private meetings between the CAE and the board without management present are an essential part of the functional reporting relationship.

A.Functional reporting to the board facilitates the independence of the internal audit activity.

C.The board approves the internal audit risk assessment and the related audit plan.

D.The board approves all decisions regarding the performance evaluation, appointment, or removal of the CAE.

11.The reporting structure that is most likely to allow the internal audit activity to accomplish its responsibilities is to report administratively to the

A.Board and functionally to the chief executive officer.

B.Controller and functionally to the chief financial officer.

C.Chief executive officer and functionally to the board of directors.

D.Chief executive officer and functionally to the external auditor.

**Answer (C) is correct.**

Reporting functionally to the board and administratively to the organization's CEO facilitates organizational independence.

A.The reverse arrangement is appropriate. The board is not involved in the routine management of the firm.

B.Reporting administratively to the controller and functionally to the chief financial officer would result in insufficient organizational status for internal auditing.

C.The external auditor is not part of the organizational hierarchy.

12.The IIA has indicated that to achieve necessary independence, the CAE should report functionally to whom?

A.Senior management.

B.Shareholders.

C.Chief executive officer.

D.The board.

**Answer (D) is correct.**

Organizational independence is effectively achieved when the CAE reports functionally to the board (Inter. Attr. Std. 1110).

A.Organizational independence is facilitated when the CAE reports functionally to the board and administratively to the CEO.

B.The CAE should report to the audit committee (i.e., the board).

C.The CAE optimally reports to the CEO for administrative purposes.

13.A charter is being drafted for a newly formed internal audit activity. Which of the following best describes an appropriate organizational position to be incorporated into the charter?

A.The chief audit executive reports to the chief executive officer but has access to the board.

B.The chief audit executive is a member of the board.

C.The chief audit executive is a staff officer reporting to the chief financial officer.

D.The chief audit executive reports to an administrative vice president.

Answer (A) is correct.

The CAE, reporting functionally to the board and administratively to the organization's CEO, facilitates organizational independence. The CAE must communicate and interact directly with the board (Attr. Std. 1111).

B.Placing the CAE in a governance position impairs his or her objectivity.

C.Serving as a staff officer and reporting to the CFO limit the influence and independence of the internal audit activity.

14. Freedom from conditions that threaten internal auditors' ability to do unbiased work is

- A. Control.
- B. Compliance.
- C. Independence.
- D. Avoidance of conflicts of interest.

**Answer (C) is correct.**

Independence is "the freedom from conditions that threaten the ability of the internal audit activity to carry out internal audit responsibilities in an unbiased manner" (The IIA Glossary).

A. Control is "any action taken by management, the board, or other parties to manage risk and increase the likelihood that established objectives and goals will be achieved" (The IIA Glossary).

B. Compliance is "adherence to policies, plans, procedures, laws, regulations, contracts, or other requirements" (The IIA Glossary).

D. Conditions other than conflicts of interest may create bias or the appearance of bias

15. Which of the following describes the chief audit executive's optimal reporting line to enhance the independence of the internal audit activity?

- A. Functional and administrative reporting to the president of the organization.
- B. Administrative reporting to the board.
- C. Administrative reporting to the chief financial officer.
- D. Functional reporting to the audit committee.

**Answer (D) is correct.**

The internal audit activity's organizational independence is effectively achieved when it reports functionally to the board (Intr. Std. 1110) and administratively to senior management (IG 1110). The "'board' in the Standards may refer to a committee or another body to which the governing body has delegated certain functions (e.g., an audit committee)" (The IIA Glossary). Thus, reporting functionally to the audit committee is the optimal reporting line to enhance the internal audit activity's independence.

- A. The internal audit activity should report functionally to the board.
- B. The internal audit activity should report administratively to senior management.
- C. The internal audit activity should report administratively to senior management, and the chief financial officer is a member of senior management. But reporting to the chief executive officer best enhances the internal audit activity's independence (IG 1110).

16. During the performance of an engagement to evaluate a division's controls over purchasing, the chief purchasing agent asked why the internal auditor had requested documents pertaining to transactions with a particular supplier. The internal auditor's proper response is to

- A. Treat the inquiry as a scope limitation.
- B. Explain the reasons for the information request to promote cooperation with the engagement client.
- C. Refuse to explain the information request to preserve the integrity of the engagement process.
- D. Consider the specific circumstances before deciding whether to disclose the reasons for the information request.

**Answer (D) is correct.**

At times, an internal auditor may be asked by the engagement client or other parties to explain why a document that has been requested is relevant to an engagement. Disclosure or nondisclosure during the engagement of the reasons documents are needed should be determined based on the circumstances. Significant irregularities may dictate a less open environment than would normally contribute to a cooperative engagement. However, that is a judgment that should be made by the chief audit executive in light of the specific circumstances. Moreover, the internal audit activity must be free from interference in determining the scope of internal auditing, performing work, and communicating results (Impl. Std. 1110.A1).

- A. A scope limitation is a restriction placed upon the internal audit activity that precludes it from accomplishing its objectives and plans.
- B. The CAE should consider the specific circumstances before deciding whether to disclose the reasons for the information request.
- C. It is not always necessary or desirable to refuse to explain an information request.

17. Prior to implementation, management has requested the internal audit activity to perform an engagement to recommend procedures and policies for improving management control over the telephone marketing operations of a major division. The chief audit executive should

- A. Not accept the engagement because recommending controls would impair future objectivity regarding this operation.
- B. Not accept the engagement because internal audit activities are presumed to have expertise regarding accounting controls, not marketing controls.
- C. Accept the engagement, but indicate to management that, because recommending controls impairs independence, future engagements in the area will be impaired.
- D. Accept the engagement because objectivity will not be impaired.

**Answer (D) is correct.**

The CAE should accept the engagement. Recommending standards of control for systems or reviewing procedures prior to implementation does not create a conflict of interest and impair objectivity.

A.The CAE should accept the engagement. Recommending controls is not considered to impair independence or objectivity.

B.The engagement should be accepted. The internal audit activity must have or obtain the knowledge, skills, and competencies to evaluate and improve all of the organization's risk management, control, and governance processes.

C.Independence is not impaired by making control recommendations.

18.Assessing individual objectivity of internal auditors is the responsibility of

A.The chief executive officer.

B.The board.

C.The audit committee.

D.The chief audit executive.

**Answer (D) is correct.**

The CAE must establish policies and procedures to assess the objectivity of individual internal auditors.

A.Assessing individual objectivity of internal auditors is the responsibility of the chief audit executive

B.Assessing individual objectivity of internal auditors is the responsibility of the chief audit executive.

C.Assessing individual objectivity of internal auditors is the responsibility of the chief audit executive.

19.Internal auditors should be objective. Objectivity

A.Requires internal auditors not to subordinate their judgment on audit matters to that of others.

B.Is required only in assurance engagements.

C.Is freedom from threats to the ability to perform audit work without bias.

D.Prohibits internal auditors from providing consulting services relating to operations for which they had previous responsibility.

**Answer (A) is correct.**

Objectivity is “an unbiased mental attitude that allows internal auditors to perform engagements in such a manner that they believe in their work product and that no quality compromises are made. Objectivity requires that internal auditors do not subordinate their judgment on audit matters to others” (Inter. Attr. Std. 1100).

B.Objectivity also is required in a consulting engagement

C.Independence is freedom from threats to the ability to perform audit work without bias.

D.Internal auditors may provide consulting services relating to operations for which they had previous responsibility.

20.The CAE bears the responsibility to do which of the following?

A.Assess the level of independence of the board.

B.Assess the level of knowledge, skills, and competencies of the chief financial officer.

C.Foster collective objectivity.

D.Foster individual objectivity.

**Answer (D) is correct.**

The CAE must establish policies and procedures to assess the objectivity of individual internal auditors.

A.Independence is a quality of the internal audit activity, not the board.

B.The concept of knowledge, skills, and competencies applies to individual internal auditors.

C.Objectivity is an individual, not a collective, quality.

21.Which of the following actions is required of the CAE in regard to the objectivity of internal auditors?

A.Maximize.

B.Prioritize.

C.Manage.

D.Assess.

**Answer (D) is correct.**

The CAE must establish policies and procedures to assess the objectivity of individual internal auditors.

A.The CAE’s responsibility with regard to the objectivity of internal auditors is to assess and maintain

B.The CAE's responsibility with regard to the objectivity of internal auditors is to assess and maintain.

C.The CAE's responsibility with regard to the objectivity of internal auditors is to assess and maintain.

22.Maintaining individual objectivity of internal auditors is the responsibility of

A.The chairperson of the board of directors.

B.The chairperson of the audit committee.

C.The external assessment team.

D.The chief audit executive.

**Answer (D) is correct.**

The responsibility rests with the CAE and with internal auditors themselves to maintain a sense of objectivity

A.The responsibility rests with the CAE and with internal auditors themselves to maintain a sense of objectivity.

B.The responsibility rests with the CAE and with internal auditors themselves to maintain a sense of objectivity. The factor most important to the maintenance of individual objectivity.

C.The responsibility rests with the CAE and with internal auditors themselves to maintain a sense of objectivity.

23.Which of the following actions is required of the CAE and internal auditors themselves in regard to the objectivity of internal auditors?

A.Maintain.

B.Delegate.

C.Enhance.

D.Promote.

**Answer (A) is correct.**

The responsibility rests with the CAE and with internal auditors themselves to maintain a sense of objectivity.

B.The responsibility rests with the CAE and with internal auditors themselves to maintain a sense of objectivity.

C.The responsibility rests with the CAE and with internal auditors themselves to maintain a sense of objectivity.

D.The responsibility rests with the CAE and with internal auditors themselves to maintain a sense of objectivity.

24.Which of the following statements about conflict of interest is false?

A.A conflict of interest could impair an individual’s ability to perform his or her duties and responsibilities objectively.

B.A conflict of interest is a situation in which an internal auditor has a competing professional or personal interest.

C.A conflict of interest only exists when the internal auditor displays unethical behavior or engages in improper acts.

D.A conflict of interest can create an appearance of impropriety that can undermine confidence in the internal auditor.

**Answer (C) is correct.**

A conflict of interest exists even if no unethical or improper act results. The IIA Glossary defines conflict of interest as “any relationship that is, or appears to be, not in the best interest of the organization.” Interpretation of Standard 1120, Conflict of Interest, states, “Conflict of interest is a situation in which an internal auditor, who is in a position of trust, has a competing professional or personal interest. Such competing interests can make it difficult to fulfill his or her duties impartially. A conflict of interest exists even if no unethical or improper act results. A conflict of interest can create an appearance of impropriety that can undermine confidence in the internal auditor, the internal audit activity, and the profession. A conflict of interest could impair an individual’s ability to perform his or her duties and responsibilities objectively.”

A.Included in the Interpretation of Standard 1120, “A conflict of interest could impair an individual’s ability to perform his or her duties and responsibilities objectively.” Avoiding conflicts of interest would facilitate an internal auditor’s impartial and unbiased mindset.

B.As stated in the Interpretation of Standard 1120, “Conflict of interest is a situation in which an internal auditor, who is in a position of trust, has a competing professional or personal interest. Such competing interests can make it difficult to fulfill his or her duties impartially.” Internal auditors should be aware of the possibility of new conflicts of interest that may result from changes in personal circumstances or the particular auditees to which an auditor may be assigned.

D.As stated in the Interpretation of Standard 1120, “A conflict of interest can create an appearance of impropriety that can undermine confidence in the internal auditor, the internal audit activity, and the profession.” A situation that could undermine confidence in the internal auditor would include auditing a family member or close friend.

25.In which of the following situations does an internal auditor potentially lack objectivity?

A.An internal auditor reviews the procedures for a new electronic data interchange (EDI) connection to a major customer before it is implemented.

B.A former purchasing assistant performs a review of internal controls over purchasing 4 months after being transferred to the internal auditing department.

C.An internal auditor recommends standards of control and performance measures for a contract with a service organization for the processing of payroll and employee benefits.

D.A payroll accounting employee assists an internal auditor in verifying the physical inventory of small motors.

**B.Answer (B) is correct.**

Persons transferred to or temporarily engaged by the internal audit activity should not be assigned to audit those activities they previously performed until at least 1 year has elapsed. Such assignments are presumed to impair objectivity.

A.Objectivity is not impaired when the internal auditor recommends standards of control for systems or reviews procedures before they are implemented.

C.Objectivity is not impaired when the internal auditor recommends standards of control for systems or reviews procedures before they are implemented.

D.Use of staff from other areas to assist the internal auditor does not impair objectivity, especially when the staff is from outside of the area where the engagement is being performed.

26.During the course of an engagement, an internal auditor makes a preliminary determination that a major division has been inappropriately capitalizing research and development expense. The engagement is not yet completed, and the internal auditor has not documented the problem or determined that it really is a problem. However, the internal auditor is informed that the chief audit executive has received the following communication from the president of the organization:

“The controller of Division B informs me that you have discovered a questionable account classification dealing with research and development expense. We are aware of the issue. You are directed to discontinue any further investigation of this matter until informed by me to proceed. Under the confidentiality standard of your profession, I also direct you not to communicate with the outside auditors regarding this issue.”

Which of the following is an appropriate action for the CAE to take regarding the questionable item?

A.Immediately report the communication to The IIA and ask for an ethical interpretation and guidance.

B.Inform the president that this scope limitation will need to be reported to the board.

C.Continue to investigate the area until all the facts are determined and document all the relevant facts in the engagement records.

D.Immediately notify the external auditors of the problem to avoid aiding and abetting a potential crime by the organization.

**Answer (B) is correct.**

A scope limitation, along with its potential effect, needs to be communicated to the board.

A. The IIA has no authority in this matter.

C. The CAE needs first to consult the board. The CAE adds value by serving the organization, and the board may, in fact, be fully aware of the problem and may not want to incur additional costs.

D. The engagement work is preliminary, and the internal auditor has not yet formed a basis for an opinion. Thus, contacting the external auditors is premature. However, if an inquiry is made by the external auditors, the internal auditors should share the work done to date

27. An internal auditor who had been supervisor of the accounts payable section should not perform an assurance review of that section

A. Because a reasonable period of time in which to establish independence cannot be determined.

B. Until at least 1 year has elapsed.

C. Until after the next annual review by the external auditors.

D. Until it is clear that the new supervisor has assumed the responsibilities.

**Answer (B) is correct.**

Persons transferred to, or temporarily engaged by, the internal audit activity should not be assigned to audit activities they previously performed until at least 1 year has elapsed. Such assignments are presumed to impair objectivity.

A. The issues are whether (1) objectivity (not independence) has been restored and (2) at least 1 year has elapsed.

C. The external review does not bear any relation to restoring the internal auditor's objectivity.

D. The new supervisor presumably would have assumed his or her responsibilities immediately. Thus, 1 year could not have elapsed.

28. A treasury department employee transferred to the internal audit activity of the same organization last month. The chief financial officer of the organization has suggested that, because of the employee's significant knowledge in this area, it would be a good idea for the employee to immediately begin an engagement to evaluate the treasury department. In this circumstance, the employee should

A. Accept the engagement and begin work immediately.

B. Discuss the need for such an engagement with the employee's former superior, the CFO.

C. Suggest that the engagement be performed by another member of the internal audit staff.

D.Offer to prepare an engagement work program but suggest that interviews with the employee's former co-workers be conducted by other members of the internal audit staff.

**Answer (C) is correct.**

Another internal auditor should be assigned. Persons transferred to or temporarily engaged by the internal audit activity should not be assigned to audit those activities they previously performed until at least 1 year has elapsed. Such assignments are presumed to impair objectivity, and additional consideration should be exercised when supervising the engagement work and communicating engagement results.

A.The proposed engagement is presumed to impair objectivity.

B.Internal auditors are not to subordinate their judgment on engagement matters to that of others.

D.The preparation of the engagement work program offers significant opportunities for bias.

29.A multinational organization has an agreement with a value-added network (VAN) that provides the encoding and communications transfer for the organization's electronic data interchange (EDI) and electronic funds transfer (EFT) transactions. Before transfer of data to the VAN, the organization performs online preprocessing of the transactions. The internal auditor is responsible for assessing preprocessing controls. In addition, the agreement between the organization and the VAN states that the internal auditor is allowed to examine and report on the controls in place at the VAN on an annual basis. The contract specifies that access to the VAN can occur on a surprise basis during the second or third quarter of the fiscal year. This period was chosen so it would not interfere with processing during the VAN's peak transaction periods. This provision was not reviewed with internal auditing. The annual engagement work schedule approved by the board of directors specifies that a full review would be done during the current year.

When the internal auditor called to arrange the annual control review during the third quarter, the VAN stated that it could not accommodate the internal auditor because the peak processing period started earlier than normal this year and all VAN personnel were occupied. This scope limitation, along with its potential effect, must be communicated to which one of the following?

A.The organization's board of directors.

B.The board of directors of the VAN.

C.The board of directors of both the organization and the VAN.

D.The limitation does not need to be communicated at the board of directors level.

**Answer (A) is correct.**

The scope limitation and its potential effect should be communicated to the board. However, the chief audit executive needs to consider whether it is appropriate to inform the board regarding scope limitations that were previously communicated to and accepted by the board.

B.The internal auditor should not communicate directly with the board of the VAN

C.The internal auditor should not communicate directly with the board of the VAN

D.A scope limitation must be communicated to the board.

30.An internal auditor has recently received an offer from the manager of the marketing department of a weekend's free use of his beachfront condominium. No engagement is currently being conducted in the marketing department, and none is scheduled. The internal auditor

A.Should reject the offer and report it to the appropriate supervisor.

B.May accept the offer because its value is immaterial.

C.May accept the offer because no engagement is being conducted or planned.

D.May accept the offer if approved by the appropriate supervisor.

**Answer (A) is correct.**

An internal auditor is not to accept fees, gifts, or entertainment from an employee, client, customer, supplier, or business associate. Accepting a fee or gift may imply that the auditor's objectivity has been impaired. Even though an engagement is not being conducted in the applicable area at that time, a future engagement may result in the appearance of impairment of objectivity. Thus, no consideration should be given to the engagement status as justification for receiving fees or gifts. The receipt of promotional items (such as pens, calendars, or samples) that are available to the general public and have minimal value do not hinder internal auditors' professional judgments. Impairment of independence or objectivity, in fact or appearance, must be disclosed to appropriate parties (Attr. Std. 1130).

B.The value of a weekend vacation is not immaterial.

C.The status of engagements is not a justification for receiving fees or gifts.

D.A supervisor may not approve unethical behavior.

31.The internal audit activity should be free to audit and report on any activity that also reports to its administrative head if it considers such coverage to be appropriate for its audit plan. Any limitation in scope or reporting of results of these activities should be brought to the attention of the

A.Chief executive officer.

B.Chief financial officer.

C.External auditor.

D.Board and senior management.

**Answer (D) is correct.**

Impairments of the internal audit activity's independence and objectivity should be communicated to the board and senior management.

- A. Although the CEO is a part of senior management and is the senior person in the administrative reporting line, impairments of independence and objectivity also should be communicated to the board.
- B. The CFO is also responsible for the organization's accounting functions. Thus, when a scope or reporting limitation exists, the CFO may be responsible for it.
- C. The external auditor should not be notified unless the board believes it is necessary.

32. Independence is freedom from conditions that threaten the ability of the internal audit activity to carry out internal audit responsibilities in an unbiased manner. Which policy best promotes independence?

- A. Requiring internal auditors to report to the chief audit executive any conflicts of interest or bias.
- B. Preventing the internal audit activity from recommending standards of control for systems that it evaluates.
- C. Allowing engagements concerning sensitive operations to be outsourced.
- D. Preventing personnel transfers from operating activities to the internal audit activity.

**Answer (A) is correct.**

Internal auditors are to report to the chief audit executive (CAE) any situation in which (1) an actual or potential impairment of independence or objectivity may reasonably be inferred or (2) they have questions about whether the situation constitutes an impairment of objectivity or independence. If the CAE determines that impairment exists or may be inferred, (s)he needs to reassign the auditor(s).

- B. Internal auditing may recommend standards of control for systems that it evaluates.
- C. Outsourcing certain engagements does not promote the independence of the internal audit activity.
- D. Transfers from operating activities to the internal audit activity usually are permitted. However, transferees should not be assigned to engagements concerning activities they previously performed until at least 1 year has elapsed.

## **PART-1 UNIT-2**

### **1. Which of the following facts, by themselves, could contribute to a lack of independence of the internal audit activity?**

The CEO accused the new auditor of not operating “in the best interests of the organization.”

The majority of audit committee members come from within the organization.

The internal audit activity’s charter has not been approved by the board.

- A. 1 only.
- B. 2 only.
- C. 2 and 3 only.
- D. 1, 2, and 3.

Answer (D) is correct.

The CEO’s statement suggests that the internal audit activity lacks the support of senior management and the board. Furthermore, the lack of outside audit committee members may contribute to a loss of independence. The board’s failure to approve the charter may have the same effect. The charter enhances the independence of the internal audit activity. By specifying the purpose, authority, and responsibility of the internal audit activity, it establishes the position of internal audit in the organization, including the nature of the chief audit executive’s functional reporting relationship with the board (Inter. Std. 1000).

- A. The other facts listed could also contribute to a lack of independence.
- B. Lack of support by the CEO and lack of a charter weaken the internal audit activity’s position.
- C. Lack of support by the CEO weakens the internal audit activity’s position.

### **2. To avoid being the apparent cause of conflict between an organization’s senior management and the board, the chief audit executive should**

- A. Communicate all engagement results to both senior management and the board.
- B. Strengthen the independence of the internal audit activity through organizational position.
- C. Discuss all reports to senior management with the board first.
- D. Request board approval of policies that include internal audit activity relationships with the board.

Answer (D) is correct.

To achieve the degree of independence necessary to effectively carry out the responsibilities of the internal audit activity, the chief audit executive has direct and unrestricted access to senior management and the board. This can be achieved through a dual-reporting relationship (Inter. Std. 1100).

- A. Receipt of all engagement results by senior management and the board is unnecessary and inefficient.
- B. Organizational position helps the internal audit activity to achieve independence but is not, by itself, enough to avoid conflict.
- C. The board essentially has an oversight rather than an operational role.

**3. An organization is in the process of establishing its new internal audit activity. The controller has no previous experience with internal auditors. Due to this lack of experience, the controller advised the applicants that the CAE will be reporting to the external auditors. However, the new chief audit executive will have free access to the controller to report anything important. The controller will then convey the CAE's concerns to the board of directors. The internal audit activity will**

- A. Be independent because the CAE has direct access to the board.
- B. Not be independent because the CAE reports to the external auditors.
- C. Not be independent because the controller has no experience with internal auditors.
- D. Not be independent because the organization did not specify that the applicants must be certified internal auditors.

Answer (B) is correct.

To achieve the degree of independence necessary to effectively carry out the responsibilities of the internal audit activity, the CAE has direct and unrestricted access to senior management and the board (Inter. Std. 1100). Also, the CAE must communicate and interact directly with the board (Attr. Std. 1111).

- A. Under this arrangement, the internal audit activity will not have direct access to the board; the access will be indirect via the controller.
- C. Whether the controller has experience with internal auditors does not affect the internal audit activity's independence.
- D. Although desirable, the CIA designation is not mandatory for a person to become an internal auditor. A CIA should insist on independence for the internal audit activity.

**4. A medium-sized publicly owned organization operating in Country X has grown to a size that the governing authority believes warrants the establishment of an internal audit activity. Country X has legislated internal audit requirements for government-owned organizations. The organization changed the bylaws to reflect the establishment of the internal audit activity. The governing authority decided that the chief audit executive (CAE) must be a certified internal auditor and will report directly to the newly established audit committee. Which of the items discussed above will contribute the most to the new CAE's independence?**

- A. The establishment of the internal audit activity is documented in the bylaws.
- B. Country X has legislated internal auditing requirements.
- C. The CAE will report to the audit committee.
- D. The CAE is to be a certified internal auditor.

Answer (C) is correct.

Independence is effectively achieved when the CAE reports functionally to the board (Inter. Std. 1110). The audit committee is a subset of the board.

- A. Documentation in the bylaws does little to promote independence.
- B. Legislated internal audit requirements in Country X do not promote independence.
- D. Independence requires support from senior management and the board.

**5.To determine the organizational placement of internal audit, the CAE**

- 1. Works with the board
  - 2. Works with senior management
  - 3. Has discretion to independently determine placement
- A. 1 only.
  - B. 2 only.
  - C. 1 and 2 only.
  - D. 3 only.

Answer (C) is correct.

The CAE cannot solely determine the organizational independence and placement of internal audit. The CAE works with the board and senior management to determine the organizational placement of internal audit.

- A. The CAE also must work with senior management.
- B. The CAE also must work with the board.
- D. The CAE does not have discretion to independently determine the organizational placement of the internal audit function.

**6.The CAE should report functionally to the board. The board is responsible for which of the following activities?**

- 1.Internal communication and information flows
  - 2.Approval of the internal audit risk assessment and related audit plan
  - 3.Approval of annual compensation and salary adjustments for the CAE
- A. 1 and 2 only.
  - B. 2 and 3 only.
  - C. 1 and 3 only.

D. 1, 2, and 3.

Answer (B) is correct.

Organizational independence is effectively achieved when the CAE reports functionally to the board. Examples of functional reporting to the board involve the board

Approving the internal audit charter

Approving the risk-based internal audit plan

Receiving communications from the CAE on the internal audit activity's performance

Approving decisions regarding the appointment and removal of the CAE

Making appropriate inquiries of management and the CAE to determine whether there are inappropriate scope or resource limitations (Inter. Attr. Std. 1110)

A. Internal communication and information flows are administrative reporting items. Administrative reporting is the reporting relationship within the management structure. Furthermore, functional reporting also involves the board's approval of annual compensation and salary adjustments for the CAE.

C. Internal communication and information flows are administrative reporting items. Moreover, functional reporting also involves the board's approval of the internal audit risk assessment and related audit plan.

D. Internal communication and information flows are administrative reporting items.

**7. The optimal administrative reporting line of the CAE is to**

- A. The audit committee.
- B. Line management.
- C. Board of directors.
- D. CEO or equivalent.

Answer (D) is correct.

The CAE should report administratively to the CEO or an equivalent so that the CAE (1) is clearly in a senior position and (2) has authority to perform duties unimpeded.

A. Functional reporting is to the board.

B. Administrative reporting preferably is to the CEO

C. The CAE must communicate and interact directly with the board. Functional reporting is to the board.

**8. Independence permits internal auditors to render impartial and unbiased judgments. The best way to achieve independence is through**

- A. Individual knowledge and skills.

- B. A dual-reporting relationship.
- C. Supervision within the organization.
- D. Organizational knowledge and skills.

Answer (B) is correct.

Independence is the freedom from conditions that threaten the ability of the internal audit activity to carry out internal audit responsibilities in an unbiased manner. To achieve the degree of independence necessary to effectively carry out the responsibilities of the internal audit activity, the CAE has direct and unrestricted access to senior management and the board. This can be achieved through a dual-reporting relationship (Inter. Std. 1100).

- A. Individual knowledge and skills allow individual auditors to achieve professional proficiency.
- C. Supervision ensures that engagement objectives are achieved, quality is assured, and staff is developed.
- D. Organizational knowledge and skills allow the internal audit activity collectively to achieve professional proficiency.

**9. Which action is not consistent with functional reporting?**

- A. Organizational independence is effectively achieved when the CAE reports functionally to the board.
- B. The CAE should meet with the board, with management present, to reinforce the independence of the internal audit activity.
- C. The board should have the final authority to approve the internal audit risk assessment.
- D. The board should approve the CAE's performance evaluation.

Answer (B) is correct.

Private meetings between the CAE and the board without management present are an essential part of the functional reporting relationship.

- A. Functional reporting to the board facilitates the independence of the internal audit activity.
- C. The board approves the internal audit risk assessment and the related audit plan.
- D. The board approves all decisions regarding the performance evaluation, appointment, or removal of the CAE.

**10. A formal document (charter) approved by the board that defines the internal audit activity's purpose, authority, and responsibility enhances its**

- A. Exercise of due professional care.
- B. Proficiency.
- C. Relationship with management.
- D. Independence.

Answer (D) is correct.

The charter establishes the internal audit activity's position within the organization, including the nature of the chief audit executive's functional reporting relationship with the board (Inter. Std. 1000). To achieve the degree of independence necessary to effectively carry out the responsibilities of the internal audit activity, the CAE has direct and unrestricted access to senior management and the board (Inter. Std. 1100).

- A. Due professional care is an attribute of work performed.
- B. Proficiency results from possessing the knowledge, skills, and other competencies required for internal auditors to perform their individual responsibilities.
- C. The internal audit activity's relationship with management is a function of professionalism. The charter establishes independence, not a working relationship.

**11. The reporting structure that is most likely to allow the internal audit activity to accomplish its responsibilities is to report administratively to the**

- A. Board and functionally to the chief executive officer.
- B. Controller and functionally to the chief financial officer.
- C. Chief executive officer and functionally to the board of directors.
- D. Chief executive officer and functionally to the external auditor.

Answer (C) is correct.

Reporting functionally to the board and administratively to the organization's CEO facilitates organizational independence.

- A. The reverse arrangement is appropriate. The board is not involved in the routine management of the firm.
- B. Reporting administratively to the controller and functionally to the chief financial officer would result in insufficient organizational status for internal auditing.
- D. The external auditor is not part of the organizational hierarchy.

**12. The board is most likely to participate in approving**

- A. Staff promotions and salary increases.
- B. Engagement communication observations, conclusions, and recommendations.
- C. Engagement work programs.
- D. Appointment of the chief audit executive

Answer (D) is correct.

Organizational independence is effectively achieved when the CAE reports functionally to the board. Examples of functional reporting to the board involve the board

Approving the internal audit charter

Approving the risk-based internal audit plan

Receiving communications from the CAE on the internal audit activity's performance

Approving decisions regarding the appointment and removal of the CAE

Making appropriate inquiries of management and the CAE to determine whether there are inappropriate scope or resource limitations (Inter. Std. 1110)

- A. The organization's CAE is responsible for staff promotions.
- B. The organization's CAE is responsible for approving engagement communication observations, conclusions, and recommendations.
- C. The CAE or designee provides appropriate engagement supervision, which includes providing appropriate instructions during the planning of the engagement and approving the engagement program.

**13. The IIA has indicated that to achieve necessary independence, the CAE should report functionally to whom?**

- A. Senior management.
- B. Shareholders.
- C. Chief executive officer.
- D. The board.

Answer (D) is correct.

Organizational independence is effectively achieved when the CAE reports functionally to the board (Inter. Attr. Std. 1110).

- A. Organizational independence is facilitated when the CAE reports functionally to the board and administratively to the CEO.
- B. The CAE should report to the audit committee (i.e., the board)
- C. The CAE optimally reports to the CEO for administrative purposes.

**14. A charter is being drafted for a newly formed internal audit activity. Which of the following best describes an appropriate organizational position to be incorporated into the charter?**

- A. The chief audit executive reports to the chief executive officer but has access to the board.
- B. The chief audit executive is a member of the board.
- C. The chief audit executive is a staff officer reporting to the chief financial officer.

D. The chief audit executive reports to an administrative vice president.

Answer (A) is correct.

The CAE, reporting functionally to the board and administratively to the organization's CEO, facilitates organizational independence. The CAE must communicate and interact directly with the board (Attr. Std. 1111).

B. Placing the CAE in a governance position impairs his or her objectivity.

C. Serving as a staff officer and reporting to the CFO limit the influence and independence of the internal audit activity.

D. Reporting to an administrative vice president limits the influence and independence of the internal audit activity.

**15. Freedom from conditions that threaten internal auditors' ability to do unbiased work is**

A. Control.

B. Compliance.

C. Independence.

D. Avoidance of conflicts of interest.

Answer (C) is correct.

Independence is "the freedom from conditions that threaten the ability of the internal audit activity to carry out internal audit responsibilities in an unbiased manner" (The IIA Glossary).

A. Control is "any action taken by management, the board, or other parties to manage risk and increase the likelihood that established objectives and goals will be achieved" (The IIA Glossary).

B. Compliance is "adherence to policies, plans, procedures, laws, regulations, contracts, or other requirements" (The IIA Glossary).

D. Conditions other than conflicts of interest may create bias or the appearance of bias.

**16. During the performance of an engagement to evaluate a division's controls over purchasing, the chief purchasing agent asked why the internal auditor had requested documents pertaining to transactions with a particular supplier. The internal auditor's proper response is to**

A. Treat the inquiry as a scope limitation.

B. Explain the reasons for the information request to promote cooperation with the engagement client.

- C. Refuse to explain the information request to preserve the integrity of the engagement process.
- D. Consider the specific circumstances before deciding whether to disclose the reasons for the information request.

Answer (D) is correct.

At times, an internal auditor may be asked by the engagement client or other parties to explain why a document that has been requested is relevant to an engagement. Disclosure or nondisclosure during the engagement of the reasons documents are needed should be determined based on the circumstances. Significant irregularities may dictate a less open environment than would normally contribute to a cooperative engagement. However, that is a judgment that should be made by the chief audit executive in light of the specific circumstances. Moreover, the internal audit activity must be free from interference in determining the scope of internal auditing, performing work, and communicating results (Impl. Std. 1110.A1).

- A. A scope limitation is a restriction placed upon the internal audit activity that precludes it from accomplishing its objectives and plans.
- B. The CAE should consider the specific circumstances before deciding whether to disclose the reasons for the information request.
- C. It is not always necessary or desirable to refuse to explain an information request.

**17. Assessing individual objectivity of internal auditors is the responsibility of**

- A. The chief executive officer.
- B. The board.
- C. The audit committee.
- D. The chief audit executive.

Answer (D) is correct.

The CAE must establish policies and procedures to assess the objectivity of individual internal auditors.

- A. Assessing individual objectivity of internal auditors is the responsibility of the chief audit executive.
- B. Assessing individual objectivity of internal auditors is the responsibility of the chief audit executive.
- C. Assessing individual objectivity of internal auditors is the responsibility of the chief audit executive.

**18. Internal auditors should be objective. Objectivity**

- A. Requires internal auditors not to subordinate their judgment on audit matters to that of others.
- B. Is required only in assurance engagements.
- C. Is freedom from threats to the ability to perform audit work without bias.
- D. Prohibits internal auditors from providing consulting services relating to operations for which they had previous responsibility.

Answer (A) is correct.

Objectivity is “an unbiased mental attitude that allows internal auditors to perform engagements in such a manner that they believe in their work product and that no quality compromises are made. Objectivity requires that internal auditors do not subordinate their judgment on audit matters to others” (Inter. Attr. Std. 1100).

B. Objectivity also is required in a consulting engagement.

C. Independence is freedom from threats to the ability to perform audit work without bias.

D. Internal auditors may provide consulting services relating to operations for which they had previous responsibility.

**19. The CAE bears the responsibility to do which of the following?**

A. Assess the level of independence of the board.

B. Assess the level of knowledge, skills, and competencies of the chief financial officer.

C. Foster collective objectivity.

D. Foster individual objectivity.

Answer (D) is correct.

The CAE must establish policies and procedures to assess the objectivity of individual internal auditors.

A. Independence is a quality of the internal audit activity, not the board.

B. The concept of knowledge, skills, and competencies applies to individual internal auditors.

C. Objectivity is an individual, not a collective, quality.

**20. Which of the following actions is required of the CAE in regard to the objectivity of internal auditors?**

A. Maximize.

B. Prioritize.

C. Manage.

D. Assess.

Answer (D) is correct.

The CAE must establish policies and procedures to assess the objectivity of individual internal auditors.

- A. The CAE's responsibility with regard to the objectivity of internal auditors is to assess and maintain.
- B. The CAE's responsibility with regard to the objectivity of internal auditors is to assess and maintain.
- C. The CAE's responsibility with regard to the objectivity of internal auditors is to assess and maintain.

**21. The CAE bears the responsibility to do which of the following?**

- A. Encourage the objectivity of the board.
- B. Encourage the objectivity of the CEO.
- C. Foster an attitude of professional skepticism among members of the board.
- D. Maintain individual objectivity.

Answer (D) is correct.

The CAE must establish policies and procedures to assess the objectivity of individual internal auditors.

- A. Objectivity is a quality of individual internal auditors, not the board.
- B. Objectivity is a quality of individual internal auditors, not the CEO.
- C. The CAE must establish policies and procedures to assess the objectivity of individual internal auditors.

**22. Maintaining individual objectivity of internal auditors is the responsibility of**

- A. The chairperson of the board of directors.
- B. The chairperson of the audit committee.
- C. The external assessment team.
- D. The chief audit executive.

Answer (D) is correct.

The responsibility rests with the CAE and with internal auditors themselves to maintain a sense of objectivity.

- A. The responsibility rests with the CAE and with internal auditors themselves to maintain a sense of objectivity.

B. The responsibility rests with the CAE and with internal auditors themselves to maintain a sense of objectivity. The factor most important to the maintenance of individual objectivity.

C. The responsibility rests with the CAE and with internal auditors themselves to maintain a sense of objectivity.

**23. Which of the following statements about conflict of interest is false?**

A. A conflict of interest could impair an individual's ability to perform his or her duties and responsibilities objectively.

B. A conflict of interest is a situation in which an internal auditor has a competing professional or personal interest.

C. A conflict of interest only exists when the internal auditor displays unethical behavior or engages in improper acts.

D. A conflict of interest can create an appearance of impropriety that can undermine confidence in the internal auditor.

Answer (C) is correct.

A conflict of interest exists even if no unethical or improper act results. The IIA Glossary defines conflict of interest as "any relationship that is, or appears to be, not in the best interest of the organization." Interpretation of Standard 1120, Conflict of Interest, states, "Conflict of interest is a situation in which an internal auditor, who is in a position of trust, has a competing professional or personal interest. Such competing interests can make it difficult to fulfill his or her duties impartially. A conflict of interest exists even if no unethical or improper act results. A conflict of interest can create an appearance of impropriety that can undermine confidence in the internal auditor, the internal audit activity, and the profession. A conflict of interest could impair an individual's ability to perform his or her duties and responsibilities objectively."

A. Included in the Interpretation of Standard 1120, "A conflict of interest could impair an individual's ability to perform his or her duties and responsibilities objectively." Avoiding conflicts of interest would facilitate an internal auditor's impartial and unbiased mindset.

B. As stated in the Interpretation of Standard 1120, "Conflict of interest is a situation in which an internal auditor, who is in a position of trust, has a competing professional or personal interest. Such competing interests can make it difficult to fulfill his or her duties impartially." Internal auditors should be aware of the possibility of new conflicts of interest that may result from changes in personal circumstances or the particular auditees to which an auditor may be assigned.

D. As stated in the Interpretation of Standard 1120, "A conflict of interest can create an appearance of impropriety that can undermine confidence in the internal auditor, the internal audit activity, and the profession." A situation that could undermine confidence in the internal auditor would include auditing a family member or close friend.

**24. When faced with an imposed scope limitation, the chief audit executive needs to**

A. Refuse to perform the engagement until the scope limitation is removed.

B. Communicate the potential effects of the scope limitation to the board.

C. Increase the frequency of engagements concerning the activity in question.

D. Assign more experienced personnel to the engagement.

Answer (B) is correct.

A scope limitation, along with its potential effect, needs to be communicated to the board.

- A. The engagement may be conducted under a scope limitation.
- C. A scope limitation does not necessarily require more frequent engagements.
- D. A scope limitation does not necessarily require more experienced personnel.

**25. The internal auditors must be able to distinguish carefully between a scope limitation and other limitations. Which of the following is not considered a scope limitation?**

- A. The divisional management of an engagement client has indicated that the division is in the process of converting a major computer system and has indicated that the information systems portion of the planned engagement will have to be postponed until next year.
- B. The board reviews the engagement work schedule for the year and deletes an engagement that the chief audit executive thought was important to conduct.
- C. The engagement client has indicated that certain customers cannot be contacted because the organization is in the process of negotiating a long-term contract with the customers and they do not want to upset the customers.
- D. None of the answers are correct.

Answer (B) is correct.

The board's decision to delete an engagement from the annual engagement work schedule is not a scope limitation. The board's approval of the internal audit plan is part of the functional reporting relationship of the internal audit activity to the board.

- A. Postponing the portion of an engagement concerning a major computer system is a scope limitation. This delay restricts the performance of engagement procedures.
- C. Prohibiting contact with certain customers is a scope limitation. This prohibition restricts the performance of specific procedures.
- D. Other answer choices state scope limitations.

**26. Which of the following combinations best illustrates a scope limitation and the appropriate response by the CAE?**

Internal Audit Action

Nature of Limitation

- |  |                        |
|--|------------------------|
| A. Engagement client limits scope based upon proprietary information.<br>controller  | Report only to the     |
| B. Engagement client will not provide access to records needed for<br>approved work schedule.  | Report to the board    |
| C. Engagement client requests that the engagement be delayed for 2 weeks<br>CEO and controller<br><br>to allow it to close its books.  | Report directly to the |
| D. Engagement client will not allow internal auditor to contact<br>because the operational engagement concerns operational efficiency<br><br>major customers as part of an engagement to evaluate<br><br>the efficiency of operations. | No reporting needed    |

Answer (B) is correct.

A scope limitation is a restriction placed on the internal audit activity that precludes it from accomplishing its objectives and plans. Among other things, a scope limitation may restrict the internal audit activity's access to records, personnel, and physical properties relevant to the performance of engagements. A scope limitation and its potential effect need to be communicated to the board.

- A. A scope limitation needs to be reported to the board.
- C. Merely delaying the engagement to permit closing the books is not usually considered a scope limitation.
- D. Reporting is necessary.

**27. An internal auditor who had been supervisor of the accounts payable section should not perform an assurance review of that section**

- A. Because a reasonable period of time in which to establish independence cannot be determined.
- B. Until at least 1 year has elapsed.
- C. Until after the next annual review by the external auditors.
- D. Until it is clear that the new supervisor has assumed the responsibilities.

Answer (B) is correct.

Persons transferred to, or temporarily engaged by, the internal audit activity should not be assigned to audit activities they previously performed until at least 1 year has elapsed. Such assignments are presumed to impair objectivity.

- A. The issues are whether (1) objectivity (not independence) has been restored and (2) at least 1 year has elapsed.
- C. The external review does not bear any relation to restoring the internal auditor's objectivity.
- D. The new supervisor presumably would have assumed his or her responsibilities immediately. Thus, 1 year could not have elapsed.

**28. A treasury department employee transferred to the internal audit activity of the same organization last month. The chief financial officer of the organization has suggested that, because of the employee's significant knowledge in this area, it would be a good idea for the employee to immediately begin an engagement to evaluate the treasury department. In this circumstance, the employee should**

- A. Accept the engagement and begin work immediately.
- B. Discuss the need for such an engagement with the employee's former superior, the CFO.
- C. Suggest that the engagement be performed by another member of the internal audit staff.
- D. Offer to prepare an engagement work program but suggest that interviews with the employee's former co-workers be conducted by other members of the internal audit staff.

Answer (C) is correct.

Another internal auditor should be assigned. Persons transferred to or temporarily engaged by the internal audit activity should not be assigned to audit those activities they previously performed until at least 1 year has elapsed. Such assignments are presumed to impair objectivity, and additional consideration should be exercised when supervising the engagement work and communicating engagement results.

- A. The proposed engagement is presumed to impair objectivity.
- B. Internal auditors are not to subordinate their judgment on engagement matters to that of others.
- D. The preparation of the engagement work program offers significant opportunities for bias.

**29. The internal audit activity encounters a scope limitation from senior management that will affect the activity's ability to meet its goals and objectives for a potential engagement client. The nature of the scope limitation needs to be**

- A. Noted in the engagement working papers, but the engagement should be carried out as scheduled and the scope limitation worked around, if possible.
- B. Communicated to the external auditors, so they can investigate the area in more detail.
- C. Communicated, preferably in writing, to the board.
- D. Communicated to management stating that the limitation will not be accepted because it would impair the internal audit activity's independence.

Answer (C) is correct.

A scope limitation, along with its potential effect, needs to be communicated to the board.

- A. The limitation needs to be communicated first to the board.
- B. No requirement or need to communicate the limitation to the external auditor exists.
- D. The internal audit activity exists to help the organization achieve its objectives. Thus, the internal auditors must communicate with the board about conflicts with management.

**30. An internal auditor assigned to audit a vendor's compliance with product quality standards is the brother of the vendor's controller. The auditor should**

- A. Accept the assignment but avoid contact with the controller during fieldwork.
- B. Accept the assignment but disclose the relationship in the engagement final communication.
- C. Notify the vendor of the potential conflict of interest.
- D. Notify the chief audit executive of the potential conflict of interest.

Answer (D) is correct.

Internal auditors are to report to the chief audit executive (CAE) any situations in which an actual or potential impairment to independence or objectivity may reasonably be inferred, or if they have questions about whether a situation constitutes an impairment to objectivity or independence.

- A. Given a family connection with the auditee, even if the auditor avoids contact with the controller, the appearance of a conflict of interest exists.
- B. Situations of potential conflict of interest or bias should be avoided, not merely disclosed.
- C. Conflicts of interest are to be reported to the chief audit executive, not the vendor or engagement client.

**31. An internal auditor has recently received an offer from the manager of the marketing department of a weekend's free use of his beachfront condominium. No engagement is currently being conducted in the marketing department, and none is scheduled. The internal auditor**

- A. Should reject the offer and report it to the appropriate supervisor.
- B. May accept the offer because its value is immaterial.
- C. May accept the offer because no engagement is being conducted or planned.
- D. May accept the offer if approved by the appropriate supervisor.

Answer (A) is correct.

An internal auditor is not to accept fees, gifts, or entertainment from an employee, client, customer, supplier, or business associate. Accepting a fee or gift may imply that the auditor's objectivity has been impaired. Even though an engagement is not being conducted in the applicable area at that time, a future engagement may result in the appearance of impairment of objectivity. Thus, no consideration should be given to the engagement status as justification for receiving fees or gifts. The receipt of promotional items (such as pens, calendars, or samples) that are available to the general public and have minimal value do not hinder internal auditors' professional judgments. Impairment of

independence or objectivity, in fact or appearance, must be disclosed to appropriate parties (Attr. Std. 1130).

- B. The value of a weekend vacation is not immaterial.
- C. The status of engagements is not a justification for receiving fees or gifts.
- D. A supervisor may not approve unethical behavior.

**32. The internal audit activity should be free to audit and report on any activity that also reports to its administrative head if it considers such coverage to be appropriate for its audit plan. Any limitation in scope or reporting of results of these activities should be brought to the attention of the**

- A. Chief executive officer.
- B. Chief financial officer.
- C. External auditor.
- D. Board and senior management.

Answer (D) is correct.

Impairments of the internal audit activity's independence and objectivity should be communicated to the board and senior management.

- A. Although the CEO is a part of senior management and is the senior person in the administrative reporting line, impairments of independence and objectivity also should be communicated to the board.
- B. The CFO is also responsible for the organization's accounting functions. Thus, when a scope or reporting limitation exists, the CFO may be responsible for it.
- C. The external auditor should not be notified unless the board believes it is necessary.

**33. As part of a company-sponsored award program, an internal auditor was offered an award of significant monetary value by a division in recognition of the cost savings that resulted from the auditor's recommendations. According to the International Professional Practices Framework, what is the most appropriate action for the auditor to take?**

- A. Accept the gift because the engagement is already concluded and the report issued.
- B. Accept the award under the condition that any proceeds go to charity.
- C. Inform audit management and ask for direction on whether to accept the gift.
- D. Decline the gift and advise the division manager's superior.

Answer (C) is correct.

Internal auditors are not to accept fees, gifts, or entertainment from an employee, client, customer, supplier, or business associate that may create the appearance that the auditor's objectivity has been impaired. The status of engagements is not to be considered as justification for receiving fees, gifts, or entertainment. Internal auditors are to report immediately the offer of all material fees or gifts to their supervisors.

- A. The auditor should not accept the gift, despite the previous completion of the engagement and issuance of the report.
- B. The auditor should not accept the award without first informing and consulting audit management
- D. Declining the gift and advising the division manager’s superior could erode the audit function’s relationship with the division in question. The auditor should inform and consult audit management for guidance.

**34. George is the new internal auditor for XYZ Corporation. George was in charge of payroll for XYZ just 10 months ago. Performing what services in regard to payroll is considered an impairment of independence or objectivity if performed by George?**

- A. Consulting services.
- B. Assurance services.
- C. Assurance or consulting services.
- D. Neither assurance nor consulting services.

Answer (B) is correct.

Objectivity is presumed to be impaired if an internal auditor provides assurance services for an activity for which the internal auditor had responsibility within the previous year. Thus, if George provides assurance services for payroll, his objectivity is presumed to be impaired. However, internal auditors may provide consulting services relating to operations for which they had previous responsibilities (Impl. Std. 1130.C1).

- A. Internal auditors may provide consulting services relating to operations for which they had previous responsibilities (Impl. Std. 1130.C1).
- C. Providing assurance services regarding payroll will impair the independence or objectivity of George.
- D. Providing consulting services regarding payroll will not impair the objectivity of George.

**35. In the course of field work, an internal auditor discovered an empty petty cash imprest fund. The custodian explained that she had borrowed the money for a family emergency. The auditor verified that the custodian replaced the money the next day and did not mention the misuse of petty cash in any engagement communication. Was the auditor’s independence or objectivity affected by the failure to communicate this finding?**

	Independence	Objectivity
A.	Yes	No
B.	Yes	Yes



- B. Ascertain if the feasibility study addresses cost-benefit relationships.
- C. Determine the requirements for preparing a manual of specifications.
- D. Participate in the drafting of recommendations for the computer acquisition and implementation.

Answer (B) is correct.

Assessing the adequacy of a feasibility study is properly within the scope of work of internal audit. The other three choices involve internal audit participation in decisions that are properly those of management.

- A. Serving on the task force for the preliminary survey is appropriate for users and functional management.
- C. Determining the requirements for preparing a manual of specifications is appropriate for users and functional management.
- D. Computer experts should participate in the drafting of recommendations for the computer acquisition and implementation.

**38. In which of the following scenarios does the auditor most likely have organizational independence but lack objectivity?**

- A. Reports to the audit client but does not report fully about the reason for corrective action taken.
- B. Reports to the board and reports fully about corrective action taken.
- C. Reports to the audit client and reports fully about corrective action taken.
- D. Reports to the board but does not report fully about the reason for corrective action taken.

Answer (D) is correct.

Organizational independence is effectively achieved when the CAE reports functionally to the board (Inter. Attr. Std. 1110). Failing to report fully about the reason for corrective action may imply bias (a loss of objectivity) with regard to the audit client.

- A. Reporting to the audit client does not allow the internal audit activity to fulfill its responsibilities.
- B. When the auditor reports to the board and reports fully about the corrective action taken, no apparent independence or objectivity issue arises.
- C. Reporting to the client indicates a lack of independence.

**39. An internal auditor most likely will have a conflict of interest by providing an assurance service with regard to a**

- A. Financial activity in which the internal auditor had been a key employee 5 years previously.
- B. Purchasing activity if a major supplier is owned by the internal auditor's sister-in-law.

- C. Data processing center for which the internal auditor had performed the service three times previously.
- D. Computer system for which the internal auditor had been the internal audit activity's representative on the design team.

Answer (B) is correct.

The CAE makes staff assignments so that potential and actual conflicts of interest and bias are avoided. A close relative's involvement with a supplier of an engagement client is an apparent conflict of interest.

- A. Objectivity is presumed to be impaired if an internal auditor provides assurance services for an activity for which the internal auditor had responsibility within the previous year. Thus, 5 years is a reasonable lapse of time to safeguard the employee from a charge of conflict of interest.
- C. Although rotation of assignments is preferable, no conflict of interest is involved in performing an assurance service for the same activity repeatedly.
- D. Objectivity is not impaired if the internal auditor's responsibility was limited to recommending standards of control for systems or reviewing procedures before implementation.

**40. Which of the following statements is an appropriate reason for the internal audit activity not to participate in the systems development process?**

- A. Recommendations prior to implementation will affect independence, and the internal auditors will not be able to perform an objective evaluation after the system is implemented.
- B. Participation will delay implementation of the project.
- C. Participation will cause the internal auditors to be labeled as partial owners of the application, and they will then have to share the blame for any problems
- D. None of the answers are correct.

Answer (D) is correct.

Objectivity is not impaired when the internal auditors recommend standards of control for systems or review procedures before they are implemented. Designing, installing, or drafting procedures for information systems is presumed to impair objectivity because of the conflict of professional interests.

- A. Internal audit activity independence is not affected by recommending control standards or reviewing procedures before implementation.
- B. The internal audit activity may participate, even if such participation delays implementation, provided the participation does not impair objectivity.
- C. The internal auditors may participate in systems development but must not draft procedures or design, install, or operate the system.

**41. The major reason for the internal auditor's involvement in information systems development is for the internal auditor to**

- A. Gain familiarity with systems for use in subsequent reviews.
- B. Help assure that systems have adequate control procedures.
- C. Help minimize the cost and development time for new systems.
- D. Propose enhancements for subsequent development and implementation.  
that remain in the system.

Answer (B) is correct.

The internal audit activity evaluates and improves risk management, control, and governance processes. The internal auditor's objectivity is not impaired when the auditor recommends standards of control for systems or reviews procedures before they are implemented. The auditor's objectivity is considered to be impaired if the auditor designs, installs, or drafts procedures for such systems. Such services may create a conflict of interest, a situation in which internal auditors have a competing professional or personal interest. This may create an appearance of impropriety that undermines confidence in the internal audit activity (Inter. Attr. Std. 1120).

- A. Gaining familiarity with systems for use in subsequent reviews is not the major reason for the internal auditor's involvement in information systems development.
- C. Minimizing the cost and development time for new systems is not the major reason for the internal auditor's involvement in information systems development
- D. Proposing enhancements for subsequent development and implementation is a managerial, not an internal auditing, function.

**42. Which of the following activities is not presumed to impair the objectivity of an internal auditor?**

- 1. Recommending standards of control for a new information system application
  - 2. Drafting procedures for running a new computer application to ensure that proper controls are installed
  - 3. Performing reviews of procedures for a new computer application before it is installed
- A. 1 only.
  - B. 2 only.
  - C. 3 only.
  - D. 1 and 3.

Answer (D) is correct.

The internal auditor's objectivity is not impaired when the auditor recommends standards of control for systems or reviews procedures before they are implemented. Designing, installing, or drafting

procedures for information systems is presumed to impair objectivity because of the conflict of professional interests.

- A. Performing reviews of procedures is presumed not to impair objectivity.
- B. Drafting procedures is presumed to impair objectivity.
- C. Recommending standards of control is presumed not to impair objectivity.

**43. A chief audit executive (CAE) for a very small internal audit department has just received a request from management to perform an audit of an extremely complex area in which the CAE and the department have no expertise. The nature of the audit engagement is within the scope of internal audit activities. Management has expressed a desire to have the engagement conducted in the very near future because of the high level of risk involved. Which of the following responses by the CAE would be in violation of the Standards?**

- A. Discuss with management the possibility of outsourcing the audit of this complex area.
- B. Add an outside consultant to the audit staff to assist in the performance of the audit engagement.
- C. Accept the audit engagement and begin immediately, since it is a high-risk area.
- D. Discuss the timeline of the audit engagement with management to determine if sufficient time exists in which to develop appropriate expertise.

Answer (C) is correct.

The internal audit activity collectively must possess or obtain the knowledge, skills, and other competencies needed to perform its responsibilities (Attr. Std. 1210). The auditors in this situation do not have such expertise. Thus, planning and executing the audit engagement without the appropriate background and skills is a violation of this standard.

- A. Outsourcing (delegating the engagement to an outside service provider) is an appropriate response when auditors do not possess the needed background or skills and cannot develop such skills in a timely fashion.
- B. Adding a consultant (cosourcing) is an appropriate response when auditors do not possess the needed background or skills and cannot develop such skills in a timely fashion.
- D. Determining whether time is sufficient to develop necessary expertise is an appropriate response. Internal auditors should be committed to life-long learning. Thus, it is not unreasonable to require them to expand their knowledge, skills, and other competencies.

**44. When hiring entry-level internal auditing staff, which of the following will most likely predict the applicant's success as an internal auditor?**

- A. Grade point average on college accounting courses.
- B. Ability to fit well socially into a group.
- C. Ability to organize and express thoughts well.
- D. Level of detailed knowledge of the organization.

Answer (C) is correct.

The internal audit activity can obtain and maintain the proficiency required by the Standards if it effectively applies The IIA's Global Internal Audit Competency Framework. One of the core competencies of the framework is communication. Accordingly, the success of an internal auditor will depend, in part, on the auditor's ability to organize and express thoughts well.

A. Although accounting educational performance is undoubtedly one criterion that must be examined, performance in one subject area is much too limited a basis for predicting an applicant's success given the broad scope of internal auditing work.

B. Social skills are a benefit to any internal auditor but cannot be considered the most important characteristic of a good candidate.

D. Entry-level internal auditors typically have relatively little knowledge of the organization. Applicants should demonstrate a general knowledge of the organization, but this factor is not the most reliable predictor of successful performance as an internal auditor.

**45. Your organization has selected you to develop an internal audit activity. Your approach will most likely be to hire**

A. Internal auditors, each of whom possesses all the skills required to handle all engagements.

B. Inexperienced personnel and train them the way the organization wants them trained.

C. Degreed accountants because most internal audit work is accounting related.

D. Internal auditors who collectively have the knowledge and skills needed to perform the responsibilities of the internal audit activity.

Answer (D) is correct.

The internal audit activity collectively must possess or obtain the knowledge, skills, and other competencies needed to perform its responsibilities (Attr. Std. 1210).

A. The scope of internal auditing is so broad that one individual cannot have the requisite expertise in all areas.

B. The internal audit activity should have personnel with various skill levels to permit appropriate matching of internal auditors with varying engagement complexities. Furthermore, experienced internal auditors should be available to train and supervise less experienced staff members.

C. Many skills are needed in internal auditing. For example, computer skills are needed in engagements involving information technology.

**46. The internal audit activity collectively must possess or obtain certain competencies. Internal audit staff should be competent in**

A. The use of the International Professional Practices Framework.

B. Finance.

C. General management principles.

D. Marketing.

Answer (A) is correct.

The internal audit activity collectively must possess or obtain the knowledge, skills, and other competencies needed to perform its responsibilities (Attr. Std. 1210). The emphasis of internal auditors' technical expertise is on (1) the IPPF; (2) governance, risk, and control; and (3) business acumen. For example, the internal audit staff and managers should demonstrate the appropriate use and interpretation of the IPPF (Competency Framework).

B. The Competency Framework does not specifically address the use of finance.

C. Internal audit staff should have certain competencies regarding internal audit management (e.g., maintaining up-to-date competencies), not general management principles.

D. Internal auditors ordinarily need not be competent in marketing.

**47. The internal audit activity collectively must possess or obtain certain competencies. Internal audit staff should be competent in**

A. The exercise of business acumen.

B. Applying tax laws to returns.

C. Determining whether personnel decisions reflect general management principles.

D. Evaluating marketing campaigns.

Answer (A) is correct.

The internal audit activity collectively must possess or obtain the knowledge, skills, and other competencies needed to perform its responsibilities (Attr. Std. 1210). The emphasis of internal auditors' technical expertise is on (1) the IPPF; (2) governance, risk, and control; and (3) business acumen. Internal auditors are competent regarding business acumen when they maintain expertise related to (1) the business environment, (2) industry practices, and (3) specific organizational factors.

B. The Competency Framework does not specifically address the exercise of applying tax laws to returns.

C. Internal audit staff should have certain competencies regarding internal audit management (e.g., maintaining up-to-date competencies), not general management principles.

D. Internal auditors ordinarily need not be competent in marketing.

**48. What is the most appropriate preventive measure for staff communication problems with engagement clients?**

A. Provide staff with sufficient training to enhance communication skills.

B. Avoid unnecessary communication with engagement clients.

- C. Discuss communication problems with staff auditors.
- D. Meet with engagement clients to resolve communication problems.

Answer (A) is correct.

The internal audit activity can obtain and maintain the proficiency required by the Standards if it effectively applies The IIA's Global Internal Audit Competency Framework. One of the core competencies of the framework is communication. Accordingly, the internal audit staff should be provided with sufficient training to enhance communication skills.

- B. The issue is the quality rather than the quantity of communication.
- C. Communication problems should be resolved through effective training.
- D. Meeting with engagement clients will not resolve problems caused by poor staff communication skills.

**49. The chief audit executive (CAE) is setting up a team to perform an assurance engagement on the organization's information system security structure. The organization has offices all over the world that rely on the system. The audit team will assess risks, monitor implementation of corrective action, and evaluate controls. Which question does not require an answer when selecting the team to conduct this audit engagement?**

- A. What types of skills are needed on the engagement?
- B. How many hours are needed to complete the engagement?
- C. Which auditors have the skills and experience to work on this audit?
- D. Are specialty skills from outside the internal audit department required?

Answer (B) is correct.

Standards 1200 and 1210 cover proficiency. The CAE should ensure that internal auditors collectively possess the knowledge, skills, and other competencies required to conduct the engagement. If the internal audit activity does not have persons sufficiently proficient in the disciplines required for the engagement, the CAE must obtain competent advice and assistance. Determining the hours needed to complete the engagement is not necessary during the selection of the audit team. This question should be answered during the budgeting phase of planning for the engagement.

- A. Determining the types of skills needed on the engagement is necessary before selecting the audit team.
- C. Determining whether auditors have the relevant skills and experience occurs before selecting the audit team.
- D. Deciding whether specialty skills from outside the internal audit activity are required occurs before the CAE selects the audit team.

**50. Which one of the following is responsible for determining the appropriate levels of education and experience needed for the internal audit staff?**

- A. Human resource manager.
- B. Chief audit executive.
- C. Chief executive officer.
- D. Chief financial officer.

Answer (B) is correct.

The CAE must ensure that the internal audit activity is able to fulfill its responsibilities. The CAE must determine the appropriate levels of education and experience needed for the internal audit staff to fulfill that responsibility.

- A. Hiring practices are an essential part of understanding the internal audit staff's background, but the human resource manager is not responsible for determining the appropriate levels of education and experience needed for the internal audit staff.
- C. The chief executive officer is not directly responsible for determining the appropriate levels of education and experience needed for the internal audit staff.
- D. The chief financial officer is not responsible for determining the appropriate levels of education and experience needed for the internal audit staff.

**51. At a minimum, how often should the skills of the internal audit staff be assessed?**

- A. Annually.
- B. Every 5 years.
- C. Quarterly.
- D. Semi-annually.

Answer (A) is correct.

The CAE should conduct periodic skills assessments to determine the specific resources available. Assessments should be performed at least annually.

- B. Periodic skills assessments should be performed more frequently than every 5 years.
- C. Periodic skills assessments do not need to be performed quarterly.
- D. Periodic skills assessments do not need to be performed semiannually.

**52. All of the following will help the CAE identify the available knowledge, skills, and competencies of the internal audit staff except**

- A. Hiring practices.
- B. Periodic skills assessment.
- C. External service provider.

D. Staff performance appraisals.

Answer (C) is correct.

External service providers are used when the internal audit staff does not have the necessary knowledge, skills, and competencies to fulfill the responsibilities of the internal audit activity.

- A. Hiring practices are an essential part of understanding the background of the internal audit staff.
- B. The CAE should conduct periodic skills assessments to determine the specific resources available.
- D. Staff performance appraisals are completed at the end of any major internal audit engagement. These appraisals help the CAE assess future training needs and current staff abilities.

**53. Use of external service providers with expertise in healthcare benefits is appropriate when the internal audit activity is**

- A. Evaluating the organization's estimate of its liability for postretirement benefits, which include healthcare benefits.
- B. Comparing the cost of the organization's healthcare program with other programs offered in the industry.
- C. Training its staff to conduct an audit of healthcare costs in a major division of the organization.
- D. All of the answers are correct.

Answer (D) is correct.

If the internal auditors lack the necessary expertise, external service providers should be employed who can provide the requisite knowledge, skills, and other competencies. Thus, external service providers may provide assistance in (1) estimating the liability for postretirement benefits, (2) developing a comparative analysis of healthcare costs, and (3) training the staff to audit healthcare costs.

- A. Use of external service providers with expertise in healthcare benefits is also appropriate when comparing healthcare costs with those of other programs and training staff to conduct healthcare audits.
- B. Use of external service providers with expertise in healthcare benefits is also appropriate when evaluating the estimated liability for postretirement benefits and training staff to conduct healthcare audits.
- C. Use of external service providers with expertise in healthcare benefits is also appropriate when comparing healthcare costs with those of other programs and evaluating the estimated liability for postretirement benefits.

**54. A chief audit executive has reviewed credentials, checked references, and interviewed a candidate for a staff position. The CAE concludes that the candidate has a thorough**

**understanding of internal audit techniques, accounting, and finance. However, the candidate has limited knowledge of economics and information technology. Which action is most appropriate?**

- A. Reject the candidate because of the lack of knowledge required by the Standards.
- B. Offer the candidate a position despite lack of knowledge in certain essential areas.
- C. Encourage the candidate to obtain additional training in economics and information technology and then reapply.
- D. Offer the candidate a position if other staff members possess sufficient knowledge in economics and information technology.

Answer (D) is correct.

Each member of the internal audit activity need not be qualified in all disciplines.

- A. The Standards do not require each internal auditor to possess a knowledge of all relevant subjects.
- B. The internal audit activity's needs may be for additional expertise in economics or information technology.
- C. Encouraging the candidate to obtain additional training does not adequately address the internal audit activity's current needs.

**55. An internal audit activity has scheduled an engagement relating to a construction contract. One portion of this engagement will include comparing materials purchased with those specified in the engineering drawings. The internal audit activity does not have anyone on staff with sufficient expertise to complete this procedure. The chief audit executive should**

- A. Delete the engagement from the schedule.
- B. Perform the entire engagement using current staff.
- C. Engage an engineering consultant to perform the comparison.
- D. Accept the contractor's written representations.

Answer (C) is correct.

If the internal auditors lack the necessary expertise, external service providers should be employed who can provide the requisite knowledge, skills, and other competencies.

- A. The engagement is within the scope of the internal audit activity.
- B. Performing the engagement using the current (unqualified) staff is inappropriate.
- D. Accepting the contractor's representations without adequate testing is inappropriate.

**56.If the internal audit activity of a nonpublic company does not have the skills to perform a particular task, an external service provider (ESP) could be brought in from**

- 1. The organization's external audit firm**
- 2. An external consulting firm**
- 3. The engagement client**
- 4. A college or university**

- A. 1 and 2 only.
- B. 2 and 4 only.
- C. 1, 2, and 3 only.
- D. 1, 2, and 4 only.

Answer (D) is correct.

Qualified ESPs may be recruited from many sources. However, an ESP associated with the engagement client is unacceptable because the person would not be independent or objective. Nonpublic companies are encouraged to follow the Sarbanes-Oxley Act's prohibition on outsourcing internal audit tasks to the firm's external auditor. However, there are circumstances in which nonpublic companies can use the external auditor for internal audit work.

- A. An ESP from a college or university is also acceptable.
- B. An ESP from a nonpublic organization's external audit firm is also acceptable.
- C. An ESP from the engagement client is not independent.

**57. A chief audit executive (CAE) has been requested by the audit committee to conduct an engagement at a chemical factory as soon as possible. The engagement will include reviews of health, safety, and environmental (HSE) management and processes. The CAE knows that the internal audit activity does not possess the HSE knowledge necessary to conduct such an engagement. The CAE must**

- A. Begin the engagement and incorporate HSE training into next year's planning to prepare for a follow-up engagement.
- B. Suggest to the audit committee that the factory's own HSE staff conduct the engagement.
- C. Seek permission from the audit committee to obtain appropriate support from an HSE professional.
- D. Defer the engagement and tell the audit committee that it will take several months to train internal audit staff for such an engagement.

Answer (C) is correct.

The chief audit executive must obtain competent advice and assistance if the internal auditors lack the knowledge, skills, or other competencies needed to perform all or part of the engagement (Impl. Std. 1210.A1).

- A. The CAE should not begin the audit without notifying the audit committee of the knowledge issue and attempting to resolve it.
- B. A review by the factory's HSE staff will not provide the audit committee with an independent review.
- D. Delaying the engagement may have serious consequences given the nature of the HSE issues involved.

**58. The internal audit activity is considering hiring a person who has a thorough understanding of internal auditing techniques, accounting, and principles of management but has nonspecialized knowledge of economics and information technology. Hiring the person is most appropriate if**

- A. A professional development program is agreed to in advance of actual hiring.
- B. A mentor is assigned to ensure completion of an individually designed professional development program.
- C. Other internal auditors possess sufficient knowledge of economics and information technology.
- D. The prospective employee could reasonably be expected to gain sufficient knowledge of these competencies in the long run.

Answer (C) is correct.

Internal auditors must possess the knowledge, skills, and other competencies needed to perform their individual responsibilities. The internal audit activity collectively must possess or obtain the knowledge, skills, and other competencies needed to perform its responsibilities (Attr. Std. 1210). However, each member of the internal audit activity need not be qualified in all disciplines.

- A. Regardless of their backgrounds, all internal auditors must enhance their knowledge, skills, and other competencies through continuing professional development.
- B. The use of a mentor is encouraged regardless of the new internal auditor's background.
- D. Unless other internal auditors possess sufficient knowledge of these competencies, hiring this person would accentuate staffing deficiencies.

**59. In some organizations, internal audit functions are outsourced. Management in a large organization should recognize that the external auditor may have an advantage, compared with the internal auditor, because of the external auditor's**

- A. Familiarity with the organization. Its annual audits provide an in-depth knowledge of the organization.
- B. Size. It can hire experienced, knowledgeable, and certified staff.
- C. Size. It is able to offer continuous availability of staff unaffected by other priorities.
- D. Structure. It may more easily accommodate engagement requirements in distant locations.

Answer (D) is correct.

Large organizations that are geographically dispersed may find outsourcing internal audit functions to external auditors to be effective. A major public accounting firm ordinarily has operations that are national or worldwide in scope.

- A. The internal auditors are likely to be more familiar with the organization than the external auditors, given the continuous nature of their responsibilities.
- B. The internal auditor also can hire experienced, knowledgeable, and certified staff.
- C. The internal auditor is more likely to be continuously available. The external auditor has responsibilities to many other clients.

**60. The CAE must ensure that the internal audit activity is able to fulfill its responsibilities. All of the following are appropriate in achieving this objective except**

- A. Identifying the available knowledge, skills, and competencies of the current internal auditing staff.
- B. Conducting periodic skills assessments to make sure each member of the internal audit activity is qualified in all disciplines.
- C. Engaging external service providers on an ongoing basis to complete parts of the engagement.
- D. Identifying an internal auditor's education, previous experience, and specialized areas of knowledge during the hiring process.

Answer (B) is correct.

The CAE should conduct periodic skills assessments to determine the specific resources available. Standard 1210 states, "The internal audit activity collectively must possess or obtain the knowledge, skills, and other competencies needed to perform its responsibilities." The internal audit as a whole, not each auditor individually, must be proficient in all necessary competencies.

- A. Identifying the available knowledge, skills, and competencies within the internal audit activity will help the CAE determine whether the current staff is sufficient to satisfy those responsibilities.
- C. Engaging external service providers can provide the necessary knowledge, skills, and competencies when the internal audit activity lacks the necessary expertise internally.
- D. Hiring practices are an essential part of understanding the background of the internal audit staff. During this process, the CAE identifies the internal auditor's education, previous experience, and specialized areas of knowledge.

**61. Which of the following statements best describes the main purpose of conducting staff performance appraisals at the end of any major internal audit engagement?**

- A. Follow guidance for obtaining external service providers.
- B. Use databases to store internal audit background information.
- C. Assess future training needs and current staff abilities.

D. Conduct periodic skills assessments.

Answer (C) is correct.

Performance appraisals are processes designed to evaluate job performance. When performance appraisals are completed at the end of any major internal audit engagement, the appraisals help the CAE assess future training needs and current staff abilities.

A. Regardless of the degree of outsourcing, services still must be performed in accordance with the Standards. The main purpose of conducting staff performance appraisals is not to follow guidance for obtaining external service providers.

B. Databases can be used to store information and can include lists of relevant skills, completed projects, acquired training, and development needs. While information acquired from staff performance appraisals can be stored in the databases, storing information in the databases is not the main purpose of staff performance appraisals.

D. Periodic skills assessments of the internal audit activity helps the CAE determine the specific resources available. Assessments should be performed at least annually. While information acquired from staff performance appraisals can be useful in conducting future periodic skills assessments, it is not the main purpose of staff performance appraisals.

**62. Which of the following statements is true with regard to the external service providers?**

A. An organization can engage external service providers associated with the engagement client to facilitate the completion of the engagement.

B. An organization may outsource some, but not all, of the functions of the internal audit activity to the external service providers.

C. External service providers are used to determine whether the current staff is sufficient to satisfy the responsibilities of the internal audit activity.

D. External service providers can provide the necessary knowledge, skills, and competencies to the internal audit activity.

Answer (D) is correct.

The CAE can obtain the necessary knowledge, skills, and competencies from external service providers if the internal audit staff is not able to fulfill internal audit responsibilities. Services still must be performed in accordance with the Standards, regardless of the degree of outsourcing.

A. External service providers associated with the engagement client are unacceptable because they would not be independent or objective.

B. An organization may outsource none, some, or all of the functions of the internal audit activity. However, oversight of and responsibility for the internal audit activity must not be outsourced.

C. The CAE determines whether the current staff is sufficient to satisfy the responsibilities of the internal audit activity. If the current staff is not able to fulfill internal audit responsibilities, the use of external service providers must be considered.

**63. Which of the following would not be permissible when outsourcing internal audit functions?**

- A. Cosourcing with external service providers for a specific engagement.
- B. Outsourcing when internal auditors lack the knowledge or skills needed to perform all or part of the engagement.
- C. Outsourcing for the oversight of and responsibility for the internal audit activity.
- D. Total external outsourcing on an ongoing basis where services are performed in accordance with the Standards.

Answer (C) is correct.

An organization may outsource none, some, or all of the functions of the internal audit activity. However, oversight of and responsibility for the internal audit activity must not be outsourced. As stated in Implementation Standard 1210.A1, "The chief audit executive must obtain competent advice and assistance if the internal auditors lack the knowledge, skills, or other competencies needed to perform all or part of the engagement."

- A. Cosourcing is the use of external service providers in a joint engagement with internal audit staff. Cosourcing is permitted and may be for a specific engagement or on an ongoing basis.
- B. If the internal audit staff is not able to fulfill internal audit responsibilities, the use of external service providers must be considered and is permitted.
- D. Partial or total external sourcing on an ongoing basis is an outsourcing alternative. Regardless of the degree of outsourcing, services still must be performed in accordance with the Standards, and guidance for obtaining external service providers should be followed.

**64. An internal auditor observes that a receivables clerk has physical access to and control of cash receipts. The auditor worked with the clerk several years before and has a high level of trust in the individual. Accordingly, the auditor notes in the engagement working papers that controls over receipts are adequate. Has the auditor exercised due professional care?**

- A. Yes, reasonable care has been taken.
- B. No, irregularities were not noted.
- C. No, alertness to conditions most likely indicative of irregularities was not shown.
- D. Yes, the engagement working papers were annotated.

Answer (C) is correct.

Internal auditors must be alert to those conditions and activities where irregularities are most likely to occur and must identify inadequate controls. Thus, the internal auditor did not exercise due professional care. Cash has a high degree of inherent risk and should therefore be subject to strict controls. Access to cash and the recordkeeping functions should be separated regardless of the personal

qualities of the individuals involved. That the internal auditor trusts the clerk is irrelevant. Management still needs to be aware that internal control over receivables is inadequate.

- A. The auditor's engagement observation is inappropriate given the lack of segregation of functions.
- B. No indication is given that irregularities have occurred.
- D. Annotating the working papers does not indicate that the auditor exercised due professional care. Cash has a high inherent risk of irregularities, and professional judgment and alertness are necessary.

**65. Due professional care implies reasonable care and competence, not infallibility or extraordinary performance. Thus, which of the following is unnecessary?**

- A. The conduct of examinations and verifications to a reasonable extent.
- B. The conduct of extensive examinations.
- C. The reasonable assurance that compliance does exist.
- D. The consideration of the possibility of material irregularities.

Answer (B) is correct.

Due professional care implies reasonable care and competence, not infallibility or extraordinary performance. It requires the internal auditor to conduct examinations and verifications to a reasonable extent.

- A. Examination and verification need only be undertaken to a reasonable extent.
- C. Providing reasonable assurance is consistent with exercising reasonable care.
- D. The possibility of material irregularities must be considered.

**66. An internal auditor judged an item to be immaterial when planning an assurance engagement. However, the assurance engagement may still include the item if it is subsequently determined that**

- A. Sufficient staff is available.
- B. Adverse effects related to the item are likely to occur.
- C. Related information is reliable.
- D. Miscellaneous income is affected.

Answer (B) is correct.

Internal auditors must exercise due professional care by considering the relative complexity, materiality, or significance of matters to which assurance procedures are applied (Impl. Std. 1220.A1). Materiality judgments are made in the light of all the circumstances and involve qualitative as well as quantitative considerations. Moreover, internal auditors also must consider the interplay of risk with materiality. Consequently, engagement effort may be required for a quantitatively immaterial item if adverse

effects are likely to occur, for example, a material contingent liability arising from an illegal payment that is otherwise immaterial.

- A. In the absence of other considerations, devoting additional engagement effort to an immaterial item is inefficient.
- C. Additional engagement procedures might not be needed if related information is reliable.
- D. The item is more likely to be included if it affects recurring income items rather than miscellaneous income.

**67. With regard to the exercise of due professional care, an internal auditor should**

- A. Consider the relative materiality or significance of matters to which assurance procedures are applied.
- B. Emphasize the potential benefits of an engagement without regard to the cost.
- C. Consider whether criteria have been established to determine whether goals are achieved, not whether those criteria are adequate.
- D. Select procedures that are likely to provide absolute assurance that irregularities do not exist.

Answer (A) is correct.

Exercising due professional care means applying the care and skill expected of a reasonably prudent and competent internal auditor (Attr. Std. 1220). Internal auditors must exercise due professional care by considering, among other things, the relative complexity, materiality, or significance of matters to which assurance procedures are applied (Impl. Std. 1220.A1).

- B. The internal auditor should consider the cost in relation to the potential benefits before beginning an engagement.
- C. Adequate criteria are needed to evaluate controls. If determined to be adequate, internal auditors must use such criteria in their evaluation. If inadequate, internal auditors must work with management to develop appropriate evaluation criteria.
- D. Internal auditors cannot give absolute assurance that noncompliance or irregularities do not exist.

**68. The internal audit activity can perform an important role in preventing and detecting significant fraud by being assigned all but which one of the following tasks?**

- A. Review large, abnormal, or unexplained expenditures.
- B. Review sensitive expenses, such as legal fees, consultant fees, and foreign sales commissions.
- C. Review every control feature pertaining to petty cash receipts.
- D. Review contributions by the organization that appear to be unusual.

Answer (C) is correct.

The internal auditor must exercise due professional care by considering the relative complexity, materiality, or significance of matters to which assurance procedures are applied. The cost of assurance in relation to its benefits also should be considered (Impl. Std. 1220.A1). Hence, an exhaustive review

of petty cash is not an efficient and effective use of limited internal audit resources because it will not prevent or detect significant fraud. The amount of any theft of petty cash will not be substantial.

- A. To prevent or detect significant fraud, the internal auditor should review large, abnormal, or unexplained expenditures.
- B. To prevent or detect significant fraud, the internal auditor should review sensitive expenses.
- D. To prevent or detect significant fraud, the internal auditor should review unusual contributions.

**69. Fact Pattern: A staff internal auditor performed a portion of an engagement to review an organization's marketing function. In particular, the internal auditor evaluated the function's effective and efficient use of resources to identify**

**Underused facilities**

**Overstaffing or understaffing**

**Nonproductive work**

**Procedures that were not cost justified**

**To test for underused facilities, the internal auditor performed a complete walk-through of all spaces assigned to the marketing function and evaluated the use of both space and capital equipment. The internal auditor analyzed reports on space usage for the last year and concluded that facilities were neither underused nor used at maximum capacity.**

**To test for overstaffing or understaffing, the internal auditor compared current staffing levels with a staffing analysis recently completed by an independent contractor. Because the staffing analysis used work standards and service demands to provide factual and reliable information on staffing requirements, the internal auditor was able to conclude that staffing levels were optimal.**

**To test for nonproductive work, the internal auditor interviewed an employee from each level and, based upon their responses, concluded that no significant amount of nonproductive work was being performed. Thus, the internal auditor concluded that additional engagement work to search for procedures that were not cost-justified would not be necessary.**

**In reference to requirements 3 and 4, due professional care**

- A. Was exercised because the internal auditor applied reasonable care and competence in both areas.
- B. Was not exercised because the internal auditor failed to apply reasonable care and competence regarding requirement 3.
- C. Was not exercised because the internal auditor failed to apply reasonable care and competence regarding both requirements 3 and 4.
- D. Was not exercised because the internal auditor failed to apply reasonable care and competence regarding requirement 4.

Answer (C) is correct.

The procedures performed as a basis for concluding that no nonproductive work was accomplished resulted in a failure to identify sufficient, reliable, relevant, and useful information to achieve the engagement's objectives (Perf. Std. 2310). The opinions of individuals whose work was in question lacks reliability. Given that the information regarding area 4 was based on that for area 3, it also is suspect.

- A. Due professional care was not exercised in regard to requirements 3 and 4.
- B. Due professional care was not exercised in regard to requirements 3 and 4.
- D. Due professional care was not exercised in regard to requirements 3 and 4.

**70. A certified internal auditor performed an assurance engagement to review a department store's cash function. Which of the following actions will be deemed lacking in due professional care?**

- A. Organizational records were reviewed to determine whether all employees who handle cash receipts and disbursements were bonded.
- B. A flowchart of the entire cash function was developed, but only a sample of transactions was tested.
- C. The final engagement communication included a well-supported recommendation for the reduction in staff, although it was known that such a reduction would adversely affect morale.
- D. Because of a highly developed system of internal control over the cash function, the final engagement communication assured senior management that no irregularities existed.

Answer (D) is correct.

Internal auditors cannot give absolute assurance that noncompliance or irregularities do not exist.

- A. Reviewing records to determine whether all employees who handle cash receipts and disbursements were bonded is a standard procedure.
- B. Sampling is permissible. Detailed reviews of all transactions are often not required or feasible.
- C. In exercising due professional care, internal auditors should be alert to inefficiency.

**71. Due professional care calls for**

- A. Detailed reviews of all transactions related to a particular function.
- B. Infallibility and extraordinary performance when the system of internal control is known to be weak.
- C. Consideration of the possibility of material irregularities during every engagement.
- D. Testing in sufficient detail to give absolute assurance that noncompliance does not exist.

Answer (C) is correct.

Due care implies reasonable care and competence, not infallibility or extraordinary performance. Due care requires the internal auditor to conduct examinations and verifications to a reasonable extent, but does not require detailed reviews of all transactions. Accordingly, internal auditors cannot give absolute assurance that noncompliance or irregularities do not exist. Nevertheless, the possibility of material irregularities or noncompliance should be considered whenever an internal auditor undertakes an internal auditing assignment.

- A. Detailed reviews of all transactions are not required.
- B. Reasonable care and skill, not infallibility or extraordinary performance, are necessary.
- D. Only reasonable, not absolute, assurance can be given.

**72. In exercising due professional care, internal auditors must consider which of the following?**

**The relative complexity, materiality, or significance of matters to which assurance procedures are applied**

**The extent of assurance procedures necessary to ensure that all significant risks will be identified**

**The probability of significant errors, irregularities, or noncompliance**

- A. 1 and 2 only.
- B. 2 and 3 only.
- C. 1 and 3 only.
- D. 1, 2, and 3.

Answer (C) is correct.

Internal auditors must exercise due professional care by considering the

Extent of work needed to achieve the engagement's objectives

Relative complexity, materiality, or significance of matters to which assurance procedures are applied

Adequacy and effectiveness of governance, risk management, and control processes

Probability of significant errors, fraud, or noncompliance

Cost of assurance in relation to potential benefits (Impl. Std. 1220.A1)

Assurance procedures alone, even when performed with due professional care, do not guarantee that all significant risks will be identified (Impl. Std. 1220.A3).

- A. The internal auditors need not consider the extent of assurance procedures necessary to ensure that all significant risks will be identified when exercising due professional care. But the internal auditors must consider the probability of significant errors, irregularities, or noncompliance.

B. The internal auditors need not consider the extent of assurance procedures necessary to ensure that all significant risks will be identified when exercising due professional care. But the internal auditors must consider the relative complexity, materiality, or significance of matters to which assurance procedures are applied.

D. The internal auditors need not consider the extent of assurance procedures necessary to ensure that all significant risks will be identified when exercising due professional care.

**73. Assurance engagements must be performed with proficiency and due professional care.**

Accordingly, the Standards require internal auditors to

Consider the probability of significant noncompliance

Perform assurance procedures with due professional care so that all significant risks are identified

Weigh the cost of assurance against the benefits

- A. 1 and 2 only.
- B. 1 and 3 only.
- C. 2 and 3 only.
- D. 1, 2, and 3.

Answer (B) is correct.

Internal auditors must exercise due professional care by considering the

Extent of work needed to achieve the engagement's objectives

Relative complexity, materiality, or significance of matters to which assurance procedures are applied

Adequacy and effectiveness of governance, risk management, and control processes

Probability of significant errors, fraud, or noncompliance

Cost of assurance in relation to potential benefits (Impl. Std. 1220.A1)

Assurance procedures alone, even when performed with due professional care, do not guarantee that all significant risks will be identified (Impl. Std. 1220.A3).

A. Assurance procedures alone, even when performed with due professional care, do not guarantee that all significant risks will be identified. Moreover, internal auditors must weigh the cost of assurance against the benefits.

C. Assurance procedures alone, even when performed with due professional care, do not guarantee that all significant risks will be identified. Moreover, internal auditors must weigh the cost of assurance against the benefits.

D. Assurance procedures alone, even when performed with due professional care, do not guarantee that all significant risks will be identified.

**74. Internal auditors are responsible for continuing their education to maintain their proficiency. Which of the following is true regarding the continuing education requirements of the practicing internal auditor?**

- A. Practicing certified internal auditors are required to obtain 40 hours of continuing professional education every 2 years.
- B. CIAs have formal requirements that must be met in order to continue as CIAs.
- C. Attendance, as an officer or committee member, at formal IIA meetings does not meet the criteria of continuing professional development.
- D. In-house programs meet continuing professional education requirements only if they have been preapproved by The IIA.

Answer (B) is correct.

Internal auditors must enhance their knowledge, skills, and other competencies through continuing professional development (Attr. Std. 1230). To maintain the CIA designation, the CIA must commit to a formal program of continuing professional development and report to the Certification Department of The IIA.

- A. Practicing certified internal auditors are required to obtain 40 hours of CPE annually.
- C. Continuing education may be obtained by participation in professional organizations.
- D. Prior approval by The IIA is not necessary for CPE courses.

**75. During a consulting engagement, an internal auditor should exercise due professional care by considering which of the following?**

- 1. Needs and expectations of engagement clients**
- 2. Relative complexity and extent of work needed**
- 3. Cost of the consulting engagement**

- A. 1 and 2.
- B. 2 and 3.
- C. 1 and 3.
- D. 1, 2, and 3.

Answer (D) is correct.

The internal auditor must exercise due professional care during a consulting engagement by considering the

- A. Needs and expectations of engagement clients, including the nature, timing, and communication of engagement results.
- B. Relative complexity and extent of work needed to achieve the engagement's objectives.
- C. Cost of the consulting engagement in relation to potential benefits (Impl. Std. 1220.C1).

**76. Internal auditors who fail to maintain their proficiency through continuing education could be found to be in violation of**

- A. The International Standards for the Professional Practice of Internal Auditing.
- B. The IIA's Code of Ethics.
- C. Both the International Standards for the Professional Practice of Internal Auditing and The IIA's Code of Ethics.
- D. None of the answers are correct.

Answer (C) is correct.

Rule of Conduct 4.3 under the competency principle states, "Internal auditors shall continually improve their proficiency and the effectiveness and quality of their services." Furthermore, Attr. Std. 1230 states, "Internal auditors must enhance their knowledge, skills, and other competencies through continuing professional development." Thus, both The IIA's Code of Ethics and the Standards are violated by failing to earn continuing education credits.

- A. The IIA's Code of Ethics also is violated. Rule of Conduct 4.3 under the competency principle states, "Internal auditors shall continually improve their proficiency and the effectiveness and quality of their services."
- B. The Standards also are violated because they require auditors to enhance their knowledge, skills, and other competencies through continuing professional development.
- D. Both the Code and the Standards would be violated.

**77. In an assurance engagement of treasury operations, an internal auditor is required to consider all of the following issues except**

- A. The audit committee has requested assurance on the treasury department's compliance with a new policy on use of financial instruments.
- B. Treasury management has not instituted any risk management policies.
- C. Due to the recent sale of a division, the amount of cash and marketable securities managed by the treasury department has increased by 350%.
- D. The external auditors have indicated some difficulties in obtaining account confirmations.

Answer (D) is correct.

Obtaining account confirmations is the responsibility of the external auditors. It should not change the internal auditor's concerns.

- A. The auditor should consider the extent of work needed to achieve the engagement's objectives (Impl. Std. 1220.A1). Assurance on compliance with a new policy is a specific engagement objective.
- B. The auditor should consider the adequacy and effectiveness of risk management, control, and governance processes (Impl. Std. 1220.A1).

C. The auditor should consider the relative complexity, materiality, or significance of matters to which assurance procedures are applied (Impl. Std. 1220.A1). The increase in the amount of cash and marketable securities the treasury department manages is significant.

**78. Which of the following statements with regard to continuing professional development of internal auditors is false?**

- A. Practicing and nonpracticing CIAs must complete 40 hours of continuing professional education (CPE) annually, including at least 2 hours of ethics training.
- B. Internal auditors are required to continue expanding their knowledge and abilities throughout their careers.
- C. Participating in conferences, seminars, training programs, online and classroom courses, and webinars contribute to continuing professional development.
- D. CIAs may earn CPE hours by translating, authoring, or contributing to publications.

Answer (A) is correct.

CIAs demonstrate their continuing professional development by completing continuing professional education (CPE). Practicing and nonpracticing CIAs must complete 40 hours and 20 hours, respectively, of CPE annually, including at least 2 hours of ethics training.

B. Internal auditors must enhance their knowledge, skills, and other competencies through continuing professional development (Attr. Std. 1230).

C. Opportunities for professional development include participating in conferences, seminars, training programs, online courses and webinars, self-study programs, or classroom courses; conducting research projects; volunteering with professional organizations; and pursuing professional certifications.

D. Qualifying CPE activities are those that contribute to internal audit competencies. They include educational programs, passing examinations, translating publications, authoring or contributing to publications, delivering oral presentations, participating as a subject matter expert volunteer, and performing external quality assessment.

**79. What is the minimum amount of annual ethics training required for practicing and nonpracticing CIAs?**

- A. 1 hour.
- B. 2 hours.
- C. 3 hours.
- D. 4 hours.

Answer (B) is correct.

Practicing and nonpracticing CIAs must complete 40 hours and 20 hours, respectively, of CPE annually, including at least 2 hours of ethics training.

A. Practicing and nonpracticing CIAs must complete more than 1 hour of ethics training annually.

- C. Practicing and nonpracticing CIAs are not required to complete 3 hours of ethics training annually.
- D. Practicing and nonpracticing CIAs are not required to complete 4 hours of ethics training annually.

**80. While auditing accounts receivable using analytical procedures, the internal auditors discovered the actual accounts receivable numbers were not within the limits of their projected results. Which of the following describes the best response in exercising due professional care under this situation?**

- A. Revise the limits of the projected results according to the needs and expectations of the client.
- B. Confirm that all results of the analytical procedures are documented in the audit workpapers.
- C. Notify the CAE that the analytical procedures have uncovered fraud in the organization.
- D. Investigate unexpected results from the analytical procedures and make sure that they are adequately explained.

Answer (D) is correct.

Any unexpected results from analytical procedures should be investigated and adequately explained. Due professional care can be demonstrated if the auditor applied the care and skill of a reasonably competent and prudent internal auditor in the same or similar circumstances.

- A. Revising the limits of the projected results will not address the unexpected results discovered and therefore does not demonstrate due professional care.
- B. Merely confirming documentation of the results of the analytical procedures will not address the unexpected results discovered and therefore does not demonstrate due professional care.
- C. In exercising due professional care, internal auditors should consider the probability of significant errors, fraud, or noncompliance. Fraud cannot be determined until the discrepancy between the projected results and the actual numbers are investigated. The auditor should expand work to determine the existence of fraud before reporting to the CAE.

**81. An individual became head of the internal audit activity of an organization 1 week ago. An engagement client has come to the person complaining vigorously that one of the internal auditors is taking up an excessive amount of client time on an engagement that seems to be lacking a clear purpose. In handling this conflict with a client, the person should consider**

- A. Discounting what is said, but documenting the complaint.
- B. Whether existing procedures within the internal audit activity provide for proper planning and quality assurance.
- C. Presenting an immediate defense of the internal auditor based upon currently known facts.
- D. Promising the client that the internal auditor will finish the work within 1 week.

Answer (B) is correct.

The CAE should examine departmental procedures and the conduct of the specific engagement mentioned to ascertain that proper planning and quality assurance procedures are in place and are being followed.

- A. The CAE has responsibilities for planning engagement work schedules and maintaining a quality assurance and improvement program and cannot afford to ignore a potentially valid complaint.
- C. Taking a defensive position with the client stifles communication, hampers future engagement involvements, and ignores basic responsibilities for managing the internal audit activity.
- D. Making a promise to end the work within a specified time without knowledge of the work schedule jeopardizes the authority of the CAE and the internal audit activity in the current and future engagements. The CAE has an obligation to assure that adequate time is allowed for achieving engagement objectives.

**82. Assessment of a quality assurance and improvement program should include evaluation of all of the following except**

- A. Adequacy of the oversight of the work of external auditors.
- B. Conformance with the Standards and Code of Ethics.
- C. Adequacy of the internal audit activity's charter.
- D. Contribution to the organization's governance processes.

Answer (A) is correct.

Oversight of the work of external auditors, including coordination with the internal audit activity, is the responsibility of the board. It is not within the scope of the process for monitoring and assessing the QAIP.

- B. Conformance with the Standards and Code of Ethics is an element of the assessment of a QAIP.
- C. Adequacy of the internal audit activity's charter, goals, objectives, policies, and procedures is an element of the assessment of a QAIP.
- D. Contribution to the organization's governance, risk management, and control processes is an element of the assessment of a QAIP.

**83. The internal audit activity's quality assurance and improvement program is the responsibility of**

- A. External auditors.
- B. The chief audit executive.
- C. The board.
- D. The audit committee.

Answer (B) is correct.

The chief audit executive must develop and maintain a quality assurance and improvement program that covers all aspects of the internal audit activity (Attr. Std. 1300).

- A. External auditors may perform an external assessment, but the CAE is responsible for it.
- C. The CAE may report results to the board, but the program is the CAE's responsibility.
- D. The CAE may report results to the audit committee, but the program is the CAE's responsibility.

**84. Which of the following is responsible for developing and maintaining a quality assurance and improvement program that covers all aspects of the internal audit activity and continuously monitors its effectiveness?**

- A. Senior management.
- B. Chief audit executive.
- C. The board of directors.
- D. Audit committee.

Answer (B) is correct.

The chief audit executive must develop and maintain a quality assurance and improvement program that covers all aspects of the internal audit activity (Attr. Std.1300).

- A. Senior management is not responsible for the quality assurance and improvement program for the internal audit activity.
- C. The directors are not responsible for the quality assurance and improvement program for the internal audit activity.
- D. The audit committee is not responsible for the quality assurance and improvement program for the internal audit activity.

**85. What are the four key steps of the Deming Cycle?**

- A. Perform, Design, Act, and Review.
- B. Examine, Act, Check, and Verify.
- C. Plan, Do, Check, and Act.
- D. Perform, Diagnose, Calculate, and Act.

Answer (C) is correct.

Plan, Do, Check, and Act are the four key steps of the Deming Cycle that operate in an interactive manner. The Deming Cycle can be used to establish an organization's quality assurance and improvement program (QAIP) in a planned and methodological manner. The steps are (1) Plan, establish standards and expectations for operating a process to meet goals; (2) Do, execute the process and collect data for further analysis in the latter steps; (3) Check, compare actual results with expected results and analyze the difference; and (4) Act, provide feedback by identifying and implementing improvements to the process.

- A. Perform, Design, Act, and Review are not the four key steps of the Deming Cycle.
- B. Examine, Act, Check, and Verify are not the four key steps of the Deming Cycle.
- D. Perform, Diagnose, Calculate, and Act are not the four key steps of the Deming Cycle.

**86. Which of the following is an example of the "Act" step in the Deming Cycle?**

- A. Developing activities to define quality and build staff awareness of standards and expectations.
- B. Undertaking improvement initiatives and documenting lessons learned.
- C. Assessing and reviewing product or process quality.
- D. Formally documenting standards and expected practices.

Answer (B) is correct.

The Deming Cycle is a continuous improvement model that can be used to establish a quality assurance and improvement program. The Deming Cycle consists of four steps: Plan, Do, Check, and Act. "Act" provides feedback by identifying and implementing improvements to the process. Undertaking improvement initiatives and documenting lessons learned is an example of the "Act" step in the Deming Cycle.

- A. The "Do" step of the Deming Cycle executes the process and collects data for further analysis in the following steps. Developing activities to define quality and build staff awareness of standards and expectations is an example of the "Do" step.
- C. The "Check" step compares actual results with expected results and analyzes the difference. Various forms of assessment and review to measure product or process quality is an example of the "Check" step in the Deming Cycle.
- D. The "Plan" step establishes standards and expectations for operating a process to meet goals. Formal documentation of standards and expected practices is an example of the "Plan" step in the Deming Cycle.

**87. According to The IIA's International Professional Practices Framework, when may a self-assessment be performed in lieu of a full external assessment?**

- A. When the self-assessment has been validated by a qualified, independent, competent, and professional external assessor.
- B. When the internal audit activity has conducted an external assessment within the past two years.
- C. When ongoing monitoring of the internal audit activity has not identified any weaknesses or areas in need of improvement.
- D. A self-assessment may not be performed in lieu of a full external assessment of the internal audit activity's conformance with the Standards.

Answer (A) is correct.

Implementation Guide 1310 states, “External assessments provide an opportunity for an independent assessor or assessment team to conclude as to the internal audit activity’s conformance with the Standards and whether internal auditors apply the Code of Ethics and to identify areas for improvement. The CAE is responsible for ensuring that the internal audit activity conducts an external assessment at least once every five years. A self-assessment may be performed in lieu of a full external assessment, provided it is validated by a qualified, independent, competent, and professional external assessor.”

B. Completion of an external assessment within the past two years is not a criterion for performance of a self-assessment.

C. Ongoing monitoring is an internal assessment and is achieved primarily through continuous activities such as engagement planning and supervision, standardized work practices, workpaper procedures and signoffs, report reviews, as well as identification of any weaknesses or areas in need of improvement and action plans to address them (Implementation Guide 1310). External assessments are still required even if the internal audit activity has not identified any weaknesses or areas in need of improvement.

D. A self-assessment may be performed in lieu of a full external assessment when certain criteria are met.

**88. Internal assessments of the internal audit activity consist of all of the following except**

- A. Evaluation of conformance with the mandatory elements of the IPPF.
- B. Evaluation of the establishment and achievement of key performance indicators.
- C. Evaluation of the quality and supervision of the audit work performed.
- D. An independent assessment team identifies areas for improvement.

Answer (D) is correct.

According to Implementation Guide 1310, “Internal assessments consist of ongoing monitoring and periodic self-assessments . . . , which evaluate the internal audit activity’s conformance with the mandatory elements of the IPPF, the quality and supervision of audit work performed, the adequacy of internal audit policies and procedures, the value the internal audit activity adds to the organization, and the establishment and achievement of key performance indicators.” External assessments provide an opportunity for an independent assessment team to identify areas for improvement for the internal audit activity.

A. Internal assessments by the internal audit activity consist of ongoing monitoring and periodic self-assessments that evaluate the internal audit activity’s conformance with the mandatory elements of the IPPF.

B. Internal assessments by the internal audit activity consist of ongoing monitoring and periodic self-assessments that evaluate the establishment and achievement of key performance indicators.

C. Internal assessments by the internal audit activity consist of ongoing monitoring and periodic self-assessments that evaluate the internal audit activity’s quality and supervision of the audit work performed.

**89. An external assessment of an internal audit activity contains an expressed opinion. The opinion may apply to**

- A. Only to the internal audit activity's conformance with the Standards.
- B. Only to the effectiveness of the internal auditing coverage.
- C. Only to the adequacy of internal control.
- D. Conformance with the Standards and an assessment for each standard.

Answer (D) is correct.

External assessments of an internal audit activity contain an expressed opinion or conclusion on overall conformance with the Standards and possibly an assessment for each standard or series of standards. An external assessment also includes, as appropriate, recommendations (corrective action plans) for improvement.

- A. An opinion may be expressed on the Standards and an assessment may be made for each standard or series of standards.
- B. The scope of an external assessment extends to more than the effectiveness of the internal auditing coverage.
- C. An external assessment addresses the internal audit activity, not the adequacy of the organization's controls.

**90. As a part of a quality program, internal assessment teams most likely will examine which of the following to evaluate the quality of engagement planning and documentation for individual engagements?**

- A. Measures of project budgets and audit plan completion.
- B. Project assignment documentation.
- C. Weekly status reports.
- D. The long-range engagement work schedule.

Answer (A) is correct.

Internal assessments must include ongoing monitoring of the performance of the internal audit activity and periodic self-assessments or assessments by other persons within the organization with sufficient knowledge of internal auditing practices (Attr. Std. 1311). The processes and tools used in ongoing internal assessments include, among other things, measures of project budgets, timekeeping systems, and audit plan completion. These may help to determine whether the appropriate amount of time was spent on all parts of the engagement (IG 1311).

- B. Project assignment documentation contains less relevant information for assessment purposes than work programs.
- C. Status reports do not bear directly on planning.
- D. The long-range engagement work schedule does not relate to planning and documentation for individual engagements.

**91. Periodic internal assessments of the internal audit activity primarily serve the needs of**

- A. The board of directors.
- B. The internal audit activity's staff.
- C. The chief audit executive (CAE).
- D. Senior management.

Answer (C) is correct.

Those conducting internal assessments generally should report to the CAE while performing the reviews and communicate directly to the CAE.

- A. The directors are secondary users of a periodic internal assessment.
- B. The internal audit activity staff are secondary users of a periodic internal assessment.
- D. Senior management is a secondary user of a periodic internal assessment.

**92. Quality program assessments may be performed internally or externally. A distinguishing feature of an external assessment is its objective to**

- A. Identify tasks that can be performed better.
- B. Determine whether internal audit services meet professional standards.
- C. Set forth the recommendations for improvement.
- D. Provide independent assurance.

Answer (D) is correct.

External assessments must be conducted at least once every 5 years by a qualified, independent reviewer or review team from outside the organization (Attr. Std. 1312). Individuals who perform the external assessment are free of any obligation to, or interest in, the organization whose internal audit activity is assessed.

- A. An internal assessment will identify tasks that can be performed better
- B. An internal assessment will determine whether internal audit services meet professional standards.
- C. An internal assessment will set forth recommendations for improvement.

**93. The interpretation related to quality assurance given by the Standards is that**

- A. External assessments can provide senior management and the board with independent assurance about the quality of the internal audit activity.
- B. Appropriate follow-up to an external assessment is the responsibility of the chief audit executive's immediate supervisor.

- C. The internal audit activity is primarily measured against The IIA's Code of Ethics.
- D. Supervision is limited to the planning, examination, evaluation, communication, and follow-up process.

Answer (A) is correct.

External assessments provide an independent and objective evaluation of the internal audit activity's compliance with the Standards and Code of Ethics.

- B. The communication of final results of an external assessment should include the CAE's responses. These include corrective action plans.
- C. The external assessment considers the internal audit activity's conformance with the Standards and the Code of Ethics.
- D. Supervision begins with planning and continues throughout the engagement.

**94. Which of the following is not true of quality assessments that are implemented according to IIA guidance?**

- A. The results of a quality assessment can be shared with senior management and the board.
- B. A quality assessment team would be expected to review the internal audit activity's efficiency and effectiveness.
- C. Company managers or members of the board may be members of the external quality assessment team if they are qualified, since they are independent of the internal audit activity.
- D. The quality assessment process may include feedback from engagement clients through interviews and questionnaires or surveys.

Answer (C) is correct.

According to IIA guidance, external assessments must be conducted by a qualified, independent assessor or assessment team from outside the organization (Attr. Std. 1312). Company managers or members of the board therefore may not be members of the external quality assessment team even if they are independent of the internal audit activity.

- A. Quality assessments are required under the quality assurance and improvement program (QAIP) (Attr. Std. 1310). The CAE must communicate the results of the QAIP to senior management and the board (Attr. Std. 1320).
- B. The scope of a full external assessment includes evaluating the efficiency and effectiveness of the internal audit activity (IG 1312).
- D. The quality assessment process may include the use of interviews, questionnaires, or surveys to obtain client feedback (IGs 1311 and 1312).

**95. Which of the following is only part of an internal audit activity's quality assurance program rather than being included as part of other responsibilities of the chief audit executive (CAE)?**

- A. The CAE provides information about and access to internal audit working papers to the external auditors to enable them to understand and determine the degree to which they may rely on the internal auditors' work.
- B. Management approves a formal charter establishing the purpose, authority, and responsibility of the internal audit activity.
- C. Each individual internal auditor's performance is appraised at least annually.
- D. Supervision of an internal auditor's work is performed throughout each audit engagement.

Answer (D) is correct.

The CAE develops and maintains a quality assurance and improvement program (Attr. Std. 1300) that includes (1) external assessments and (2) ongoing and periodic internal assessments. Ongoing monitoring is incorporated into the routine policies and practices used to manage the internal audit activity. Among the processes used in ongoing internal assessments is engagement planning and supervision (IG 1311).

- A. Providing working papers to the external auditors relates to the responsibility of the CAE to coordinate with external auditors.
- B. A CAE's responsibility to seek approval of a charter to establish the authority, purpose, and responsibility of the internal audit activity is not part of a quality assurance program.
- C. Individual performance appraisals are part of a CAE's responsibility for personnel management and development.

**96. At what minimal required frequency does the chief audit executive report the results of internal assessments in the form of ongoing monitoring to senior management and the board?**

- A. Monthly.
- B. Quarterly.
- C. Annually.
- D. Biennially.

Answer (C) is correct.

To demonstrate conformance with the mandatory IIA guidance, the results of external and periodic internal assessments are communicated upon completion of such assessments and the results of ongoing monitoring are communicated at least annually (Inter. Std. 1320).

- A. The CAE may report on a monthly basis, but the minimal requirement for reporting is annually.
- B. The CAE may report on a quarterly basis, but the minimal requirement for reporting is annually.
- D. The CAE is required to report more frequently than every 2 years.

**97. Internal auditors may include in their audit report that their activities conform with The IIA Standards. They may use this statement only if**

- A. It is supported by the results of the quality program.

- B. An independent external assessment of the internal audit activity is conducted annually.
- C. Senior management or the board is accountable for implementing a quality program.
- D. External assessments of the internal audit activity are made by external auditors.

Answer (A) is correct.

The chief audit executive may state that the internal audit activity conforms with the International Standards for the Professional Practice of Internal Auditing only if the results of the quality assurance and improvement program support this statement (Attr. Std. 1321).

- B. An independent external assessment of the internal audit activity must be conducted at least once every 5 years.
- C. The CAE must develop and maintain a QAIP that covers all aspects of the internal audit activity.
- D. Assessments also may be made by others who are (1) independent, (2) qualified, and (3) from outside the organization.

**98. Following an external assessment of the internal audit activity, who is (are) responsible for communicating the results to the board?**

- A. Internal auditors.
- B. Audit committee.
- C. Chief audit executive.
- D. External auditors.

Answer (C) is correct.

The chief audit executive must communicate the results of the QAIP to senior management and the board (Attr. Std. 1320).

- A. The chief audit executive (not internal auditors) is responsible for communicating the results of external assessments to the board.
- B. The chief audit executive (not the audit committee) is responsible for communicating the results of external assessments to the board.
- D. The chief audit executive (not external auditors) is responsible for communicating the results of external assessments to the board.

**99. Which of the following would demonstrate that the internal audit activity is in compliance with IIA practices?**

- A. The chief audit executive determines the form and content of the results communicated.
- B. The results of external assessments are communicated upon their completion.
- C. The results of periodic internal assessments are communicated at least twice a year.
- D. The results of ongoing monitoring are communicated upon their completion.

Answer (B) is correct.

“To demonstrate conformance with the Definition of Internal Auditing and the Standards, and application of the Code of Ethics, the results of external and periodic internal assessments are communicated upon completion of such assessments and the results of ongoing monitoring are communicated at least annually. The results include the assessor’s or assessment team’s evaluation with respect to the degree of conformance” (Inter. Std. 1320).

- A. The form, content, and frequency of communicating the results of the quality assurance and improvement program is established through discussions with senior management and the board and considers the responsibilities of the internal audit activity and chief audit executive as contained in the internal audit charter.
- C. The results of periodic internal assessments are communicated upon their completion.
- D. The results of ongoing monitoring are communicated at least annually.

**100. Potential conflicts of interest with the quality assurance assessment team should be disclosed to**

- A. Senior management and the board.
- B. Internal audit staff.
- C. Internal audit activity.
- D. Chief audit executive.

Answer (A) is correct.

The chief audit executive must communicate the results of the quality assurance and improvement program to senior management and the board. Disclosures should include the qualifications and independence of the assessor(s) or assessment team, including potential conflicts of interest.

- B. Potential conflicts of interest with the quality assurance assessment team should not be disclosed to the internal audit staff.
- C. Potential conflicts of interest with the quality assurance assessment team should not be disclosed to the internal audit activity.
- D. The chief audit executive should disclose the potential conflicts of interest with the quality assurance assessment team to the appropriate parties.



### **PART-1 UNIT 3**

1.The role of the internal audit activity in the ethical culture of an organization is to

- A.Avoid active support of the ethical culture because of possible loss of independence.
- B.Evaluate the effectiveness of the organization’s formal code of conduct.
- C.Assume accountability for the effectiveness of the governance process.
- D.Become the chief ethics officer.

Answer (B) is correct.

The internal audit activity periodically assesses the elements of the ethical climate of the organization and its effectiveness in achieving legal and ethical compliance. Internal auditors therefore evaluate the effectiveness of, among other things, a formal code of conduct and related statements and policies.

- A.Internal auditors must be active ethics advocates. However, assuming the role of, for example, chief ethics officer may, in some circumstances, impair individual objectivity and the internal audit activity’s independence.
- C.The organization’s board and its senior management are responsible for the effectiveness of the governance process.
- D.The internal auditor’s basic role is to be the assessor of the ethical culture. However, an internal auditor may become chief ethics officer or a member of an ethics council, although the first role may, in some circumstances, impair individual objectivity and the internal audit activity’s independence.

2.The internal audit activity most directly contributes to an organization’s governance process by

- A.Identifying significant exposures to risk.
- B.Evaluating the effectiveness of internal control over financial reporting.
- C.Promoting continuous improvement of controls.
- D.Evaluating the design of ethics-related activities.

Answer (D) is correct.

Performance Standard 2110 states, “The internal audit activity must assess and make appropriate recommendations to improve the organization’s governance processes for:

- Making strategic and operational decisions.
- Overseeing risk management and control.
- Promoting appropriate ethics and values within the organization.

- Ensuring effective organizational performance management and accountability.
- Communicating risk and control information to appropriate areas of the organization.
- Coordinating the activities of, and communicating information among, the board, external and internal auditors, other assurance providers, and management.”

Thus, in an assurance engagement, the internal audit activity must evaluate the design, implementation, and effectiveness of the organization’s ethics-related objectives, programs, and activities.

A. Identifying significant exposures to risk most directly relates to risk management rather than to governance.

B. Evaluating the effectiveness of internal control over financial reporting more directly relates to risk management rather than to governance.

C. Promoting continuous improvement of controls relates to controls rather than to governance.

3. Which of the following correctly classifies the corporate governance functions as internal or external?

Internal

External

A. Corporate charter

Bylaws

B. Laws

Board of directors

C. Internal audit function

Corporate charter

D. Bylaws

Government regulation

Answer (D) is correct.

Bylaws are an example of internal corporate governance, and laws, regulations, and the government regulators who enforce them are examples of external governance.

A. Bylaws are an example of internal corporate governance.

B. Laws provide external corporate governance, and a board of directors provides internal corporate governance.

C. A corporate charter is an example of internal corporate governance

4. Which of the following is a false statement about the role of internal auditors in an organization’s ethical culture?

A. Roles may include chief ethics officer.

B. The role of chief ethics officer sometimes conflicts with the independence of the internal audit activity.

C. In a more mature system, the internal audit activity emphasizes compliance.

D. In a more mature governance system, the internal audit activity's emphasis is on optimizing structure and practices.

Answer (C) is correct.

The role of the internal audit activity depends on the maturity of the governance system. In a less mature system, the internal audit activity emphasizes compliance with policies, procedures, laws, etc. It also addresses the basic risks to the organization.

A. Internal auditors' roles may include chief ethics officer.

B. In some circumstances, the role of chief ethics officer may conflict with the independence attribute of the internal audit activity.

D. In a more mature governance system, the internal audit activity's emphasis is on optimizing structure and practices.

5. Senior management is primarily responsible for

A. Implementing and monitoring controls designed by the board of directors.

B. Ensuring that external auditors oversee risk management and control processes.

C. Evaluating the controls over the reliability and integrity of financial and operational information.

D. Determining who will be risk owners.

Answer (D) is correct.

Senior management determines (1) where specific risks are to be managed, (2) who will be risk owners (managers responsible for specific day-to-day risks), and (3) how specific risks will be managed.

A. The board has oversight responsibilities but ordinarily does not become involved in the details of operations.

B. Management ensures that sound risk management processes are in place and are adequate and effective.

C. Internal auditors are responsible for evaluating the adequacy and effectiveness of controls, including those relating to the reliability and integrity of financial and operational information.

6. Ensuring effective organizational performance management and accountability is most directly the proper function of

A. Control.

B. Governance.

C.Risk management.

D.A quality assurance program.

Answer (B) is correct.

Organizational performance is measured by achieving objectives. The IIA Glossary defines governance as the combination of processes and structures implemented by the board to inform, direct, manage, and monitor the activities of the organization toward the achievement of its objectives. Thus, ensuring effective organizational performance management and accountability is most directly the proper function of governance.

A.Governance (not control) is directly responsible for ensuring effective organizational performance management and accountability.

C.Governance (not risk management) is directly responsible for ensuring effective organizational performance management and accountability.

D.A quality assurance program normally is implemented for an organizational unit, e.g., the internal audit activity.

7.Which of the following is not a goal of corporate governance?

A.Complying with society's legal and regulatory rules.

B.Providing an overall benefit to society.

C.Reporting fully and truthfully to stakeholders.

D.Maximizing executive compensation.

Answer (D) is correct.

Governance practices may use various legal forms, structures, strategies, and procedures. They ensure that the organization (1) complies with society's legal and regulatory rules; (2) satisfies the generally accepted business norms, ethical principles, and social expectations of society; (3) provides overall benefit to society and enhances the interests of the specific stakeholders in both the long- and short-term; and (4) reports fully and truthfully to its stakeholders, including the public, to ensure accountability for its decisions, actions, and performances. But maximizing executive compensation is not a goal of corporate governance.

A.Ensuring compliance with society's legal and regulatory rules is a goal of corporate governance.

B.Proving an overall benefit to society is a goal of corporate governance.

C.Reporting fully and truthfully to stakeholders is a goal of corporate governance.

8.Which of the following is most likely an internal audit role in a less structured governance process?

- A. Designing specific governance processes.
- B. Playing a consulting role in optimizing governance practices and structure.
- C. Providing advice about basic risks to the organization.
- D. Evaluating the effectiveness of specific governance processes.

Answer (C) is correct.

A less mature governance system will emphasize the requirements for compliance with policies, procedures, plans, laws, regulations, and contracts. It will also address the basic risks to the organization. Thus, the internal audit activity will provide advice about such matters. As the governance process becomes more structured, the internal audit activity's emphasis will shift to optimizing the governance structure and practices.

- A. Internal auditors impair their objectivity by designing processes. However, evaluating the design and effectiveness of specific processes is a typical internal audit role.
- B. Playing a consulting role in optimizing governance practices and structure is typical of a more structured internal auditing governance maturity model. The emphasis shifts to considering best practices and adapting them to the specific organization.
- D. Evaluating the effectiveness of specific governance processes is typical of a more structured internal auditing governance maturity model.

9. Which of the following is a situation in which an internal auditor's role of chief ethics officer conflicts with the independence attribute of the internal audit activity?

- A. The chief ethics officer requests that the internal auditors assess whether the organization as a whole is not complying with the organization's code of conduct.
- B. The chief ethics officer informs the board of recommendations made by the internal audit activity regarding the organization's compliance with the code of conduct.
- C. The chief ethics officer proposes and implements a new whistleblower program for the organization.
- D. The internal audit activity informs the chief ethics officer that the organization is in compliance with all laws and regulations.

Answer (C) is correct.

Proposing and implementing a new whistleblower program conflicts with the independence attribute of the internal audit activity. Implementation is a management function and is therefore inconsistent with the organizational independence of the internal audit activity.

- A. Independence is not impaired when the chief ethics officer requests that the internal auditors assess whether the organization as a whole is not complying with the organization's code of conduct.
- B. Independence is not impaired when the chief ethics officer informs the board of recommendations made by the internal audit activity regarding the organization's compliance with the code of conduct.

D.Independence is not impaired when the internal audit activity informs the chief ethics officer that the organization is in compliance with all laws and regulations.

10.The role of the internal audit activity in the ethical culture of an organization is to

- A.Assess its effectiveness in achieving legal compliance.
- B.Avoid involvement in the ethical culture because of loss of objectivity.
- C.Become a member of an ethics council.
- D.Assume responsibility for the governance process.

Answer (A) is correct.

The internal audit activity periodically assesses the elements of the ethical climate of the organization and its effectiveness in achieving legal and ethical compliance. Internal auditors therefore evaluate the effectiveness of, among other things, a formal code of conduct and related statements and policies.

B.Internal auditors must be active ethics advocates. However, assuming the role of, for example, chief ethics officer may, in some circumstances, impair individual objectivity and the internal audit activity's independence.

C.The internal auditor's basic role is to be the assessor of the ethical culture. However, an internal auditor may become chief ethics officer or a member of an ethics council, although the first role may, in some circumstances, impair individual objectivity and the internal audit activity's independence.

D.The organization's board and its senior management are responsible for the effectiveness of the governance process.

11.Which of the following correctly classifies governance functions as internal or external?

Internal

External

- |                           |                       |
|---------------------------|-----------------------|
| A.Internal audit function | Government regulation |
| B.Senior management       | Corporate charter     |
| C.Privacy laws            | External auditors     |
| D.Corporate charter       | Ethical culture       |

Answer (A) is correct.

The internal audit function is an example of internal corporate governance, and laws, regulations, and the government regulators who enforce them are examples of external governance.

B.A corporate charter is an example of internal corporate governance.

C.Laws provide external corporate governance, and a board of directors provides internal corporate governance.

D.An ethical culture is an example of internal corporate governance.

12.Governance should help ensure that the objectives of an entity's stakeholders are met. Stakeholders include

1.Employees

2.Regulators

3.Suppliers

4.Customers

A.1 and 4 only.

B.2 and 3 only.

C.2, 3, and 4 only.

D.1, 2, 3, and 4.

Answer (D) is correct.

Stakeholders are persons or entities who are affected by the activities of the entity. Among others, these include (1) shareholders, (2) employees, (3) suppliers, (4) customers, (5) neighbors of the entity's facilities, and (6) government regulators.

A.Regulators and suppliers are stakeholders.

B.Employees and customers are stakeholders.

C.Employees are stakeholders.

13.The internal and external auditors report directly to an audit committee composed of independent directors. This practice is directly related to which of the following governance principles?

1. Effective use of internal and external auditors.

2. Effective interaction among the board, management, and assurance providers.

3. An organizational structure that supports accomplishing strategic objectives.

4. An organizational structure used to measure organizational and individual performance.

A.1 and 2 only.

B.2 and 3 only.

C.3 and 4 only.

D.1, 2, 3, and 4.

Answer (A) is correct.

Internal and external auditors should be used effectively to ensure (1) their independence, (2) the adequacy of their resources and the scope of their activities, and (3) the effectiveness of operations. Moreover, an entity should have an independent and objective board with sufficient expertise, experience, authority, and resources to conduct independent inquiries.

B. An organizational structure that supports accomplishing strategic objectives is not directly related

C. An organizational structure that supports accomplishing strategic objectives and an organizational structure used to measure organizational and individual performance are not directly related.

D. An organizational structure that supports accomplishing strategic objectives and an organizational structure used to measure organizational and individual performance are not directly related.

14. Which of the following should be stated in an organization's code of conduct?

1. The organization's values and objectives

2. The behavior expected

3. The strategies for maintaining a culture inconsistent with legal, ethical, and societal responsibilities

A. 1 and 2 only.

B. 1 and 3 only.

C. 2 and 3 only.

D. 1, 2, and 3.

Answer (A) is correct.

Codes of conduct and vision statements are issued to state

- The organization's values and objectives;
- The behavior expected; and
- The strategies for maintaining a culture consistent with legal, ethical, and societal responsibilities.

B. The code of conduct and vision statements should state the strategies for maintaining a culture consistent, not inconsistent, with legal, ethical, and societal responsibilities. Additionally, the behavior expected should be stated.

C. The code of conduct and vision statements should state the strategies for maintaining a culture consistent, not inconsistent, with legal, ethical, and societal responsibilities. Additionally, the organization's values and objectives should be stated.

D. The code of conduct and vision statements should state the strategies for maintaining a culture consistent, not inconsistent, with legal, ethical, and societal responsibilities.

15. Directors, management, external auditors, and internal auditors all play important roles in creating proper control processes. Senior management is primarily responsible for

- A. Establishing and maintaining an organizational culture.
- B. Reviewing the reliability and integrity of financial and operational information.
- C. Ensuring that external and internal auditors oversee the administration of the system of risk management and control processes.
- D. Implementing and monitoring controls designed by the board of directors.

Answer (A) is correct.

Management plans, organizes, and directs the performance of sufficient actions to provide reasonable assurance that goals and objectives will be achieved. Management periodically reviews its objectives and goals and modifies its processes to accommodate changes in internal and external conditions. Management also establishes and maintains an organizational culture, including an ethical climate that fosters control.

- B. Internal auditors are responsible for evaluating the adequacy and effectiveness of controls, including those relating to the reliability and integrity of financial and operational information.
- C. Senior management's role is to oversee the establishment, administration, and assessment of the system of risk management and control processes.
- D. The board has oversight responsibilities but ordinarily does not become involved in the details of operations.

16. Which of the following statements regarding corporate governance is not correct?

- A. Corporate control mechanisms include internal and external mechanisms.
- B. The compensation scheme for management is part of the corporate control mechanisms.
- C. The dilution of shareholders' wealth resulting from employee stock options or employee stock bonuses is an accounting issue rather than a corporate governance issue.
- D. The internal auditor of a company has more responsibility than the board for the company's corporate governance.

Answer (D) is correct.

Governance is the responsibility of the board. Internal audit's responsibility is to assess governance processes and make appropriate recommendations for improvement.

- A. Corporate control mechanisms include both internal (e.g., internal auditing) and external (e.g., external auditing) mechanisms.
- B. Management's compensation scheme is part of the control environment, specifically, the human resource element.

C.The dilution of shareholders' wealth resulting from employee stock options or employee stock bonuses is an accounting issue. Governance is "the combination of processes and structures implemented by the board to inform, direct, manage, and monitor the activities of the organization toward the achievement of its objectives" (The IIA Glossary).

17.Which of the following statements about organizational governance is true?

- A.The internal auditor has more responsibility than the board for organizational governance.
- B.Governance functions are internal but not external.
- C.The compensation of management is a governance process.
- D.The dilution of shareholders wealth from stock options or bonuses is a governance issue.

Answer (C) is correct.

Management's compensation is part of the control environment, specifically, the human resource element. Governance applies to all organizational activities, including risk management and control.

- A.Governance is the responsibility of the board. Internal audit's responsibility is to assess governance processes and make appropriate recommendations for improvement.
- B.Governance functions are internal (e.g., internal auditing) and external (e.g., external auditing).
- D.The dilution of shareholders' wealth resulting from stock options or bonuses is an accounting issue. Governance is "the combination of processes and structures implemented by the board to inform, direct, manage, and monitor the activities of the organization toward the achievement of its objectives" (The IIA Glossary).

18.Which of the following is a function of the internal audit activity in organizational governance?

- A.Carrying out board directives to achieve organizational objectives.
- B.Ensuring the timely implementation of audit recommendations.
- C.Monitoring compliance with the code of conduct.
- D.Establishing the definition of governance.

Answer (C) is correct.

The internal audit activity should monitor compliance with the organizational code of conduct set by the board and management.

- A.Management is responsible for carrying out board directives to achieve organizational objectives.

B.Management has the responsibility of ensuring the timely implementation of the audit recommendations. The internal audit activity is responsible for the development of a timely procedure to monitor the disposition of the audit recommendations.

D.The internal audit activity is responsible for working with the board and senior management to determine the definition of governance.

19.A code of conduct was developed several years ago and distributed by a large financial institution to all its officers and employees. What is the internal auditor's best approach to providing the board with the highest level of comfort about the code of conduct?

A.Fully evaluate the comprehensiveness of the code and compliance with it and report the results to the board.

B.Fully evaluate organizational practices for compliance with the code and report to the board.

C.Review employee activities for compliance with provisions of the code and report to the board.

D.Perform tests on various employee transactions to detect potential violations of the code of conduct.

Answer (A) is correct.

When evaluating a code of conduct, it is important to consider two items: comprehensiveness and compliance. The code should address the ethical issues that the employees are expected to encounter and provide suitable guidance. The internal auditor also must consider the extent to which employees are complying with the standards established.

B.Evaluating practices and reporting to the board is not the best approach.

C.Reviewing employee activities does not provide as much comfort about the code of conduct as evaluation of comprehensiveness.

D.Performing tests on employee transactions is not the best approach.

20.In an assurance engagement, what is the internal auditor's responsibility for evaluating ethics-related activities?

A.Evaluate their design, implementation, and effectiveness.

B.Evaluate only the design of ethics-related activities.

C.Review employee activities for compliance with provisions of the code.

D.Perform tests on various employee transactions.

Answer (A) is correct.

The internal audit activity must evaluate the design, implementation, and effectiveness of the organizations ethics-related objectives, programs, and activities.

B.Internal auditors must evaluate the design, implementation, and effectiveness of ethics-related activities, objectives, and programs.

C.Internal auditors must evaluate the design, implementation, and effectiveness of ethics-related activities, objectives, and programs

D.Internal auditors must evaluate the design, implementation, and effectiveness of ethics-related activities, objectives, and programs.

21.What are the major components of governance?

1. Strategic direction
2. Oversight
3. Regulations
4. Ethics

A.1 and 2 only.

B.1, 2, and 4 only.

C.3 and 4 only.

D.2 and 4 only.

Answer (A) is correct.

Strategic direction determines (1) the business model, (2) overall objectives, (3) the risk appetite, and (4) the limits of organizational conduct. The elements of oversight are (1) the board's responsibilities to stakeholders, (2) the risk management activities of senior management and the board, and (3) internal and external assurance activities.

B.Ethics is not a major component of governance.

C.Regulations and ethics are not major components of governance

D.Ethics is not, and strategic direction is, a major component of governance.

22.What are the elements of the oversight component of governance?

- 1.The business model
- 2.Limits of organizational conduct
- 3.External assurance
- 4.Internal auditing

- A.2 and 4 only.
- B.3 and 4 only.
- C.1, 2, and 4 only.
- D.1, 2, 3, and 4.

Answer (B) is correct.

Strategic direction determines (1) the business model, (2) overall objectives, (3) the risk appetite, and (4) the limits of organizational conduct. The elements of oversight are (1) the risk management activities of senior management and the board and (2) internal and external assurance activities.

- A.Strategic direction determines the limits of organizational conduct.
- C.Strategic direction determines the business model and limits of organizational conduct.
- D.The elements of oversight are external assurance and internal auditing

23.Which of the following is a purpose of governance practices?

- A.Enhancing the interests of specific stakeholders only in the short term.
- B.Satisfying ethical principles but not society's expectations.
- C.Delegating organizational oversight to the internal audit activity.
- D.Reporting fully and truthfully to the public.

Answer (D) is correct.

Governance practices may use various legal forms, structures, strategies, and procedures. They ensure that the organization (1) complies with society's legal and regulatory rules; (2) satisfies the generally accepted business norms, ethical principles, and social expectations of society; (3) provides overall benefit to society and enhances the interests of the specific stakeholders in both the long- and short term; and (4) reports fully and truthfully to its stakeholders, including the public, to ensure accountability for its decisions, actions, and performances.

- A.The interests of specific stakeholders also should be enhanced in the long term.
- B.The social expectations of society should be satisfied.
- C.The board is responsible for overseeing the organization's activities and cannot delegate this responsibility to another function.

24.A corporation's results met the expectations of the market, but many people in the organization noticed that they were overly optimistic. Moreover, no one suggested that the results be changed. Who, whether officially or informally, should have been an ethics advocate regarding the results?

- 1.Senior management

2. Internal auditors

3. Employees in the accounting department

A. 1 only.

B. 1 and 2 only.

C. 1 and 3 only.

D. 1, 2, and 3.

Answer (D) is correct.

Because decision making in most organizations is complex and dispersed, each individual should be an ethics advocate, whether officially or informally. Thus, it is the responsibility of senior management, the internal auditors, and the employees in the accounting department to be ethics advocates and suggest that the results might not be accurate.

A. The internal auditors and employees in the accounting department also should have been ethics advocates.

B. The employees in the accounting department also should have suggested that the results might not be accurate.

C. The internal auditors also should have suggested that the results might not be accurate

25. Which of the following is most likely an internal audit activity's function in a less structured governance process?

A. Evaluating the effectiveness of specific governance processes that are distinct from control.

B. Compliance with procedures, policies, and plans.

C. Acting as a consultant in optimizing governance practices.

D. Designing processes to address basic risks.

Answer (B) is correct.

A less mature governance system emphasizes the requirements for compliance with policies, procedures, plans, laws, regulations, and contracts. It also addresses the basic risks to the organization. Thus, the internal audit activity provides advice about such matters. As the governance process becomes more structured, the internal audit activity's emphasis will shift to optimizing the governance structure and practices.

A. Evaluating the effectiveness of specific governance processes is typical of a more structured internal auditing governance maturity model. Moreover, governance does not exist as processes distinct from control and risk management.

C. Playing a consulting role in optimizing governance practices and structure is typical of a more structured internal auditing governance maturity model. The emphasis shifts to considering best practices and adapting them to the specific organization.

D. Internal auditors impair their objectivity by designing processes. However, evaluating the design and effectiveness of specific processes is a typical internal audit role.

26. Which of the following is a situation in which an internal auditor's role conflicts with the independence attribute of the internal audit activity?

A. The internal audit activity recommends a new whistleblower program for the organization.

B. The internal audit activity informs the board that it has implemented an organization-wide employee ethics program.

C. The board requests that the internal auditors assess whether the organization is complying with the code of conduct.

D. The CEO informs the board of recommendations made by the internal audit activity regarding the organization's compliance with the code of conduct.

Answer (B) is correct.

The design and implementation of governance processes are the responsibility of the board and management.

A. Recommending a new whistleblower program does not conflict with the independence attribute of the internal audit activity. But design and implementation are management functions inconsistent with the organizational independence of the internal audit activity.

C. The internal audit activity may assess governance processes.

D. The internal audit activity may recommend improvements in government processes.

27. Careful Corp. always has its internal auditors review transactions between Careful Corp. and its subsidiary, Risky Corp., to ensure that the transactions are carried out in a fair and transparent manner. This practice is most closely related to which of the following governance principles?

A. Oversight of related party transactions and conflicts of interest.

B. Effective interaction among the board, management, and assurance providers.

C. An organizational structure that supports accomplishing strategic objectives.

D. An organizational structure used to measure organizational and individual performance

Answer (A) is correct.

Careful Corp. and Risky Corp. are related (a parent and its subsidiary). Accordingly, having the internal auditors review transactions between Careful and Risky is most closely related to the governance principle of oversight of related party transactions and conflicts of interest.

- B. Although this practice would involve effective interaction among the board, management, and assurance providers, this practice is most closely related to another governance principle.
- C. This practice will not necessarily support the organization in accomplishing strategic objectives.
- D. This practice will not help measure organizational and individual performance.

28. Which of the following is consistent with a governance principle?

- A. Members of the audit committee are executives of the entity.
- B. The internal audit activity is organizationally independent.
- C. The entity engages in undisclosed related party transactions.
- D. A senior executive who can influence accounting policies receives stock options if earnings targets are met.

Answer (B) is correct.

Internal and external auditors should be used effectively to ensure (1) their independence, (2) the adequacy of their resources and the scope of their activities, and (3) the effectiveness of operations.

- A. The board should be independent and objective.
- C. The entity should oversee related party transactions.
- D. Compensation policies should encourage appropriate behavior consistent with the entity's values.

29. Which of the following statements regarding oversight as a component of governance is false?

- A. Risk management activities are performed by senior management and risk owners.
- B. Oversight includes internal and external assurance activities.
- C. Oversight is the governance component with which internal auditing is most concerned.
- D. Oversight determines the overall objectives.

Answer (D) is correct.

The elements of oversight are (1) the risk management activities of senior management and the board and (2) internal and external assurance activities. Strategic direction determines (1) the business model, (2) overall objectives, (3) the risk appetite, and (4) the limits of organizational conduct. Strategic direction, not oversight, determines overall objectives.

A.The performance of risk management activities by senior management and risk owners is an element of oversight.

B.Internal and external assurance activities are elements of oversight.

C.Oversight is the governance component with which internal auditing is most concerned. It is also the component to which risk management and control activities are most likely to be applied.

30.Strategic direction includes

A.Risk management activities performed by risk owners.

B.External assurance activities.

C.The governance component with which internal auditing is most concerned.

D.The organization's risk appetite.

Answer (D) is correct.

Strategic direction determines (1) the business model, (2) overall objectives, (3) the risk appetite, and (4) the limits of organizational conduct. The elements of oversight are (1) the risk management activities of senior management and the board and (2) internal and external assurance activities.

A.The performance of risk management activities by senior management and risk owners is an element of oversight.

B.Internal and external assurance activities are elements of oversight.

C.Oversight is the governance component with which internal auditing is most concerned. It is also the component to which risk management and control activities are most likely to be applied.

31.Which of the following are duties of risk committees?

1.Identifying key risks

2.Connecting risks to risk management processes

3.Delegating risks to risk owners

4.Considering whether tolerance levels delegated to risk owners are consistent with the organization's risk appetite.

A.1 and 2 only.

B.1 only.

C.2, 3, and 4 only.

D.1, 2, 3, and 4.

Answer (D) is correct.

A risk committee may be created that

- Identifies key risks,
- Connects them to risk management processes,
- Delegates them to risk owners, and
- Considers whether tolerance levels delegated to risk owners are consistent with the organization's risk appetite.

A. Risk committees also delegate risks to risk owners and consider whether tolerance levels delegated to risk owners are consistent with the organization's risk appetite.

B. Risk committees also connect risks to risk management processes, delegate risks to risk owners, and consider whether tolerance levels delegated to risk owners are consistent with the organization's risk appetite.

C. Risk committees also identify key risks.

32. Which of the following statements about organizational culture is false?

A. The organizational culture sets the values, objectives, and strategies of the organization.

B. Governance does not largely depend on organizational culture for effectiveness.

C. Organizational culture defines roles and behaviors.

D. The culture influences compliance with corporate social responsibilities.

Answer (B) is correct.

Governance practices reflect the organization's unique culture and largely depend on it for effectiveness.

A. The organizational culture does set the values, objectives, and strategies of the organization

C. The organizational culture does define roles and behaviors.

D. Organizational culture is reflected in complying with corporate social responsibilities.

33. Which of the following most likely should be stated in an entity's vision statement?

A. Personnel policies.

B. The strategic plan.

C. The strategy for maintaining a culture consistent with legal responsibilities.

D. Principles of internal control.

Answer (C) is correct.

Codes of conduct and vision statements are issued to state

- The organization's values and objectives;
- The behavior expected; and
- The strategies for maintaining a culture consistent with legal, ethical, and societal responsibilities.

A. Personnel policies are operating matters not appropriate for a vision statement.

B. The strategic plan is developed after a vision (mission) statement is drafted.

D. A vision statement is a broad description of an entity's mission, not a list of control principles

34. Which of the following is considered a potential stakeholder of an entity?

A. Shareholders.

B. Employees.

C. Suppliers.

D. All of the answers are correct.

Answer (D) is correct.

Stakeholders are persons or entities who are affected by the activities of the entity. Among others, these include shareholders, employees, suppliers, customers, neighbors of the entity's facilities, and government regulators.

A. Employees and suppliers are also stakeholders.

B. Shareholders and suppliers are also stakeholders.

C. Shareholders and employees are also stakeholders.

35. Which of the following most likely are considered potential stakeholders of an entity?

A. Close competitors.

B. Tax authorities.

C. Creditors of employees.

D. Neighbors of its facilities.

Answer (D) is correct.

Stakeholders are persons or entities who are affected by the activities of the entity. Among others, they include (1) shareholders, (2) employees, (3) suppliers, (4) customers, (5) neighbors of the entity's facilities, and (6) government regulators.

A. Close competitors are less likely than neighbors of an entity's facilities to be stakeholders.

B. Tax authorities are less likely than neighbors of an entity's facilities to be stakeholders.

C. Creditors of employees are less likely than neighbors of an entity's facilities to be stakeholders.

36. Attentive, Inc., has three managers: Albert, Bradley, and Chris.

- Albert is in charge of the accounting department. His duties involve the daily audit and producing the year-end financial statements.
- Bradley is in charge of production. His duties involve ensuring that production stays on schedule and that waste is minimized.
- Chris is in charge of support staff. His duties include ensuring that the workplace remains clean.

This practice is most closely related to which of the following governance principles?

A. Clear, enforced lines of responsibility and accountability.

B. An independent and objective board with sufficient expertise, experience, authority, and resources to conduct independent inquiries.

C. Reinforcement of an ethical culture, including employee feedback without fear of retaliation.

D. Clear definition and implementation of risk management policies and processes.

Answer (A) is correct.

Albert, Bradley, and Chris are responsible for different departments. This practice is therefore most closely related to the governance principle of clear, enforced lines of responsibility.

B. This practice does not demonstrate that there is an independent and objective board with sufficient expertise, experience, authority, and resources to conduct independent inquiries.

C. This practice does not reinforce an ethical culture, including employee feedback without fear of retaliation.

D. This practice does not facilitate a clear definition and implementation of risk management policies and processes.

37. <List A> applies to all organizational activities. Thus, its processes provide overall direction for <List B> activities. <List C> activities are a key element of risk management.

List A

List B

List C

A.Governance	Risk management	Internal control
B.Risk management	Governance	Internal control
C.Internal control	Risk management	Governance
D.Risk management	Internal control	Governance

Answer (A) is correct.

Governance applies to all organizational activities. Thus, its processes provide overall direction for risk management activities. Internal control activities are a key element of risk management. They implement the organization's risk management strategies.

B.Governance, not risk management, applies to all organizational activities.

C.Governance, not internal control, applies to all organizational activities.

D.Governance, not risk management, applies to all organizational activities. Additionally, internal control activities, not governance activities, are a key element of risk management.

38.In the governance structure, risk owners

A.Are senior managers.

B.Are responsible for day-to-day operations.

C.Identify stakeholders and unacceptable outcomes.

D.Carry out board directives.

Answer (B) is correct.

Risk owners are managers responsible for specific day-to-day operations. Senior managers determine who will be risk owners.

A.Senior managers determine who will be risk owners.

C.Directors identify stakeholders and unacceptable outcomes.

D.Senior managers carry out board directives.

39.The board as defined by The IIA

A.Ordinarily is a supervisory group appointed by senior managers.

B.May be the head of the organization.

C.Performs day-to-day governance functions.

D.Establishes reporting requirements for risk owners.

Answer (B) is correct.

The board is defined by The IIA as the highest governing body responsible for directing or overseeing the activities and management of the organization. It ordinarily includes an independent group of directors (e.g., a board of directors, a supervisory board, or a board of governors or trustees). If such a group does not exist, the board may be the head of the organization. The term also may refer to an audit committee to which the governing body has delegated certain functions. Thus, the board is the source of overall direction to, and the authority of, management. It also has the ultimate responsibility for oversight.

A. The board ordinarily includes an independent group of directors.

C. Management performs day-to-day governance functions.

D. Senior management establishes reporting requirements for risk owners related to their risk management activities.

40. The internal audit activity periodically assesses the elements of the ethical climate of the organization and its effectiveness in achieving legal and ethical compliance. Internal auditors therefore evaluate the effectiveness of which of the following?

1) Regular reviews of the processes that undermine the ethical culture

2) Confidential reporting of alleged misconduct

3) Personnel practices that encourage contributions by employees

A. 1 and 2 only.

B. 2 and 3 only.

C. 1 and 3 only.

D. 1, 2, and 3.

Answer (D) is correct.

The internal audit activity periodically assesses the elements of the ethical climate of the organization and its effectiveness in achieving legal and ethical compliance. Internal auditors therefore evaluate the effectiveness of regular reviews of the processes that undermine the ethical culture, confidential reporting of alleged misconduct, and personnel practices that encourage contributions by employees.

A. The internal audit staff also evaluates the effectiveness of personnel practices that encourage contributions by employees

B. The internal auditors also evaluate the effectiveness of regular reviews of the processes that undermine the ethical culture.

C. The internal auditors also evaluate the effectiveness of confidential reporting of alleged misconduct.

41. The internal audit activity's evaluation of the ethical climate of the organization extends to

1. Evaluating the effectiveness of background checks
2. Defining roles and specifying accountability
3. Evaluating the effectiveness of declarations by suppliers about the requirements of ethical behavior

A. 1 and 2 only.

B. 2 and 3 only.

C. 1 and 3 only.

D. 1, 2, and 3.

Answer (C) is correct.

The internal audit activity periodically assesses the elements of the ethical climate of the organization and its effectiveness in achieving legal and ethical compliance. As part of this assessment, the internal audit activity evaluates the effectiveness of background checks and of declarations by suppliers about the requirements of ethical behavior. However, defining roles and specifying accountability are management functions.

A. The internal audit staff also evaluates the effectiveness of declarations by suppliers about required behavior.

B. The internal auditors also evaluate the effectiveness of background checks.

D. The internal auditors do not have the authority to define roles and specify accountability

42. The board of directors of a corporation is not responsible for

A. Electing or removing directors.

B. Selecting and removing officers.

C. Coordinating audit activities.

D. Setting management compensation.

Answer (A) is correct.

The board of directors is responsible for (1) selecting and removing officers; (2) making decisions about capital structure; (3) adding, amending, or repealing bylaws; (4) initiating fundamental changes; (5) declaring and distributing dividends; (6) setting management compensation; (7) coordinating audit activities; and (8) evaluating and managing risk. But shareholders can elect or remove directors at the annual meeting.

- B.The board is responsible for selecting and removing officers.
- C.The board is responsible for coordinating audit activities.
- D.The board is responsible for setting management compensation.

43.The board of director's primary responsibility regarding internal control is to

- A.Identify stakeholders and the outcomes that are unacceptable.
- B.Review the reliability and integrity of financial and operational information.
- C.Establish a system of risk management.
- D.Implement and monitor controls designed.

Answer (A) is correct.

The board acts on behalf of the entity's stakeholders. Typically, the board discusses yearly performance and expected outcomes at an annual shareholders' meeting.

- B.Internal auditors are responsible for evaluating the adequacy and effectiveness of controls, including those relating to the reliability and integrity of financial and operational information.
- C.Senior management's role is to oversee the establishment, administration, and assessment of the system of risk management and control processes.
- D.The board has oversight responsibilities but ordinarily does not become involved in the details of operations.

44.An organization's code of conduct should address

- A.The organization's values, objectives, and adherence to legal responsibilities.
- B.Internal controls and proper reporting guidelines.
- C.The complexity of the organization and approach to risk-taking.
- D.Areas of significant risk within the organization.

Answer (A) is correct.

When evaluating a code of conduct, an internal auditor should consider (1) comprehensiveness and (2) compliance. The code should address the ethical issues that employees are expected to encounter and provide suitable guidance.

- B.A code of conduct does not establish internal control principles and standards.

- C.The governance bodies in an organization determine the overall approach to risk-taking.
- D.Management identifies the key risk areas within the organization. The internal auditor reviews these decisions to evaluate risk management within the organization.

45.An organization’s code of conduct should

- A.Establish monitoring activities.
- B.Address expected behavior and societal responsibilities.
- C.Specify key risks.
- D.Measure performance.

Answer (B) is correct.

Codes of conduct and vision statements are issued to state the organization’s values and objectives; the behavior expected; and the strategies for maintaining a culture consistent with legal, ethical, and societal responsibilities.

- A.A code of conduct does not establish monitoring activities.
- C.Management identifies the key risks within the organization. The internal auditor reviews these decisions to evaluate risk management within the organization.
- D.A code of conduct states (1) values and objectives, (2) expected behavior, and (3) strategies for maintaining an ethical culture.

46.Which of the following is least likely to influence corporate governance?

- A.Government regulators.
- B.Internal audit functions.
- C.External service providers.
- D.Corporate charters and bylaws.

Answer (C) is correct.

Corporate governance can be influenced by internal mechanisms (e.g., corporate charters and bylaws, boards of directors, and internal audit functions) and by external mechanisms (e.g., laws, regulations, and the government regulators who enforce them). As defined by The IIA Glossary, an external service provider is a person or firm outside of the organization that has special knowledge, skill, and experience in a particular discipline. Though external, an external service provider is least likely to influence corporate governance. Instead, they are relied upon to supplement the internal audit function when internal audit staff lack necessary knowledge, skill, or experience.

A. Corporate governance can be influenced by internal or external mechanisms. External mechanisms include government regulators who influence corporate governance by enforcing laws and regulations.

B. Corporate governance can be influenced by internal or external mechanisms. Internal mechanisms include internal audit functions, which influence corporate governance by evaluating and improving the processes and structures that enable an organization to achieve its objectives.

D. Corporate governance can be influenced by internal or external mechanisms. Internal mechanisms include corporate charters and bylaws, which influence corporate governance by establishing structures and policies.

47. According to the Standards, governance is

A. A process to identify, assess, manage, and control potential events or situations to provide reasonable assurance regarding the achievement of the organization's objectives.

B. The combination of processes and structures implemented by the board to inform, direct, manage, and monitor the activities of the organization toward the achievement of its objectives.

C. The leadership, organizational structures, and processes that ensure that the enterprise's information technology supports the organization's strategies and objectives.

D. The highest level governing body charged with the responsibility to direct and or oversee the organization's activities and hold senior management accountable.

Answer (B) is correct.

Governance is defined in the Standards as the "combination of processes and structures implemented by the board to inform, direct, manage, and monitor the activities of the organization toward the achievement of its objectives."

A. This statement defines risk management according to the Standards.

C. This statement defines information technology governance according to the Standards.

D. The statement defines, in part, board according to the Standards.

48. Which of the following statements is correct regarding governance?

A. Governance models are most effective when the framework is modeled after publicly traded companies' processes or systems.

B. Governance involves a set of relationships between an organization's management, board, shareholders, and other stakeholders.

C. Governance is independent of organizational culture.

D. Governance exists as a distinct process and structure separate from risk management and control.

B. Answer (B) is correct.

The globally accepted definition of corporate governance given by the Organization for Economic Co-operation and Development (OECD) states, “Corporate governance involves a set of relationships between a company’s management, its board, its shareholders, and other stakeholders. Corporate governance also provides the structure through which the objectives of the company are set, and the means of attaining those objectives and monitoring performance are determined.”

A. Governance requirements vary by entity type and regulatory jurisdiction. The design and practice of effective governance vary with the size and complexity of the organizations, along with the legal and regulatory requirements of the jurisdiction.

C. Governance practices reflect the organization’s unique culture and largely depend on it for effectiveness.

D. Governance does not exist independently of risk management and control. Rather, governance, risk management, and control are closely related. Effective governance considers risk when setting strategy, and risk management relies on effective governance. Additionally, effective governance relies on controls and communication to the board on their effectiveness. Control and risk are also related as controls manage risks.

49. Which of the following is the least likely purpose of governance?

A. Influence government regulators.

B. Establish appropriate structures.

C. Provide direction to the organization.

D. Establish appropriate processes

Answer (A) is correct.

Governance is concerned with optimizing organizational activities to achieve the organization’s objectives. Thus, its primary purposes are to inform, direct, manage, and monitor “internal” activities. Although government regulators influence governance, reciprocating such influence is not a primary purpose of governance.

B. A purpose of governance is to establish necessary structures to achieve organizational objectives.

C. Governance informs, directs, manages, and monitors the activities of the organization toward the achievement of its objectives.

D. A purpose of governance is to establish necessary processes to achieve organizational objectives.

50. Risk owners are responsible for which of the following?

I. Evaluating the organization’s ability to carry out risk management activities as designed.

II. Determining the expectations of stakeholders and the outcomes that are unacceptable.

III. Establishing monitoring activities.

IV. Ensuring that information to be reported is accurate, timely, and available.

A.I and II only.

B.I and III only.

C.I, III, and IV only.

D.III and IV only.

Answer (C) is correct.

Risk owners are responsible for (1) evaluating the adequacy of the design of risk management activities and the organization's ability to carry them out as designed; (2) determining whether risk management activities are operating as designed; (3) establishing monitoring activities; and (4) ensuring that information to be reported to senior management and the board is accurate, timely, and available.

A.The board determines the expectations of stakeholders and the outcomes that are unacceptable.

B.Risk owners also are responsible for ensuring that information to be reported to senior management and the board is accurate, timely, and available.

D.Risk owners also are responsible for evaluating the adequacy of the design of risk management activities and the organization's ability to carry them out as designed.

51. Which group is responsible for the initiation of fundamental changes for the organization?

A.Senior management.

B.Risk committee.

C.Internal audit activity.

D.Board of directors.

Answer (D) is correct.

The board of directors is the source of overall direction to, and the authority of, management and has the ultimate responsibility for oversight. The board has the following duties: (1) selection and removal of officers; (2) decisions about capital structure; (3) adding, amending, or repealing bylaws; (4) initiation of fundamental changes; (5) decisions to declare and distribute dividends; (6) setting of management compensation; (7) coordinating audit activities; and (8) evaluating and managing risk. Initiation of fundamental changes for the organization includes mergers and acquisitions.

A.Senior management performs day-to-day governance functions and carries out the board's directives to achieve the organization's objectives. Senior management is not responsible for the initiation of fundamental changes for the organization.

B.A risk committee may be created by the board to identify key risks and to consider whether tolerance levels delegated to risk owners are consistent with the organization's risk appetite.

C.The role of the internal audit activity depends on the maturity of the governance system. In a less mature system, the internal audit activity emphasizes compliance with policies, procedures, and laws.

In a more mature governance system, the internal audit activity's emphasis is on optimizing structure and practices. The internal audit activity is not responsible for the initiation of fundamental changes for the organization.

52. The responsibility of the internal audit activity in an assurance engagement for ethics-related matters is

- A. To evaluate the design and effectiveness of the organization's ethics-related activities.
- B. To promote and set the example of ethical behavior.
- C. To establish and maintain sound ethics-related objectives and programs.
- D. To oversee the organization's ethical climate.

Answer (A) is correct.

Implementation Standard 2110.A1 states, "The internal audit activity must evaluate the design, implementation, and effectiveness of the organization's ethics-related objectives, programs, and activities." The internal audit activity periodically assesses the elements of the ethical climate of the organization and its effectiveness in achieving legal and ethical compliance.

- B. Senior management has ultimate responsibility for promoting and setting the example of ethical behavior (i.e., setting the tone at the top).
- C. Senior management is responsible for establishing and maintaining sound ethics-related objectives and programs.
- D. The board oversees the organization's ethical climate.

53. According to COSO, culture is

- A. The behavior expected within the organization.
- B. The attitude and actions of the board and management regarding the importance of control within the organization.
- C. The combination of processes and structures within the organization.
- D. A reflection of the organization's mission and vision and consists of the attitudes, behaviors, and understanding about risk.

Answer (D) is correct.

According to the COSO Enterprise Risk Management framework, culture consists of the attitudes, behaviors, and understanding about risk, both positive and negative, that influence the decisions of management and personnel and reflect the mission, vision, and core values of the organization.

A. Codes of conduct and vision statements are issued to state the behavior expected within the organization.

B. The control environment reflects the attitude and actions of the board and management regarding the importance of control within the organization.

C. Answer (C) is incorrect.

Governance is the combination of processes and structures implemented by the board to inform, direct, manage, and monitor the activities of the organization toward the achievement of its objectives.

54. Organizational culture is reflected in which of the following?

I. Measuring performance

II. Specifying accountability

III. Complying with corporate social responsibilities

A. I only.

B. I and II only.

C. II and III only.

D. I, II, and III.

Answer (D) is correct.

Organizational culture is reflected in measuring performance, specifying accountability and complying with corporate social responsibilities.

A. Organizational culture also is reflected in specifying accountability and complying with corporate social responsibilities.

B. Organizational culture also is reflected in complying with corporate social responsibilities.

C. Organizational culture also is reflected in measuring performance.

55. Organizational culture that is risk averse likely has which of the following effects on the organization's control environment?

Importance of control within the organization

Engagement risks are assessed high

A. High

More likely

B. High

Less likely

C.Low

More likely

D.Low

Less likely

Answer (B) is correct.

Organizational culture that is risk averse is more likely to regard the importance of control within the organization as high. Consequently, engagement risks and controls are less likely to be assessed high.

A.Although the importance of control within the organization is likely to be high when organizational culture is risk averse, engagement risks are less likely to be assessed high.

C.An organizational culture that is risk aggressive is more likely to regard the importance of control within the organization as low. Consequently, engagement risks and controls are more likely to be assessed high.

D.Although engagement risks are less likely to be assessed high when organizational culture is risk averse, the importance of control within the organization is more likely to be high.

56.Which of the following should be defined in the internal audit plan for an assessment of governance?

1. The nature of the work
2. The governance process
3. The nature of the assessments

A.1 and 2 only.

B.2 and 3 only.

C.1 and 3 only.

D.1, 2, and 3.

Answer (D) is correct.

The audit plan should include higher-risk governance processes. It should define (1) the nature of the work; (2) the governance processes; and (3) the nature of the assessments, e.g., consideration of specific risks, processes, or activities.

A.The nature of the assessments also should be defined in the audit plan.

B.The nature of the work also should be defined in the audit plan.

C.The governance process also should be defined in the audit plan.

57. A basic principle of governance is

- A. Assessment of the governance process by an independent internal audit activity.
- B. Holding the board, senior management, and the internal audit activity accountable for its effectiveness.
- C. Exclusive use of external auditors to provide assurance about the governance process.
- D. Separation of the governance process from promoting an ethical culture in the organization.

Answer (A) is correct.

The internal audit activity must assess and make appropriate recommendations for improving the governance process.

- B. The internal audit activity is an assessor of the governance process. It is not accountable for that process.
- C. External parties and internal auditors may provide assurance about the governance process.
- D. The internal audit activity must assess and make appropriate recommendations for improving the governance process in its promotion of appropriate ethics and values within the organization.

58. In the governance process, the internal audit activity most likely should

- A. Coordinate the activities of the external and internal auditors and management.
- B. Communicate risk and control information.
- C. Evaluate the process for performance management.
- D. Promote ethics and values.

Answer (C) is correct.

The internal audit activity must assess and make appropriate recommendations to improve the organization's governance processes for

- Making strategic and operational decisions;
- Overseeing risk management and control;
- Promoting appropriate ethics and values within the organization;
- Ensuring effective organizational performance management and accountability;
- Communicating risk and control information to appropriate areas of the organization; and

- Coordinating the activities of, and communicating information among, the board, external and internal auditors, other assurance providers, and management (Perf. Std. 2110).

A. The internal audit activity evaluates the processes by which activities of the external and internal auditors and management are coordinated.

B. The internal audit activity evaluates the processes by which risk and control information is communicated.

D. The internal audit activity evaluates the processes by which ethics and values are promoted.

59. Which of the following should an internal auditor consider when assessing governance?

- 1) Audits of specific processes
- 2) Governance issues arising from audits not focused on governance
- 3) The results of other assurance providers' work
- 4) Information such as adverse incidents indicating an opportunity to improve governance

A. 1 and 3 only.

B. 2 and 4 only.

C. 1, 2, and 3 only.

D. 1, 2, 3, and 4.

Answer (D) is correct.

Assessments of governance are likely to be based on numerous audits. The internal auditor should consider

- Audits of specific processes,
- Governance issues arising from audits not focused on governance,
- The results of other assurance providers' work, and
- Other information such as adverse incidents indicating an opportunity to improve governance

A. Internal auditors should also consider governance issues arising from audits not focused on governance and other information such as adverse incidents indicating an opportunity to improve governance.

B. Internal auditors should also consider audits of specific processes and the results of other assurance providers' work.

C. Internal auditors should also consider other information such as adverse incidents indicating an opportunity to improve governance.

60. The internal audit activity should contribute to the organization's governance process by evaluating the processes through which

1. Ethics and values are promoted.
2. Effective organizational performance management and accountability are ensured.
3. Risk and control information is communicated.
4. Activities of the external and internal auditors and management are coordinated.

A.1 only.

B.4 only.

C.2 and 3 only.

D.1, 2, 3, and 4.

Answer (D) is correct.

The internal audit activity must assess and make appropriate recommendations to improve the organization's governance processes for:

- Making strategic and operational decisions;
- Overseeing risk management and control;
- Promoting appropriate ethics and values within the organization;
- Ensuring effective organizational performance management and accountability;
- Communicating risk and control information to appropriate areas of the organization; and
- Coordinating the activities of, and communicating information among, the board, external and internal auditors, other assurance providers, and management (Perf. Std. 2110).

A.The internal audit activity also evaluates the processes through which effective organizational performance management and accountability are ensured, risk and control information is communicated, and activities of the external and internal auditors and management are coordinated.

B.The internal audit activity also evaluates the processes through which ethics and values are promoted, effective organizational performance management and accountability are ensured, and risk and control information is communicated.

C.The internal audit activity also evaluates the processes through which ethics and values are promoted and activities of the external and internal auditors and management are coordinated.

61.The design and practice of effective governance vary with

- 1) The size, complexity, and life-cycle maturity of the organization
- 2) The organization's stakeholder structure
- 3) Legal and cultural requirements

A.1 and 2 only.

B.2 and 3 only.

C.1 and 3 only.

D.1, 2, and 3.

Answer (D) is correct.

The design and practice of effective governance vary with

- The size, complexity, and life-cycle maturity of the organization;
- The organization's stakeholder structure; and
- Legal and cultural requirements.

A.The design and practice of effective governance also vary with legal and cultural requirements.

B.The design and practice of effective governance also vary with the size, complexity, and life-cycle maturity of the organization.

C.The design and practice of effective governance also vary with its stakeholder structure.

62.Craig is the chief audit executive (CAE) of Marlin, Inc., and is in the process of planning an assessment of governance at Marlin. Which of the following should Craig consider in planning the assessment of governance?

A.Whether all major decisions have been authorized by senior management.

B.Whether he can rely on the assessment of internal control performed by external auditors.

C.Whether employees at all levels of the organization adhere to the code of ethics.

D.All of the answers are correct.

Answer (D) is correct.

The CAE should consider the following in planning assessments of governance:

- An audit should address controls in governance processes that are designed to prevent or detect events that could have a negative effect on the organization;
- Controls within governance processes often are significant in managing multiple risks; and,
- If other audits assess controls in governance processes, the auditor should consider relying on their results.

Thus, Craig should consider all of the answer choices when planning the assessment of governance.

A.Craig also should determine whether he can rely on the assessment of internal control performed by external auditors and whether employees at all levels of the organization adhere to the code of ethics.

B.Craig also should verify that all major decisions have been authorized by senior management and determine whether employees at all levels of the organization adhere to the code of ethics.

C.Craig also should verify that all major decisions have been authorized by senior management and determine whether he can rely on the assessment of internal control performed by external auditors.

63.Which of the following most likely should be considered in the internal audit activity's planning for the assessment of governance?

A.Whether all decisions have been authorized by the board.

B.Relying on the assessment of internal control in other audits.

C.The compliance of the organization with the internal audit activity's definition of governance.

D.The ways in which control and risk are unrelated.

Answer (B) is correct.

The chief audit executive should consider the following in planning assessments of governance:

- An audit should address controls in governance processes that are designed to prevent or detect events that could have a negative effect on the organization;
- Controls within governance processes often are significant in managing multiple risks; and,
- If other audits assess controls in governance processes, the auditor should consider relying on their results.

A.Management performs most governance functions. For example, senior management determines (1) where risks are managed, (2) who will be risk owners, and (3) how risks will be managed.

C.The internal audit activity should agree upon the definition of governance with the board and senior management. The IIA has defined governance. But if the organization's definition differs, the CAE may use that definition.

D.Controls address risks. Thus, they are related.

64.Which of the following are roles of the internal audit activity in best practice governance activities?

1) Report significant audit issues

2) Support the board in enterprise-wide risk assessment

3) Conduct follow-up and report on management's response to external audit

4) Act as custodian of corporate assets in the pursuit of positive outcomes for stakeholders

A.1 and 3 only.

B.2 and 4 only.

C.1, 2, and 3 only.

D.1, 2, 3, and 4.

Answer (C) is correct.

The internal audit activity reports significant audit issues, supports the board in enterprise-wide risk assessment, and conducts follow-up and reports on management's response to external audits as part of its best practice governance activities.

A.The internal audit activity also supports the board in enterprise-wide risk assessment.

B.The internal audit activity also reports significant audit issues and conducts follow-up and reports on management's response to external audits but does not act as custodian of corporate assets in pursuit of positive outcomes for stakeholders.

D.The board and senior management, not the internal audit activity, act as custodians of corporate assets in the pursuit of positive outcomes for stakeholders.

65.The design and implementation of governance processes are the responsibility of

The board

Management

A.Yes

Yes

B.Yes

No

C.No

Yes

D.No

No

Answer (A) is correct.

Governance is one of the three basic processes identified in the Definition of Internal Auditing. The design and implementation of governance processes are the responsibility of the board and management.

B.Management is also responsible for the design and implementation of governance processes.

C.The board is also responsible for the design and implementation of governance processes.

D.Both management and the board are responsible for the design and implementation of governance processes.

66.Which of the following statements regarding governance is false?

A.Governance has a range of definitions depending on the circumstances.

B.Governance models generally treat governance as a process or a system that is static.

- C. Governance requirements vary by entity type and regulatory jurisdiction.
- D. Governance does not exist as distinct processes and control structures.

Answer (B) is correct.

Governance models generally treat governance as a process or a system that is not static. The approach in the Standards emphasizes the board and its governance activities.

- A. Governance does have a range of definitions depending on the circumstances. The chief audit executive may use a different definition when the organization uses a different model.
- C. Governance requirements do vary by entity type and regulatory jurisdiction. Examples include publicly traded companies, not-for-profits, governments, private companies, and stock exchanges.
- D. Governance does not exist as distinct processes and control structures but instead as relationships with risk management and control.

67. Which of the following statements about governance is true?

- A. Governance exists as distinct processes and controls.
- B. The chief audit executive is likely to use consultants to assess governance when the organization's process is mature.
- C. Governance is essentially a static process.
- D. Governance has a range of definitions depending on the circumstances.

Answer (D) is correct.

Governance has a range of definitions depending on the circumstances. The chief audit executive should work with the board and senior management, as appropriate, to determine how governance should be defined for internal audit purposes.

- A. Governance does not exist as distinct processes and structures but as relationships with risk management and control.
- B. The chief audit executive is likely to use consultants to assess governance when the organization's process is (1) not mature, or (2) control issues are known.
- C. Governance models generally treat governance as a process or a system that is not static. The approach in the Standards emphasizes the board and its governance activities.

68. The internal audit activity assesses the coordination of the activities of the board, management, and auditors. This assessment most directly relates to the function of

- A. Quality assurance.

- B.Risk management.
- C.Governance.
- D.The control environment.

Answer (C) is correct.

The internal audit activity must assess and make appropriate recommendations to improve the organization's governance processes for:

- Making strategic and operational decisions;
- Overseeing risk management and control;
- Promoting appropriate ethics and values within the organization;
- Ensuring effective organizational performance management and accountability;
- Communicating risk and control information to appropriate areas of the organization; and
- Coordinating the activities of, and communicating information among, the board, external and internal auditors, other assurance providers, and management (Perf. Std. 2110).

A.A quality assurance program normally is implemented for an organizational unit, e.g., the internal audit activity.

B.Governance (not risk management) is directly responsible for coordinating the activities of, and communicating information among, the board, external and internal auditors, other assurance providers, and management

D.Governance (not control) is directly responsible for coordinating the activities of, and communicating information among, the board, external and internal auditors, other assurance providers, and management

69.Which of the following is not a role of the internal audit activity in best practice governance activities?

- A.Support the board in enterprise-wide risk assessment.
- B.Ensure the timely implementation of audit recommendations.
- C.Monitor compliance with the corporate code of conduct.
- D.Discuss areas of significant risks.

Answer (B) is correct.

Management has the responsibility of ensuring the timely implementation of the audit recommendations. The internal audit activity is responsible for the development of a timely procedure to monitor the disposition of the audit recommendations. It works with senior management and the board to ensure that audit recommendations receive appropriate attention.

A. One internal audit activity role is to support the board in enterprise-wide risk assessment. The board and management are responsible for the identification of an appropriate risk model and methodology.

C. The internal audit activity should monitor compliance with the corporate code of conduct set by the board and management.

D. The internal audit activity is responsible for discussing significant financial, technical, and operational risks and exposures as well as the plans to minimize such risks.

70. The internal audit activity most directly contributes to the governance process by

A. Assessing organizational performance management.

B. Evaluating the adequacy of controls over safeguarding of assets.

C. Evaluating the effectiveness of the risk-management system.

D. Assessing whether the organization's objectives align with its mission.

Answer (A) is correct.

The internal audit activity must assess and make appropriate recommendations to improve the organization's governance processes for:

- Making strategic and operational decisions;
- Overseeing risk management and control;
- Promoting appropriate ethics and values within the organization;
- Ensuring effective organizational performance management and accountability;
- Communicating risk and control information to appropriate areas of the organization; and
- Coordinating the activities of, and communicating information among, the board, external and internal auditors, other assurance providers, and management (Perf. Std. 2110).

B. Evaluating the adequacy of controls over safeguarding of assets relates to controls, not governance.

C. Evaluating the effectiveness of the risk-management system relates to risk management, not governance.

D. Assessing whether the organization's objectives align with its mission relates to risk management, not governance.

71. Examples of CSR include all of the following except

A. A pharmaceutical company that produces potentially addictive pain medication donates to addiction treatment facilities.

B. A tobacco company donates money to stop-smoking initiatives as a result of the settlement to a lawsuit.

C. A professional services firm pays its employees a bonus each year for providing services as volunteers to local not-for-profit organizations.

D.A delivery company uses its distribution network to deliver supplies for free to areas affected by natural disasters.

Answer (B) is correct.

The donation is not an example of CSR because it is not voluntary. Socially responsible actions that are required in response to corporate misdeeds or in response to a lawsuit are more akin to punishment than to CSR.

A.The donation is voluntary and intended to benefit groups other than shareholders.

C.The bonus is voluntary and benefits groups other than shareholders. CSR does not only apply to corporate entities, despite its title.

D.The delivery is voluntary and benefits groups other than shareholders.

72.Which of the following is not a benefit of implementing ISO 14000?

A.Increased cost of waste management.

B.Savings in consumption of energy.

C.Lower distribution costs.

D.Improved corporate image.

Answer (A) is correct.

Using ISO 14000 can (1) decrease, not increase, the cost of waste management; (2) provide savings in consumption of energy and materials; (3) lower distribution costs; and (4) improve corporate image among regulators, customers, and the public.

B.Using ISO 14000 should result in savings in consumption of energy and materials

C.Using ISO 14000 should lower distribution costs.

D.Using ISO 14000 should improve corporate image among regulators, customers, and the public.

73.Which of the following stakeholders have needs that must be considered when determining the effects of a corporate social responsibility (CSR) program?

1. Shareholders

2. Employees

3. Competitors

4. Society

- A.1 only.
- B.4 only.
- C.1 and 3 only.
- D.1, 2, and 4 only.

Answer (D) is correct.

An organization has many stakeholders whose needs must be balanced when developing a CSR program. Shareholders, employees, and society must be considered, among others. Competitors' needs are not a factor in a CSR decision.

- A.Shareholders are not the only stakeholders that must be considered in a CSR program.
- B.Society is not the only stakeholder that must be considered in a CSR program.
- C.Competitors are not a stakeholder to be considered in a CSR program.

74.Although corporate social responsibility (CSR) involves the incurrence of certain costs, in what ways can CSR also produce benefits?

- 1) Positive public perception on a local, national, and international level
- 2) Retention of workers
- 3) Charity as a form of advertising
- 4) Deductibility of charitable donations

- A.1 and 3 only.
- B.2 and 4 only.
- C.2, 3, and 4 only.
- D.1, 2, 3, and 4.

Answer (D) is correct.

CSR can be profitable. Serving the community involves certain costs; however, the benefits of CSR may exceed the costs. Examples of the benefits are

- Positive public perception on a local, national, and international level;
- Retention of workers;
- Charity as a form of advertising (brand building); and
- Deductibility of charitable donations.

A.The benefits of CSR can also include the retention of workers and the deductibility of charitable donations.

B.The benefits of CSR can also include positive public perception on a local, national, and international level.

C.The benefits of CSR can also include positive public perception on a local, national, and international level.

75.Which of the following is true regarding ISO 14000?

A.It is a set of criteria established by the International Organization for Standardization for financial reporting.

B.It details certain requirements for environmental performance and details the punishments for failing to meet those requirements.

C.It often results in higher costs in processes but is compensated for by an improved public image.

D.None of the answers are correct.

Answer (D) is correct.

ISO 14000 is a set of criteria established by the International Organization for Standardization for an environmental management system. This system is not required but provides standards for implementing and maintaining environmental management systems. Additionally, such systems provide lower costs and improve corporate image.

A.ISO 14000 is a set of criteria established by the International Organization for Standardization for an environmental management system.

B.ISO 14000 does not state requirements for environmental performance.

C.ISO 14000 often results in lower costs of waste management, savings in consumption of energy and materials, and lower distribution costs. Additionally, these standards often result in improved corporate image among regulators, customers, and the public.

76.Which of the following is true regarding ISO 14000?

A.It applies to environmental management systems.

B.It provides for investigation of violations.

C.It states requirements for environmental performance, such as efficient uses of resources and reductions of waste.

D.It is a set of criteria established for a quality management program.

A.Answer (A) is correct.

ISO 14000 is a set of criteria established by the International Organization for Standardization for an environmental management system. This system is not required but provides standards for implementing and maintaining environmental management systems. Moreover, such systems provide lower costs and improve corporate image.

B.ISO 14000 does not state requirements for environmental performance.

C.ISO 14000 is merely a set of criteria for certification of an environmental management system. It states no requirements and has no enforcement process.

D.ISO 14000 is a set of criteria established by the International Organization for Standardization for an environmental management system.

77.Business ethics scholar Archie B. Carroll has identified four responsibilities an organization must fulfill to be called socially responsible. All of the following is one of these four responsibilities except

A.Environmental responsibility in consumption of energy.

B.Philanthropic responsibility to be a good corporate citizen.

C.Economic responsibility to be profitable.

D.Ethical responsibility to be ethical in its practices.

Answer (A) is correct.

ISO 14000 standards are a set of criteria established by the International Organization for Standardization (ISO) for certification of an environmental management system. The benefits of using ISO 14000 can include (1) reduced cost of waste management; (2) savings in consumption of energy and materials; (3) lower distribution costs; and (4) improved corporate image among regulators, customers, and the public. However, compliance with an ISO 14000 criterion is not one of the four responsibilities that an organization must fulfill to be called socially responsible as identified by Archie B. Carroll. These four responsibilities are (1) economic responsibility, (2) legal responsibility, (3) ethical responsibility, and (4) philanthropic responsibility.

B.Philanthropic responsibility to be a good corporate citizen, or to do what is desired by stakeholders, can be described as engaging in corporate contributions and giving back to the communities in which the corporations function. Philanthropic responsibility is one of the identified responsibilities an organization must fulfill to be called socially responsible.

C.An organization has the economic responsibility to be profitable (or to do what is required by capitalism) in order to provide an investment return to the organization's owners and shareholders. Economic responsibility to be profitable is one of the identified responsibilities an organization must fulfill to be called socially responsible.

D.An organization has the ethical responsibility to be ethical in its practices, given local and global standards. Ethical responsibility has a broad scope and includes (1) treatment of employees; (2) truthful advertising; (3) providing a clean and safe workplace; and (4) managing waste, recycling, and consumption. Ethical responsibility is one of the identified responsibilities an organization must fulfill to be called socially responsible.

78.The Global Reporting Initiative (GRI) has developed a sustainability reporting framework that

- A.Emphasizes how to implement and manage a CSR initiative.
- B.Provides specific guidance on measuring CSR performance.
- C.Manages the disclosure of CSR to stakeholders.
- D.Provides a forum in which governments can work together to share experiences and to seek solutions to common problems.

Answer (B) is correct.

The GRI has developed a sustainability reporting framework that provides specific guidance on measuring CSR performance against predefined criteria.

- A.The International Organization for Standardization (ISO) 26000 framework emphasizes how to implement and manage a CSR initiative.
- C.Organizations exercise significant discretion in deciding what to disclose about their CSR performance. In most jurisdictions, public companies are not required to disclose their CSR performance. However, most organizations with stated CSR objectives provide public information about their approach and results.
- D.The mission of the Organization for Economic Co-operation and Development (OECD) is to provide a forum in which governments can work together to share experiences and to seek solutions to common problems.

79.A company has denied for years that it bears any responsibility for damage allegedly caused by its trucks to public roads. No further actions have been taken by the company. This is an example of which corporate social responsibility strategy?

- A.Proaction.
- B.Accommodation.
- C.Defense.
- D.Reaction.

Answer (D) is correct.

Reaction is when the organization denies or ignores responsibility and tries to maintain the status quo. The company has denied responsibility for years. Therefore, this is an example of a reaction strategy.

- A.Proaction is when the organization takes the initiative in implementing a CSR program that serves as an example for the industry. There is no indication the company has taken the initiative in implementing a CSR program.
- B.Accommodation is when the organization assumes additional responsibilities only when pressured. The company has not assumed any responsibility for the damage to the roads.

C. Defense is when the organization uses legal action or public relations efforts to avoid additional responsibilities. There is no indication the company has used public relations or initiated legal action.

80. Within the organization, who generally is responsible for establishing CSR objectives and measuring performance?

- A. Management.
- B. The board.
- C. All employees.
- D. Internal auditors.

Answer (A) is correct.

Management generally is responsible for establishing CSR objectives, assessing and managing risks, measuring performance, and monitoring and reporting activities.

B. The board is responsible for overseeing CSR and the effectiveness of governance, risk management, and the internal control process related to CSR.

C. All employees are responsible for the success of CSR initiatives. However, management generally is responsible for establishing CSR objectives and measuring performance.

D. The internal auditor is responsible for evaluating whether controls over CSR are adequate to achieve CSR objectives.

81. Which of the following is the least likely risk of failing to implement an effective CSR program?

- A. Loss of reputation.
- B. Failure to comply with regulations.
- C. Failure to set performance targets.
- D. Loss of employees.

Answer (C) is correct.

Failing to set performance targets is not considered a risk of failing to implement an effective CSR program. Setting objectives, performance goals, and strategies are generally considered to be CSR business activities. Examples of CSR performance targets include reduced safety incidents and increased employee volunteerism.

A. The organization's brand or reputation could be damaged if an effective CSR program is not implemented. Organizations, by behaving in a socially responsible manner, have the opportunity to enhance, not damage, their reputation.

B. Failing to comply with regulations or contractual obligations is a likely consequence of failing to implement an effective CSR program.

D. Risks of failing to implement an effective CSR program include employees leaving the organization and difficulty attracting new employees.

82. In which CSR business activity would an organization consider CSR risks before projects are approved?

A. Integrating CSR principles and controls into the decision-making process.

B. Establishing and communicating policies and procedures.

C. External and internal reporting of results.

D. Monitoring, evaluating results, and benchmarking.

Answer (A) is correct.

CSR business activities generally include (1) establishing and communicating policies and procedures; (2) setting objectives, performance goals, and strategies; (3) communicating and integrating CSR principles and controls into the business decision-making processes; (4) monitoring, evaluating results, and benchmarking; (5) engaging stakeholders; (6) auditing; and (7) external and internal reporting of results. CSR controls are actions taken to manage CSR risks. Thus, an organization considers CSR risks before projects are approved and communicates and integrates CSR principles and controls into the business decision-making processes.

B. In this activity, the organization establishes and communicates policies and procedures for areas such as corporate governance, business ethics, human resources, and stakeholder relations. However, it is not the business activity that includes considering CSR risks before approval of projects.

C. The external and internal reporting of results occurs after projects are approved.

D. The monitoring and evaluating of results is performed after projects are approved. Although benchmarking may be performed before projects are approved, the consideration of CSR risks before project approval is performed in a separate activity.

83. A CSR audit procedure requires the internal auditor to determine if the organization's code of conduct includes provisions on anti-corruption. This procedure is most likely testing which CSR element?

A. Working conditions.

B. Environment.

C. Governance.

D. Ethics.

Answer (D) is correct.

A CSR audit of the ethics element typically includes determining whether the organization reflects an anti-corruption culture, as evidenced, for example, in the organization's risk assessment, code of conduct, or policies.

A. Tests relating to the working conditions element most likely concern fair pay and hiring practices, among others.

B. Tests relating to the environment element most likely concern social and environmental issues (e.g., social and environmental impact assessments).

C. Tests relating to the governance element most likely concern the board and reporting information to stakeholders.

84. The internal auditor is performing a CSR audit by stakeholder group. Which of the following represent a stakeholder group?

I. Shareholders.

II. Neighboring communities.

III. Employees and their families.

IV. The environment.

A. I and III only.

B. I, II, and III only.

C. I, II, and IV only.

D. I, II, III, and IV.

Answer (D) is correct.

Typical CSR stakeholder groups are (1) customers, (2) employees and their families, (3) the environment, (4) neighboring communities, (5) shareholders, and (6) suppliers.

A. Stakeholder groups also include neighboring communities and the environment.

B. Stakeholder groups also include the environment.

C. Stakeholder groups also include employees and their families.

## PART 1 UNIT 4

**Question: 1** When the executive management of an organization decided to form a team to investigate the adoption of an activity-based costing (ABC) system, an internal auditor was assigned to the team. The best reason for including an internal auditor is the internal auditor's knowledge of

- A. Activities and cost drivers.
- B. Information processing procedures.
- C. Current product cost structures.
- D. Risk management processes.

**Answer (D) is correct.**

The internal audit activity's scope of work extends to evaluating the organization's risk management processes. The internal audit activity should assist the organization by identifying and evaluating significant exposures to risk and contributing to the improvement of risk management and control systems.

- A** An engineer has more knowledge than an internal auditor about activities and cost drivers.
- B** An information systems expert has more knowledge than an internal auditor about information needs and information processing procedures.
- C** A management accountant has more knowledge than an internal auditor about a company's current product cost.

**Question: 2** Internal auditors should review the means of physically safeguarding assets from losses arising from

- A. Misapplication of accounting principles.
- B. Procedures that are not cost justified.
- C. Exposure to the elements.
- D. Underusage of physical facilities.

**Answer (C) is correct.**

The internal audit activity must evaluate risk exposures relating to governance, operations, and information systems regarding the safeguarding of assets (Impl. Std. 2120.A1). For example,

internal auditors evaluate risk exposure arising from theft, fire, improper or illegal activities, and exposure to the elements.

**A** Misapplication of accounting principles relates to the reliability of information and not physical safeguards.

**B** Procedures that are not cost justified relate to efficiency, not effectiveness, of operations.

**D** Underusage of facilities relates to efficiency of operations.

**Question: 3** Which of the following activities is outside the scope of internal auditing?

A. Evaluating risk exposures regarding compliance with policies, procedures, and contracts.

B. Safeguarding of assets.

C. Evaluating risk exposures regarding compliance with laws and regulations.

D. Ascertaining the extent to which management has established criteria to determine whether objectives have been accomplished.

**Answer (B) is correct.**

Safeguarding assets is an operational activity and is therefore beyond the scope of the internal audit activity. However, the internal audit activity's assurance function evaluates the adequacy and effectiveness of controls related to the organization's governance, operations, and information systems regarding safeguarding of assets (Perf. Std. 2130).

**A** Internal auditors must evaluate risk exposures relating to, among other things, the organization's compliance with laws, regulations, policies, procedures, and contracts.

**C** The internal audit activity must evaluate risk exposures relating to, among other things, the organization's compliance with laws, regulations, policies, procedures, and contracts.

**D** Ascertaining the extent to which management has established adequate criteria to determine whether objectives have been accomplished is within the scope of internal auditing.

**Question: 4** Standard 2120 states that the internal audit activity must evaluate the effectiveness and contribute to the improvement of risk management processes. Conformance with Standard 2120 is best demonstrated by

A. The work programs for formal consulting engagements.

B. The business continuity plan.

C. The charter of the internal audit activity.

D. Review by the internal auditors immediately following a disaster.

**Answer (C) is correct.**

Documents demonstrating conformance with Standard 2120 include the internal audit charter. It describes the internal audit activity's roles and responsibilities regarding risk management. Other documents include (1) the internal audit plan, (2) minutes of meetings in which internal audit recommendations were discussed, (3) internal audit risk assessments, and (4) internal audit action plans addressing risks.

A A work program is a listing of specific procedures.

B Business continuity planning is just one element of risk management.

D The internal audit activity's role needs to be understood before a crisis.

**Question: 5** Which of the following is not an activity undertaken as part of risk management?

A. Risk identification.

B. Risk analysis.

C. Risk exposure.

D. Risk response.

**Answer (C) is correct.**

Risk exposure is a condition, not an activity.

A Risk management processes include risk identification, risk analysis, and appropriate risk response.

B Risk management processes include risk identification, risk analysis, and appropriate risk response.

D Risk management processes include risk identification, risk analysis, and appropriate risk response.

**Question: 6** In the risk management process, management's view of the internal audit activity's role is likely to be determined by all of the following factors except

A. Organizational culture.

B. Preferences of the independent auditor.

C. Ability of the internal audit staff.

D. Local conditions and customs of the country.

**Answer (B) is correct.**

Ultimately, the role of internal auditing in the risk management process is determined by senior management and the board. Their view on internal auditing's role is likely to be determined by factors such as the culture of the organization, ability of the internal audit staff, and local conditions and customs.

**A** Organizational culture is a factor that influences management's view of the role of internal auditing.

**C** The ability of the internal audit staff is a factor that influences management's view of the role of internal auditing.

**D** Local conditions and customs of the country influence management's view of the role of internal auditing.

**Question: 7** Which of the following is the most accurate term for a process to identify, assess, manage, and control potential events or situations to provide reasonable assurance regarding the achievement of the organization's objectives?

A. The internal audit activity.

B. Control process.

C. Risk management.

D. Consulting service.

**Answer (C) is correct.**

Risk management is "a process to identify, assess, manage, and control potential events or situations to provide reasonable assurance regarding the achievement of the organization's objectives" (The IIA Glossary).

**A** The internal audit activity assists in risk management; it is not the same thing as risk management.

**B** Control processes are "the policies, procedures, and activities that are part of a control framework designed to ensure that risks are contained within the risk tolerances established by the risk management process" (The IIA Glossary).

**D** Consulting services are "advisory and related client service activities, the nature and scope of which are agreed with the client" (The IIA Glossary).

**Question: 8** The internal audit activity must evaluate the effectiveness and contribute to the improvement of risk management processes. With respect to evaluating the adequacy of risk management processes, internal auditors most likely should

- A. Recognize that organizations should use similar techniques for managing risk.
- B. Determine that the key objectives of risk management processes are being met.
- C. Determine the level of risks acceptable to the organization.
- D. Treat the evaluation of risk management processes in the same manner as the risk analysis used to plan engagements.

**Answer (B) is correct.**

Internal auditors need to obtain sufficient and appropriate evidence to determine that key objectives of the risk management processes are being met to form an opinion on the adequacy of risk management processes.

**A** Risk management processes vary with the size and complexity of an organization's business activities.

**C** Management and the board determine the level of acceptable organizational risks.

**D** Evaluating management's risk processes differs from the internal auditors' risk assessment used to plan an engagement, but information from a comprehensive risk management process is useful in such planning.

**Question: 9** Which of the following is a false statement about risk responses?

- A. Each organization must assess the relationship between the likelihood and significance of risks.
- B. Identified risks cannot simply be accepted.
- C. Some risks require the creation of elaborate control structures.
- D. There is no direct correlation between the severity of a risk and the cost of the response to that risk.

**Answer (B) is correct.**

While some risks require the creation of elaborate control structures, others may simply be accepted.

**A** Each organization must assess the relationship between the likelihood and significance of risks and must design the appropriate controls.

**C** This is a true statement about risk responses. For example, although the total physical destruction of a data center may be highly unlikely, if it were to occur, the ability of the entity to function may be questionable. Therefore, a contingency plan for such an occurrence is almost a necessity.

**D** There is no direct correlation between the severity of a risk and the cost of the response to that risk.

**Question: 10** Which of the following is the correct order of steps in the risk management process?

1. Identify risks
2. Monitor risk responses
3. Formulate risk responses
4. Assess and prioritize risks
5. Identify context

A. 5, 1, 4, 3, 2.

B. 1, 4, 3, 2, 5.

C. 1, 3, 5, 4, 2.

D. 1, 5, 4, 3, 2.

**Answer (A) is correct.**

The correct order of steps in the risk management process is as follows: identify context, identify risks, assess and prioritize risks, formulate risk responses, and monitor risk responses.

**B** Identifying context occurs before identifying risks.

**C** Identifying context occurs before identifying risks; assessing and prioritizing risks occurs before formulating risk responses.

**D** Identifying context occurs before identifying risks.

**Question: 11** When assessing the risk associated with an activity, an internal auditor should

- A. Determine how the risk should best be managed.
- B. Provide assurance on the management of the risk.
- C. Update the risk management process based on risk exposures.
- D. Design controls to mitigate the identified risks.

**Answer (B) is correct.**

The internal audit activity must evaluate and contribute to the improvement of processes using a systematic, disciplined, and risk-based approach. Assurance service is an objective of evidence examination to provide an independent assessment.

**A** Risk management is a key responsibility of senior management and the board, not the internal auditor.

**C** Designing and updating the risk management process is a role of management.

**D** The design and implementation of controls is the responsibility of management, not internal audit.

**Question: 12** The primary reason that a bank would maintain a separate compliance function is to

A. Better manage perceived high risks.

B. Strengthen controls over the bank's investments.

C. Ensure the independence of line and senior management.

D. Better respond to shareholder expectations.

**Answer (A) is correct.**

The risk management process identifies, assesses, manages, and controls potential risk exposures. Organizations such as brokers, banks, and insurance companies may view risks as sufficiently critical to warrant continuous oversight and monitoring.

**B** A separate compliance function may help strengthen controls, but this is not its primary purpose.

**C** Risk management is the direct responsibility of management.

**D** A separate compliance function will help respond to shareholder needs, but this is not its primary purpose.

**Question: 13** An internal auditor plans to conduct an audit of the adequacy of controls over investments in new financial instruments. Which of the following would not be required as part of such an engagement?

A. Determine if policies exist which describe the risks the chief financial officer may take and the types of instruments in which the chief financial officer may make investments.

- B. Determine the extent of management oversight over investments in sophisticated instruments.
- C. Determine whether the chief financial officer is getting higher or lower rates of return on investments than are chief financial officers in comparable organizations.
- D. Determine the nature of controls established by the chief financial officer to monitor the risks in the investments.

**Answer (C) is correct.**

The auditor does not need to develop a comparison of investment returns with those of other organizations. In some financial investment scandals, such comparisons can be highly misleading because high returns were due to taking on a high level of risk. Also, this determination does not test the adequacy of the controls.

**A** The first step should be to determine the nature of policies established to manage the risks associated with the investments. New financial instruments are very risky.

**B** Sophisticated financial instruments are complex by their nature and can carry a high level of risk. Thus, the auditor should determine the nature of the risk management process established to monitor and authorize such investments.

**D** A fundamental control concept over cash-like assets is the chief financial officer's establishment of a mechanism to monitor the risks.

**Question: 14** Which of the following goals sets risk management strategies at the optimum level?

- A. Minimize costs.
- B. Maximize market share.
- C. Minimize losses.
- D. Maximize shareholder value.

**Answer (D) is correct.**

The risk management processes chosen depend on the organization's culture, management style, and business objectives. These choices should optimize stakeholder (for example, shareholder) value by coping effectively with uncertainty, risks, and opportunities. Thus, maximizing shareholder value is a comprehensive approach that relates to risk management strategies across the organization.

**A** Minimizing costs is not a comprehensive approach.

**B** Maximizing market share is not a comprehensive approach.

**C** Minimizing losses is not a comprehensive approach.

**Question: 15** Which of the following threatens the independence of an internal auditor who had participated in the initial establishment of a risk management process?

- A. Developing assessments and reports on the risk management process.
- B. Managing the identified risks.
- C. Evaluating the adequacy and effectiveness of management's risk processes.
- D. Recommending controls to address the risks identified.

**Answer (B) is correct.**

Assuming management's responsibility for the risk management process is a potential threat to the internal audit activity's independence. It requires a full discussion and board approval.

**A** Developing assessments and reports on the organization's risk management processes is not only an internal audit role but normally also a high audit priority.

**C** Internal auditors assist both management and the board by examining, evaluating, reporting, and recommending improvements on the adequacy and effectiveness of risk management processes.

**D** Internal auditors may recommend controls.

**Question: 16** Which of the following may be assessed by the internal auditor as part of the risk management process?

1. Significant risks
  2. Ongoing monitoring activities
  3. Previous risk evaluation reports by management, internal auditors, external auditors, and any other sources
- A. 1 and 2 only.
  - B. 1 and 3 only.
  - C. 2 and 3 only.
  - D. 1 only.

**Answer (A) is correct.**

Significant risks and ongoing monitoring activities are assessed by the internal audit activity as part of the risk management process (Inter. of Std. 2120). But review of previous risk evaluation reports is a means of obtaining evidence for an assessment.

**B** Review of previous risk evaluation reports by management, internal auditors, external auditors, and any other sources is an audit procedure, a means of obtaining evidence for an assessment. Moreover, internal auditors assess ongoing monitoring activities.

**C** Review of previous risk evaluation reports by management, internal auditors, external auditors, and any other sources is an audit procedure, and internal auditors assess significant risks.

**D** Ongoing monitoring activities may also be assessed by the internal auditor to determine the effectiveness of the risk management process.

**Question: 17** Which of the following is not a responsibility of the chief audit executive?

A. To communicate the internal audit activity's plans and resource requirements to senior management and the board for review and approval.

B. To coordinate with other internal and external providers of audit and consulting services to ensure proper coverage and minimize duplication.

C. To oversee the establishment, administration, and assessment of the organization's system of risk management processes.

D. To follow up on whether appropriate management actions have been taken on significant reported risks.

**Answer (C) is correct.**

Overseeing the establishment, administration, and assessment of the organization's system of risk management processes is the role of senior management, not the CAE.

**A** The CAE should communicate the internal audit activity's plans and resource requirements, including significant interim changes, to senior management and to the board for review and approval. The CAE also should communicate the impact of resource limitations.

**B** The CAE should share information and coordinate activities with other internal and external providers of relevant assurance and consulting services to ensure proper coverage and minimize duplication of efforts.

**D** The CAE should establish and maintain a system to monitor the disposition of results communicated to management.

**Question: 18** If an organization has no formal risk management processes, the chief audit executive should

- A. Establish risk management processes based on industry norms.
- B. Formulate hypothetical results of possible consequences resulting from risks not being managed.
- C. Inform regulators that the organization is guilty of an infraction.
- D. Formally discuss with the directors their obligations for risk management processes.

**Answer (D) is correct.**

In situations where the organization does not have formal risk management processes, the chief audit executive formally discusses with management and the board their obligations to understand, manage, and monitor risks within the organization and the need to satisfy themselves that there are processes operating within the organization, even if informal, that provide the appropriate level of visibility into the key risks and how they are being managed and monitored.

**A** Internal auditors have no authority to establish risk management processes. They must seek direction from management and the board as to their role in the process.

**B** Internal auditors are not required to perform a risk analysis of the possible consequences of not establishing a risk management process. However, such a request might be made by management.

**C** In the absence of a specific legal requirement, internal auditors are not required to report to outside parties.

**Question: 19** Risk modeling or risk analysis is often used in conjunction with development of long-range engagement work schedules. The key input in the evaluation of risk is

- A. Previous engagement results.
- B. Management concerns and preferences.
- C. Specific requirements of professional standards.
- D. Judgment of the internal auditors.

**Answer (D) is correct.**

Assessing the risk of an activity entails analysis of numerous factors, estimation of probabilities and amounts of potential losses, and an appraisal of the costs and benefits of risk reduction.

Consequently, in assessing the magnitude of risk associated with any factor in a risk model, informed judgment by the internal auditor is required.

**A** The informed judgment of the internal auditor is still required to assess the magnitude of risk indicated by previous engagement results.

**B** To assess the risk posed by management concerns, informed judgment of the internal auditor is required.

**C** Professional standards do not specify the basic inputs for a risk analysis.

**Question: 20** Which of the following statements regarding monitoring risk responses is false?

**A.** The manager of an operating unit is in the best position to monitor the effects of the chosen risk response strategies.

**B.** The two least important sources of information for ongoing assessments of the adequacy of risk responses are those closest to the activities themselves and the audit function.

**C.** Analyzing risks and responses are among the normal duties of internal auditors.

**D.** Operating managers may not always be objective about the risks facing their units.

**Answer (B) is correct.**

The two most, not least, important sources of information for ongoing assessments of the adequacy of risk responses are those closest to the activities themselves and the audit function.

**A** Those closest to the activities themselves are an important source of information for ongoing assessments of the adequacy of risk responses; therefore, the manager of an operating unit is in the best position to monitor the effects of the chosen risk response strategies.

**C** The audit function is an important source of information for ongoing assessments of the adequacy of risk responses; therefore, analyzing risks and responses are among the normal duties of internal auditors.

**D** It is true that operating managers may not always be objective about the risks facing their units, especially if they had a stake in designing a particular response strategy.

**Question: 21** Which of the following are part of the risk analysis process?

1. Estimating the significance of an event
2. Assessing the event's likelihood
3. Considering the means to manage the risk

**A.** 1 and 2 only.

- B. 2 and 3 only.
- C. 1 and 3 only.
- D. 1, 2, and 3.

**Answer (D) is correct.**

The risk analysis process may be formal or informal. It involves estimating the significance of an event, assessing the event’s likelihood, and considering the means to manage the risk.

- A The risk analysis process also includes considering the means to manage the risk.
- B The risk analysis process also includes estimating the significance of an event.
- C The risk analysis process also includes assessing the event’s likelihood.

**Question: 22** A chief audit executive is reviewing the following enterprise-wide risk map:

I M P A C T	LIKELIHOOD			
		Remo te	Possib le	Likel y
	Critic al			Risk C
	Major	Risk B	Risk A	
Minor	Risk D			

Which of the following is the correct prioritization of risks, considering limited resources in the internal audit activity?

- A. Risk B, Risk C, Risk A, Risk D.
- B. Risk C, Risk A, Risk D, Risk B.
- C. Risk C, Risk A, Risk B, Risk D.
- D. Risk A, Risk B, Risk C, Risk D.

**Answer (C) is correct.**

Risk is the possibility of an event’s occurrence that could have an impact on the achievement of objectives. Risk is measured in terms of impact (exposures) and likelihood (probability). Prioritizing is needed to make decisions for applying resources to engagements based on the relative significance of their risk and exposure estimates. The best order of priority listed

(highest to lowest) is (1) Risk C (likely-critical), (2) Risk A (possible-major), (3) Risk B (remote-major), and (4) Risk D (remote-minor).

**A** Risks C and A clearly take precedence over Risk B. They have a higher likelihood and/or a greater impact.

**B** Risk B clearly has a higher priority than Risk D. It has a higher likelihood and a greater impact.

**D** Risk C has a higher likelihood and a greater impact than Risks A and B.

**Question: 23** Risk modeling in a consulting service is done by ranking the engagement's potential to

1. Improve management of risk
2. Add value
3. Improve the organization's operations

- A. 1 and 2 only.
- B. 2 and 3 only.
- C. 1 and 3 only.
- D. 1, 2, and 3.

**Answer (D) is correct.**

Risk modeling in a consulting service is done by ranking the engagement's potential to (1) improve management of risks, (2) add value, and (3) improve the organization's operations (Impl. Std. 2010.C1). Senior management assigns a weight to each item based on organizational objectives. The engagements with the appropriate weighted values are included in the annual audit plan.

**A** Risk modeling in a consulting service also includes ranking the engagement's potential to improve the organization's operations.

**B** Risk modeling in a consulting service also includes ranking the engagement's potential to improve management of risk.

**C** Risk modeling in a consulting service also includes ranking the engagement's potential to add value.

**Question: 24** A chief audit executive is reviewing the following enterprise-wide risk map:

		LIKELIHOOD		
I M P A C T		Remot e	Possibl e	Likel y
	Critical	Risk A	Risk B	
	Major			Risk D
	Minor		Risk C	

Which of the following is the correct prioritization of risks, considering limited resources in the internal audit activity?

- A. Risk B, Risk C, Risk A, Risk D.
- B. Risk A, Risk B, Risk C, Risk D.
- C. Risk D, Risk B, Risk C, Risk A.
- D. Risk B, Risk C, Risk D, Risk A.

**Answer (C) is correct.**

Risk is the possibility of an event's occurrence that could have an impact on the achievement of objectives. Risk is measured in terms of impact (exposures) and likelihood (probability). Prioritizing is needed to make decisions for applying resources to engagements based on the relative significance of their risk and exposure estimates. The best order of priority listed (highest to lowest) is (1) Risk D (likely-major), (2) Risk B (possible-critical), (3) Risk C (possible-minor), and (4) Risk A (remote-critical). However, it is not entirely clear that Risk D and Risk C should have higher priorities than Risks B and A, respectively. For example, depending on the values assigned to the variables, a possible-critical impact (B) might have a higher priority than a likely-major impact (D).

**A** Risk D clearly takes precedence over Risk C. It has a higher likelihood and a greater impact.

**B** Risk B clearly has a higher priority than Risk A. It has a higher likelihood and the same impact.

**D** Risk D has a higher likelihood and a greater impact than Risk C.

**Question: 25** Determining whether risk management processes are effective is a judgment resulting from the internal auditor's assessment that

1. Organizational objectives support and align with the organization's mission
2. Significant risks are identified and assessed

3. Appropriate risk responses are selected that align risks with the organization's risk appetite
4. Relevant risk information is captured and communicated in a timely manner across the organization

- A. 1 and 4 only.
- B. 2 and 3 only.
- C. 1, 2, and 4 only.
- D. 1, 2, 3, and 4.

**Answer (D) is correct.**

Determining whether risk management processes are effective is a judgment resulting from the internal auditor's assessment that

1. Organizational objectives support and align with the organization's mission;
2. Significant risks are identified and assessed;
3. Appropriate risk responses are selected that align risks with the organization's risk appetite; and
4. Relevant risk information is captured and communicated in a timely manner across the organization, enabling staff, management, and the board to carry out their responsibilities.

**A** The internal auditor should also assess whether appropriate risk responses are selected that align risks with the organization's risk appetite and whether significant risks are identified and assessed.

**B** The internal auditor should also assess whether organizational objectives support and align with the organization's mission and whether relevant risk information is captured and communicated in a timely manner across the organization.

**C** The internal auditor should also assess whether appropriate risk responses are selected that align risks with the organization's risk appetite.

**Question: 26** Which of the following statements about risk management is false?

- A. Management ensures that sound risk management processes are functioning.
- B. Boards have an oversight function.
- C. The internal audit activity may be directed to recommend improvements.

D. The internal audit activity may not have a consulting role in identifying, evaluating, and implementing risk management methods.

**Answer (D) is correct.**

The internal audit activity does have a consulting role in identifying, evaluating, and implementing risk management methods and controls.

A This is a true statement.

B Boards do have an oversight function. They determine that risk management processes are in place, adequate, and effective.

C The internal audit activity may be directed to examine, evaluate, report, or recommend improvements.

**Question: 27** Which of the following is a false statement concerning risk management?

A. Every risk that could affect achievement of objectives must be considered.

B. Risk identification must be performed for the entire entity.

C. The manager of an operating unit is in the best position to monitor the effects of the chosen risk response strategies.

D. Risk management is too important to be delegated to a committee.

**Answer (D) is correct.**

In large or complex entities, senior management may appoint a risk committee to review the risks identified by the various operating units and create a coherent response plan.

A Every risk that could affect achievement of objectives must be considered.

B Risk identification must be performed for the entire entity. Some occurrences may be inconsequential for the entity but disastrous for an individual unit.

C The manager of an operating unit is in the best position to monitor the effects of the chosen risk response strategies.

**Question: 28** Senior management has assessed all identifiable risks to the achievement of the organization's objectives in terms of both probability and potential effect. The most likely next step is to

A. Adopt the ISO 9000 framework to ensure process quality.

B. Rank the identified risk areas.

- C. Enter into electronic data interchange (EDI) arrangements with the organization's most important suppliers.
- D. Assign the task of ranking the identified risk areas to the internal audit activity.

**Answer (B) is correct.**

After all risks that could impact the achievement of organizational objectives have been identified, the next step is to rank the risk areas in terms of seriousness, i.e., the combination of probability and potential impact.

**A** Whether adoption of the ISO 9000 framework is appropriate cannot be determined until the risk assessment is complete.

**C** Whether EDI is appropriate cannot be determined until the risk assessment is complete.

**D** Risk management is a key responsibility of senior management and the board and cannot be delegated.

**Question: 29** Which of the following is a true statement about the use by senior management and the board of the internal audit activity as a source of information about risk management processes?

- A. The internal audit activity cannot be expected to be objective about risk management processes.
- B. The internal audit activity is not a good source of information about the daily functioning of risk management processes.
- C. Senior management and the board need this information sooner than internal audit can provide it.
- D. The internal audit activity should be used as a source of information about the success of ongoing risk management activities.

**Answer (D) is correct.**

The two most important sources of information for ongoing assessments of the adequacy of risk responses (and the changing nature of the risks) are those closest to the activities themselves and the audit function. Operating managers may not always be objective about the risks facing their units, especially if they had a stake in designing a particular response strategy.

**A** Internal auditors must have an impartial, unbiased attitude and avoid any conflict of interest. (Attr. Std. 1120).

**B** Operational management's proximity to the daily functioning of the risk management processes makes it an important source of information about them. However, the internal audit activity is an important source of information as well.

**C** The board approves the internal audit activity's workplan.

**Question: 30** Senior management has identified the following risk areas within the organization:

Derivatives trading:	Likelihood high, Impact low
Materials acquisition:	Likelihood low, Impact low
Petty cash:	Likelihood high, Impact low
Bond issue:	Likelihood low, Impact high
Transportation fleet:	Likelihood high, Impact medium

Which of the following is a true statement in terms of overall risk exposure of the areas named?

- A. Derivatives trading has less risk exposure than the transportation fleet.
- B. The transportation fleet has less risk exposure than the bond issue.
- C. The transportation fleet has more risk exposure than the bond issue.
- D. Materials acquisition has more risk exposure than petty cash.

**Answer (A) is correct.**

Risk exposure is measured in terms of (1) impact on the achievement of the entity's objectives and (2) the likelihood (probability) of that impact. In this simple model, no values are assigned to impact and likelihood. Thus, one required assumption is that risk exposures for risk areas with the same impact and likelihood can be established only on the basis of professional judgment using factors not given in the question. A related assumption is needed when one risk area has a high (low) likelihood and a low (high) impact, and a second risk area has the opposite characteristics. In this case, professional judgment based on factors not given also is needed to determine which risk area has the higher risk exposure. A third assumption is that the risk area with the greater likelihood (impact) has a higher risk exposure than a second risk area with the same impact (likelihood). Based on the assumptions, derivatives trading has less risk exposure than the transportation fleet. These risk areas have the same likelihood, but the transportation fleet has a higher impact.

**B** Given (1) no values for impact and likelihood and (2) the required assumptions for this simple model, it cannot be determined whether the transportation fleet or the bond issue has the higher risk exposure. Their likelihoods and impacts differ in opposite directions. The transportation fleet has the higher likelihood but the lower impact.

**C** Given (1) no values for impact and likelihood and (2) the required assumptions for this simple model, it cannot be determined whether the transportation fleet or the bond issue has the higher risk exposure. Their likelihoods and impacts differ in opposite directions. The transportation fleet has the higher likelihood but the lower impact.

**D** Materials acquisition has a lower likelihood than, and the same impact as, petty cash. Thus, petty cash has the greater risk exposure.

**Question: 31** Senior management has identified the following risk areas within the organization:

Derivatives trading: Likelihood high, Impact high

Materials acquisition: Likelihood low, Impact low

Petty cash: Likelihood high, Impact low

Bond issue: Likelihood low, Impact high

Transportation fleet: Likelihood high, Impact medium

Which of the following is a false statement in terms of overall risk exposure of the areas named?

- A. The bond issue is riskier than petty cash.
- B. The bond issue is riskier than materials acquisition.
- C. Petty cash is riskier than materials acquisition.
- D. The transportation fleet is riskier than petty cash.

**Answer (A) is correct.**

The bond issue and petty cash both have one high risk measure and one low risk measure; i.e., they have equivalent overall risk exposure.

**B** The bond issue is riskier than materials acquisition.

**C** Petty cash is riskier than materials acquisition.

**D** The transportation fleet is riskier than petty cash.

**Question: 32** The internal audit activity of a large not-for-profit organization is reviewing the following results of senior management's latest enterprise-wide risk assessment:

Fictitious vendors: Likelihood possible, Impact major

Internet intrusion: Likelihood likely, Impact major

Executive nepotism: Likelihood remote, Impact critical

Fraudulent fundraising: Likelihood possible, Impact minor

Based on management's assessment, where should the chief audit executive devote the most internal audit resources?

- A. Fictitious vendors.
- B. Internet intrusion.
- C. Executive nepotism.
- D. Fraudulent fundraising.

**Answer (B) is correct.**

With a combination of major impact and likely occurrence, Internet intrusion has the greatest overall risk exposure and thus should receive the majority of limited internal audit resources.

A Fictitious vendors have a lower overall risk exposure than Internet intrusion.

C Executive nepotism has a lower overall risk exposure than Internet intrusion.

D Fraudulent fundraising has the lowest overall risk exposure of the four identified areas.

**Question: 33** Internal audit has prepared the following risk map for the upcoming audit year:

		LIKELIHOOD		
		Low	Medium	High
I M P A C T	High		Risk M	
	Medium		Risk N	Risk K
	Low	Risk L		

Where should the chief audit executive devote the most internal audit resources?

- A. All the identified risks should be allocated equal resources.
- B. Cannot be determined from the information given.

- C. Risk M.
- D. Risk K.

**Answer (B) is correct.**

Risk K and Risk M both have one high risk measure and one medium risk measure, giving them the same overall risk exposure. Allocating more resources to one over the other cannot be justified based on the information given.

**A** Risks K and M clearly have greater overall risk exposure than Risks L and N.

**C** Risk M and Risk K have the same overall risk exposure. Allocating more resources to one over the other cannot be justified based on the information given.

**D** Risk K and Risk M have the same overall risk exposure. Allocating more resources to one over the other cannot be justified based on the information given.

**Question: 34** The internal auditors are assessing the risk of fraud involving senior management. An impact factor is

- A. Fines and penalties.
- B. Inadequacy of internal controls.
- C. Unusual transactions.
- D. Potential override of internal controls.

**Answer (A) is correct.**

An impact factor is a potential result of an event. These events are usually identified through the risk assessment process. For example, the consequences of fraud may include direct financial loss in the form of fines and penalties.

**B** Inadequacy of internal controls is a risk that normally is identified during risk assessment.

**C** The existence of complex or unusual transactions is a risk that normally is identified during risk assessment.

**D** An impact factor is a potential result of an event. Potential override of internal controls is a cause of an event that normally is identified during risk assessment.

**Question: 35** Which risk response reflects a change from acceptance to sharing?

- A. An insurance policy on a manufacturing plant was not renewed.

- B. Management purchased insurance on previously uninsured property.
- C. Management sold a manufacturing plant.
- D. After employees stole numerous inventory items, management implemented mandatory background checks on all employees.

**Answer (B) is correct.**

The categories of risk responses under the COSO ERM model are avoidance, retention (acceptance), reduction, sharing, and exploitation. If management does not insure a building, the response is acceptance. Ordinarily, acceptance is based on a judgment that the cost of another response is excessive. However, once management purchases insurance, the risk is shared with an outside party.

A Not renewing insurance represents a change from risk sharing to risk acceptance.

C Selling property avoids all the risks of ownership.

D Management originally accepted the risk of employee theft by not implementing pre-hire investigation. Conducting background checks on all employees reduces the risk of theft.

**Question: 36** Who is responsible for the organization's risk management and control processes?

1. The internal auditor.
  2. The external auditor.
  3. Senior management.
  4. The board of directors.
- A. 1 and 3 only.
  - B. 3 and 4 only.
  - C. 2 and 3 only.
  - D. 1, 2, and 3.

**Answer (B) is correct.**

Risk management is a key responsibility of senior management and the board. To achieve its business objectives, management ensures that sound risk management processes are in place and functioning. Boards have an oversight role to determine that appropriate risk management processes are in place and that these processes are adequate and effective. In this role, they may direct the internal audit activity to assist them by examining, evaluating, reporting, or recommending improvements to the adequacy and effectiveness of risk management processes.

Management and the board are responsible for the organization's risk management and control processes.

**A** The internal auditor evaluates risk management as a basis for findings and recommendations. But the internal auditor is not responsible for operational management of its processes.

**C** The external audit function is not responsible for the organization's risk management systems. Management may ask the external auditor to report any deficiencies in the control environment, but the responsibility is management's.

**D** The internal and external auditors are not primarily responsible for risk management and control processes.

**Question: 37** An internal auditor plans to audit the adequacy of controls over credit approval. Which of the following is not a required procedure in such an engagement?

**A.** Determine whether policies exist that place credit limits on individual transactions that exceed standardized thresholds.

**B.** Determine the extent of management oversight of loan covenants.

**C.** Determine whether loans and other liabilities are valued in accordance with industry regulations.

**D.** Determine the nature of controls established by the chief financial officer to monitor risks in the acquisition of debt.

**Answer (C) is correct.**

For an engagement to evaluate the controls over credit approval, the internal auditor does not need to establish valuation criteria for the outstanding debt. Debt already acquired by the organization does not require further credit approval. Also, the adequacy of controls is not the primary objective of an engagement involving the valuation of complex debt instruments.

**A** The internal auditor should determine the nature of policies established to manage the risks associated with credit approval. Credit approval should be subject to policies consistent with the organization's tolerance for credit risk.

**B** Oversight by a management committee is an important control. Thus, the auditor should determine the nature of the risk management process established to monitor and authorize undertakings represented by loan covenants. The specific process used by an organization must fit its culture, management style, and business objectives.

**D** A fundamental control concept over the assumption of liabilities is the chief financial officer's establishment of a mechanism to monitor the risks.

**Question: 38** The internal auditor should evaluate the adequacy of controls over the safeguarding of assets from all of the following except

- A. Improper employee usage.
- B. Misappropriation schemes.
- C. Exposure to the elements.
- D. Underusage of physical facilities.

**Answer (D) is correct.**

The internal audit activity must evaluate risk exposures relating to governance, operations, and information systems regarding the safeguarding of assets (Impl. Std. 2120.A1). For example, internal auditors evaluate risk exposure arising from theft, fire, improper or illegal activities, and exposure to the elements. But underusage of facilities relates to efficiency of operations.

**A** The internal auditor should review the approved uses of secure assets and ensure that proper procedures are applied to their use.

**B** The internal auditor should identify assets at risk of being misappropriated.

**C** The internal auditor should identify assets at risk of spoilage or destruction due to improper exposure to the elements.

**Question: 39** When a customer fails to pay his or her invoice within 2 months, a notification is sent to inform the credit manager of the situation. This is an example of which kind of event identification method?

- A. Internal analysis.
- B. Threshold triggers.
- C. Process flow analysis.
- D. Loss event data methodologies.

**Answer (B) is correct.**

A predetermined risk response may be made when a certain event occurs, such as when cash is below a given level or a customer has not paid an invoice within a certain period of time.

**A** In internal analysis, the entity can consider its own experience with similar risks when planning a response to future events.

**C** In process flow analysis, a single business process is studied in isolation for the events that affect its inputs, tasks, responsibilities, and outputs.

**D** Loss event data methodologies are used to associate losses with adverse events in the past to make predictions. An example is matching workers' compensation claims with the frequency of accidents.

**Question: 40** Many organizations use electronic funds transfer to pay their suppliers instead of issuing checks. Regarding the risks associated with issuing checks, which of the following risk management techniques does this represent?

- A. Controlling.
- B. Accepting.
- C. Transferring.
- D. Avoiding.

**Answer (D) is correct.**

Risk responses may include avoidance, acceptance, sharing, and reduction. By eliminating checks, the organization avoids all risk associated with them.

**A** Eliminating checks does not represent an ongoing control.

**B** Eliminating checks avoids instead of accepts the associated risk.

**C** Eliminating checks does not transfer risk to anyone else. Risk is eliminated.

**Question: 41** Which of the following are core assurance roles provided by the internal audit activity?

1. Giving assurance on risk management processes
2. Evaluating risk management processes
3. Reviewing the management of key risks
4. Setting the risk appetite

- A. 1 and 2 only.
- B. 3 and 4 only.
- C. 1, 2, and 3 only.
- D. 1, 2, and 4 only.

**Answer (C) is correct.**

Giving assurance on risk management processes, evaluating risk management processes, and reviewing the management of key risks are among the core assurance roles provided by the internal audit activity.

**A** Reviewing the management of key risks is also a core assurance role provided by the internal audit activity.

**B** Setting the risk appetite is not a core assurance role provided by the internal audit activity, but giving assurance on and evaluating risk management processes are.

**D** The internal audit activity should not undertake roles that threaten its independence and objectivity; therefore, the internal audit activity should not set the risk appetite.

**Question: 42** Which of the following are roles that the internal audit activity should not undertake since they would threaten its independence and objectivity?

- A. Imposing risk management processes.
- B. Making decisions on risk responses.
- C. Implementing risk responses on management's behalf.
- D. All of the answers are correct.

**Answer (D) is correct.**

Among the risk management roles that threaten the independence and objectivity of the internal audit activity are imposing risk management processes, making decisions on risk responses, and implementing risk responses on management's behalf.

**A** The internal audit activity also should not make decisions on risk responses or implement risk responses on management's behalf.

**B** The internal audit activity also should not impose risk management process or implement risk responses on management's behalf.

**C** The internal audit activity also should not impose risk management process or make decisions on risk responses.

**Question: 43** The level of assurance that risk management can provide regarding the achievement of entity objectives is

- A. Positive.
- B. Absolute.
- C. Reasonable.

D. Negative.

**Answer (C) is correct.**

Risk management should provide reasonable assurance that entity objectives are achieved.

A Positive is a type, not a level, of assurance.

B No set of risk responses can provide absolute assurance that objectives will be achieved.

D Negative is a type, not a level, of assurance.

**Question: 44** Senior management performed the following steps during its recent deliberations over risk management:

1. Identified all the risks that might impede the achievement of the company's mission.
2. Designed new procedures to mitigate the risks associated with surplus equipment, one of the areas in which the risk of adverse impact was both material and likely.
3. Ensured that the director of surplus management understood and enacted the new procedures.
4. Reviewed regular reports from internal audit about the effectiveness of the new procedures for surplus equipment.

The most serious deficiency with the process is that

- A. Senior management did not consult with the director of equipment management before formulating the risk response.
- B. Senior management did not prioritize the identified risks.
- C. Internal audit was involved in the process too late.
- D. The board did not create the position of chief risk officer.

**Answer (B) is correct.**

Management designed risk procedures related to one of the risk areas without regard to the potential impact of the other identified risks.

A. While those closest to an activity usually have the most knowledge about it, this is not the most serious deficiency.

C. The risk management process is management's responsibility. Monitoring is an appropriate function within the risk management process to be assigned to the internal audit activity.

D. A chief risk officer may be appointed to coordinate the entity's risk management activities. However, not all entities can justify creating such a position in terms of the cost/benefit tradeoff.

**Question: 45** Which of the following factors affects the control risk of an organization?

- A. Potential problems like technological obsolescence.
- B. Unusual pressures on management.
- C. Complex accounts that require expert valuations.
- D. Segregation of duties.

**Answer (D) is correct.**

Control risk is the risk that controls fail to effectively manage controllable risks. A common control is segregation of duties. For example, it separates the responsibilities for authorization of transactions, recording of transactions, and custody of assets. Thus, segregation of duties affects the control risk of an organization.

**A** Only control activities affect control risk. The identification of a risk is not a control activity.

**B** Although unusual pressures on management could result in management override of controls or fraud, the existence of pressures alone does not affect control risk.

**C** The existence of complex accounts requiring expert valuations does not affect control risk.

**Question: 46** What is the board's role in the risk management process?

- A. Oversees risk management processes.
- B. Ensures that sound risk management processes are functioning.
- C. Consult in implementing risk management methods and controls.
- D. Contributes to the improvement of risk management processes.

**Answer (A) is correct.**

Risk management is a key responsibility of senior management and the board. Boards have an oversight function and determine that risk management processes are in place, adequate, and effective.

**B** Management ensures that sound risk management processes are functioning. Management must focus on risks at all levels of the entity and take the necessary action to manage them.

**C** In addition to its assurance role, the internal audit activity has a consulting role in identifying, evaluating, and implementing risk management methods and controls. It determines that the methods chosen are comprehensive and appropriate for the organization.

**D** According to Standard 2120, “the internal audit activity must evaluate the effectiveness and contribute to the improvement of risk management processes.” Risk management processes include (1) identification of context, (2) risk identification, (3) risk assessment and prioritization, (4) risk response, and (5) risk monitoring.

**Question: 47** Risk is measured in terms of

- A. Adherence to policies, plans, and procedures.
- B. Discipline and structure.
- C. Impact and likelihood.
- D. Conditions that threaten the internal audit’s ability.

**Answer (C) is correct.**

The IIA Glossary defines risk as the possibility of an event occurring that will have an impact on the achievement of objectives. Risk is measured in terms of impact and likelihood.

**A** The IIA Glossary defines compliance as the adherence to policies, plans, procedures, laws, regulations, contracts, or other requirements.

**B** The control environment provides the discipline and structure for the achievement of the primary objectives of the system of internal control.

**D** The IIA Glossary defines independence as the freedom from conditions that threaten the ability of the internal audit activity to carry out internal audit responsibilities in an unbiased manner.

**Question: 48** The Chief Audit Executive’s responsibilities for risk management include which of the following?

- A. Determining the internal audit activity’s role in risk management.
- B. Ensuring sound risk management processes are functioning.
- C. Identifying, evaluating, and implementing risk management methods and control.
- D. Having formal discussions with the board about their obligations for understanding, managing, and monitoring risks.

**Answer (D) is correct.**

The CAE must understand management's and the board's expectations of the internal audit activity in risk management. This understanding is codified in the charters of the internal audit activity and the board. If the organization has no formal risk management processes, the CAE has formal discussions with management and the board about their obligations for understanding, managing, and monitoring risks.

**A** Senior management and the board are responsible for determining the internal audit activity's role in risk management. This role is based on factors such as organizational culture, abilities of the internal audit staff, and local conditions and customs.

**B** Management is responsible for ensuring that sound risk management processes are functioning. Risk management processes are designed to fit the organization's culture, management style, and objectives.

**C** The internal audit activity may be directed to examine, evaluate, report, or recommend improvements to risk management processes. Additionally, the internal audit activity has a consulting role in identifying, evaluating, and implementing risk management methods and control.

**Question: 49** Which of the following represents a risk avoidance strategy?

- A. The company has elected to exit the construction industry due to the high number of injuries.
- B. The board has agreed to outsource the delivery segment of the business because of the high costs.
- C. The new manager has been tasked with the responsibility of tracking identified risks.
- D. Providing training on new products for sales personnel to increase revenue.

**Answer (A) is correct.**

Risk avoidance ends the activity from which the risk arises. Exiting the industry avoids the risk of construction injuries.

**B** This action represents risk sharing. Risk sharing transfers some loss potential to another party. Examples are insurance, outsourcing, hedging, and entering into joint ventures.

**C** This action represents risk monitoring. Risk monitoring (1) tracks identified risks, (2) evaluates current risk response plans, (3) monitors residual risks, and (4) identifies new risks.

**D** This action represents risk reduction (mitigation). Risk reduction lowers the level of risk associated with an activity. For example, providing training to sales personnel for new products reduces the risk of decreased revenues due to lack of product knowledge.

**Question: 50** The company maintains a fund to pay for repairs to warehouse equipment. Which risk response strategy is the company using?

- A. Risk avoidance.
- B. Risk retention.
- C. Risk reduction.
- D. Risk sharing.

**Answer (B) is correct.**

Risk retention accepts the risk of an activity and is synonymous with self-insurance. The company accepts the risk of equipment repairs by using a form of self-insurance (a company fund) to pay for repairs.

**A** Risk avoidance ends the activity from which the risk arises. However, the company is still exposed to the risk of equipment repairs.

**C** Risk reduction (mitigation) lowers the level of risk associated with an activity. However, the company is still exposed to the same level of risk.

**D** Risk sharing transfers some loss potential to another party, for example, having an insurance policy. However, the company is using a form of self-insurance to manage the risk.

**Question: 51** Which of the following is a factor affecting risk?

- A. New personnel.
- B. New or revamped information systems.
- C. Rapid growth.
- D. All of the answers are correct.

**Answer (D) is correct.**

New personnel, new or revamped information systems, and rapid growth are all factors that affect risk.

**A** New or revamped information systems and rapid growth are also factors affecting risk.

**B** New personnel and rapid growth are also factors affecting risk.

**C** New personnel and new or revamped information systems are also factors affecting risk.

**Question: 52** Management considers risk appetite for all of the following reasons except

- A. Aligning with development of strategy.
- B. Aligning with business objectives.
- C. Implementing risk responses.
- D. Setting risk capacity.

**Answer (D) is correct.**

Risk appetite consists of the types and amount of risk the entity is willing to accept in pursuit of value. Among other things, risk appetite should be considered in

1. Aligning with development of strategy.
2. Aligning with business objectives.
3. Prioritizing risks.
4. Implementing risk responses.

Risk capacity is the maximum amount of risk an entity is able to assume. Management considers risk capacity in setting risk appetite.

**A** Management considers risk appetite when evaluating strategic options.

**B** Management considers risk appetite when setting objectives.

**C** Management considers risk appetite when implementing risk responses.

**Question: 53** Each of the following is a limitation of enterprise risk management (ERM), except

- A. ERM deals with risk, which relates to the future and is inherently uncertain.
- B. ERM operates at different levels with respect to different objectives.
- C. ERM can provide absolute assurance with respect to objective categories.
- D. ERM is as effective as the people responsible for its functioning.

**Answer (C) is correct.**

ERM cannot provide absolute assurance with respect to different objectives. However, if it could, it would be an advantage, not a limitation.

**A** ERM is limited because some matters are beyond management's ability to predict and control.

**B** A limitation of ERM is that different objectives concern different needs, and the ERM attention devoted to them varies.

**D** Limitations of ERM arise from the possibility of faulty human judgment, simple errors or mistakes, collusion, and management override.

**Question: 54** According to COSO, which component of enterprise risk management (ERM) addresses an entity's operating structures and core values?

- A. Review and revision.
- B. Governance and culture.
- C. Strategy and objective-setting.
- D. Information, communication, and reporting.

**Answer (B) is correct.**

The governance and culture component addresses board responsibilities, operating structures, and core values, among others.

**A** The review and revision component addresses the review of, and changes in, strategy, performance targets and tolerance, and ERM practices.

**C** The strategy and objective-setting component addresses business context, risk appetite, strategy selection, and business objectives.

**D** The information, communication, and reporting component addresses information systems, communication channels, and reporting (on risk, culture, and performance).

**Question: 55** Which of the following is closely related to traditional risk management instead of enterprise risk management (ERM)?

- A. Rapid response to opportunities.
- B. Organization-level view of risk.
- C. Emphasis on specific functions.
- D. Achieving financial goals.

**Answer (C) is correct.**

The enterprise risk management approach set forth by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) attempts to approach an organization as a whole instead of focusing on any specific area or risk.

**A** Rapid response to opportunities is a characteristic of ERM, which tries to offset potential risks with opportunities.

**B** ERM tries to view risk as it affects every level of an organization.

**D** Financial goals are an example of the methods ERM uses to achieve objectives in one or more separate but overlapping categories.

**Question: 56** Which of the following members of an organization has ultimate ownership responsibility of the enterprise risk management, provides leadership and direction to senior managers, and monitors the entity's overall risk activities in relation to its risk appetite?

- A. Chief risk officer.
- B. Chief executive officer.
- C. Internal auditors.
- D. Chief financial officer.

**Answer (B) is correct.**

The chief executive officer (CEO) sets the tone at the top of the organization and has ultimate responsibility for ownership of the ERM. The CEO will influence the composition and conduct of the board, provide leadership and direction to senior managers, and monitor the entity's overall risk activities in relation to its risk appetite. If any problems arise with the organization's risk appetite, the CEO will also take any measures to adjust the alignment to better suit the organization.

**A** The risk officer works in assigned areas of responsibility in a staff function. The work of a risk officer often extends beyond one specific area because the officer will have the necessary resources to work across many segments or divisions.

**C** The internal auditors evaluate the ERM and may provide recommendations.

**D** The CFO is subordinate to the CEO.

**Question: 57** Company management completes event identification and assesses the severity of risk. Management then acts to alter the severity of risk. According to COSO, which of the following types of risk does this situation represent?

- A. Inherent risk.
- B. Actual residual risk.
- C. Event risk.
- D. Detection risk.

**Answer (B) is correct.**

Actual residual risk is the risk that remains after management acts to alter its severity. It should not exceed target residual risk.

**A** Inherent risk is the risk that exists in the absence of management actions to alter its severity, that is, a risk response in the form of acceptance or pursuit.

**C** COSO defines an event as an occurrence or set of occurrences. It defines risk as the possibility that events will occur and affect the achievement of strategy and business objectives.

**D** Detection risk is the risk that the audit procedures performed to reduce audit risk to an acceptably low level will not detect a material misstatement.

**Question: 58** The function of the chief risk officer (CRO) is most effective when the CRO

- A. Manages risk as a member of senior management.
- B. Shares the management of risk with line management.
- C. Shares the management of risk with the chief audit executive.
- D. Monitors risk as part of the enterprise risk management team.

**Answer (D) is correct.**

A CRO is a member of management assigned primary responsibility for enterprise risk management processes. The CRO is most effective when supported by a specific team with the necessary expertise and experience related to organization-wide risk.

**A** Senior management has an oversight role in risk management.

**B** The risk knowledge at the line level is specific only to that area of the organization.

**C** The CAE should not be accountable for a management function.

**Question: 59** Enterprise risk management

- A. Guarantees achievement of organizational objectives.
- B. Requires establishment of risk and control activities by internal auditors.
- C. Involves the identification of events with negative impacts on organizational objectives.
- D. Includes selection of the best risk response for the organization.

**Answer (C) is correct.**

The IIA Glossary defines risk management as a process to identify, assess, manage, and control potential events or situations to provide reasonable assurance regarding the achievement of the

organization's objectives. Thus, enterprise risk management involves the identification of events with negative effects on achievement of organizational objectives.

**A** Risk management processes cannot guarantee achievement of objectives.

**B** Involvement of internal auditors in establishing control activities impairs their independence and objectivity.

**D** Enterprise risk management is concerned with selecting not the best risk response but the risk response that falls within the enterprise's risk tolerances and appetite.

**Question: 60** Inherent risk is

A. A potential event that may affect the achievement of strategy and business objectives.

B. A risk response.

C. The risk after management takes action to alter its severity.

D. The risk when management has not taken action to reduce the impact or likelihood of an adverse event.

**Answer (D) is correct.**

Inherent risk is the risk when management does not act to alter its severity. Severity commonly is measured as a combination of impact and likelihood.

**A** A risk event is a potential event that may affect the entity adversely.

**B** A risk response is an action taken to bring identified risks within the entity's risk appetite.

**C** The risk remaining after management takes action to alter its severity is actual residual risk.

**Question: 61** Risk management, at any level, consists of

1. Identifying potential events that may affect the entity
2. Managing the associated risk to be within the entity's risk appetite

A. 1 only.

B. 2 only.

C. 1 and 2.

D. Neither 1 nor 2.

**Answer (C) is correct.**

Risk management, at any level, consists of (1) identifying potential events that may affect the entity and (2) managing the associated risk to be within the entity's risk appetite. Risk management should also provide reasonable assurance that entity objectives are achieved.

**A** Risk management also consists of managing the associated risk to be within the entity's risk appetite.

**B** Risk management also consists of identifying potential events that may affect the entity.

**D** Risk management consists of both options.

**Question: 62** The internal auditor who works in enterprise risk management (ERM) may perform each of the following activities except

- A. Auditing ERM.
- B. Evaluating the design of the overall entity.
- C. Setting the risk appetite of the organization.
- D. Identifying improvement opportunities.

**Answer (C) is correct.**

Internal auditing performs an assurance function (the third line of management accountability). The entity's assurance function (1) audits (reviews) ERM practices, (2) identifies issues and improvements, (3) makes recommendations, and (4) informs the board and executives of matters needing resolution. The third line's independence and objectivity should be enabled by reporting directly to the board. The third line also should be able to evaluate, and make recommendations to improve, the design and operating effectiveness of the overall entity. However, the first line of accountability determines the entity's risk appetite. Risk appetite consists of the types and amount of risk the organization is willing to accept in pursuit of value. Subject to board approval, management sets the risk appetite.

**A** The entity's assurance functions (the third line of management accountability) include audit (review) of ERM practices.

**B** The entity's assurance functions should be able to evaluate, and make recommendations to improve, the design and operating effectiveness of the overall entity.

**D** The entity's assurance functions identify issues and improvements.

**Question: 63** Which of the following is an example of risk reduction?

- A. Purchasing insurance.

- B. Never beginning the risk-producing activity.
- C. Hiring additional employees to perform routine maintenance checks on machinery.
- D. After considering all the alternatives and implementing control activities, continuing to engage in the risk-producing activity.

**Answer (C) is correct.**

Hiring additional employees to perform routine maintenance checks on machinery would reduce the risk of a complete break-down in machinery and is an example of risk reduction.

A Purchasing insurance is a form of risk sharing.

B This is an example of risk avoidance.

D This is an example of risk acceptance.

**Question: 64** Which of the entity objectives address effectiveness and efficiency?

- A. Strategic objectives.
- B. Operations objectives.
- C. Reporting objectives.
- D. Compliance objectives.

**Answer (B) is correct.**

Operations objectives address effectiveness and efficiency.

A Strategic objectives are consistent with and support the entity's mission.

C Reporting objectives relate to reliability of information contained in reports.

D Compliance objectives relate to adherence to laws and regulations.

**Question: 65** A manufacturing firm identified that it would have difficulty sourcing raw materials locally, so it decided to relocate its production facilities. According to COSO, this decision represents which of the following responses to the risk?

- A. Risk reduction.
- B. Prospect theory.
- C. Risk sharing.
- D. Risk acceptance.

**Answer (A) is correct.**

Risk reduction (mitigation) reduces the risk so that it is within the target residual risk profile and risk appetite. By relocating its production facilities, the firm has reduced the risk of having difficulty sourcing materials locally.

**B** Prospect theory is not a response to risk according to COSO.

**C** Risk sharing transfers some loss potential to another party.

**D** Risk acceptance takes no action to alter the severity of the risk.

**Question: 66** According to COSO, the component of enterprise risk management (ERM) that best relates to continuous improvement is

- A. Monitoring.
- B. Information, communication, and reporting.
- C. Strategy and objective-setting.
- D. Review and revision.

**Answer (D) is correct.**

A principle related to the review and revision component states that the organization must continually improve ERM at all levels even if actual performance aligns with target performance or tolerance.

**A** Monitoring is a component of the COSO internal control framework, not the ERM framework.

**B** Although the information, communication, and reporting component addresses how areas for improvement may be communicated and reported, no related principles guide continuous improvement efforts.

**C** No principles related to the strategy and objective-setting component guide continuous improvement efforts.

**Question: 67** Which of the following qualities should be possessed by a board of directors?

- A. A majority of the board should be outside directors.
- B. Directors generally should have years of experience in the industry.
- C. Directors must be willing to challenge management's choices.
- D. All of the answers are correct.

**Answer (D) is correct.**

Directors' attitudes are a key component of the internal environment. They must possess certain qualities to be effective.

- A majority of the board should be outside directors.
- Directors generally should have years of experience either in the industry or in corporate governance.
- Directors must be willing to challenge management's choices. Complacent directors increase the chances of adverse consequences.

**A** Directors should also have years of experience in the industry and be willing to challenge management's decision.

**B** A majority of the board should be outside directors, and directors must be willing to challenge management's choices.

**C** A majority of the board should be outside directors, and directors should also have years of experience in the industry.

**Question: 68** When ERM is effective regarding all of the objectives, the board and management have reasonable assurance that

1. Reporting is reliable
2. Compliance is achieved
3. The extent of achievement of strategic and operations objectives is known

- A. 1 and 2 only.
- B. 2 and 3 only.
- C. 1 and 3 only.
- D. 1, 2, and 3.

**Answer (D) is correct.**

When ERM is effective regarding all of the objectives, the board and management have reasonable assurance that (1) reporting is reliable, (2) compliance is achieved, and (3) the extent of achievement of strategic and operations objectives is known.

**A** The board and management also have reasonable assurance that the extent of achievement of strategic and operations objectives is known.

**B** The board and management also have reasonable assurance that reporting is reliable.

C The board and management also have reasonable assurance that compliance is achieved.

**Question: 69** Which of the following statements regarding the chief risk officer is false?

- A. The creation of a separate risk management function may include the appointment of a chief risk officer.
- B. The chief risk officer is a member of management assigned primary responsibility for ERM processes.
- C. The chief risk officer is most effective when supported by a specific team with the necessary expertise.
- D. The chief risk officer should be employed in the internal audit function.

**Answer (D) is correct.**

The chief risk officer should not be employed in the internal audit function.

**A** A separate function may coordinate and manage ERM and apply special skills and knowledge. The creation of a separate risk management function may include the appointment of a chief risk officer.

**B** It is true that the chief risk officer is a member of management assigned primary responsibility for ERM processes.

**C** The chief risk officer is most effective when supported by a specific team with the necessary expertise and experience related to organization-wide risk.

**Question: 70** Which of the following activities are included in ERM?

- 1. Determining risk appetite
  - 2. Identifying potential risks
  - 3. Communicating information on risks consistently and at all levels
  - 4. Providing assurance on the effectiveness of risk management
- A. 1 and 3 only.
  - B. 2 and 4 only.
  - C. 1, 2, and 3 only.
  - D. 1, 2, 3, and 4.

**Answer (D) is correct.**

Determining risk appetite, identifying potential threats, communicating information on risks consistently and at all levels, and providing assurance on the effectiveness of risk management are among the activities included in ERM.

**A** ERM also includes identifying potential risks and providing assurance on the effectiveness of risk management.

**B** ERM also includes determining risk appetite and communicating information on risks consistently and at all levels.

**C** ERM also includes providing assurance on the effectiveness of risk management.

**Question: 71** According to COSO, a risk profile is a view of the relationship between

- A. Risk capacity and risk appetite.
- B. Inherent risk and target residual risk.
- C. Tolerance and risk appetite.
- D. Risk and performance.

**Answer (D) is correct.**

A risk profile is a composite view of (1) the types, severity, and interdependencies of risks related to a specific strategy or business objective and (2) their effect on performance.

**A** An entity's risk capacity is the maximum that can be assumed. The risk appetite is the maximum the entity is willing to accept. Both appear on the risk profile. But the purpose of the profile is to view the relationship between risks and a specific strategy or business objective and their effect on performance.

**B** Inherent risk is the risk in the absence of management actions to alter its severity. Target residual risk is the risk the entity prefers to assume knowing that management has acted to alter its severity. But the risk profile relates risk to a strategy or objective.

**C** An entity's tolerance and risk appetite may appear on its risk profile. However, the profile views the relationship between risk and a strategy or objective (and ultimately) performance.

**Question: 72** Senior management has identified the trading of marketable securities as a high-risk activity. In response, a new supervisory position was created. Every evening after the close of business, this supervisor reviews every trade made during the day. After 6 months of trading marketable securities under this system, the quantified risk reported by the internal audit activity is termed

- A. Responded risk.

- B. True risk.
- C. Managed risk.
- D. Residual risk.

**Answer (D) is correct.**

Residual risk is the risk remaining after management takes action to alter its severity.

A “Responded risk” is not a meaningful term in this context.

B “True risk” is not a meaningful term in this context.

C Managed risk is not as appropriate for this situation as one of the other answer choices.

**Question: 73** According to COSO, the benefits of enterprise risk management (ERM) include all of the following except

- A. Decreased performance variability.
- B. Elimination of all risks.
- C. Improved resource allocation.
- D. Improved risk identification and management.

**Answer (B) is correct.**

ERM helps to manage risks, but it does not eliminate risks.

A ERM helps management decrease performance variability by setting performance tolerances that align with strategy, business objectives, and risk appetite.

C ERM helps to improve resource allocation by deploying resources based on the severity and priority of risks.

D ERM helps improve risk identification and management by integrating ERM practices throughout the entire organization, starting with strategy selection through performance results.

**Question: 74** According to COSO, ERM is best defined as

- A. A process, effected by an entity’s board of directors, management, and other personnel, designed to provide reasonable assurance regarding the achievement of objectives relating to operations, reporting, and compliance.
- B. A serial process in which one component affects only the next component.

- C. A process that takes a control-based approach to an organization.
- D. The culture, capabilities, and practices that organizations rely on to manage risk in creating, preserving, and realizing value.

**Answer (D) is correct.**

The COSO ERM framework is a basis for coordinating and integrating all of an organization's risk management activities. Effective integration (1) improves decision-making, and (2) enhances performance. It is defined as the culture, capabilities, and practices that organizations rely on to manage risk in creating, preserving, and realizing value.

**A** The COSO's internal control framework is a process, effected by an entity's board of directors, management, and other personnel, designed to provide reasonable assurance regarding the achievement of objectives relating to operations, reporting, and compliance. The COSO ERM framework complements and incorporates some concepts of, the COSO internal control framework.

**B** The components are interrelated. For example, the governance and culture component affects all components.

**C** The COSO ERM framework takes a risk-based approach to an organization.

**Question: 75** The components of enterprise risk management (ERM) should be present and functioning. What does "present" mean?

- I. Components exist in the design of ERM.
  - II. Components exist in the implementation of ERM.
  - III. Components continue to operate to achieve strategy and business objectives.
- A. I only.
  - B. II only.
  - C. I and II.
  - D. I, II, and III.

**Answer (C) is correct.**

The components and principles of ERM, and their related controls, should be present and functioning to help the entity achieve its strategy and business objective. "Present" means such components, principles, and controls exist in the design and implementation of ERM.

**A** The components also should exist in the implementation of ERM.

**B** The components also should exist in the design of ERM.

**D** “Functioning” means the components, principles, and controls continue to operate to achieve strategy and business objectives.

**Question: 76** According to COSO, which of the following provides oversight of an entity’s enterprise risk management (ERM)?

- A. Management.
- B. The risk officer.
- C. The board of directors.
- D. Financial executives.

**Answer (C) is correct.**

The board provides risk oversight of ERM culture, capabilities, and practices. Also, board committees may be formed for this purpose, e.g., a risk committee.

**A** Management generally has day-to-day responsibility for managing ERM.

**B** A risk officer may coordinate risk management activities but will not provide oversight.

**D** Financial executives may be more involved with the internal auditing activity to ensure that risk management processes regarding financial reporting are operating effectively. Their involvement with the internal auditing activity is not oversight of ERM.

**Question: 77** An organization determined that its variable interest rate on an existing loan will increase significantly in the near future. It therefore decided to hedge its variable rate by locking in a fixed rate over the remaining loan period. According to the COSO ERM framework, this decision is which response to risk?

- A. Reduction.
- B. Acceptance.
- C. Sharing.
- D. Avoidance.

**Answer (C) is correct.**

Sharing reduces the severity of the risk by transferring some risk to another party. Examples are insurance; hedging; joint ventures; outsourcing; and contractual agreements with customers, vendors, or other business partners.

**A** Reduction lowers the severity of the risk without transferring a portion of the risk.

**B** Acceptance takes no action to alter the severity of the risk.

**D** Avoidance is action to remove the risk. An action to remove variable interest rate risk is to pay the loan, for example, by refinancing (not hedging) at a fixed rate.

**Question: 78** An entity defines its risk appetite in which component of the COSO ERM framework?

A. Performance.

B. Strategy and objective-setting.

C. Governance and culture.

D. Control environment.

**Answer (B) is correct.**

The entity defines risk appetite in the strategy and objective-setting component of ERM. In defining risk appetite, the entity considers its mission, vision, culture, prior strategies, and risk capacity.

**A** Although the risk appetite concept is applied in the performance component, it is defined in the strategy and objective-setting component.

**C** The entity defines its risk appetite in the strategy and objective-setting component of ERM. The governance and culture component is the basis for all of the components.

**D** The control environment is a component of the COSO internal control framework, not the ERM framework.

**Question: 79** The underlying premise of the COSO ERM framework is that every organization exists to

A. Maximize profits.

B. Identify and manage risks.

C. Provide value for its stakeholders.

D. Achieve strategy and business objectives.

**Answer (C) is correct.**

ERM is defined as the culture, capabilities, and practices, integrated with strategy-setting and performance, that organizations rely on to manage risk in creating, preserving, and realizing value.

**A** ERM's broad premise is to create, preserve, and realize value for the entity's stakeholders, not simply to maximize profits.

**B** Risks are identified and managed to provide value for stakeholders.

**D** Strategy and business objectives are the means by which the entity intends to add value for its stakeholders.

**Question: 80** Banks provide reconciliation statements to their clients. From the clients' perspective, this practice is a form of which method of managing risks associated with cash?

- A. Reduction.
- B. Accepting.
- C. Transferring.
- D. Avoiding.

**Answer (A) is correct.**

Risk responses may include avoidance, acceptance, sharing, pursuit, and reduction. By using bank reconciliations, businesses can reduce the risk of theft and misappropriation.

**B** Using a bank reconciliation reduces, but does not accept, the risk associated with theft of cash.

**C** Risk is not transferred to anyone else. The risk of theft is not being transferred to the bank.

**D** The risk of theft is not avoided through use of a bank reconciliation.

**Question: 81** For an enterprise wide risk management program to be most effective, it should be led by which of the following?

- A. A management committee.
- B. The chief audit executive.
- C. A centralized coordinator.
- D. Audit committee members.

**Answer (C) is correct.**

An enterprise risk management (ERM) program is most effective when led by a centralized coordinator, such as a risk officer. This person facilitates ERM by working with other managers in establishing effective risk management in their areas of responsibility.

**A** Although management is responsible for managing risks and the CEO is ultimately responsible for ERM, an ERM program is most effective when led by a centralized coordinator.

**B** The chief audit executive (CAE) leads the internal audit activity, which is responsible for evaluating and improving the risk management process. A CAE's operational responsibility for an ERM program could impair the objectivity of the internal audit activity.

**D** As directors, audit committee members provide only oversight of ERM.

**Question: 82** According to COSO, the difference between inherent risk and actual residual risk results because of management's

- A. Actions to alter the severity of inherent risk.
- B. Actions to alter the severity of actual residual risk.
- C. Inability to alter the severity of inherent risk.
- D. Inability to share the actual residual risk.

**Answer (A) is correct.**

Inherent risk is the risk without management actions to alter its severity. Actual residual risk remains after management actions to alter its severity.

**B** Actual residual risk is the risk that remains after management's actions to alter its severity.

**C** The difference results only if management actions alter the severity of inherent risk.

**D** The inability to share actual residual risk does not create the difference between inherent risk and actual residual risk. Sharing is a risk response reduces inherent risk.

**Question: 83** According to COSO's ERM framework, which of the following is an essential element of the governance and culture component?

- A. Human capital.
- B. Reports on risk and culture.
- C. Information systems.
- D. Risk responses.

**Answer (A) is correct.**

A principle within the governance and culture component is that the organization attract, develop, and retain capable individuals.

B Reporting on risk, culture, and performance is a principle within the review and revision component.

C Leveraging information and technology is a principle within the information, communication, and reporting component.

D Implementing risk responses is a principle within the performance component.

**Question: 84** According to the COSO ERM framework, which of following best describes the difference between strategy and business objectives?

A. Strategy is the plan to achieve business objectives.

B. Business objectives are the steps to achieve strategy.

C. Strategy is the organization's core purpose, and business objectives are what the organization aspires to achieve over time.

D. Business objectives are broader in scope than strategy.

**Answer (B) is correct.**

Strategy is the plan to achieve the entity's mission and vision and apply its core values. Business objectives are the measurable steps taken to achieve the entity's strategy.

A Strategy is the plan to achieve the organization's mission and vision and apply its core values.

C Mission is the organization's core purpose, but vision is its aspirations for what it intends to achieve over time.

D Strategy is the overall plan to achieve the organization's mission and vision. It reflects a broader scope than business objectives.

**Question: 85** According to the COSO ERM framework, the characteristic of risk that reflects its nature and scope is

A. Severity.

B. Velocity.

C. Persistence.

D. Complexity.

**Answer (D) is correct.**

Complexity is the nature and scope of a risk. Interdependence of risks ordinarily increases their complexity.

**A** Common measures of severity are combinations of a risk's impact and likelihood.

**B** Velocity is the speed at which a risk affects the entity.

**C** Persistence is how long a risk affects an entity, including the time it takes the entity to recover.

**Question: 86** According to COSO, which of the following has day-to-day responsibility for enterprise risk management?

A. Management.

B. The board of directors.

C. External auditors.

D. Internal auditors.

**Answer (A) is correct.**

Management generally has day-to-day responsibility for managing risk. The principal owners of risk (first line of accountability) manage performance and risks taken to achieve strategy and business objectives.

**B** The board is responsible for risk oversight of ERM culture, capabilities, and practices. But it may delegate that responsibility to a board committee (e.g., a risk committee).

**C** External auditors must be independent of the entity and therefore must not perform management functions. However, an external, independent audit provides information useful in managing ERM.

**D** Internal auditors have an assurance function (the third line of management accountability). They must have organizational independence and be objective.

**Question: 87** Company management completes event identification and analyzes the risks. The company wishes to assess its risk after management's response to the risk. According to COSO, which of the following types of risk does this situation represent?

A. Inherent risk.

B. Residual risk.

- C. Event risk.
- D. Detection risk.

**Answer (B) is correct.**

Risk that remains even after management's initial response is residual risk.

**A** Inherent risk is risk that is natural or that exists in the absence of internal controls.

**C** Event risk is risk due to unforeseen events taking place.

**D** Detection risk is the risk that the auditor will conclude that no material errors are present when in fact there are.

**Question: 88** Which of the following is not a principle related to the review and revision component of the COSO ERM framework?

- A. The organization pursues improvement of ERM.
- B. The organization develops and evaluates its portfolio view of risk.
- C. The organization reviews entity performance results and considers risk.
- D. The organization identifies and assesses changes that may substantially affect strategy and business objectives.

**Answer (B) is correct.**

“The organization develops and evaluates its portfolio view of risk” is one of the five principles related to the performance component of the COSO ERM framework. The three principles related to the review and revision component of the COSO ERM framework are the organization (1) identifies and assesses changes that may substantially affect strategy and business objectives, (2) reviews entity performance results and considers risk, and (3) pursues improvement of ERM.

**A** “The organization pursues improvement of ERM” is one of the three principles related to the review and revision component of the COSO ERM framework. The organization must continually improve ERM at all levels, even if actual performance aligns with target performance or tolerance.

**C** “The organization reviews entity performance results and considers risk” is one of the three principles related to the review and revision component of the COSO ERM framework. Performance results that deviate from target performance or tolerance may indicate (1) unidentified risks, (2) improperly assessed risks, (3) new risks, (4) opportunities to accept more risk, or (5) the need to revise target performance or tolerance.

**D** “The organization identifies and assesses changes that may substantially affect strategy and business objectives” is one of the three principles related to the review and revision component of the COSO ERM framework. Changes in the organization’s business context and culture are most likely to substantially affect strategy and business objectives. Such changes may result from changes in the organization’s internal or external environment.

**Question: 89** According to the COSO ERM framework, which of the following is not a characteristic of business objectives?

- A. Measurable.
- B. Dynamic.
- C. Specific.
- D. Observable.

**Answer (B) is correct.**

According to the COSO ERM framework, business objectives are (1) specific, (2) measurable, (3) observable, and (4) obtainable. Business contexts may be characterized as dynamic, complex, or unpredictable. A dynamic business context means new, emerging, and changing risks can appear at any time.

**A** According to the COSO ERM framework, a characteristic of business objectives is that they are measurable.

**C** According to the COSO ERM framework, a characteristic of business objectives is that they are specific.

**D** According to the COSO ERM framework, a characteristic of business objectives is that they are observable.

**Question: 90** Which of the following is not a principle related to the information, communication, and reporting component of the COSO ERM framework?

- A. The organization identifies risks that disrupt operations of the ERM.
- B. The organization leverages its information systems to support ERM.
- C. The organization uses communication channels to support ERM.
- D. The organization reports on risk, culture, and performance at multiple levels and across the entity.

**Answer (A) is correct.**

“The organization identifies risks that disrupt operations and affect the reasonable expectation of achieving strategy and business objectives” is one of the five principles related to the performance component of the COSO ERM framework. The three principles related to the information, communication, and reporting component of the COSO ERM framework are 1) the organization leverages its information systems to support ERM, 2) the organization uses communication channels to support ERM, and 3) the organization reports on risk, culture, and performance at multiple levels and across the entity.

**B** “The organization leverages its information systems to support ERM” is one of the three principles related to the information, communication, and reporting component of the COSO ERM framework. Data management practices help ensure that risk information is useful, timely, relevant, and of high quality.

**C** “The organization uses communication channels to support ERM” is one of the three principles related to the information, communication, and reporting component of the COSO ERM framework. Management communicates the organization’s strategy and business objectives to internal and external stakeholders. Communications methods include written documents, electronic messages, public events or forums, and informal or spoken communications.

**D** “The organization reports on risk, culture, and performance at multiple levels and across the entity” is one of the three principles related to the information, communication, and reporting component of the COSO ERM framework. The purpose of reporting is to support personnel in their (1) understanding of the relationships among risk, culture, and performance and (2) decision making related to setting strategy and objectives, governance, and day-to-day operations.

**Question: 91** Which of the following has the greatest effect on the strategy and objective-setting component of the COSO ERM framework?

- A. Performance results that deviate from target performance.
- B. Reviews of industry peers and peer comparisons.
- C. Compliance with obligations and achievement of expectations.
- D. Changes in the organization’s business context.

**Answer (D) is correct.**

A principle related to the strategy and objective-setting component of the COSO ERM framework is that the organization analyzes business context and its effect on the risk profile. Thus, changes in the business context, among the choices, has the greatest effect on the strategy and objective-setting component.

**A** Performance results that deviate from target performance or tolerance may indicate unidentified risks, improperly assessed risks, new risks, opportunities to accept more risk, or the need to revise target performance or tolerance. This relates to the performance component of the COSO ERM framework.

**B** Methods of identifying areas for improvement of ERM include continual or separate evaluations, peer comparisons, and reviews of industry peers. This relates to the review and revision component of the COSO ERM framework.

**C** Compliance with obligations and achievement of expectations is one of the factors to be considered in selecting and implementing risk responses. This relates to the performance component of the COSO ERM framework.

**Question: 92** Which of the following approaches to providing assurance on the risk management process is based on the principle that effective risk management processes develop as value is added at each stage of maturation?

- A. The process element approach.
- B. The key principles approach.
- C. The maturity model approach.
- D. None of the answers are correct.

**Answer (C) is correct.**

The maturity model approach is based on the principle that effective risk management processes develop as value is added at each stage of maturation. Accordingly, this approach determines where risk management is on the maturity curve and whether it (1) is progressing as expected, (2) adds value, and (3) meets organizational needs.

**A** The process element approach determines whether certain elements (i.e., formal risk identification, formal risk analysis, risk evaluation, etc.) have been implemented.

**B** The key principles approach determines the extent to which risk management creates and protects value, is fully integrated with management at all levels, is part of decision making, directly addresses uncertainty in risk assessment, is systematic, is based on the best available information, is adapted to the specific entity, considers human and cultural factors so that results are helpful to users of the process, is transparent and inclusive of stakeholders, remains relevant, and promotes continuous improvement.

**D** One of the answers is correct.

**Question: 93** Which of the following is not a component of the ISO 31000 model?

- A. Monitoring and review.
- B. Continual improvement.
- C. Unitary control framework.
- D. Design of framework.

**Answer (C) is correct.**

“Unitary control framework” is not a component of the ISO 31000 model.

**A** Monitoring and review is a component of the ISO 31000 model.

**B** Continual improvement is a component of the ISO 31000 model.

**D** Design of framework is a component of the ISO 31000 model.

**Question: 94** The ISO 31000 model describes three approaches to providing assurance on risk management processes. Which of the following is not one of these approaches?

- A. Maturity model.
- B. Negative assurance.
- C. Key principles.
- D. Process element.

**Answer (B) is correct.**

Negative assurance is not a concept applicable to providing assurance on risk management processes described in the ISO 31000 model.

**A** The maturity model approach is based on the principle that effective risk management processes develop as value is added at each stage of maturation.

**C** The key principles approach determines the extent to which risk management creates and protects value, is fully integrated with management at all levels, etc.

**D** The process element approach determines whether each element has been implemented.

**Question: 95** According to ISO 31000, which of the following is not a principle of risk management?

- A. Considers human and cultural factors.
- B. Delegates accountability and authority.

- C. Promotes continuous improvement.
- D. Explicitly addresses uncertainty.

**Answer (B) is correct.**

According to the ISO 31000 risk management framework, 11 principles are the foundation for an effective risk management process. These principles state that risk management (1) creates and protects value; (2) is an integral part of organizational processes; (3) is part of decision making; (4) explicitly addresses uncertainty; (5) is systematic, structured, and timely; (6) is based on the best available information; (7) is tailored to each organization; (8) considers human and cultural factors; (9) is transparent and inclusive; (10) is dynamic, repetitive, and responsive to change; and (11) promotes continuous improvement.

**A** A principle of risk management according to ISO 31000 is that risk management considers human and cultural factors.

**C** A principle of risk management according to ISO 31000 is that risk management promotes continuous improvement.

**D** A principle of risk management according to ISO 31000 is that risk management explicitly addresses uncertainty.

**Question: 96** The ISO 31000 approach to risk management is

- A. Resource based.
- B. Process based.
- C. Objective based.
- D. Principles based.

**Answer (D) is correct.**

The ISO 31000 is a principles-based approach to risk management. It states 11 principles that are the foundation for an effective risk management process. Risk management (1) creates and protects value; (2) is an integral part of organizational processes; (3) is part of decision making; (4) explicitly addresses uncertainty; (5) is systematic, structured, and timely; (6) is based on the best available information; (7) is tailored to each organization; (8) considers human and cultural factors; (9) is transparent and inclusive; (10) is dynamic, repetitive, and responsive to change; and (11) promotes continuous improvement.

**A** The ISO 31000 approach to risk management is principles based, not resource based.

**B** The ISO 31000 approach to risk management is principles based, not process based.

C The COSO ERM approach to risk management is objective based.

**Question: 97** According to ISO 31000, the design of a risk management framework involves all of the following except

- A. Deciding on an appropriate risk response.
- B. Integrating risk management into organizational processes.
- C. Allocating the necessary resources.
- D. Establishing communication and reporting methods.

**Answer (A) is correct.**

Deciding on an appropriate risk response is not involved in the design of a risk management framework according to ISO 31000. According to a component of ISO 31000, the design of a framework for managing risk ensures a foundation is established for effective risk management processes. This foundation involves (1) understanding the organization and its context, (2) establishing a risk management policy, (3) delegating accountability and authority, (4) integrating risk management into organizational processes, (5) allocating the necessary resources, and (6) establishing internal and external communication and reporting methods.

**B** According to a component of ISO 31000, the design of a framework for managing risk involves integrating risk management into organizational processes.

**C** According to a component of ISO 31000, the design of a framework for managing risk involves allocating the necessary resources as part of the foundation for establishment of effective risk management processes.

**D** According to a component of ISO 31000, the design of a framework for managing risk involves establishing communication and reporting methods.

**Question: 98** The monitoring and review component of the ISO 31000 risk management framework

- A. Ensures the long-term effectiveness of risk management processes.
- B. Assesses the effectiveness of risk management processes.
- C. Ensures sufficient resources have been committed.
- D. Assists the organization in achieving its directives.

**Answer (B) is correct.**

The ISO 31000 risk management framework consists of five components: (1) a mandate and commitment by the board and senior management, (2) the design of a framework for managing risk, (3) implementing risk management, (4) monitoring and review of the framework, and (5) continual improvement of the framework. Monitoring and review of the framework assesses the effectiveness of risk management processes.

A This is the purpose of the continual improvement component of the ISO 31000 risk management framework.

C This is a purpose of the mandate and commitment component of the ISO 31000 risk management framework.

D This is the purpose of the implementation component of the ISO 31000 risk management framework.

**Question: 99** The elements of the ISO 31000 risk management process include all of the following except

- A. Risk treatment.
- B. Risk analysis.
- C. Risk appetite.
- D. Risk identification.

**Answer (C) is correct.**

The ISO risk management process consists of seven elements: (1) communication and consultation requires ongoing, structured communication and consultation with those affected in the organization's operations; (2) establishing the context identifies and understands the external and internal factors that will influence the organization's risk management; (3) risk identification considers sources of risk, areas of impact, and potential events and their causes and consequences; (4) risk analysis considers the impact and likelihood of each risk; (5) risk evaluation prioritizes the identified risks; (6) risk treatment decides on an appropriate risk response that is consistent with the organization's risk appetite; and (7) monitor and review evaluates whether the risk treatments are effective. Risk appetite is the amount of risk the organization is willing to accept. It is considered during risk treatment, but is not a separate element.

A Risk treatment is an element of the ISO 31000 risk management process. Risk treatment decides on an appropriate risk response (avoid, share, reduce, or accept) that is consistent with the organization's risk appetite.

**B** Risk analysis is an element of the ISO 31000 risk management process. Risk analysis considers the impact and likelihood of each risk.

**D** Risk identification is an element of the ISO 31000 risk management process. Risk identification considers sources of risk, areas of impact, and potential events and their causes and consequences.

**Question: 100** According to the ISO 31000 risk management framework, the board is responsible for

- A. Providing assurance regarding the risk management system.
- B. Identifying and managing risks.
- C. Overseeing risk management.
- D. Setting the organization's risk attitude.

**Answer (C) is correct.**

According to the ISO 31000 risk management framework, the board is responsible for overseeing risk management and has overall responsibility for ensuring that risk management processes are in place, adequate, and effective.

**A** The internal audit activity is responsible for providing assurance regarding the entire risk management system. Standard 2120 states, "The internal audit activity must evaluate the effectiveness and contribute to the improvement of risk management processes."

**B** Management is responsible for identifying and managing risks. Management must focus on risks at all levels of the entity and take the necessary action to manage them.

**D** Management is responsible for setting the organization's risk attitude, which is defined by ISO as an "organization's approach to assess and eventually pursue, retain, take, or turn away from risk." Management also identifies and manages risks.

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## PART-1 UNIT-5

1. Which of the following statements best describes the relationship between planning and controlling?

- A. Planning looks to the future; controlling is concerned with the past.
- B. Planning and controlling are completely independent of each other.
- C. Planning prevents problems; controlling is initiated by problems that have occurred.
- D. Controlling cannot operate effectively without the tools provided by planning.

Answer (D) is correct.

Control is the process of making certain that plans are achieving the desired objectives. The elements of control include (1) establishing standards for the operation to be controlled, (2) measuring performance against the standards, (3) examining and analyzing deviations, (4) taking corrective action, and (5) reappraising the standards based on experience. Planning provides needed tools for the control process by establishing standards, i.e., the first step.

- A. A control system looks to the future when it provides for corrective action and review and revision of standards.
- B. Planning and controlling overlap.
- C. Comprehensive planning includes creation of controls.

2. An internal auditor is examining inventory control in a merchandising division with annual sales of US \$3,000,000 and a 40% gross profit rate. Tests show that 2% of the monetary amount of purchases do not reach inventory because of breakage and employee theft. Adding certain controls costing US \$35,000 annually could reduce these losses to .5% of purchases. Should the controls be recommended?

- A. Yes, because the projected saving exceeds the cost of the added controls.
- B. No, because the cost of the added controls exceeds the projected savings.
- C. Yes, because the ideal system of internal control is the most extensive one.
- D. Yes, regardless of cost-benefit considerations, because the situation involves employee theft.

Answer (B) is correct.

Controls must be subject to the cost-benefit criterion. The annual cost of these inventory controls is US \$35,000, but the cost savings is only US \$27,000  $\{(2.0\% - 0.5\%) \times [\$3,000,000 \text{ sales} \times (1.0 - 0.4 \text{ gross profit rate})]\}$ . Hence, the cost exceeds the benefit, and the controls should not be recommended.

- A. The cost exceeds the benefit.

C.The ideal system is subject to the cost-benefit criterion. The most extensive system of internal controls may not be cost effective.

D.Cost-benefit considerations apply even to employee theft.

3.Specific airline ticket information, including fare, class, purchase date, and lowest available fare options, as prescribed in the organization’s travel policy, is obtained and reported to department management when employees purchase airline tickets from the organization’s authorized travel agency. Such a report provides information for

A.Quality of performance in relation to the organization’s travel policy.

B.Identifying costs necessary to process employee business expense report data.

C.Departmental budget-to-actual comparisons.

D.Supporting employer’s business expense deductions.

Answer (A) is correct.

Comparison of actual performance against a standard provides information for assessing quality of performance.

B.This ticket information is preliminary; employees may change tickets and routings prior to their trip.

C.Departmental budget-to-actual comparisons do not necessarily reflect the actual costs ultimately incurred.

D.Supporting expense deductions may not necessarily reflect actual costs.

4.According to The IIA Glossary appended to the Standards, which of the following are most directly designed to ensure that risks are contained?

A.Risk management processes.

B.Internal audit activities.

C.Control processes.

D.Governance processes.

Answer (C) is correct.

Control processes are the policies, procedures, and activities that are part of a control framework, designed to ensure that risks are contained within the risk tolerances established by the risk management process.

A.Risk management is a process to identify, assess, manage, and control potential events or situations to provide reasonable assurance regarding the achievement of the organization’s objectives.

B. An internal audit activity is a department, division, team of consultants, or other practitioner(s) that provides independent, objective assurance and consulting services designed to add value and improve an organization's operations.

D. Governance is the combination of processes and structures implemented by the board to inform, direct, manage, and monitor the activities of the organization toward the achievement of its objectives.

5. Which of the following is not implied by the definition of control?

A. Measurement of progress toward goals.

B. Uncovering of deviations from plans.

C. Assignment of responsibility for deviations.

D. Indication of the need for corrective action.

Answer (C) is correct.

The elements of control include (1) establishing standards for the operation to be controlled, (2) measuring performance against the standards, (3) examining and analyzing deviations, (4) taking corrective action, and (5) reappraising the standards based on experience. Thus, assigning responsibility for deviations found is not a part of the controlling function.

A. Measurement of progress toward goals is implied by the definition of control.

B. Uncovering of deviations from plans is implied by the definition of control.

D. Indication of the need for corrective action is implied by the definition of control.

6. The actions taken to manage risk and increase the likelihood that established objectives and goals will be achieved are best described as

A. Supervision.

B. Quality assurance.

C. Control.

D. Compliance.

Answer (C) is correct.

Control is "any action taken by management, the board, and other parties to manage risk and increase the likelihood that established objectives and goals will be achieved" (The IIA Glossary).

A. Supervision is just one means of achieving control.

B. Quality assurance relates to just one set of objectives and goals. It does not pertain to achievement of all established organizational objectives and goals.

D.Compliance is “adherence to policies, plans, procedures, laws, regulations, contracts, or other requirements” (The IIA Glossary).

7.Which of the following control procedures does an internal auditor expect to find during an engagement to evaluate risk management and insurance?

- A.Periodic internal review of the in-force list to evaluate the adequacy of insurance coverage.
- B.Required approval of all new insurance policies by the organization’s CEO.
- C.Policy of repetitive standard journal entries to record insurance expense.
- D.Cutoff procedures with regard to insurance expense reporting.

Answer (A) is correct.

Obtaining insurance and periodically reviewing its adequacy are among management’s responses to the findings of a risk assessment. Insurance coverage should be sufficient to ensure that the relevant assessed risks are managed in accordance with the organization’s risk appetite.

- B.CEO approval is an operational decision ordinarily delegated to a lower level manager.
- C.A policy concerning standard journal entries is an accounting control, not a risk management and insurance control.
- D.Cutoff procedures with regard to insurance expense reporting are an accounting control, not a risk management and insurance control.

8.An internal auditor fails to discover an employee fraud during an assurance engagement. The nondiscovery is most likely to suggest a violation of the International Professional Practices Framework if it was the result of a

- A.Failure to perform a detailed review of all transactions in the area.
- B.Determination that any possible fraud in the area would not involve a material amount.
- C.Determination that the cost of extending procedures in the area would exceed the potential benefits.
- D.Presumption that the internal controls in the area were adequate and effective.

Answer (D) is correct.

The internal audit activity evaluates the adequacy and effectiveness of controls (Impl. Std. 2130.A1). Moreover, the internal audit activity must assist the organization in maintaining effective controls by evaluating their effectiveness and efficiency and by promoting continuous improvement (Perf. Std. 2130). Thus, an internal auditor must not simply assume that controls are adequate and effective.

- A.Due professional care does not require detailed reviews of all transactions.

B.The relative complexity, materiality, or significance of matters to which assurance procedures are applied should be considered.

C.The internal auditor should consider the cost of assurance in relation to potential benefits.

9.Controls should be designed to ensure that

A.Operations are performed efficiently.

B.Management's plans have not been circumvented by worker collusion.

C.The internal audit activity's guidance and oversight of management's performance is accomplished economically and efficiently.

D.Management's planning, organizing, and directing processes are properly evaluated.

Answer (A) is correct.

The purpose of control processes is to support the organization in the management of risks and the achievement of its established and communicated objectives. The control processes are expected to ensure, among other things, that operations are performed efficiently and achieve established results.

B.Collusion is an inherent limitation of internal control.

C.The board provides oversight of risk management and control processes administered by management.

D.Controls are actions by management, the board, and others to manage risk and increase the likelihood that established goals and objectives will be achieved (The IIA Glossary). The internal audit activity evaluates the effectiveness of control processes. Thus, controls do not directly address management's planning, organizing, and directing processes. Internal auditors evaluate management processes to determine whether reasonable assurance exists that objectives and goals will be achieved.

10.Controls provide assurance to management that desired actions will be accomplished when objectives are established in writing and

A.Standards are adopted, results are compared with the standards, and corrective actions are undertaken.

B.Are communicated to employees in writing and are updated by operating personnel as conditions change.

C.Policies and procedures for activities are set out in manuals for use by properly trained personnel.

D.Internal reviews as to the propriety and effectiveness of the objectives are undertaken on a periodic basis by the internal audit activity.

Answer (A) is correct.

The elements of control include (1) establishing standards for the operation to be controlled, (2) measuring performance against the standards, (3) examining and analyzing deviations, (4) taking

corrective action, and (5) reappraising the standards based on experience. These elements of control provide reasonable assurance to management that established objectives and goals will be achieved.

B. More than simply the establishment and communication of objectives is required for effective control.

C. The essential elements of adoption of standards, comparison, and corrective action are also needed

D. The essential elements of adoption of standards, comparison, and corrective action are also needed.

11. Which of the following best defines control?

A. Control is the result of proper planning, organizing, and directing by management.

B. Controls are statements of what the organization chooses to accomplish.

C. Control is provided when cost-effective measures are taken to restrict deviations to a tolerable level.

D. Control accomplishes objectives and goals in an accurate, timely, and economical fashion.

Answer (A) is correct.

A control is “any action taken by management, the board, and other parties to manage risk and increase the likelihood that established objectives and goals will be achieved” (The IIA Glossary). Thus, control is the result of proper planning, organizing, and directing by management.

B. Established objectives and goals are what the organization chooses to accomplish.

C. The internal audit activity evaluates the efficiency of controls, but the definition of control addresses effectiveness in achieving objectives and goals.

D. Efficient performance accomplishes objectives and goals in an accurate, timely, and economical fashion.

12. Internal auditors regularly evaluate controls. Which of the following best describes the concept of control as recognized by internal auditors?

A. Management regularly discharges personnel who do not perform up to expectations.

B. Management takes action to enhance the likelihood that established goals and objectives will be achieved.

C. Control represents specific procedures that accountants and internal auditors design to ensure the correctness of processing.

D. Control procedures should be designed from the “bottom up” to ensure attention to detail.

Answer (B) is correct.

A control is any action taken by management, the board, and other parties to manage risk and increase the likelihood that established objectives and goals will be achieved (The IIA Glossary).

A. Termination of employees who perform unsatisfactorily is not a comprehensive definition of control.

C. Control is not limited to processing. Moreover, it should be designed by management, the board, and others, not by internal auditors. The internal auditor's objectivity is impaired by designing such systems.

D. Some control procedures may be designed from the bottom up, but the concept of control flows from management and the board down through the organization.

13. Use of standard operating procedures as controls is most likely to be effective in an organization that has which of the following characteristics?

A. An aversion to risk.

B. An entrepreneurial focus.

C. Effective leadership.

D. A diverse product mix.

Answer (A) is correct.

Controls are actions taken to manage risks, and a precondition to the existence of any control is an organization's desire to manage risks. The more risk averse an organization, the more likely its members will comply with controls. Accordingly, the use of standard operating procedures as controls is most likely to be effective in an organization that is risk averse. This is depicted in Figure 4.3 in the Knowledge Transfer Outline.

B. Standard operating procedures are less likely to be effective as controls in a risk tolerant organization than in a risk averse organization. Generally, an organization with an entrepreneurial focus has a high risk appetite and risk tolerance.

C. Effective leadership can exist in both risk tolerant and risk averse organizations. The effectiveness of an organization's controls may be less influenced by its leadership than by its attitude toward risk.

D. The effectiveness of an organization's controls is less influenced by its product mix than by its attitude toward risk.

14. Internal control can provide only reasonable assurance that the organization's objectives will be met efficiently and effectively. One factor limiting the likelihood of achieving those objectives is that

A. The internal auditor's primary responsibility is the detection of fraud.

B. The board is active and independent.

C. The cost of internal control should not exceed its benefits.

D. Management monitors performance.

Answer (C) is correct.

A limiting factor is that the cost of internal control should not exceed its expected benefits. Thus, the potential loss associated with any exposure or risk is weighed against the cost to control it. Although the cost-benefit relationship is a primary criterion that should be considered in designing and implementing internal control, the precise measurement of costs and benefits usually is not possible.

A. The internal audit activity's responsibility regarding controls is to evaluate effectiveness and efficiency and to promote continuous improvement.

B. An effective governance function strengthens the control environment.

D. Senior management's role is to oversee the establishment, administration, and assessment of the system of risk management and control processes.

15. Internal auditors need to determine the extent to which management has established adequate control criteria. For this purpose, which of the following actions may be appropriate?

Determining whether objectives have been accomplished

Using management's adequate control criteria in their evaluation

Working with management to develop appropriate control evaluation criteria

A. 1 only.

B. 1 and 2 only.

C. 1, 2, and 3.

D. 2 only.

Answer (C) is correct.

"Adequate criteria are needed to evaluate controls. Internal auditors must ascertain the extent to which management has established adequate criteria to determine whether objectives and goals have been accomplished. If adequate, internal auditors must use such criteria in their evaluation. If inadequate, internal auditors must identify appropriate evaluation criteria through discussion with management and/or the board" (Impl. Std. 2210.A3).

A. The internal auditors also may take the actions described in statements 2 and 3.

B. The internal auditors also may take the action described in statement 3

D. The internal auditors also may take the actions described in statements 1 and 3.

16. The PCAOB's AS 2201 states that internal controls may be preventive or detective. Which of the following controls is preventive?

- A. Requiring two persons to open mail.
- B. Reconciling the accounts receivable subsidiary file with the control account.
- C. Using batch totals.
- D. Preparing bank reconciliations.

Answer (A) is correct.

Preventive controls have the objective of preventing errors or fraud that could result in a misstatement of the financial statements. Detective controls have the objective of detecting errors and fraud that have already occurred that could misstate the financial statements. Assigning two individuals to open mail is an attempt to prevent misstatement of cash receipts.

- B. Reconciling the subsidiary file with the master file may detect and lead to the correction of errors, but the control does not prevent errors.
- C. The use of batch totals may detect a missing or lost document but will not necessarily prevent a document from becoming lost.
- D. Bank reconciliations disclose errors in the accounts but have no preventive effect.

17. Internal control cannot be designed to provide reasonable assurance regarding the achievement of objectives concerning

- A. Reducing the cost of an internal audit.
- B. Elimination of all fraud.
- C. Availability of reliable data for decision-making purposes and protection of important documents and records.
- D. Mitigation of risk.

Answer (B) is correct.

Internal control is a process designed to provide reasonable assurance regarding the achievement of the entity's objectives. It can provide reasonable assurance regarding (1) reliability of financial reporting, (2) compliance with applicable laws and regulations, and (3) effectiveness and efficiency of operations. Because of inherent limitations, however, no system can be designed to eliminate all fraud.

- A. More effective control permits the auditor to accept a higher level of detection risk and thus to reduce substantive testing.
- C. More effective internal control provides management with better data for decision-making purposes. The physical safety of important documents and records also is assured.
- D. More effective internal control provides some assurance that controls mitigate risks at the entity, activity, and transaction levels.

18.The primary reason to establish internal control is to

- A.Safeguard the resources of the organization.
- B.Provide reasonable assurance that the objectives of the organization are achieved.
- C.Encourage compliance with organizational objectives.
- D.Ensure the accuracy, reliability, and timeliness of information.

Answer (B) is correct.

Internal control is a process, effected by those charged with governance, management, and other personnel, designed to provide reasonable assurance about the achievement of the entity's objectives. They include (1) reliability of financial reporting, (2) effectiveness and efficiency of operations, and (3) compliance with applicable laws and regulations.

- A.Safeguarding resources is included in the overall purpose of providing reasonable assurance that the entity's objectives are achieved.
- C.Encouraging compliance with management's intentions is included in the overall purpose of providing reasonable assurance that the entity's objectives are achieved.
- D.Ensuring the accuracy, reliability, and timeliness of information is included in the overall purpose of providing reasonable assurance that the entity's objectives are achieved.

19.Effective internal control

- A.Assists with the safeguarding of assets.
- B.Eliminates risk and potential loss to the organization.
- C.Cannot be circumvented by management.
- D.Is unaffected by changing circumstances and conditions encountered by the organization.

Answer (A) is correct.

Safeguarding of assets is included in the overall purpose of providing reasonable assurance that an organization's objectives are achieved

- B.Some risks are unavoidable and others can be eliminated only at excessive costs.
- C.The potential for management override is a basic limitation of internal control.
- D.Controls should be modified as appropriate for changes in conditions.

20.Internal controls are designed to provide reasonable assurance that

- A. Material errors or fraud will be prevented, or detected and corrected, within a timely period by employees in the course of performing their assigned duties.
- B. Management's plans have not been circumvented by worker collusion.
- C. The internal auditing department's guidance and oversight of management's performance is accomplished economically and efficiently.
- D. Management's planning, organizing, and directing processes are properly evaluated.

Answer (A) is correct.

Cost-effective controls should restrict deviations to a tolerable rate. Thus, material errors and improper or illegal acts should be prevented, or detected and corrected, within a timely period by employees in the normal course of performing their assigned duties. Accordingly, the cost-benefit relationship is considered by management during the design of systems, and the potential loss associated with any exposure or risk is weighed against the cost to control it.

- B. Collusion is an inherent limitation of internal control. Manual or automated controls can be circumvented by collusion.
- C. The board of directors or a similar body is responsible for the guidance and oversight of management.
- D. The examination and evaluation of management processes is a function of the internal auditing department.

21. 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. Faulty judgment.
- D. Collusion among employees.

Answer (A) is correct.

Internal control has inherent limitations. The performance of incompatible duties, however, is a failure to assign different people the functions of authorization, recording, and asset custody, not an inevitable limitation of internal control. Segregation of duties is a category of control activities.

- B. Management establishes internal controls. Thus, it can override those controls.
- C. Human judgment in decision making may be faulty.
- D. Controls, whether manual or automated, may be circumvented by collusion among two or more people

22. An entity should consider the cost of a control in relationship to the risk. Which of the following controls best reflects this philosophy for a large dollar investment in heavy machine tools?

- A. Conducting a weekly physical inventory.
- B. Placing security guards at every entrance 24 hours a day.
- C. Imprinting a controlled identification number on each tool.
- D. Having all dispositions approved by the vice president of sales.

Answer (C) is correct.

A controlled identification number on each tool and periodic checking allow for an effective control at reasonable cost.

- A. The cost of weekly inventories would likely outweigh the benefits derived.
- B. The cost of 24-hour guards would likely outweigh the benefits derived.
- D. Although the disposition of assets should be approved, the vice president of sales, who is not familiar with the heavy equipment, would not be the appropriate officer to provide the authorization.

23. Which of the following items is an example of an inherent limitation in an internal control system?

- A. Segregation of employee duties.
- B. Human error in decision making.
- C. Ineffective board of directors.
- D. Understaffed internal audit functions.

Answer (B) is correct.

Because of its inherent limitations, internal control can be designed and operated to provide only reasonable assurance that the entity's objectives are met. Thus, (1) human judgment is faulty, (2) controls may fail because of human error, (3) manual or automated controls can be circumvented by collusion, and (4) management may inappropriately override internal control.

- A. Segregation of employee duties is a control, not an inherent limitation of control.
- C. A board is not inherently ineffective, but human judgment at any level may be faulty.
- D. An understaffed internal audit function is not an inherent limitation of control. However, this would be an identified weakness that requires correction.

24. Manual controls would most likely be more suitable than automated controls for which of the following?

- A. Large, unusual, or nonrecurring transactions.
- B. High-volume transactions that require additional calculations.
- C. Situations with routine errors that can be predicted and corrected.
- D. Circumstances that require a high degree of accuracy.

Answer (A) is correct.

Manual controls may be more suitable where judgment and discretion are required, such as (1) for large, unusual, or nonrecurring transactions; (2) for circumstances where misstatements are difficult to define, anticipate, or predict; (3) in changing circumstances that require a control response outside the scope of an existing automated control; and (4) in monitoring the effectiveness of automated controls.

- B. Automated controls are suitable for high-volume transactions that require additional calculations.
- C. Automated controls are suitable for routine errors that can be predicted and corrected.
- D. Automated controls are suitable for circumstances that require a high degree of accuracy.

25. Which of the following is an inherent limitation of internal control?

- A. Judgmental sampling.
- B. Collusion.
- C. Segregation of duties.
- D. Employee evaluation.

Answer (B) is correct.

Two or more people may collude, or management may override the internal control

- A. Judgmental sampling is an audit procedure performed by the internal audit function and is not a limitation of control.
- C. Segregation of duties is a control that mitigates risks of misappropriation of assets and is not a limitation of control.
- D. Employee evaluation is a control, not a limitation of control.

26. The primary responsibility for establishing and maintaining internal control rests with

- A.The external auditors.
- B.The internal auditors.
- C.Management.
- D.The controller or the treasurer.

Answer (C) is correct.

Internal control is a process, effected by those charged with governance, management, and other personnel, designed to provide reasonable assurance about the achievement of the entity's objectives with regard to reliability of financial reporting, effectiveness and efficiency of operations, and compliance with applicable laws and regulations.

- A.The external auditors do not have primary responsibility for establishing and maintaining internal control.
- B.The internal auditors do not have primary responsibility for establishing and maintaining internal control.
- D.Neither the controller nor the treasurer has primary responsibility for establishing and maintaining internal control.

27.Inherent limitations in internal control must be considered in evaluating its effectiveness in preventing or detecting errors and fraud. Inherent limitations or the effects of them do not include

- A.The inability to provide more than reasonable assurance.
- B.Incompatible functions performed by the same person.
- C.Faulty human judgment in decision making.
- D.Simple error.

Answer (B) is correct.

No matter how well designed and operated, internal control can provide only reasonable assurance that entity objectives will be achieved. The likelihood of achievement is affected by such inherent limitations as faulty human judgment in decision making, simple error or mistake, collusion, and management override. The performance of incompatible functions, however, is a failure to separate duties properly, not an inevitable limitation of internal control. The separation of functional responsibilities is an important category of control activities.

- A.The inability to provide more than reasonable assurance is the effect of inherent limitations.
- C.Human judgment in decision making can be faulty and is therefore an inherent limitation of internal control.
- D.Simple error is an inherent limitation of internal control.

28. The risk that an internal auditor may not detect a material error or fraud during an audit is increased by

- A. An evaluation-reward system having not been implemented.
- B. Management override of internal control.
- C. Review of the internal audit plan by those charged with governance.
- D. Fundamental differences in the application of accounting standards.

Answer (B) is correct.

Management override is an inherent limitation of internal control. Management establishes controls, therefore, it can override those policies and procedures. Thus, the auditor must always identify management override of controls as a fraud risk and perform certain procedures to further address this risk.

- A. An evaluation-reward system would be implemented to encourage compliance with the control system. Although such a system may identify errors and instances of fraud, the absence of an evaluation-reward system should not increase the risk that an internal auditor may not detect a material error or fraud.
- C. Review of the internal audit plan by those charged with governance does not increase the risk that an internal auditor may not detect a material error or fraud during an audit.
- D. The fundamental differences in the application of accounting standards do not increase the risk that an internal auditor may not detect a material error or fraud during an audit.

29. An auditor is concerned about management override as a limitation of internal control. Which of the following tests would best assess the validity of the auditor's concern?

- A. Matching purchase orders to accounts payable.
- B. Verifying that approved spending limits are not exceeded.
- C. Tracing sales orders to the revenue account.
- D. Reviewing minutes of board meetings.

Answer (B) is correct.

To determine whether management has overridden approvals, the auditor should compare actual expenditures with budgeted amounts.

- A. Matching purchase orders with accounts payable helps assure that purchases were recorded.
- C. Tracing sales orders to the revenue account helps assure that all sales have been recorded

D.Reviewing minutes of board meetings identifies authorizations but does not provide evidence about override of the authorizations.

30.Which of the following statements about internal control is true?

A.Properly maintained internal control reasonably ensures that collusion among employees cannot occur.

B.The establishment and maintenance of internal control are important responsibilities of the internal auditor.

C.Exceptionally effective internal control is enough for the organization to achieve objectives.

D.A limitation of internal control is that management makes judgments about the extent of controls it implements.

Answer (D) is correct.

Because of inherent limitations, internal control, no matter how effective, can provide only reasonable assurance about achieving the entity's objectives. For example, when management designs and implements controls, it makes judgments about the nature and extent of (1) controls it implements and (2) the risks it assumes.

A.Collusion is an inherent limitation of internal control.

B.Establishment and maintenance of internal control are responsibilities of management.

C.Internal control cannot provide absolute assurance because any system of internal control is subject to inherent limitations.

31.The requirement that purchases be made from suppliers on an approved vendor list is an example of a

A.Preventive control.

B.Detective control.

C.Corrective control.

D.Monitoring control.

Answer (A) is correct.

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.

B.A detective control identifies errors after they have occurred.

C. Corrective controls correct the problems identified by detective controls.

D. Monitoring controls are designed to ensure the quality of the control system's performance over time.

32. Controls that are designed to provide management with assurance of the realization of specified minimum gross margins on sales are

A. Directive controls.

B. Preventive controls.

C. Detective controls.

D. Output controls.

Answer (A) is correct.

The objective of directive controls is to cause or encourage desirable events to occur, e.g., providing management with assurance of the realization of specified minimum gross margins on sales.

B. Preventive controls deter undesirable events from occurring.

C. Detective controls uncover and correct undesirable events that have occurred

D. Output controls relate to the accuracy and reasonableness of information processed by a system, not to operating controls.

33. Managerial control can be divided into feedforward, concurrent, and feedback controls. Which of the following is an example of a feedback control?

A. Quality control training.

B. Budgeting.

C. Forecasting inventory needs.

D. Variance analysis.

Answer (D) is correct.

A feedback control measures actual performance, i.e., something that has already occurred, to ensure that a desired future state is attained. It is used to evaluate past activity to improve future performance. A variance is a deviation from a standard. Thus, variance analysis is a feedback control.

A. Quality control training is a feedforward, or future-directed, control.

B. Budgeting is a feedforward, or future-directed, control.

C.Forecasting inventory needs is a feedforward, or future-directed, control

34.The operations manager of a company notified the chief financial officer of that organization 60 days in advance that a new, expensive piece of machinery was going to be purchased. This notification allowed the chief financial officer to make an orderly liquidation of some of the company's investment portfolio on favorable terms. What type of control was involved?

- A.Feedback.
- B.Strategic.
- C.Concurrent.
- D.Feedforward.

Answer (D) is correct.

Feedforward controls provide for the active anticipation of problems so that they can be avoided or resolved in a timely manner. Another example is the quality control inspection of raw materials and work-in-process to avoid defective finished goods.

- A.Feedback controls apply to decision making based on evaluations of past performance.
- B.Strategic controls are broad-based and affect an organization over a long period. They apply to such long-term variables as quality and R&D.
- C.Concurrent controls adjust ongoing processes.

35.Which of the following is not a type of control?

- A.Preventive.
- B.Reactive.
- C.Detective.
- D.Directive.

Answer (B) is correct.

Controls may be preventive (to deter undesirable events from occurring), detective (to detect and correct undesirable events which have occurred), or directive (to cause or encourage a desirable event to occur). "Reactive" is not a specified type of control. However, controls may be reactive in the sense that they detect an undesirable event and react to it or correct it.

- A.Controls may be preventive.

- C.Controls may be detective.
- D.Controls may be directive.

36.Which of the following is a feedback control?

- A.Preventive maintenance.
- B.Inspection of completed goods.
- C.Close supervision of production-line workers.
- D.Measuring performance against a standard.

Answer (B) is correct.

Feedback controls obtain information about completed activities. They permit improvement in future performance by learning from past mistakes. Thus, corrective action occurs after the fact. Inspection of completed goods is an example of a feedback control.

- A.Preventive maintenance is a feedforward control. It attempts to anticipate and prevent problems.
- C.The close supervision of production-line workers is a concurrent control. It adjusts an ongoing process.
- D.Measuring performance against a standard is a general aspect of control.

37.Which of the following is an operating control for a research and development department?

- A.Research and development personnel are hired by the payroll department.
- B.Research and development expenditures are reviewed by an independent person.
- C.All research and development costs are charged to expense in accordance with the applicable accounting principles.
- D.The research and development budget is properly allocated between new products, product maintenance, and cost reduction programs.

Answer (D) is correct.

Operating controls are those applicable to production and support activities. Because they may lack established criteria or standards, they should be based on management principles and methods. The appropriate allocation of R&D costs to new products, product maintenance, and cost reduction programs is an example. This is in contrast to the expensing of R&D costs, which is required by the rules of external financial reporting.

- A.Only the human resources department should be responsible for hiring. A department responsible for recordkeeping (e.g., payroll) should not authorize transactions.

- B. Reviewing monetary amounts is a financial control.
- C. Expensing R&D costs is an accounting treatment rather than a control.

38. When assessing application controls, which one of the following input controls or edit checks is most likely to be used to detect a data input error in the customer account number field?

- A. Limit check.
- B. Validity check.
- C. Control total.
- D. Hash total.

Answer (B) is correct.

Validity checks are tests of identification numbers or transaction codes for validity by comparison with items already known to be correct or authorized. For example, Social Security numbers on payroll input records can be compared with Social Security numbers authorized by the personnel department.

- A. Reasonableness, limit, and range checks are based upon known limits for given information. For example, the hours worked per week is not likely to be greater than 45.
- C. A record count is a control total of the number of records processed during the operation of a program. Financial totals summarize dollar amounts in an information field in a group of records.
- D. A hash total is the number obtained from totaling the same field value for each transaction in a batch. The total has no meaning or value other than as a comparison with another hash total.

39. Which one of the following input controls or edit checks would catch certain types of errors within the payment amount field of a transaction?

- A. Record count.
- B. Echo check.
- C. Check digit.
- D. Limit check.

Answer (D) is correct.

A limit, reasonableness, or range test determines whether an amount is within a predetermined limit for given information. It can only detect certain errors (i.e., those that exceed the acceptable limit).

- A. A record count determines the number of documents entered into a process.

B. An echo check tests the reliability of computer hardware. For example, the CPU sends a signal to a printer that is echoed just prior to printing. The signal verifies that the proper print position has been activated.

C. A self-checking number is generated by applying an algorithm to an identification number.

40. A customer intended to order 100 units of product Z96014, but incorrectly ordered nonexistent product Z96015. Which of the following controls most likely would detect this error?

A. Check digit verification.

B. Record count.

C. Hash total.

D. Redundant data check.

Answer (A) is correct.

Check digit verification is used to identify incorrect identification numbers. The digit is generated by applying an algorithm to the ID number. During input, the check digit is recomputed by applying the same algorithm to the entered ID number.

B. A record count is a control total of the number of transactions in a batch.

C. A hash total is a control total that is the sum of a field without a defined meaning.

D. A redundant data check searches for duplicate information in a database.

41. The procedure requiring preparation of a prelisting of incoming cash receipts, with copies of the prelist going to the cashier and to accounting, is an example of which type of control?

A. Preventive.

B. Corrective.

C. Detective.

D. Directive.

Answer (A) is correct.

A prelisting of cash receipts in the form of checks is a preventive control. It is intended to deter undesirable events from occurring. Because irregularities involving cash most likely take place before receipts are recorded, either remittance advices or a prelisting of checks should be prepared in the mailroom so as to establish recorded accountability for cash as soon as possible. A cash register tape is a form of prelisting for cash received over the counter. One copy of a prelisting will go to accounting for posting to the cash receipts journal, and another is sent to the cashier for reconciliation with checks and currency received.

- B.A corrective control remedies an error or irregularity.
- C.A detective control uncovers an error or irregularity that has already occurred.
- D.A directive control causes or encourages a desirable event.

42.Controls may be classified according to the function they are intended to perform, for example, as detective, preventive, or directive. Which of the following is a directive control?

- A.Monthly bank statement reconciliations.
- B.Dual signatures on all disbursements over a specific amount.
- C.Recording every transaction on the day it occurs.
- D.Requiring all members of the internal audit activity to be CIAs.

Answer (D) is correct.

Requiring all members of the internal audit activity to be CIAs is a directive control. The control is designed to cause or encourage a desirable event to occur. The requirement enhances the professionalism and level of expertise of the internal audit activity.

- A.Monthly bank statement reconciliation is a detective control. The events audited have already occurred.
- B.Requiring dual signatures on all disbursements over a specific amount is a preventive control. The control is designed to deter an undesirable event.
- C.Recording every transaction on the day it occurs is a preventive control. The control is designed to deter an undesirable event.

43.An organization's policies and procedures are part of its overall system of internal controls. The control function performed by policies and procedures is

- A.Feedforward control.
- B.Implementation control.
- C.Feedback control.
- D.Application control.

Answer (A) is correct.

Feedforward controls anticipate and prevent problems. Policies and procedures serve as feedforward controls because they provide guidance on how an activity should be performed to best ensure that an objective is achieved.

- B.Implementation controls are applied during systems development

C.Policies and procedures provide primary guidance before and during the performance of some task rather than give feedback on its accomplishment.

D.Application controls apply to specific applications, e.g., payroll or accounts payable.

44.As part of a total quality control program, a firm not only inspects finished goods but also monitors product returns and customer complaints. Which type of control best describes these efforts?

A.Feedback control.

B.Feedforward control.

C.Production control.

D.Inventory control.

Answer (A) is correct.

A feedback control measures actual performance, something that has already occurred, to ensure that a desired future state is attained. It is used to evaluate the past to improve future performance. Inspecting finished goods, monitoring product returns, and evaluating complaints are post-action controls intended to eliminate deviations in future cycles of the process under control.

B.Feedforward controls anticipate problems before they occur.

C.Customer complaints are not part of production control.

D.The three types of control are feedforward, concurrent, and feedback.

45.The use of financial statement analysis, quality control procedures, and employee performance evaluations are all examples of

A.Preliminary controls.

B.Concurrent controls.

C.Feedback controls.

D.Feedforward controls.

Answer (C) is correct.

A feedback control operates to provide information about processes that have already occurred.

A.Feedforward (preliminary) controls anticipate and avoid future performance problems, e.g., budgeting.

B.Concurrent controls are applied midstream, e.g., inspection on an assembly line.

D.Feedforward (preliminary) controls anticipate and avoid future performance problems, e.g., budgeting.

46.The internal audit activity of an organization is an integral part of the organization’s risk management, control, and governance processes because it evaluates and contributes to the improvement of those processes. Select the type of control provided when the internal audit activity conducts a systems development analysis.

- A.Feedback control.
- B.Strategic plans.
- C.Policies and procedures.
- D.Feedforward control.

Answer (D) is correct.

A feedforward control provides information on potential problems so that corrective action can be taken in anticipation, rather than as a result, of a problem.

- A.A feedback control provides information on the results of a completed activity.
- B.Strategic plans are developed by senior management to provide long-range guidance for the organization.
- C.Policies and procedures are developed by management. They are the most basic control subsystem of an organization.

47.Of the following, the controls that are often difficult for internal auditors to evaluate because of the lack of criteria or standards are

- A.Preventive controls.
- B.Financial controls.
- C.Corrective controls.
- D.Operating controls.

Answer (D) is correct.

Operating controls are those used in the management processes of directing and controlling and are based on comparison of results with standards. As an activity becomes less mechanical, however, standards become more difficult to determine. Control standards for security, for example, are less easily developed than for the output per hour of a machine because the degree of security achieved is not readily measurable.

A.Preventive controls keep loss exposures from occurring. They include not only operating controls but also those for which quantifiable standards are readily determined.

B.Financial controls, e.g., a budget, are subject to quantifiable standards that are relatively easy to measure.

C.Corrective controls are post-detection or remedial controls. They may include controls for which standards are easily defined, such as financial controls.

48.When a copy of the sale invoice is not received by an organization's shipping department, an employee requests the document from the proper authority. This process is a(n)

A.Directive, detective control.

B.Passive, mitigating control.

C.Active, detective control.

D.Detective, preventive control.

Answer (C) is correct.

When shipping documents are not received in the shipping department (such as copies of the sales invoice, customer order form, and bill of lading), the clerk should attempt to obtain the proper documentation from the originating organization. This type of control is detective because it detects and attempts to correct an undesirable event that has occurred. It is also active because it takes a conscious intervention by the clerk to ensure the documentation is received.

A.The control is detective, but it is not directive. A directive control causes or encourages a desirable event to occur.

B.The control is neither passive nor mitigating. It is detected by the clerk in a conscious effort to maintain proper documentation. Moreover, a mitigating (compensating) control is used when other controls are not feasible, for example, supervisory review when segregation of duties is absent.

D.The control is not preventive. It does not deter an undesirable event.

49.An adequate and effective system of internal control provides reasonable assurance that objectives will be achieved. Controls may be preventive, detective, or directive. Which of the following is a detective control for the procurement function?

A.Goods received are counted and compared with quantities on purchase order and receiving reports.

B.The procurement function is organizationally separate from receiving, disbursing, and accounting.

C.Review and approval of each procurement action is required prior to the final issuance of a purchase order.

D.Prenumbered standard purchase order forms include all relevant terms required to be used in all applicable instances.

Answer (A) is correct.

Detective controls are designed to detect and correct undesirable events that have occurred. Accounting for all goods received and comparing quantities on purchase orders and receiving reports is an example.

B. Segregation of duties is a preventive control. Preventive controls deter undesirable events from occurring.

C. Review and approval of each procurement action is a preventive control.

D. Using prenumbered standard purchase order forms is a preventive control.

50. Which of the following would be a preventive control?

A. Approving customer credit prior to shipping merchandise.

B. Reviewing the sequence of prenumbered documents.

C. Comparing a bank deposit slip with the total cash received as noted on a prelisting sheet prepared in the mail room.

D. Scanning the general ledger for accounts with unusually high or low balances.

Answer (A) is correct.

Preventive controls deter the occurrence of unwanted events. In contrast, detective controls alert the proper people after an unwanted event. Approving customer credit prior to shipping prevents merchandise from being shipped on credit to customers who are likely to default on making future payment.

B. Reviewing the sequence of prenumbered documents is a detective control designed to detect potentially fraudulent transactions.

C. Comparing a bank deposit slip with the total cash received as noted on a prelisting sheet prepared in the mail room is a detective control designed to detect whether less cash was deposited than received.

D. Scanning the general ledger for accounts with unusually high or low balances is a detective control designed to detect accounts with inaccurate balances.

51. An auditor is planning an audit of a company's recently implemented electronic data interchange (EDI) system for purchasing and billing. Which of the following controls over the accuracy of raw-material purchases would be least important in this environment?

A. Computer system controls.

B. Controls contained within the EDI vendor software.

C. Adequate audit trails.

D. Management review of individual transactions.

Answer (D) is correct.

Management review of individual transactions (a manual control) is less important in an EDI system than automated controls applicable to all transactions.

A.Computer system controls (e.g., input, processing, and output controls) are important automated controls in an EDI system.

B.At a minimum, the controls for an EDI system should include the controls contained within the EDI software.

C.An audit trail (or management trail) is a processing history control that enables management to track transactions from their source to their output. Such controls are very important in an EDI system.

52.Which of the following are considered control environment factors?

Detection Risk	Human Resources
	Policies and Practices
A.Yes	Yes
B.Yes	No
C.No	Yes
D.No	No

Answer (C) is correct.

Human resource policies and practices are part of the control environment. These policies and practices relate to recruitment, orientation, training, evaluating, counseling, promoting, compensating, and remedial actions. The control environment is the component that sets the tone of an organization, influencing the control consciousness of its people. It is the foundation for the other components.

A.Human resource policies and practices are part of the control environment, but detection risk is not. It is the risk that the audit procedures will fail to detect material misstatements. Thus, detection risk is a function of the effectiveness of the procedures used by the auditor.

B.Human resource policies and practices are part of the control environment, but detection risk is not. It is the risk that the audit procedures will fail to detect material misstatements. Thus, detection risk is a function of the effectiveness of the procedures used by the auditor.

D.Human resource policies and practices are part of the control environment, but detection risk is not. It is the risk that the audit procedures will fail to detect material misstatements. Thus, detection risk is a function of the effectiveness of the procedures used by the auditor.

53. Which of the following is an example of a detective control?

- A. The accounting department has a procedure for voiding and issuing replacement checks.
- B. The manager is given a check log reconciliation at the close of each business day.
- C. Checks are pre-numbered and kept in a locked cabinet.
- D. The staff accountant was warned about printing a check prior to receiving authorization.

Answer (B) is correct.

Providing the manager with a check log reconciliation at the close of each business day is a detective control. A detective control uncovers an error or irregularity that has already occurred. It is designed to detect undesirable events. Examples of detective controls include physical counts, reconciliations, reviews and comparisons, exception reports, and security cameras.

A. The procedure in the accounting department for voiding and issuing replacement checks is a directive control. A directive control is designed to cause or encourage a desirable event to occur. Examples are policy and procedure manuals, laws and regulations, and employee training.

C. The pre-numbering of checks and keeping checks in a locked cabinet are preventive controls. Preventive controls deter the occurrence of unwanted events and are designed to prevent errors, fraud, theft, and misstatements. Passwords, access codes, and locked doors are all examples of preventive controls.

D. Warning the staff accountant for performing an action prior to receiving authorization is a corrective control. A corrective control remedies an error or irregularity and helps mitigate damage once the problem has materialized. An example would be the enforcement of policies and procedures.

54. An employee steals money from his company's bank deposits, then makes up for the stolen cash with cash from the next day's deposits. If there is not enough cash the next day, the employee has to wait another day to make up for the deposit. And the cycle continues. This can go undetected for months. Which of the following controls could the organization implement as a preventive control to address this situation?

- A. The accounting supervisor is notified when the checking account amount drops below a certain level.
- B. Weekly, a manager at the main office checks deposit validation dates received from the bank with the sales deposit records.
- C. Daily, the accounting staff at the organization's main office reconcile the amount deposited with the cash register tape from the day's sales.
- D. Deposit slips and deposit bags have sequential numbers. The manager is required to write the deposit bag number on the deposit slip. The reason for any voided deposit slips or bags is to be documented.

Answer (D) is correct.

Preventive controls are actions taken prior to the occurrence of events. They are designed with the intent of stopping errors, irregularities, or undesirable events from occurring. An example of preventive control is the segregation of the duties of authorization, recordkeeping, and custody. When numbered deposit slips and deposit bags are used, any missing or voided numbers need to be explained. Additionally, recording the deposit bag number on the deposit slip deters the employee from taking cash from or changing the deposit.

A. Alerting the accounting supervisor when the bank balance drops below a preset limit is an example of a detective control. Detective controls alert the proper people after an unwanted event. They are effective when detection occurs before material harm occurs.

B. Comparing the dates of the deposits from the bank with expected dates of the sales deposits is a compensatory control. Compensatory or mitigative controls may reduce risk when the primary controls are ineffective. The red flag occurs when the bank consistently validates deposits being made several days after they should have been.

C. Reconciling the amount deposited with the cash register tape from the day's sales by a person different from the one who makes the deposit is a compensatory control.

55. Which of the following is not an objective of application controls?

A. Maintaining a record to track the process of data from input to storage and to the eventual output.

B. Processing data as intended in an acceptable time period.

C. Establishing logical access controls over infrastructure, applications, and data.

D. Confirming input data are accurate, complete, authorized, and correct.

Answer (C) is correct.

Establishing logical access controls over infrastructure, applications, and data is an IT general control. According to IIA GTAG, application controls are those that pertain to the scope of individual business processes or application systems. The objective of application controls is to ensure that (1) input data are accurate, complete, authorized, and correct; (2) data are processed as intended in an acceptable time period; (3) data stored are accurate and complete; (4) outputs are accurate and complete; and (5) a record is maintained to track the process of data from input to storage and to the eventual output.

A. Maintaining a record to track the process of data from input to storage and to the eventual output is an objective of application controls. According to IIA GTAG, controls are designed and operating effectively to ensure that an audit trail is generated and maintained for all transactional data.

B. Processing data as intended in an acceptable time period is an objective of application controls. According to IIA GTAG, processing controls are designed and operating effectively to ensure that all (1) transactions are processed in a timely manner and within the correct accounting period and (2) rejected transactions have been identified and reprocessed in a timely manner.

D. Confirming input data are accurate, complete, authorized, and correct is an objective of application controls. According to IIA GTAG, input controls are designed and operating effectively to ensure that (1) all transactions have been authorized and approved prior to data entry, (2) all entered transactions will be processed correctly and completely, (3) all rejected transactions have been identified and

reprocessed appropriately and completely, (4) data automatically posted from another system are processed accurately and completely, and (5) correct data files and databases are used in processing.

56. Which of the following describes a characteristic of a control matrix?

- A. Transactions are accumulated for processing.
- B. The data entered into an input field is compared to a table of valid values for that field.
- C. Track the number of records processed by the system.
- D. More than one control may be needed to adequately address a single risk.

Answer (D) is correct.

A control matrix is useful for matching controls with risks. Controls do not necessarily match risks one-to-one. Certain controls may address more than one risk, and more than one control may be needed to address a single risk.

A. With batch input controls, transactions are accumulated and submitted to the computer as a single batch. The user cannot influence the process once the job has begun. Batch processing is efficient for such applications as payroll because large numbers of routine transactions must be processed on a regular schedule. This is not a characteristic of a control matrix.

B. Validity checks compare the data entered in a given field with a table of valid values for that field. Validity checks are used for controlling online input. This is not a characteristic of a control matrix.

C. Record counts is a batch input control that tracks the number of records processed by the system for comparison to the number that the user expected to be processed. This is not a characteristic of a control matrix.

57. Which of the following input controls are based on the logic that processing efficiency is greatly increased when files are sorted on some designated field?

- A. Sequence checks.
- B. Validity checks.
- C. Range checks.
- D. Format checks.

Answer (A) is correct.

Sequence checks are based on the logic that processing efficiency is greatly increased when files are sorted on some designated field. If the system discovers a record out of order, it may indicate that the files were not properly prepared for processing.

B. Validity checks compare the data entered in a given field with a table of valid values for that field. For example, a customer number must already be on the list of approved customers.

C. Range (reasonableness) checks are based on known limits for given information. Anything outside the range requires management authorization. For example, a quantity field may allow numbers from 0 to 100, with anything over 100 requiring approval.

D. Format (field) checks are tests of the characters in a field to verify that they are of an appropriate type for that field. For example, an alphabetic character field would not allow a number to be entered.

58. One objective of IT general controls is to

A. Design controls based on the management functions of planning, organizing, directing, and controlling.

B. Ensure that processing results are complete, accurate, and properly distributed.

C. Ensure the integrity of program and data files and of computer operations.

D. Give primary consideration to authorization, validation, and error notification.

Answer (C) is correct.

According to IIA GTAG, IT general controls over information and related technologies are those that pertain to all systems components, processes, and data present in an organization's IT environment. The objectives of IT general controls are to ensure the appropriate development and implementation of applications as well as the integrity of program and data files and of computer operations. The most common IT general controls are (1) logical access controls over infrastructure, applications, and data; (2) system development life cycle controls; (3) program change management controls; (4) physical security controls over the data center; and (5) system and data backup and recovery controls.

A. Operating controls should be designed with regard to the management functions of planning, organizing, directing, and controlling. Because they lack established criteria or standards, operating controls should be based on management principles and methods.

B. Output controls ensure that processing results are complete, accurate, and properly distributed. An important output control is user review. Users should be able to determine when output is incomplete or not reasonable, particularly when the user prepared the input.

D. Primary consideration should be given to authorization, validation, and error notification when designing data input controls. Those controls that pertain to the scope of individual business processes are application controls. They include the data cycle process from input to storage and to the eventual output.

59. Which of the following are included in the control environment described in the COSO internal control framework?

A. Organizational structure, management philosophy, and planning.

B. Integrity and ethical values, assignment of authority, and human resource policies.

C. Competence of personnel, backup facilities, laws, and regulations.

D.Risk assessment, assignment of responsibility, and human resource practices.

Answer (B) is correct.

The control environment is a set of standards, processes, and structures that includes

1. Integrity and ethical values
2. Commitment to competence
3. Board of directors or audit committee
4. Management's philosophy and operating style
5. Organizational structure
6. Assignment of authority and responsibility
7. Human resource policies and practices

A.Planning is not an element of the control environment.

C.Backup facilities, laws, and regulations are not elements of the control environment.

D.Risk assessment is part of planning the internal audit activity and specific engagements.

60.The COSO framework treats internal control as a process designed to provide reasonable assurance regarding the achievement of objectives related to

A.Reliability of financial reporting.

B.Effectiveness and efficiency of operations.

C.Compliance with applicable laws and regulations.

D.All of the answers are correct.

Answer (D) is correct.

The COSO framework treats internal control as a process designed to provide reasonable assurance regarding the achievement of objectives related to reliability of financial reporting, effectiveness and efficiency of operations, and compliance with applicable laws and regulations.

A.The effectiveness and efficiency of operations and compliance with applicable laws and regulations are also correct.

B.The reliability of financial reporting and compliance with applicable laws and regulations are also correct.

C.Reliability of financial reporting and effectiveness and efficiency of operations are also correct.

61. Which of the following are elements of the control environment?

- A. Integrity and ethical values.
- B. Organizational structure.
- C. Assignment of authority and responsibility.
- D. All of the answers are correct.

Answer (D) is correct.

The five principles that relate to the control environment are

- The organization demonstrates a commitment to integrity and ethical values;
- The board demonstrates independence from management and exercises oversight for internal control;
- Management establishes, with board oversight, structures, reporting lines, and appropriate authorities and responsibilities;
- The organization demonstrates a commitment to attract, develop, and retain competent individuals in alignment with objectives; and
- The organization holds individuals accountable for their internal control responsibilities in pursuit of objectives.

A. Organizational structure and assignment of authority and responsibility are also part of the control environment.

B. Integrity and ethical values and assignment of authority and responsibility are also part of the control environment.

C. Integrity and ethical values and organizational structure are also part of the control environment

62. An organization's directors, management, external auditors, and internal auditors all play important roles in creating a proper control environment. Senior management is primarily responsible for

- A. Establishing a proper organizational culture and specifying a system of internal control.
- B. Designing and operating a control system that provides reasonable assurance that established objectives and goals will be achieved.
- C. Ensuring that external and internal auditors adequately monitor the control environment.
- D. Implementing and monitoring controls designed by the board of directors.

Answer (A) is correct.

Senior management is primarily responsible for establishing a proper organizational culture and specifying a system of internal control.

B.Senior management is not likely to be involved in the detailed design and day-to-day operation of a control system.

C.Management administers risk and control processes. It cannot delegate this responsibility to the external auditors or to the internal audit activity.

D.The board has oversight governance responsibilities but ordinarily does not become involved in the details of operations.

63.In regard to The IIA's Electronic Systems Assurance and Control study, which of the following is not a business assurance objective?

A.Recordability.

B.Capability.

C.Protectability.

D.Functionality.

Answer (A) is correct.

Recordability is not a business assurance objective

B.Capability is one of the five business assurance objectives.

C.Protectability is one of the five business assurance objectives.

D.Functionality is one of the five business assurance objectives

64.Which of the following statements is not accurate with regard to soft controls?

A.The COSO and CoCo models emphasize soft controls.

B.The communication of ethical values and the fostering of mutual trust are soft controls in the CoCo model.

C.Soft controls have become more necessary as technology advances have empowered employees.

D.Control self-assessment is not an approach to audit soft controls.

Answer (D) is correct.

One approach to auditing soft controls is control self-assessment, which is the involvement of management and staff in the assessment of internal controls within their work group.

A.The COSO and CoCo models emphasize soft controls.

B.The communication of ethical values and the fostering of mutual trust are soft controls in the CoCo model

C.Soft controls have become more necessary as technology advances have empowered employees.

65.The COSO model for internal control lists five specific areas encompassed by the control environment component. Which of the following are elements of the control environment?

A.Integrity and ethical values.

B.Organizational structure.

C.Assignment of authority and responsibility.

D.All of the answers are correct.

Answer (D) is correct.

The five principles that relate to the control environment are

- The organization demonstrates a commitment to integrity and ethical values;
- The board demonstrates independence from management and exercises oversight for internal control;
- Management establishes, with board oversight, structures, reporting lines, and appropriate authorities and responsibilities;
- The organization demonstrates a commitment to attract, develop, and retain competent individuals in alignment with objectives; and
- The organization holds individuals accountable for their internal control responsibilities in pursuit of objectives.

A.Organizational structure and assignment of authority and responsibility are also part of the control environment.

B.Integrity and ethical value and assignment of authority and responsibility are also part of the control environment.

C.Integrity and ethical value and organizational structure are also part of the control environment.

66.Which of the following is not a component of the CoCo model?

A.Commitment.

B.Capability.

C.Risk assessment.

D.Monitoring and learning.

Answer (C) is correct.

Risk assessment is not one of the four components of the CoCo model. The four components are commitment, capability, monitoring and learning, and purpose.

- A. Commitment is a component of the CoCo model.
- B. Capability is a component of the CoCo model.
- D. Monitoring and learning is a component of the CoCo model.

67. Which of the following statements is correct regarding corporate compensation systems and related bonuses?

1. A bonus system should be considered part of the control environment of an organization and should be considered in formulating a report on internal control.
2. Compensation systems are not part of an organization's control system and should not be reported as such.
3. An audit of an organization's compensation system should be performed independently of an audit of the control system over other functions that impact corporate bonuses.

- A. 1 only.
- B. 2 only.
- C. 3 only.
- D. 2 and 3 only.

Answer (A) is correct.

The control environment includes, among other things, the element of human resource policies and practices. Thus, hiring, orientation, training, evaluation, counseling, promotion, compensation, and remedial actions must be considered by management.

- B. Compensation systems are part of the organization's control systems.
- C. Audits of the compensation systems can be combined with an audit of other functions that affect corporate bonuses.
- D. Compensation systems are part of the organization's control systems, and they may be audited in combination with other functions that affect corporate bonuses.

68. The policies and procedures helping to ensure that management directives are executed and actions are taken to address risks to achievement of objectives describes

- A. Risk assessments.
- B. Control environments.

C.Control activities.

D.Monitoring.

Answer (C) is correct.

Control activities are the policies and procedures helping to ensure that management directives are executed and actions are taken to address risks to achievement of objectives.

A.Risk assessment identifies and analyzes external or internal risks to achievement of the objectives at the activity level as well as the entity level.

B.Control environments reflect the attitude and actions of the board and management regarding the significance of control within the organization.

D.Monitoring is a process that assesses the quality of the system's performance over time.

69.Which of the following is the common name for Internal Control: Guidance for Directors on the Combined Code?

A.COSO.

B.COBIT.

C.The Turnbull Report.

D.CoCo.

Answer (C) is correct.

One of the three most recognized internal control frameworks is Internal Control: Guidance for Directors on the Combined Code. It is commonly known as the Turnbull Report and was issued by the Institute of Chartered Accountants in England and Wales.

A.The COSO (Committee of Sponsoring Organizations of the Treadway Commission) issued Internal Control – Integrated Framework.

B.COBIT is the integrated framework for information technology controls issued by the IT Governance Institute.

D.CoCo refers to Guidance on Control (original title: Criteria of Control) issued by the Canadian Institute of Chartered Accountants.

70.A restaurant chain has over 680 restaurants. All food orders for each restaurant are required to be entered into an electronic device that records all food orders by food servers and transmits the order to the kitchen for preparation. All food servers are responsible for collecting cash for all their orders and must turn in cash at the end of their shift equal to the sales value of food ordered for their I.D. number. The manager then reconciles the cash received for the day with the computerized record of food orders generated. All differences are investigated immediately by the restaurant. Organizational headquarters

has established monitoring controls to determine when an individual restaurant might not be recording all its revenue and transmitting the applicable cash to the corporate headquarters. Which one of the following is the best example of a monitoring control?

- A. The restaurant manager reconciles the cash received with the food orders recorded on the computer.
- B. All food orders must be entered on the computer, and segregation of duties is maintained between the food servers and the cooks.
- C. Management prepares a detailed analysis of gross margin per store and investigates any store that shows a significantly lower gross margin.
- D. Cash is transmitted to corporate headquarters on a daily basis.

Answer (C) is correct.

Monitoring is a process that assesses the quality of internal control over time. It involves assessment by appropriate personnel of the design and operation of controls and the taking of corrective action. Monitoring can be done through ongoing activities or separate evaluations. Ongoing monitoring procedures are built into the normal recurring activities of an entity and include regular management and supervisory activities. Thus, analysis of gross margin data and investigation of significant deviations is a monitoring process.

- A. The manager's activity is an example of a reconciliation control applied at the store level. Monitoring is an overall control that determines whether other controls are operating effectively.
- B. The division of duties is an operational control.
- D. Daily transmission of cash is an operational control.

71. Management has a role in the maintenance of control. In fact, management sometimes is a control. Which of the following most likely involves managerial functions as a control?

- A. Monitoring performance.
- B. Board approval of the charter of the internal audit activity.
- C. Maintenance of a quality assurance program.
- D. Establishment of an internal audit activity.

Answer (A) is correct.

Monitoring is a component of the internal control. It is a process that assesses the quality of the system's performance over time. It consists of ongoing activities built into normal operations to ensure that they continue to be performed effectively. Supervision and other ordinary management functions, consideration of communications with external parties, and the actions of internal and external auditors are examples.

- B. The board is the entity's governing body, not its management.

C. A quality assurance program is a form of internal assessment. The manager of the program should be independent of the operations assessed.

D. An internal audit activity should be independent of the operations reviewed and is not a managerial function.

72. Which of the following is most likely to be performed in the control activities component of internal control?

A. Ongoing evaluations.

B. Information processing.

C. Assessing fraud risks.

D. Segregation of duties.

Answer (D) is correct.

The COSO model describes control activities as policies and procedures that help ensure that management directives are carried out. They are intended to ensure that necessary actions are taken to address risks to achieve the entity's objectives. Control activities have various objectives and are applied at various organizational and functional levels. They may be preventive or detective, and segregation of duties is usually present.

A. Ongoing evaluations are performed in the monitoring component of internal control.

B. Information processing is performed in the information and communication component of internal control.

C. Fraud risk assessment is performed in the risk assessment component of internal control.

73. According to COSO, the use of ongoing and separate evaluations to identify and address changes in internal control effectiveness can best be accomplished in which of the following stages of the monitoring-for-change continuum?

A. Control baseline.

B. Change identification.

C. Change management.

D. Control revalidation/update.

Answer (B) is correct.

Of the four steps in the monitoring-for-change continuum described in the 2009 COSO document *Guidance on Monitoring Internal Control Systems*, change identification is the one in which separate and ongoing evaluations can best be accomplished.

A.The control baseline is the supported understanding of the internal control system’s design and of whether controls have been implemented to accomplish the organization’s internal control objectives.

C.Change management is the process used when changes have occurred or been identified. The changes must be managed, and a new control baseline should be established.

D.Control revalidation is the process of using monitoring procedures to revalidate the conclusion that controls are effective.

74.Which of the following is the control component that reflects the attitude and actions of the board and management regarding the significance of control within the organization?

A.Risk assessment.

B.Control activities.

C.Control environment.

D.Monitoring.

Answer (C) is correct.

According to the COSO model for internal control, the control environment reflects the attitude and actions of the board and management regarding the significance of control within the organization.

A.Risk assessment identifies and analyzes external or internal risks to achievement of the objectives at the activity level as well as the entity level.

B.Control activities are the policies and procedures helping to ensure that management directives are executed and actions are taken to address risks achievement of objectives.

D.Monitoring is a process that assesses the quality of the system’s performance over time.

75.An organization’s directors, management, and internal auditors all have important roles in creating a proper control environment. Senior management is primarily responsible for

A.Establishing a proper ethical culture.

B.Designing and operating a control system that provides reasonable assurance that established objectives and goals will be achieved.

C.Ensuring that external and internal auditors adequately monitor the control environment.

D.Implementing and monitoring controls designed by the board of directors.

Answer (A) is correct.

The COSO model treats 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 entity objectives. The control environment component of internal control reflects the attitude and actions of the board and management regarding the significance of control within the organization. It

sets the organization's tone and influences the control consciousness of its personnel. Moreover, the control environment provides discipline and structure for the achievement of the primary objectives of internal control. The control environment includes, among other elements, integrity and ethical values. Thus, standards should be effectively communicated, e.g., by management example. Management also should remove incentives and temptations for dishonest or unethical acts.

B. Senior management is not likely to be involved in the detailed design and day-to-day operation of a control system.

C. Management administers risk and control processes. It cannot delegate this responsibility to the external or internal auditors.

D. The board has oversight governance responsibilities but ordinarily does not become involved in the details of operations.

76. Management's aggressive attitude toward financial reporting and its emphasis on meeting projected profit goals most likely would significantly influence an entity's control environment when

A. The audit committee is active in overseeing the entity's financial reporting policies.

B. External policies established by parties outside the entity affect its accounting practices.

C. Management is dominated by one individual who is also a shareholder.

D. Internal auditors have direct access to the board of directors and entity management.

Answer (C) is correct.

Management's philosophy and operating style is one factor affecting the control environment as described in the COSO model for internal control. Such characteristics as management's attitudes and actions toward financial reporting and its emphasis on meeting budget, profit, and other goals have a significant influence on the control environment, especially when management is dominated by one or a few individuals. When incentives or pressures are present to achieve certain performance goals, the auditor should heighten his or her concern about the possibility of fraud.

A. An active audit committee serves to mitigate the risks associated with certain management attitudes

B. External influences serve to mitigate the risks associated with certain management attitudes

D. An effective internal audit function serves to mitigate the risks associated with certain management attitudes.

77. According to COSO, which of the following is the most effective method to transmit a message of ethical behavior throughout an organization?

A. Demonstrating appropriate behavior by example.

B. Strengthening internal audit's ability to deter and report improper behavior.

C. Removing pressures to meet unrealistic targets, particularly for short-term results.

D.Specifying the competence levels for every job in an organization and translating those levels to requisite knowledge and skills.

Answer (A) is correct.

Through words and actions, management communicates its attitude toward integrity and ethical values. In this way, management sets the tone at the top. Demonstrating appropriate behavior by example is the most effective method to transmit a message of ethical behavior throughout an organization.

B.An organization's internal audit function is not primarily concerned with reporting improper behavior.

C.Although this is an effective way of promoting ethical behavior throughout an organization, it is not the most effective. Integrity and ethical values should be reflected by the tone at the top.

D.Specifying the competence levels for every job in an organization and translating those levels to requisite knowledge and skills transmits a message of commitment to competence throughout the organization, not ethical behavior.

78.Within the COSO Internal Control – Integrated Framework, which of the following components is designed to ensure that internal controls continue to operate effectively?

A.Control environment.

B.Risk assessment.

C.Information and communication.

D.Monitoring.

Answer (D) is correct.

Monitoring is the process of assessing the quality of the system's performance over time. It is designed to ensure that internal controls continue to operate effectively.

A.The control environment sets the tone of an organization. It is the foundation for all other components of internal control, providing discipline and structure. It does not involve monitoring the ongoing effectiveness of internal control.

B.Risk assessment is the identification and analysis of relevant risks to achievement of the objectives, forming a basis for determining how the risks should be managed.

C.Information and communication concerns how pertinent information must be identified, captured, and communicated in a form and time frame that enable people to carry out their responsibilities.

79.A company's new time clock process requires hourly employees to select an identification number and then choose the clock-in or clock-out button. A video camera captures an image of the employee using the system. Which of the following exposures can the new system be expected to change the least?

- A. Fraudulent reporting of employees' own hours.
- B. Errors in employees' overtime computation.
- C. Inaccurate accounting of employees' hours.
- D. Recording of other employees' hours.

Answer (B) is correct.

This internal control process is responsible for verifying that the correct employee enters the proper amount of time (s)he worked. This function is not responsible for applying pay rates to the amount of hours worked and therefore would not change any errors in overtime computations.

- A. By recording the time an employee clocks in and clocks out, the system prevents an employee from falsifying the amount of hours (s)he worked.
- B. By recording the time an employee punches in and punches out, the system will have an accurate record/accounting of the number of hours the employee worked.
- C. By requiring an identification number, the new system will prevent one employee from recording and falsifying the amount of hours another employee worked.

80. According to COSO, which of the following is a compliance objective?

- A. To maintain adequate staffing to keep overtime expense within budget.
- B. To maintain a safe level of carbon dioxide emissions during production.
- C. To maintain material price variances within published guidelines.
- D. To maintain accounting principles that conform to GAAP.

Answer (B) is correct.

Compliance objectives relate to adherence to laws and regulations. Maintaining a safe level of carbon dioxide emissions during production is an example.

- A. Operations objectives address effectiveness and efficiency.
- B. Operations objectives address effectiveness and efficiency.
- C. Reporting objectives concern the reliability of financial reporting.

81. A senior executive of an international organization who wishes to demonstrate the importance of the security of company information to all team members should

- A. Visibly participate in a global information security campaign.

- B. Allocate additional budget resources for external audit services.
- C. Review and accept the information security risk assessments in a staff meeting.
- D. Refer to the organization's U.S. human resources policies on privacy in a company newsletter.

Answer (A) is correct.

Through words and actions, management communicates its attitude toward integrity and ethical values. In this way, management sets the tone at the top. By visibly participating in a global information security campaign, management's commitment to the security of company information is evident to all team members.

- B. Allocating additional resources for external audit services does not necessarily demonstrate a commitment from management. By allocating resources to an external party, management may be trying to avoid responsibility.
- C. By simply reviewing and accepting the information provided, management is not taking an active role in the risk assessment process.
- D. Stated policies are a starting point, but it is the corporate culture that determines what actually happens in practice. Actions are more effective in showing importance than referring to a company newsletter.

82. Each of the following is a method to evaluate internal controls based on the framework set by the Committee of Sponsoring Organizations (COSO), except

- A. Distinguishing economy risk from industry risk and enterprise risk.
- B. Evaluating internal control systems that focus first on risk identification of specific losses.
- C. Identifying mitigating controls to prevent losses.
- D. Testing to determine whether the controls are operating effectively and have prevented losses in the past.

Answer (A) is correct.

Evaluating internal controls based on the COSO framework does not require distinguishing economic risk from industry risk and enterprise risk. Therefore, it is NOT a method to evaluate internal controls based on the COSO framework.

- B. Risk assessment is a component of the COSO framework for internal controls. Risk identification is the first step of risk assessment.
- C. Risk assessment is a component of the COSO framework for internal controls. Risks must be addressed through a process of identification and a process of analysis. Risk analysis involves the process of identifying means to mitigate the risk.
- D. Under COSO framework for internal control, internal controls should be monitored and tested both continually and through separate evaluations to determine whether the controls are effective and efficient.

83. A company implements an enterprise resource planning application to help improve its financial and operational reporting while gaining other efficiencies related to sales and inventory management. For the implementation, the company hires an individual specializing in preparing the company for the changes through documenting new policies and procedures and developing new training. This is an example of

- A. Change management.
- B. A social event.
- C. Segregation of duties.
- D. An economic event.

Answer (A) is correct.

Hiring a specialized individual to help with the transition into a new enterprise resource planning application is a way to help manage the change. Thus, this is an example of change management.

- B. Hiring a specialized individual for purposes of transitioning is not a social event.
- C. Segregation of duties involves separating tasks in order to create more effective internal controls
- D. Neither documenting new policies and procedures nor developing new training has any economic impact.

84. Each of the following statements is correct regarding the existence and implementation of codes of conduct except

- A. Employees understand what behavior is acceptable or unacceptable and know what to do if they encounter improper behavior.
- B. The codes of conduct are comprehensive, addressing conflicts of interest, illegal or other improper payments, anticompetitive guidelines, and insider trading.
- C. The codes of conduct are periodically acknowledged by all employees.
- D. The codes of conduct must be in writing and displayed in public areas, such as a break room.

Answer (D) is correct.

While it may be beneficial to have a code of conduct in writing, the code does not need to be displayed in all public areas. It should, however, be accessible to employees should they need to refer to it.

- A. The main objective of a code of conduct is to inform employees of how to handle difficult situations and to indicate conduct that is deemed acceptable.
- B. It is important that codes of conduct are comprehensive and that they address all situations that could affect the conduct of employees.

C. Codes of conduct should be periodically acknowledged by all employees to remind them of their obligations related to conduct and to update them on organizational expectations.

85. Which of the following is a true statement about the COSO report on internal control?

- A. Internal control is not limited to accounting controls.
- B. Internal control is restricted to financial reporting.
- C. Internal control is not management's responsibility.
- D. Control frameworks should be well defined and inflexible.

Answer (A) is correct.

The Internal Control -- Integrated Framework, also known as COSO Framework, report by COSO made the following declarations:

Internal control is defined broadly. It is not limited to accounting controls or financial reporting.

While accounting and financial reports are important issues, there are other important aspects of the business, such as resources protection; operational efficiency and effectiveness; and compliance with rules, regulations, and organization policies. These factors affect financial reporting.

Internal control is management's responsibility. The participation of all persons within an organization is required if it is to be effective.

The control framework is tied to the business objectives and is flexible enough to be adaptable.

- B. Internal control is defined broadly. It is not limited to accounting controls or financial reporting.
- C. Internal control is management's responsibility. The participation of all persons within an organization is required if it is to be effective.
- D. The control framework is tied to business objectives and should be flexible enough to be adaptable.

86. Control activities constitute one of the five components of internal control described in the COSO model. Control activities do not encompass

- A. Performance reviews.
- B. Information processing.
- C. Physical controls.
- D. An internal auditing function.

Answer (D) is correct.

The COSO model describes control activities as policies and procedures that help ensure that management directives are carried out. They are intended to ensure that necessary actions are taken to address risks to achieve the entity's objectives. Control activities have various objectives and are

applied at various organizational and functional levels. However, an internal auditing function is part of the monitoring component.

- A. Performance reviews is a category of control activities.
- B. Information processing is a category of control activities
- C. Physical controls is a category of control activities.

87. The design or operation of a control may not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct, misstatements on a timely basis. According to AU-C 265, this circumstance is a

- A. Material weakness.
- B. Significant deficiency.
- C. Control deficiency.
- D. Critical deficiency.

Answer (C) is correct.

A control deficiency may arise either in the design or operation of a control. It is the lowest level of deficiency identified in the standards. A design deficiency results when (1) a necessary control is missing or (2) a control operating as designed does not meet the control objective. An operating deficiency results when (1) a properly designed control does not function as designed, or (2) the person performing the control does not have the authority or competence to perform it effectively.

A. A material weakness is a deficiency, or a combination of deficiencies, in internal control so that more than a remote chance exists that a material misstatement of the entity's financial statements will not be prevented, or detected and corrected, on a timely basis.

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

D. The standards do not use the term "critical deficiency."

88. When obtaining an understanding of internal control in a financial statement audit, the independent external auditor is primarily concerned with

- A. Detecting all errors.
- B. Determining the effectiveness of operations.
- C. Assessing the risk of material misstatement.
- D. Determining its efficiency.

Answer (C) is correct.

The auditor must obtain a sufficient understanding of the entity and its environment, including its internal control, to assess the risk of material misstatement and to design the nature, timing, and extent of further audit procedures.

- A. The auditor is concerned with the possibility of material errors and fraud.
- B. Determining the effectiveness of operations relates to management objectives that normally do not affect the fairness of the financial statements.
- D. The consideration of risk in a financial statement audit is concerned with the effectiveness rather than the efficiency of internal control.

89. The requirement of the Foreign Corrupt Practices Act of 1977 to devise and maintain adequate internal control is assigned in the act to the

- A. Chief financial officer.
- B. Board of directors.
- C. Director of internal auditing.
- D. Company as a whole, with no designation of specific persons or positions.

Answer (D) is correct.

The accounting requirements apply to all issuers that must register under the Securities Exchange Act of 1934. The responsibility is thus placed on companies, not individuals.

- A. Compliance with the FCPA is not the specific responsibility of the chief financial officer, the board of directors, or the director of internal auditing.
- B. Compliance with the FCPA is not the specific responsibility of the chief financial officer, the board of directors, or the director of internal auditing.
- C. Compliance with the FCPA is not the specific responsibility of the chief financial officer, the board of directors, or the director of internal auditing.

90. An external auditor cannot

- A. Express an opinion on a client's assertions about internal control.
- B. Express an opinion on the fairness of the financial statements of a nonissuer.
- C. Make specific recommendations to a client with respect to internal control weaknesses.

D. Report to outside parties regarding a client's compliance with the internal control provisions of the Foreign Corrupt Practices Act.

Answer (D) is correct.

Whether a client is in conformity with the FCPA is a legal question. Auditors cannot be expected to provide legal advice. The role of the auditor is to assess control risk in the course of an engagement to attest to the fair presentation of the financial statements.

A. As a result of an examination of management's written assertion about the effectiveness of internal control, the practitioner may express an opinion either directly on the effectiveness of internal control or on management's assertion.

B. An external auditor can express an opinion on the fairness of the financial statements of an issuer or a nonissuer.

C. An external auditor must communicate all significant deficiencies and material weaknesses noted during the consideration of internal control during a financial statement audit to those charged with governance. Moreover, an auditor may, but is not required to, suggest corrective actions.

91. Internal control is a function of management, and effective control is based upon the concept of charge and discharge of responsibility and duty. Which of the following is one of the overriding principles of internal control?

A. Responsibility for accounting and financial duties should be assigned to one responsible officer.

B. Responsibility for the performance of each duty must be fixed.

C. Responsibility for the accounting duties must be borne by the audit committee of the company.

D. Responsibility for accounting activities and duties must be assigned only to employees who are bonded.

Answer (B) is correct.

Effective internal control may be obtained by decentralization of responsibilities and duties. Fixing the responsibility for each performance or duty makes it easier to trace problems to the person(s) responsible and hold them accountable for their actions.

A. Accounting (record keeping) should be separated from finance (asset custody).

C. The audit committee is responsible for overseeing the internal and external audits, not for accounting duties.

D. Bonding is not an overriding internal control principle. Employees having custodial, rather than accounting, responsibility are usually bonded.

**PART-1 UNIT-6**

**1. Which of the following tools would best give a graphical representation of a sequence of activities and decisions?**

- A. Flowchart.
- B. Control chart.
- C. Histogram.
- D. Run chart.

Answer (A) is correct.

Flowcharting is an essential aid in the program development process that involves a sequence of activities and decisions. A flowchart is a pictorial diagram of the definition, analysis, or solution of a problem in which symbols are used to represent operations, data flow, equipment, etc.

- B. A control chart is used to monitor deviations from desired quality measurements during repetitive operations.
- C. A histogram is a bar chart showing conformance to a standard bell curve.
- D. A run chart tracks the frequency or amount of a given variable over time.

**2. Of the following, which is the most efficient source for an auditor to use to evaluate a company's overall control system?**

- A. Control flowcharts.
- B. Copies of standard operating procedures.
- C. A narrative describing departmental history, activities, and forms usage.
- D. Copies of industry operating standards.

Answer (A) is correct.

Control flowcharting is a graphical means of representing the sequencing of activities and information flows with related control points. It provides an efficient and comprehensive method of describing relatively complex activities, especially those involving several departments.

- B. Copies of procedures and related forms do not provide an efficient overview of processing activities.
- C. A narrative review covering the history and forms usage of the department is not as efficient or comprehensive as flowcharting for the purpose of communicating relevant information about controls.

D. Industry standards do not provide a picture of existing practice for subsequent audit activity.

**3. The diamond-shaped symbol is commonly used in flowcharting to show or represent a**

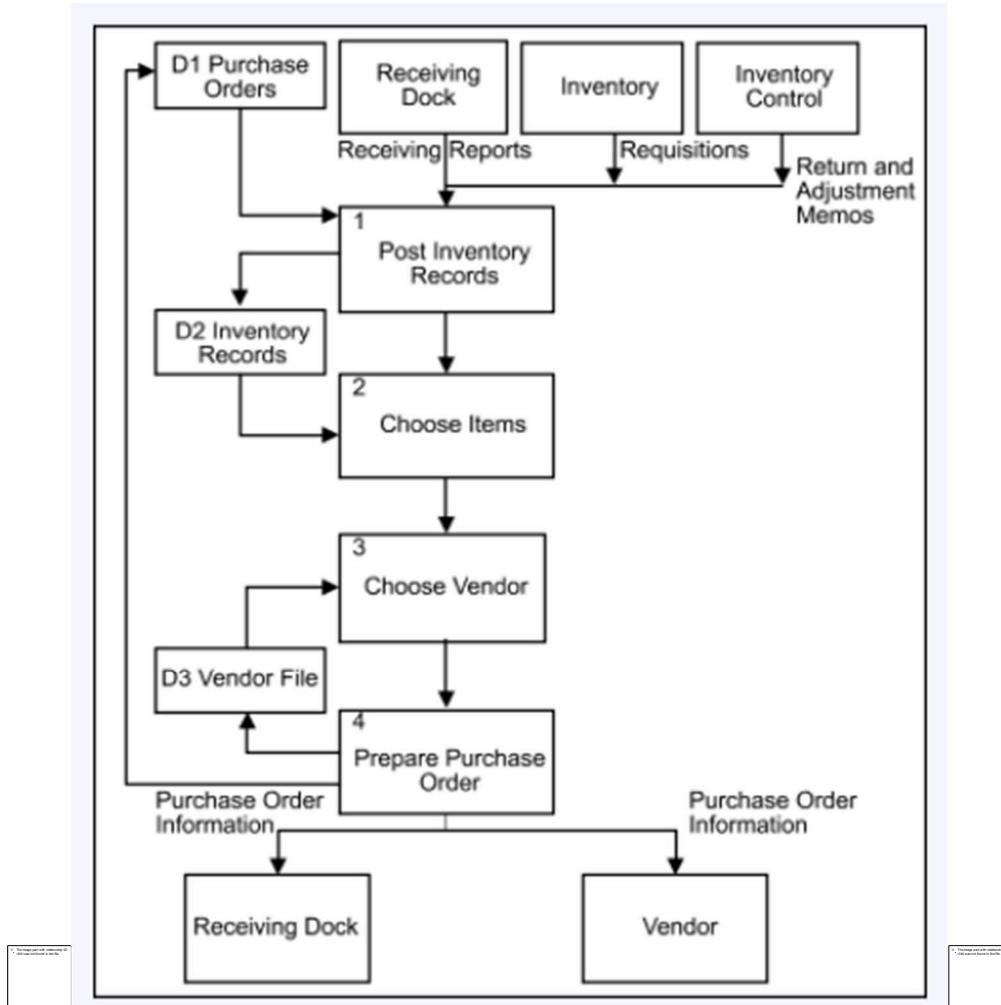
- A. Process or a single step in a procedure or program.
- B. Terminal output display.
- C. Decision point, conditional testing, or branching.
- D. Predefined process.

Answer (C) is correct.

Flowcharts illustrate in pictorial fashion the flow of data, documents, and/or operations in a system. Flowcharts may summarize a system or present great detail, e.g., as found in program flowcharts. The diamond-shaped symbol represents a decision point or test of a condition in a program flowchart, that is, the point at which a determination must be made as to which logic path (branch) to follow.

- A. The rectangle is the appropriate symbol for a process or a single step in a procedure or program
- B. A terminal display is signified by a symbol similar to the shape of a cathode ray tube.
- D. A predefined processing step is represented by a rectangle with double lines on either side.

**4. Fact Pattern:**



**Q:**This figure shows how

- A.Physical media are used in the system.
- B.Input/output procedures are conducted.
- C.Data flow within and out of the system.
- D.Accountability is allocated in the system.

Answer (C) is correct.

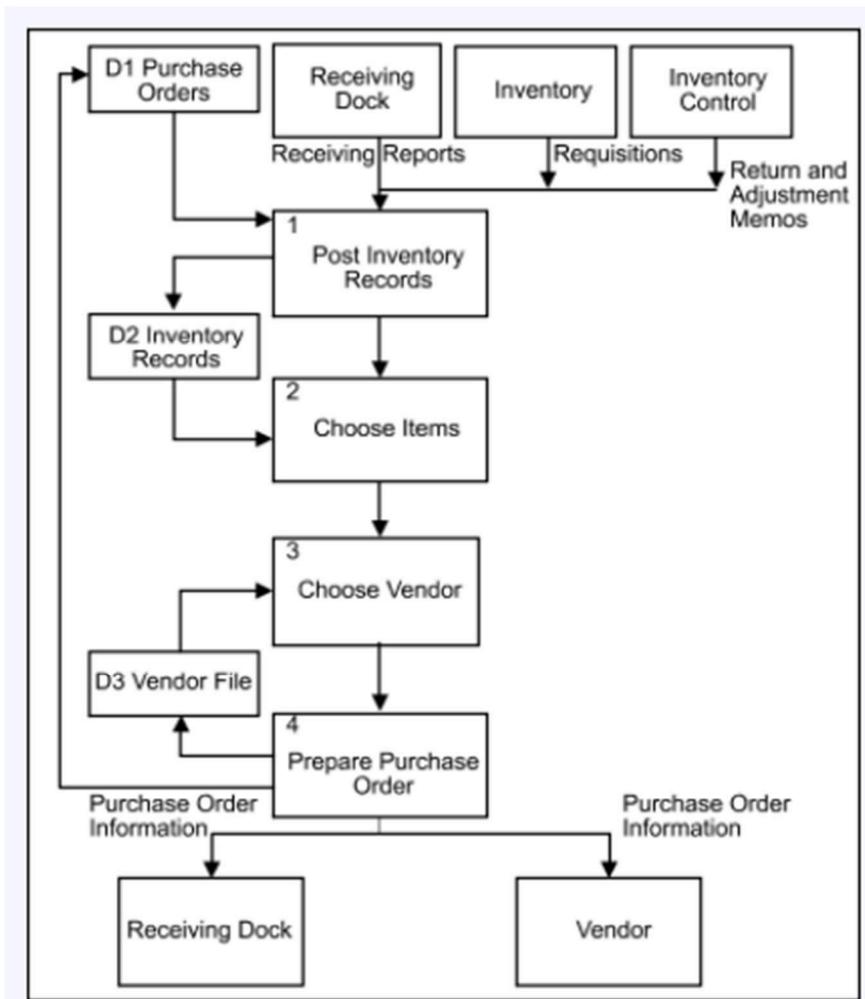
A data flow diagram shows how data flow to, from, and within a system and the processes that manipulate the data.

A.The figure does not show physical media or input/output procedures (manifestations of how the system works rather than what it accomplishes). Flowcharts depict these matters.

B.The figure is a data flow diagram; it depicts the flow of data within and out of the system. Flowcharts show how input/output procedures are conducted.

D.The figure does not show how accountability is allocated in the system. Accountability transfers are usually shown in flowcharts.

**5.Fact Pattern:**



Q:This data flow diagram could be expanded to show the

- A. Edit checks used in preparing purchase orders from stock records.
- B. Details of the preparation of purchase orders.
- C. Physical media used for stock records, the vendor file, and purchase orders.
- D. Workstations required in a distributed system for preparing purchase orders.

Answer (B) is correct.

A data flow diagram can be used to depict lower-level details as well as higher-level processes. A system can be divided into subsystems, and each subsystem can be further subdivided at levels of increasing detail. Thus, any process can be expanded as many times as necessary to show the required level of detail.

- A. A data flow diagram does not depict edit checks.
- C. Flowcharts, not data flow diagrams, show the physical media on which data such as stock records, the vendor file, and purchase orders are maintained.
- D. Flowcharts, not data flow diagrams, show the workstations through which data pass and the sequence of activities.

**6. An auditor's flowchart of a client's accounting system is a diagrammatic representation that depicts the auditor's**

- A. Assessment of the risks of material misstatement.
- B. Identification of weaknesses in the system.
- C. Assessment of the control environment's effectiveness.
- D. Understanding of the system.

Answer (D) is correct.

The auditor should document (1) the understanding of the entity and its environment and the components of internal control, (2) the sources of information regarding the understanding, and (3) the risk assessment procedures performed. The form and extent of this documentation are influenced by the nature and complexity of the entity's controls. For example, documentation of the understanding of internal control of a complex information system in which many transactions are electronically initiated, authorized, recorded, processed, or reported may include questionnaires, flowcharts, or decision tables.

- A. The conclusions about the assessments of the RMMs should be documented. These are professional judgments of the auditor documented in the workpapers.
- B. The flowchart is a tool to document the auditor's understanding of internal control, but it does not specifically identify weaknesses in the system.
- C. The auditor's judgment is the ultimate basis for concluding that controls are effective.

**7. When documenting internal control, the independent auditor sometimes uses a systems flowchart, which can best be described as a**

- A. Pictorial presentation of the flow of instructions in a client's internal computer system.
- B. Diagram that clearly indicates an organization's internal reporting structure.
- C. Graphic illustration of the flow of operations that is used to replace the auditor's internal control questionnaire.
- D. Symbolic representation of a system or series of sequential processes.

Answer (D) is correct.

A systems flowchart is a symbolic representation of the flow of documents and procedures through a series of steps in the accounting process of the client's organization.

- A. A pictorial presentation of the flow of instructions in a client's internal computer system is a computer program flowchart.
- B. The organizational chart depicts the client's internal reporting structure.
- C. A flowchart does not necessarily replace the auditor's internal control questionnaire. Controls beyond those depicted on the systems flowchart must also be considered by the auditor, and information obtained from the questionnaire may be used to develop the flowchart.

**8. The normal sequence of documents and operations on a well-prepared systems flowchart is**

- A. Top to bottom and left to right.
- B. Bottom to top and left to right.
- C. Top to bottom and right to left.
- D. Bottom to top and right to left.

Answer (A) is correct.

The direction of flow in the normal sequence of documents and operations on a well-prepared systems flowchart is from top to bottom and from left to right.

- B. The normal vertical movement is top to bottom.
- C. The normal horizontal movement is left to right.
- D. The normal sequence is top to bottom and left to right.

**9. Which method of evaluating internal controls during the preliminary survey provides the internal auditor with the best visual grasp of a system and a means for analyzing complex operations?**

- A. A flowcharting approach.
- B. A questionnaire approach.
- C. A matrix approach.
- D. A detailed narrative approach.

Answer (A) is correct.

Flowcharts are graphical representations of the step-by-step progression of transactions, including document (information) preparation, authorization, flow, storage, etc. Flowcharting allows the internal auditor to analyze a system and to identify the strengths and weaknesses of the purported internal controls and the appropriate areas of audit emphasis.

- B. A questionnaire approach provides only an agenda for evaluation.
- C. A matrix approach does not provide the visual grasp of the system that a flowchart does.
- D. A detailed narrative does not provide the means of evaluating complex operations that a flowchart does.

**10. Internal auditors often flowchart a control system and reference the flowchart to narrative descriptions of certain activities. This is an appropriate procedure to**

- A. Determine whether the system meets established management objectives.
- B. Document that the system meets international auditing requirements.
- C. Determine whether the system can be relied upon to produce accurate information.
- D. Gain the understanding necessary to test the effectiveness of the system.

Answer (D) is correct.

Flowcharting is a pictorial method of analyzing and understanding the processes and procedures involved in operations, whether manual or computerized. Flowcharting is therefore useful in the preliminary survey and in obtaining an understanding of internal control. It is also helpful in systems development.

- A. To determine whether the system meets established management objectives, the auditor must perform more extensive procedures. A flowchart is an aid to understanding the system. It does not provide evidence about the actual operating effectiveness of the system.
- B. International auditing standards do not require the use of flowcharts.

C.To determine whether the system can be relied upon to produce accurate information, the auditor must perform more extensive procedures. A flowchart is an aid to understanding the system. It does not provide evidence about the actual operating effectiveness of the system.

**11.An internal auditor develops a flowchart primarily to**

- A.Detect errors and irregularities.
- B.Analyze a system and identify internal controls.
- C.Determine functional responsibilities.
- D.Reduce the need for interviewing auditee personnel.

Answer (B) is correct.

Flowcharting is a tool commonly used to learn what set of procedures is supposed to be in effect in a control system. An internal control flowchart is a pictorial diagram of documents and their processing and disposition within the system. It is a basis for preliminary evaluation and is followed by testing to see if the prescribed procedures are in effect and are working as intended.

- A.Flowcharts only show where errors and irregularities might occur.
- C.Questionnaires are used to determine functional responsibilities.
- D.Flowchart development usually requires asking questions of the auditee.

**12.An auditor frequently uses flowcharts to determine whether there is**

- A.Satisfactory performance of an operation.
- B.Sufficient but not excessive personnel assigned to an operation.
- C.Authority to meet the performance criteria.
- D.Inefficiency and lack of controls.

Answer (D) is correct.

Flowcharts are graphical representations of the step-by-step progression of transactions including document (information) preparation, authorization, flow, storage, etc. Flowcharting allows the internal auditor to analyze a system and to identify the strengths and weaknesses of the purported internal controls and the appropriate areas of audit emphasis.

- A.This information is not given in a flowchart.
- B.This information is not given in a flowchart.
- C.This information is not given in a flowchart.

**13. A flowchart of process activities and controls may provide**

- A. Information on where fraud could occur.
- B. Information on the extent of a past fraud.
- C. An indication of where fraud has occurred in a process.
- D. No information related to fraud prevention.

Answer (A) is correct.

Flowcharting is a pictorial method of analyzing and understanding the processes and procedures involved in operations, whether manual or computerized. Flowcharting is therefore useful in the preliminary survey and in obtaining an understanding of internal control. It is also helpful in systems development. Consequently, by indicating control weaknesses, flowcharts show where fraud may occur.

- B. Flowcharts do not provide any evidence of the extent of fraud.
- C. Other procedures would be needed to detect where fraud has occurred
- D. Flowcharts provide evidence of where fraud may occur. Flowcharts therefore help in prevention.

**14. The internal auditor wishes to develop a flowchart of (1) the process of receiving sales order information at headquarters, (2) the transmission of the data to the plants to generate the shipment, and (3) the plants' processing of the information for shipment. The internal auditor should**

- A. Start with management's decisions to set sales prices. Gather internal documentation on the approval process for changing sales prices. Complement documentation with a copy of the program flowchart. Prepare an overview flowchart that links these details.
- B. Start with a shipment of goods and trace the transaction back through the origination of the sales order as received from the sales representative.
- C. Start with the receipt of a sales order from a sales representative and "walk through" both the manual and computerized processing at headquarters and the plant until the goods are shipped and billed.
- D. Obtain a copy of the plants' systems flowchart for the sales process, interview relevant personnel to determine if any changes have been made, and then develop an overview flowchart which will highlight the basic process.

Answer (C) is correct.

The survey during the engagement planning phase helps the internal auditor to become familiar with activities, risks, and controls and to identify areas for audit emphasis. Flowcharting is a typical survey procedure, and the walk-through is a means of gathering information to be reflected in the flowchart.

- A.The issue is the processing of sales orders, not the system for making changes in the sales price data.
- B.Starting with the completed transaction does not identify processing steps in which documents or data were diverted and processed separately.
- D.Processing steps that occur other than at the plant level must also be considered.

**15.An internal auditor reviews and adapts a systems flowchart to understand the flow of information in the processing of cash receipts. Which of the following statements is true regarding the use of such flowcharts? The flowcharts**

- A.Show specific control procedures used, such as edit tests that are implemented and batch control reconciliations.
- B.Are a good guide to potential segregation of duties.
- C.Are generally kept up to date for systems changes.
- D.Show only computer processing, not manual processing.

Answer (B) is correct.

Systems flowcharts are overall graphic analyses of the flow of data and the processing steps in an information system. Accordingly, they can be used to show segregation of duties and the transfer of data between different segments in the organization.

- A.A program flowchart will identify the specific edit tests implemented.
- C.The flowcharts are usually not kept up to date for changes. Thus, the auditor will have to interview key personnel to determine changes in processing since the flowchart was developed.
- D.A systems flowchart should show both manual and computer processing.

**16.Graphical notations that show the flow and transformation of data within a system or business area are called**

- A.Action diagrams.
- B.Program structure charts.
- C.Conceptual data models.
- D.Data flow diagrams.

Answer (D) is correct.

Data flow diagrams show how data flow to, from, and within the system and the processes that manipulate the data. A data flow diagram can be used to depict lower-level details as well as higher-level processes. A system can be divided into subsystems, and each subsystem can be further subdivided at levels of increasing detail. Thus, any process can be expanded as many times as necessary to show the required level of detail.

- A. Action diagrams are process logic notations that combine graphics and text to support the definition of technical rules.
- B. Program structure charts are graphical depictions of the hierarchy of modules or instructions in a program.
- C. Conceptual data modules are independent definitions of the data requirements that are explained in terms of entities and relationships.

**17. In documenting the procedures used by several interacting departments the internal auditor will most likely use a(n)**

- A. Horizontal (or systems) flowchart.
- B. Vertical flowchart.
- C. Gantt chart.
- D. Internal control questionnaire.

Answer (A) is correct.

Flowcharting is a useful tool for systems development as well as understanding the internal control structure. A flowchart is a pictorial diagram of the definition, analysis, or solution of a problem in which symbols are used to represent operations, data flow, equipment, etc. A systems flowchart provides an overall view of the inputs, processes, and outputs of a system, such as a set of interacting departments.

- B. A vertical flowchart does not highlight the interaction between departments.
- C. A Gantt chart is not a tool for documenting procedures. Gantt charts typically are used in industry as a method of recording progress toward goals for employees and machinery.
- D. An internal control questionnaire does not highlight the interaction between departments.

**18. Which of the following is a true statement comparing a horizontal flowchart with a vertical flowchart?**

- A. A horizontal flowchart provides more room for written descriptions that parallel the symbols.
- B. A horizontal flowchart brings into sharper focus the assignment of duties and independent checks on performance.
- C. A horizontal flowchart is usually longer.
- D. A horizontal flowchart does not provide as broad a picture at a glance.

Answer (B) is correct.

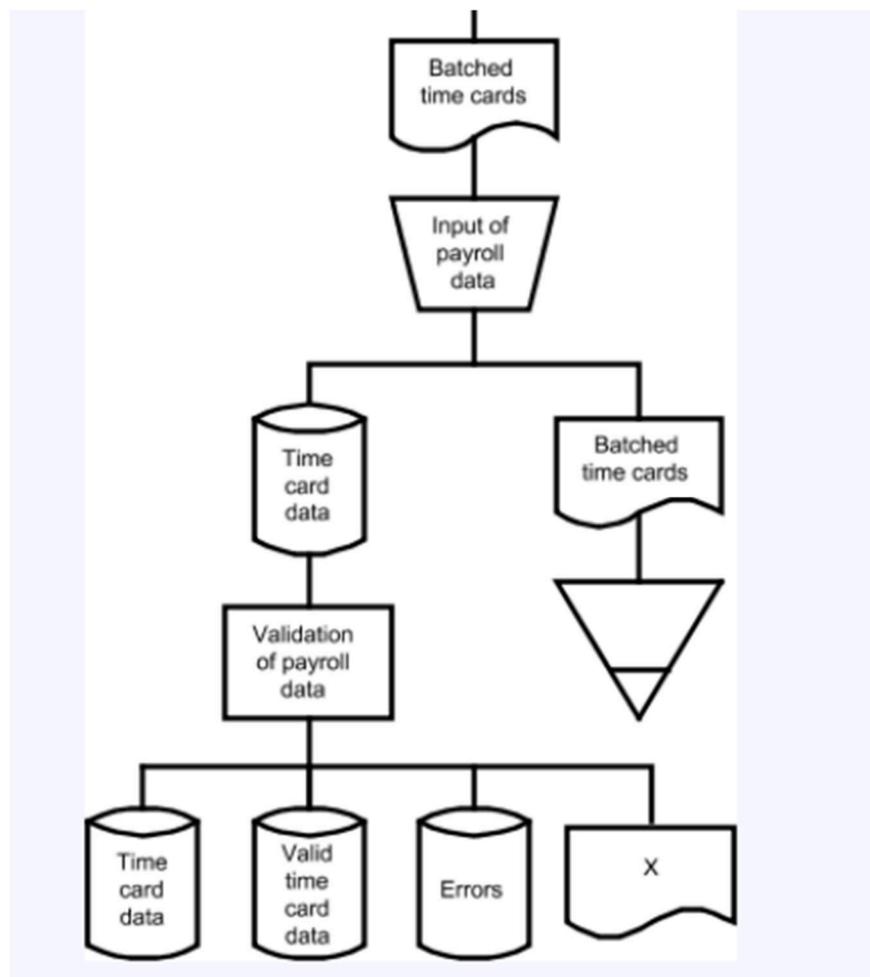
A horizontal or systems flowchart depicts the functions or departments involved in a process successively from left to right. Thus, the steps performed by a function or department are presented in the same column. A vertical flowchart displays step-by-step processes effectively, but it does not delineate the system's components as well. By emphasizing the flow of processing between departments or people, a horizontal flowchart more clearly shows any inappropriate separation of duties and lack of independent checks on performance.

A. A vertical flowchart is usually designed to provide for written descriptions.

C. A horizontal flowchart is usually shorter. Space for written descriptions is not usually provided.

D. More of the flow of processing can be depicted on one page than in a vertical flowchart with written descriptions.

**19. The following is a section of a system flowchart for a payroll application:**



**Symbol X could represent**

- A. Erroneous time cards.
- B. An error report.
- C. Batched time cards.
- D. Unclaimed payroll checks.

Answer (B) is correct.

Symbol X is a document, that is, hard copy output of the validation routine shown. The time card data, the validated data, and the errors are recorded on magnetic disk after the validation process. Thus, either an error report or the valid time card information is represented by Symbol X.

- A. Time cards were stored offline before the validation process.
- C. Time cards were stored offline before the validation process.
- D. No payroll checks are shown.

**20. An advantage of using systems flowcharts to document information about internal control instead of using internal control questionnaires is that systems flowcharts**

- A. Identify internal control deficiencies more prominently.
- B. Provide a visual depiction of clients' activities.
- C. Indicate whether controls are operating effectively.
- D. Reduce the need to observe clients' employees performing routine tasks.

Answer (B) is correct.

Systems flowcharts provide a visual representation of a series of sequential processes, that is, of a flow of documents, data, and operations. In many instances, a flowchart is preferable to a questionnaire because a picture is usually more easily comprehended.

- A. A systems flowchart can present the flow of information and documents in a system, but it does not specifically identify the deficiencies.
- C. The flowchart does not provide evidence of how effectively controls are actually operating.
- D. The flowchart is useful in documenting the understanding of internal control, but it does not reduce the need for observation of employees performing tasks if those tests of controls are deemed necessary.

**21. Which of the following is optimal to provide a summary-level description of a complex new computer system?**

- A. A control flowchart.

- B. Program code checking and flowchart verification.
- C. A system flowchart.
- D. A detailed narrative.

Answer (C) is correct.

Flowcharts are graphical representations of the step-by-step progression of information through preparation, authorization, flow, storage, etc. In particular, a system flowchart depicts areas of responsibility arranged horizontally across the page in vertical columns. Accordingly, activities, controls, and document flows that are the responsibility of a given department or function are shown in the same column.

- A. A control flowchart is specific to controls and therefore not optimal to provide a summary-level description of a complex new system.
- B. Program code checking and flowchart verification are verification procedures, not summary-level description tools.
- D. A detailed narrative provides a detail-level description, not a summary-level description.

**22. An adequate system of internal controls is most likely to detect a fraud perpetrated by a**

- A. Group of employees in collusion.
- B. Single employee.
- C. Group of managers in collusion.
- D. Single manager.

Answer (B) is correct.

Segregation of duties and other control processes serve to prevent or detect a fraud committed by an employee acting alone. One employee may not have the ability to engage in wrongdoing or may be subject to detection by other employees in the course of performing their assigned duties. However, collusion may circumvent controls. For example, comparison of recorded accountability for assets with the assets known to be held may fail to detect fraud if persons having custody of assets collude with recordkeepers.

- A. A group has a better chance of successfully perpetrating a fraud than does an individual employee.
- C. Management can override controls.
- D. Even a single manager may be able to override controls.

**23. Internal control should follow certain basic principles to achieve its objectives. One of these principles is the segregation of functions. Which one of the following examples does not violate the principle of segregation of functions?**

- A. The chief financial officer has the authority to sign checks but gives the signature block to the assistant chief financial officer to run the check-signing machine.
- B. The warehouse clerk, who has the custodial responsibility over inventory in the warehouse, may authorize disposal of damaged goods.
- C. The sales manager has the responsibility to approve credit and the authority to write off accounts.
- D. The department time clerk is given the undistributed payroll checks to mail to absent employees.

Answer (A) is correct.

The chief financial officer's department should have custody of assets but should not authorize or record transactions. Because the assistant chief financial officer reports to the chief financial officer, the chief financial officer is merely delegating an assigned duty related to asset custody.

- B. Authorization to dispose of damaged goods could be used to cover thefts of inventory for which the warehouse clerk has custodial responsibility. Transaction authorization is inconsistent with asset custody.
- C. The sales manager could approve credit to a controlled organization and then write off the account as a bad debt. The sales manager's authorization of credit is inconsistent with his or her indirect access to assets.
- D. The time clerk could conceal the termination of an employee and retain that employee's paycheck. Recordkeeping is inconsistent with asset custody.

**24. Which of the following describes the most effective preventive control to ensure proper handling of cash receipt transactions?**

- A. Have bank reconciliations prepared by an employee not involved with cash collections and then have them reviewed by a supervisor.
- B. One employee issues a prenumbered receipt for all cash collections; another employee reconciles the daily total of prenumbered receipts to the bank deposits.
- C. Use predetermined totals (hash totals) of cash receipts to control posting routines.
- D. The employee who receives customer mail receipts prepares the daily bank deposit, which is then deposited by another employee.

Answer (B) is correct.

Sequentially numbered receipts should be issued to maintain accountability for cash collected. Such accountability should be established as soon as possible because cash has a high inherent risk. Daily cash receipts should be deposited intact so that receipts and bank deposits can be reconciled. The reconciliation should be performed by someone independent of the cash custody function.

- A. The bank reconciliation is a detective, not a preventive, control.

- C. Use of hash totals is a control over the completeness of posting routines, not cash receipts.
- D. A cash remittance list should be prepared before a separate employee prepares the bank deposit. The list and deposit represent separate records based on independent counts made by different employees.

**25. Which of the following activities performed by a payroll clerk is a control weakness rather than a control strength?**

- A. Has custody of the check signature stamp machine.
- B. Prepares the payroll register.
- C. Forwards the payroll register to the chief accountant for approval.
- D. Draws the paychecks on a separate payroll checking account.

Answer (A) is correct.

Payroll checks should be signed by someone who is not involved in timekeeping, recordkeeping, or payroll preparation. The payroll clerk performs a recordkeeping function.

- B. Preparing the payroll register is one of the recordkeeping tasks of the payroll clerk.
- C. The payroll register should be approved by an officer of the organization. This control is a strength.
- D. Paychecks should be drawn on a separate payroll checking account. This control is a strength.

**26. One payroll engagement objective is to determine whether segregation of duties is proper. Which of the following activities is incompatible?**

- A. Hiring employees and authorizing changes in pay rates.
- B. Preparing the payroll and filing payroll tax forms.
- C. Signing and distributing payroll checks.
- D. Preparing attendance data and preparing the payroll.

Answer (D) is correct.

Attendance data are accumulated by the timekeeping function. Preparing the payroll is a payroll department function. For control purposes, these two functions should be separated to avoid the perpetration and concealment of irregularities.

- A. Hiring employees and authorizing changes in pay rates are both personnel functions.

- B. Preparing the payroll and filing payroll tax forms are both functions of the payroll department.
- C. Proper treasury functions include signing and distributing payroll checks.

**27. Which of the following observations made during the preliminary survey of a local department store's disbursement cycle reflects a control strength?**

- A. Individual department managers use prenumbered forms to order merchandise from vendors.
- B. The receiving department is given a copy of the purchase order complete with a description of goods, quantity ordered, and extended price for all merchandise ordered.
- C. The chief financial officer's office prepares checks for suppliers based on vouchers prepared by the accounts payable department.
- D. Individual department managers are responsible for the movement of merchandise from the receiving dock to storage or sales areas as appropriate.

Answer (C) is correct.

Accounting for payables is a recording function. The matching of the supplier's invoice, the purchase order, and the receiving report (and usually the purchase requisition) should be the responsibility of the accounting department. These are the primary supporting documents for the payment voucher prepared by the accounts payable section that will be relied upon by the chief financial officer in making payment.

- A. The managers should submit purchase requisitions to the purchasing department. The purchasing function should be separate from operations.
- B. To encourage a fair count, the receiving department should receive a copy of the purchase order from which the quantity has been omitted.
- D. The receiving department should transfer goods directly to the storeroom to maintain security. A copy of the receiving report should be sent to the storeroom so that the amount stored can be compared with the amount in the report.

**28. Which one of the following situations represents an internal control weakness in the payroll department?**

- A. Payroll department personnel are rotated in their duties.
- B. Paychecks are distributed by the employees' immediate supervisor.
- C. Payroll records are reconciled with quarterly tax reports.
- D. The timekeeping function is independent of the payroll department.

Answer (B) is correct.

Paychecks should not be distributed by supervisors because an unscrupulous person could terminate an employee and fail to report the termination. The supervisor could then clock in and out for the

employee and keep the paycheck. A person unrelated to either payroll recordkeeping or the operating department should distribute checks.

A.Periodic rotation of payroll personnel inhibits the perpetration and concealment of fraud.

C.This analytical procedure may detect a discrepancy.

D.Timekeeping should be independent of asset custody and employee records.

**29.Fact Pattern:** An organization has grown rapidly and has just automated its human resource system. The organization has developed a large database that tracks employees, employee benefits, payroll deductions, job classifications, ethnic code, age, insurance, medical protection, and other similar information. Management has asked the internal audit activity to review the new system.

**Q:**The automated system contains a table of pay rates matched with the employee job classifications. The best control to ensure that the table is updated correctly for only valid pay changes is to

A.Limit access to the data table to management and line supervisors who have the authority to determine pay rates.

B.Require a supervisor in the department, who does not have the ability to change the table of pay rates, to compare the changes with a signed management authorization.

C.Ensure that adequate edit and reasonableness checks are built into the automated system.

D.Require that all pay changes be signed by the employee to verify that the change goes to a bona fide employee.

Answer (B) is correct.

To maintain a proper segregation of duties, changes in pay rates should be authorized by someone outside the human resources department. Furthermore, authorization should be independently verified by an individual who does not have a recording function.

A.Access to the database should be severely restricted to personnel within the human resources or payroll departments.

C.Edit checks will not detect unauthorized changes.

D.The control must ensure that changes in the table of pay rates are properly authorized and entered into the system.

**30.Fact Pattern:** An organization has grown rapidly and has just automated its human resource system. The organization has developed a large database that tracks employees, employee benefits, payroll deductions, job classifications, ethnic code, age, insurance, medical

**protection, and other similar information. Management has asked the internal audit activity to review the new system.**

**Q:An employee in the payroll department is contemplating a fraud involving the addition of a fictitious employee and the entry of fictitious hours worked. The paycheck would then be sent to the payroll employee's home address. The most effective control procedure to prevent this type of fraud is to require that**

- A. A report of all new employees added be approved by someone outside of the payroll department. Also, a report showing all employees and hours worked should be sent to the supervisor's department for review.
- B. All new employees and their hours worked be entered by the human resources department.
- C. All changes to employee records be approved by supervisors outside of both human resources and payroll.
- D. The payroll department physically delivers paychecks to employees rather than mailing them.

Answer (A) is correct.

The payroll department has a recording function. It should not authorize pay rate changes or the addition or deletion of employees from the payroll. Accordingly, authorization of such changes should be made by an individual outside the department. Verification of payroll data should also be made outside the department. Proper segregation of duties is critical in the prevention of payroll fraud.

B. The entry of new employees and their hours should be segregated. The human resources department should not be responsible for both activities.

C. Approving changes in existing employee records does not prevent the fraud of entering a fictitious employee.

D. Physical delivery of paychecks does not prevent the payroll employee from withholding the fictitious employee's check. Moreover, a department with a recording function should not have an asset custody function.

**31.Fact Pattern: An organization has grown rapidly and has just automated its human resource system. The organization has developed a large database that tracks employees, employee benefits, payroll deductions, job classifications, ethnic code, age, insurance, medical protection, and other similar information. Management has asked the internal audit activity to review the new system.**

**Q:Human resources and payroll are separate departments. Which of the following combinations provides the best segregation of duties?**

- A. Human resources adds employees, payroll processes hours, and human resources delivers the paychecks to employees.

B. Human resources adds employees, reviews and submits payroll hours to payroll for processing, and delivers paychecks to employees.

C. Human resources adds employees, and payroll processes hours and enters employee bank account numbers. Paychecks are automatically deposited in the employee's bank account.

D. Payroll adds employees and enters employees' bank account numbers but processes hours only as approved by human resources. Paychecks are automatically deposited in the employee's bank account.

Answer (C) is correct.

The functions of transaction authorization and recording should be segregated to minimize opportunities for fraud. Furthermore, automatic check deposit reduces asset custody risk.

A. The human resources department should not add employees and deliver paychecks. These two duties should be segregated.

B. The functions are all performed by human resources. There is no segregation of duties.

D. Payroll is adding employees and processing hours. These two duties should be performed by different departments.

**32. Upon receipt of purchased goods, receiving department personnel match the quantity received with the packing slip quantity and mark the retail price on the goods based on a master price list. The annotated packing slip is then forwarded to inventory control and goods are automatically moved to the retail sales area. The most significant control strength of this activity is**

A. Immediately pricing goods for retail sale.

B. Matching quantity received with the packing slip.

C. Using a master price list for marking the sale price.

D. Automatically moving goods to the retail sales area.

Answer (C) is correct.

Use of the master price list ensures that the correct retail price is marked.

A. Timing is not as important as the accuracy of prices.

B. Matching quantity received with the packing slip does not ensure receipt of the quantity ordered.

D. Goods may or may not be needed in retail sales.

**33. The manager of a production line has the authority to order and receive replacement parts for all machinery that requires periodic maintenance. The internal auditor received an anonymous tip that the manager ordered substantially more parts than were necessary from a family member in the parts supply business. The unneeded parts were never delivered. Instead, the**

**manager processed receiving documents and charged the parts to machinery maintenance accounts. The payments for the undelivered parts were sent to the supplier, and the money was divided between the manager and the family member. Which of the following internal controls would have most likely prevented this fraud from occurring?**

- A. Establishing predefined spending levels for all vendors during the bidding process.
- B. Segregating the receiving function from the authorization of parts purchases.
- C. Comparing the bill of lading for replacement parts to the approved purchase order.
- D. Using the company's inventory system to match quantities requested with quantities received.

Answer (B) is correct.

Segregating the parts authorization and receiving functions would have improved internal control. If the parts in question had been sent to the company and a receiving report had been prepared by an employee other than the one ordering the goods, the fraud could not have occurred. Moreover, the receiving department should not accept goods unless it has a blind copy of a properly approved purchase order for the items.

- A. Predefined spending levels would probably already include the fraudulent amounts and would only limit the size of the fraud.
- C. The bill of lading would agree with the purchase order. The quantity received (verified by a third party) should be compared to both the bill of lading and the purchase order.
- D. The computer matching would only verify the fraudulent paperwork.

**34. Which one of the following is most likely to be considered an internal control weakness?**

- A. The petty cash custodian has the ability to steal petty cash. Documentation for all disbursements from the fund must be submitted with the request for replenishment of the fund.
- B. An inventory control clerk at a manufacturing plant has the ability to steal one completed television set from inventory a year. The theft probably will never be detected.
- C. An accounts receivable clerk, who approves sales returns and allowances, receives customer remittances and deposits them in the bank. Limited supervision is maintained over the employee.
- D. A clerk in the invoice processing department fails to match a vendor's invoice with its related receiving report. Checks are not signed unless all appropriate documents are attached to a voucher.

Answer (C) is correct.

Segregation of duties among key functions is an important control procedure. An accounts receivable clerk who is permitted to approve sales returns and allowances and also receive customer remittances could misappropriate funds received and cover the shortage by debiting sales returns and allowances. Limited supervision is insufficient to compensate for lack of segregation of duties.

- A. The requirement for documentation will reveal a theft when the fund is reimbursed unless the documents can be falsified.
- B. The amount involved is probably not material.
- D. The requirement for documentation will uncover the oversight.

**35. One characteristic of an effective internal control structure is the proper segregation of duties. The combination of responsibilities that would not be considered a violation of segregation of functional responsibilities is**

- A. Signing of paychecks and custody of blank payroll checks.
- B. Preparation of paychecks and check distribution.
- C. Approval of time cards and preparation of paychecks.
- D. Timekeeping and preparation of payroll journal entries.

Answer (D) is correct.

Combining the timekeeping function and the preparation of the payroll journal entries would not be improper because the employee has no access to assets or to employee records in the human resources department. Only through collusion could an embezzlement be perpetrated. Accordingly, the functions of authorization, recordkeeping, and custodianship remain separate.

- A. Persons with recordkeeping but not custody of assets responsibilities should have access to blank checks, while the duty of signing checks should be assigned to persons (e.g., the chief financial officer) with no recordkeeping function.
- B. Payroll preparation and payment to employees should be segregated since they are incompatible recordkeeping and custodianship functions.
- C. Approval of time cards is an authorization function that is incompatible with the recordkeeping function of preparation of paychecks.

**36. An internal auditor noted that the accounts receivable department is separate from other accounting activities. Credit is approved by a separate credit department. Control accounts and subsidiary ledgers are balanced monthly. Similarly, accounts are aged monthly. The accounts receivable manager writes off delinquent accounts after 1 year, or sooner if a bankruptcy or other unusual circumstances are involved. Credit memoranda are prenumbered and must correlate with receiving reports. Which of the following areas could be viewed as an internal control weakness of the above organization?**

- A. Write-offs of delinquent accounts.
- B. Credit approvals.

- C. Monthly aging of receivables.
- D. Handling of credit memos.

Answer (A) is correct.

The accounts receivable manager has the ability to perpetrate irregularities because (s)he performs incompatible functions. Authorization and recording of transactions should be separate. Thus, someone outside the accounts receivable department should authorize write-offs.

- B. Credit approval is an authorization function that is properly segregated from the recordkeeping function.
- C. Monthly aging is appropriate.
- D. The procedures regarding credit memoranda are standard controls.

**37. Which of the following controls would prevent the ordering of quantities in excess of an organization's needs?**

- A. Review of all purchase requisitions by a supervisor in the user department prior to submitting them to the purchasing department.
- B. Automatic reorder by the purchasing department when low inventory level is indicated by the system.
- C. A policy requiring review of the purchase order before receiving a new shipment.
- D. A policy requiring agreement of the receiving report and packing slip before storage of new receipts.

Answer (A) is correct.

Supervisory review at the originating department level is one means of control over the number of items ordered. This control is an example of the segregation of duties. Authorization should be separate from recordkeeping and asset custody.

- B. Automatic reordering does not consider future plans, which could lead to purchases of excess material.
- C. Review of the purchase order before receiving a new shipment is a control for the risk of accepting unordered goods.
- D. A policy requiring agreement of the receiving report and packing slip before storage of new receipts is a control over the risk of receiving an amount other than that ordered.

**38. Checks from customers are received in the organization's mail room each day. What controls should be in place to safeguard them?**

- A. Establishing a separate post office box for customer payments.
- B. Forwarding all checks to the cashier upon receipt.
- C. Requiring a specific mail clerk to list and restrictively endorse each check.
- D. Providing bonding protection for mail clerks.

Answer (C) is correct.

An employee who does not have access to other records should open the mail and prepare a list of checks received. The check listing will later be reconciled with the daily bank deposit and entries to accounts receivable. A restrictive endorsement (“for deposit only”) will put transferees on notice to act accordingly (that is, deposit the check in the organization’s account).

- A. Requiring a specific mail clerk to list and restrictively endorse each check provides more protection than establishing a separate post office box for customer payments.
- B. The same person should not both receive and deposit checks.
- D. Bonding insures against, but does not directly prevent, losses.

**39. The internal auditor recognizes that certain limitations are inherent in any system of internal controls. Which one of the following scenarios is the result of an inherent limitation of internal control?**

- A. The comptroller both makes and records cash deposits.
- B. A security guard allows one of the warehouse employees to remove assets from the premises without authorization.
- C. The organization sells to customers on account, without credit approval.
- D. An employee who is unable to read is assigned custody of the organization’s computer tape library and run manuals that are used during the third shift.

Answer (B) is correct.

Inherent limitations in internal control arise from mistakes in judgment, misunderstandings of instructions, personnel carelessness, distraction, fatigue, collusion, perpetrations by management, changing conditions, and deterioration of degrees of compliance. Thus, a control (use of security guards) based on segregation of functions may be overcome by collusion among two or more employees.

- A. Segregating the functions of recording and asset custody is customary. That the comptroller both makes and records cash deposits is an avoidable control weakness.
- C. Transactions can and should be authorized before execution. The fact that the organization sells to customers on account, without credit approval, is an avoidable control weakness.
- D. Assignment of an unqualified employee is an avoidable control weakness.

**40. Which of the following controls would help prevent overpaying a vendor?**

- A. Reviewing and canceling supporting documents when a check is issued.
- B. Requiring the check signer to mail the check directly to the vendor.
- C. Reviewing the accounting distribution for the expenditure.
- D. Approving the purchase before ordering from the vendor.

Answer (A) is correct.

Reviewing and canceling the supporting documents prevents paying a vendor twice for the same purchase. If the person who signs the check cancels the required documents, they cannot be recycled in support of a duplicate payment voucher. Securing the paid voucher file from access by the accounts payable clerk is another effective control.

- B. Requiring the check signer to mail the check directly to the vendor would prevent the check from being misappropriated.
- C. Reviewing the accounting distribution for the expenditure would ensure that the expenditure is debited to the proper account(s).
- D. Approving the purchase before ordering from the vendor would ensure that only authorized purchases are made.

**41. A receiving department receives copies of purchase orders for use in identifying and recording inventory receipts. The purchase orders list the name of the vendor and the quantities of the materials ordered. A possible error that this system could allow is**

- A. Payment to unauthorized vendors.
- B. Payment for unauthorized purchases.
- C. Overpayment for partial deliveries.
- D. Delay in recording purchases.

Answer (C) is correct.

To ensure a fair count, the copy of the purchase order sent to the receiving clerk should not include quantities. The receiving clerk should count the items in the shipment and prepare a receiving report. Copies are sent to inventory control and accounts payable.

- A. Comparing receipts with purchase orders will help detect unauthorized vendors.
- B. Comparing receipts with purchase orders will help detect unauthorized purchases.
- D. Using purchase orders to identify receipts will not cause a delay in recording purchases.

**42. Which of the following situations will cause an internal auditor to question the adequacy of controls over a purchasing function?**

- A. The original and one copy of the purchase order are mailed to the vendor. The copy on which the vendor acknowledges acceptance is returned to the purchasing department.
- B. Receiving reports are forwarded to purchasing where they are matched with purchase orders and sent to accounts payable.
- C. The accounts payable section prepares documentation for payments.
- D. Unpaid voucher files and perpetual inventory records are independently maintained.

Answer (B) is correct.

Purchasing and receiving should be organizationally independent. Moreover, comparing the purchase order and the receiving report should be the responsibility of a third person. Fraud perpetrated by a purchasing department employee could be concealed if (s)he is the first to obtain the receiving report.

- A. This practice ensures accurate communication.
- C. Accounts payable may prepare documentation but should not sign checks.
- D. Separately maintaining unpaid vouchers and perpetual inventory records is acceptable.

**43. Which of the following ensures that all inventory shipments are billed to customers?**

- A. Shipping documents are prenumbered and are independently accounted for and matched with sales invoices.
- B. Sales invoices are prenumbered and are independently accounted for and traced to the sales journal.
- C. Duties for recording sales transactions and maintaining customer account balances are separated.
- D. Customer billing complaints are investigated by the controller's office.

Answer (A) is correct.

Shipping documents are prepared at the time of shipment. They are prenumbered to facilitate detection of unrecorded shipments. A gap in the sequence of documents may indicate an irregularity. An employee outside the shipping department should account for these documents. Sales invoices are generated by the organization's computer system at the same time as the shipping documents and should have the same numbers. Thus, every shipping document should be matched with a sales invoice to ensure proper billing.

- B. Accounting for sales invoices alone does not prevent or detect unbilled shipments.
- C. Segregating the duties for recording sales transactions and maintaining customer accounts does not ensure that all shipments are invoiced.

D. Customers who are not billed may not notify the organization.

**44. If internal control is well designed, two tasks that should be performed by different persons are**

A. Approval of bad debt write-offs, and reconciliation of the accounts payable subsidiary ledger and controlling account.

B. Distribution of payroll checks and approval of sales returns for credit.

C. Posting of amounts from both the cash receipts journal and cash payments journal to the general ledger.

D. Recording of cash receipts and preparation of bank reconciliations.

Answer (D) is correct.

Recording of cash establishes accountability for assets. The bank reconciliation compares that recorded accountability with actual assets. The recording of cash receipts and preparation of bank reconciliations should therefore be performed by different individuals because the preparer of a reconciliation could conceal a cash shortage. For example, if a cashier both prepares the bank deposit and performs the reconciliation, (s)he could embezzle cash and conceal the theft by falsifying the reconciliation.

A. There is no conflict between writing off bad debts (accounts receivable) and reconciling accounts payable, which are liabilities.

B. Distribution of payroll checks and approval of sales returns are independent functions. People who perform such disparate tasks are unlikely to be able to perpetrate and conceal a fraud. In fact, some organizations use personnel from an independent function to distribute payroll checks.

C. Posting both ledgers would cause no conflict as long as the individual involved did not have access to the actual cash. If a person has access to records but not the assets, no danger exists of embezzlement without collusion.

**45. Which of the following activities represents both an appropriate human resources department function and a deterrent to payroll fraud?**

A. Distribution of paychecks.

B. Authorization of overtime.

C. Authorization of additions and deletions from the payroll.

D. Collection and retention of unclaimed paychecks.

Answer (C) is correct.

The payroll department is responsible for assembling payroll information (recordkeeping). The human resources department is responsible for authorizing employee transactions, such as hiring, firing, and

changes in pay rates and deductions. Segregating the recording and authorization functions helps prevent fraud.

- A. The chief financial officer should perform the asset custody function regarding payroll.
- B. Authorizing overtime is a responsibility of operating management.
- D. Unclaimed checks should be in the custody of the chief financial officer until they can be deposited in a special bank account.

**46. An organization has computerized sales and cash receipts journals. The computer programs for these journals have been properly debugged. The internal auditor discovered that the total of the accounts receivable subsidiary accounts differs materially from the accounts receivable control account. This discrepancy could indicate**

- A. Credit memoranda being improperly recorded.
- B. Receivables being lapped.
- C. Receivables not being properly aged.
- D. Statements being intercepted prior to mailing.

Answer (A) is correct.

Sales returns and allowances require the crediting of accounts receivable. Thus, the recording of unauthorized credit memoranda is one explanation for the discrepancy if sales and cash receipts are properly recorded.

- B. Lapping entails the theft of cash receipts and the use of subsequent receipts to conceal the theft. The effect is to overstate receivables, but no difference between the control total and the total of subsidiary amounts would arise.
- C. Aging does not involve accounting entries.
- D. Interception of customer statements might indicate fraudulent receivables but would not cause the subsidiary ledger discrepancy.

**47. An internal auditor noted that several shipments were not billed. To prevent recurrence of such nonbilling, the organization should**

- A. Numerically sequence and independently account for all controlling documents (such as packing slips and shipping orders) when sales journal entries are recorded.
- B. Undertake a validity check with customers as to orders placed.
- C. Release product for shipment only on the basis of credit approval by the credit manager or other authorized person.
- D. Undertake periodic tests of gross margin rates by product line and obtain explanations of significant departures from planned rates.

Answer (A) is correct.

The sequential numbering of documents provides a standard control over transactions. The numerical sequence should be accounted for by an independent party. A major objective is to detect unrecorded and unauthorized transactions.

B. This check would not prevent or detect unrecorded and unauthorized transactions.

C. Credit approval does not ensure billing.

D. Testing gross margin rates is an analytical procedure, not a preventive control.

**48. A preliminary survey of the purchasing function indicates that**

- **Department managers initiate purchase requests that must be approved by the plant superintendent,**
- **Purchase orders are typed by the purchasing department using prenumbered and controlled forms,**
- **Buyers regularly update the official vendor listing as new sources of supply become known,**
- **Rush orders can be placed with a vendor by telephone but must be followed by a written purchase order before delivery can be accepted, and**
- **Vendor invoice payment requests must be accompanied by a purchase order and receiving report.**

**One possible fault of this system is that**

A. Purchases could be made from a vendor controlled by a buyer at prices higher than normal.

B. Unnecessary supplies can be purchased by department managers.

C. Payment can be made for supplies not received.

D. Payment can be made for supplies received but not ordered by the purchasing department.

Answer (A) is correct.

A risk exposure typical of the purchasing function is that purchases may be made from vendors with respect to whom buyers or other employees have a conflict of interest. The result may be excessive prices or amounts, or poor quality of goods and services acquired. Accordingly, additions to the vendor file should be authorized at an appropriate level and not by the buyers. Similarly, bidders' lists should be approved by supervisory personnel.

- B.The requirement of a written purchase order approved by the plant superintendent is a satisfactory control to prevent unnecessary purchases.
- C.Payment is not made without a receiving report.
- D.Payment requests must be supported by an approved purchase order.

**49.Management is concerned with the potential for unauthorized changes in the payroll. Which of the following is the proper organizational structure to prevent such unauthorized changes?**

- A.The payroll department maintains and authorizes all changes in the personnel records.
- B.The payroll department is supervised by the management of the human resources division.
- C.The payroll department's functions are limited to maintaining the payroll records, distributing paychecks, and posting the payroll entries to the general ledger.
- D.The personnel department authorizes the hiring and pay levels of all employe

Answer (D) is correct.

The payroll department is responsible for assembling payroll information (recordkeeping). The personnel department is responsible for authorizing and executing employee transactions such as hiring, firing, and changes in pay rates and deductions. Segregating these functions helps prevent fraud. Thus, the payroll for each period should be compared with the active employment files of the personnel department.

- A.The personnel department should be responsible for these functions.
- B.The payroll and personnel departments should be independent.
- C.The payroll department should not post the payroll entries to the general ledger or distribute the paychecks. These functions are the responsibility of the accounting department and the chief financial officer's office, respectively.

**50.In a well-designed internal control structure in which the cashier receives remittances from the mail room, the cashier should not**

- A.Endorse the checks.
- B.Prepare the bank deposit slip.
- C.Deposit remittances daily at a local bank.
- D.Post the receipts to the accounts receivable subsidiary ledger cards.

Answer (D) is correct.

The cashier is an assistant to the chief financial officer and thus performs an asset custody function. Individuals with custodial functions should not have access to the accounting records. If the cashier

were allowed to post the receipts to the accounts receivable subsidiary ledger, an opportunity for embezzlement would arise that could be concealed by falsifying the books.

- A.It is a part of the custodial function, which is the primary responsibility of a cashier.
- B.It is a part of the custodial function, which is the primary responsibility of a cashier.
- C.It is a part of the custodial function, which is the primary responsibility of a cashier.

**51.Which one of the following situations represents an internal control weakness in accounts receivable?**

- A.Internal auditors confirm customer accounts periodically.
- B.Delinquent accounts are reviewed only by the sales manager.
- C.The cashier is denied access to customers' records and monthly statements.
- D.Customers' statements are mailed monthly by the accounts receivable department.

Answer (B) is correct.

Internal control over accounts receivable begins with a proper segregation of duties. Thus, the cashier, who performs an asset custody function, should not be involved in recordkeeping. Accounts should be periodically confirmed by an auditor, and delinquent accounts should be reviewed by the head of accounts receivable and the credit manager. Customer statements should be mailed monthly by the accounts receivable department without allowing access to the statements by employees of the cashier's department. The sales manager should not be the only person to review delinquent accounts because (s)he may have an interest in not declaring an account uncollectible.

- A.Periodic confirmation of accounts receivable is an internal control strength.
- C.An employee with asset-custody responsibilities should not have access to records for that asset.
- D.Monthly account statements give customers an opportunity to complain about incorrect billings or missing payments.

**52.Which one of the following situations represents a strength of internal control for purchasing and accounts payable?**

- A.Prenumbered receiving reports are issued randomly.
- B.After vendor invoices are approved for payment, the purchasing department issues payment vouchers.
- C.Unmatched receiving reports are reviewed on an annual basis.
- D.Vendors' invoices are matched against purchase orders and receiving reports before a liability is recorded.

Answer (D) is correct.

A voucher should not be prepared for payment until the vendor's invoice has been matched against the corresponding purchase order and receiving report. This procedure provides assurance that a valid transaction has occurred and that the parties have agreed on the terms, such as price and quantity.

A. Prenumbered receiving reports should be issued sequentially. A gap in the sequence may indicate an erroneous or fraudulent transaction.

B. Accounts payable matches an approved vendor invoice with supporting documents (purchase requisition, purchase order, and receiving report). After verification, accounts payable issues a payment voucher, including an unsigned check.

C. Annual review of unmatched receiving reports is too infrequent. More frequent attention is necessary to remedy deficiencies in internal control.

**53. To control purchasing and accounts payable, an information system must include certain source documents. For a manufacturing organization, these documents should include**

A. Purchase orders, receiving reports, and vendor invoices.

B. Receiving reports and vendor invoices.

C. Purchase requisitions, purchase orders, receiving reports, and vendor invoices.

D. Purchase requisitions, purchase orders, inventory reports of goods needed, and vendor invoices.

Answer (C) is correct.

Before ordering an item, the purchasing department should have on hand a purchase requisition reflecting an authorized request by a user department. Before a voucher is prepared for paying an invoice, the accounts payable department should have the purchase requisition, a purchase order (to be certain the items were indeed ordered), the vendor's invoice, and a receiving report (to be certain the items were received).

A. A purchase requisition is also needed.

B. A purchase order and requisition are also necessary.

D. A receiving report is needed.

**54. Auditors document their understanding of internal control with questionnaires, flowcharts, and narrative descriptions. A questionnaire consists of a series of questions concerning controls that auditors consider necessary to prevent or detect errors and fraud. The most appropriate question designed to contribute to the auditors' understanding of the completeness of the expenditure (purchases-payables) cycle concerns the**

A. Internal verification of quantities, prices, and mathematical accuracy of sales invoices.

B. Use and accountability of prenumbered checks.

- C. Disposition of cash receipts.
- D. Qualifications of accounting personnel.

Answer (B) is correct.

A completeness assertion relates to whether all transactions and accounts that should be presented in the financial statements are so presented. The exclusive use of sequentially numbered documents facilitates control over expenditures. An unexplained gap in the sequence alerts the auditor to the possibility that not all transactions have been recorded. A failure to use prenumbered checks would therefore suggest a higher assessment of control risk. If a company uses prenumbered checks, it should be easy to determine exactly which checks were used during a period.

- A. Determination of proper amounts of sales invoices concerns the valuation assertion. Also, sales invoices are part of the sales-receivables (revenue) cycle.
- C. Cash receipts are part of the revenue cycle.
- D. Consideration of the qualifications of accounting personnel is not a test of controls over the completeness of any cycle. This procedure is appropriate during the consideration of the control environment.

**55. The initiation of the purchase of materials and supplies would be the responsibility of the**

- A. Purchasing department.
- B. Stores control department.
- C. Inventory control department.
- D. Production department.

Answer (C) is correct.

The inventory control department would be responsible for initiating a purchase. It has access to the inventory records and would therefore know when stocks were getting low.

- A. The purchasing department places orders that have been initiated and authorized by others
- B. The stores control department has custody of materials; it does not maintain inventory records.
- D. The production department manufactures goods and obtains materials from stores control.

**56. Multiple copies of the purchase order are prepared for recordkeeping and distribution with a copy of the purchase order sent to the vendor and one retained by the purchasing department. In addition, for proper informational flow and internal control purposes, a version of the purchase order would be distributed to the**

- A. Accounts payable, receiving, and stores control departments.

- B.Accounts payable, receiving, and inventory control departments.
- C.Accounts payable, accounts receivable, and receiving departments.
- D.Accounts payable, receiving, and production planning departments.

Answer (B) is correct.

The accounts payable department should receive a copy of the purchase order for internal control purposes to ensure that all invoices paid are for properly authorized items. The receiving department should receive a copy (with the quantity omitted to encourage an honest count) so that its employees will know that incoming shipments were authorized and should be accepted. In addition, the department issuing the purchasing requisition (the inventory control department) should receive a copy as a notification that the order has been placed.

- A.The stores control department does not need to know that a purchase has been initiated.
- C.The accounts receivable department does not need a copy.
- D.The production planning department does not need a copy.

**57.Organizational independence in the processing of payroll is achieved by segregation of functions that are built into the system. Which one of the following functional segregations is not required for internal control purposes?**

- A.Segregation of timekeeping from payroll preparation.
- B.Segregation of personnel function from payroll preparation.
- C.Segregation of payroll preparation and paycheck distribution.
- D.Segregation of payroll preparation and maintenance of year-to-date records.

Answer (D) is correct.

Most companies have their payrolls prepared by the same individuals who maintain the year-to-date records. There is no need for this segregation of functions because both duties involve recordkeeping.

- A.Segregating timekeeping and payroll preparation is an effective control. It prevents one person from claiming that an employee worked certain hours and then writing a check to that employee. Payment to an absent or fictitious employee would therefore require collusion between two employee
- B.Personnel should be separate from payroll. The former authorizes the calculation of the payroll by the latter.
- C.Segregating paycheck preparation from distribution makes it more difficult for checks to be made out to fictitious employees.

**58.If employee paychecks are distributed by hand to employees, which one of the following departments should be responsible for the safekeeping of unclaimed paychecks?**

- A. Payroll department.
- B. Timekeeping department.
- C. Production department in which the employee works or worked.
- D. Cashier department.

Answer (D) is correct.

The responsibility for unclaimed paychecks should be given to a department that has no opportunity to authorize or write those checks. Because the treasury function serves only an asset custody function and thus has had no input into the paycheck process, it is the logical repository of unclaimed checks.

- A. The payroll department was responsible for causing the check to be written.
- B. The timekeeping department authorized payment based on a certain number of hours worked.
- C. A production supervisor or fellow worker has an opportunity to intercept the check of a fictitious or terminated employee.

**59. Organizational independence is required in the processing of customers' orders in order to maintain an internal control structure. Which one of the following situations is not a proper segregation of duties in the processing of orders from customers?**

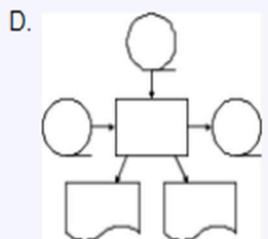
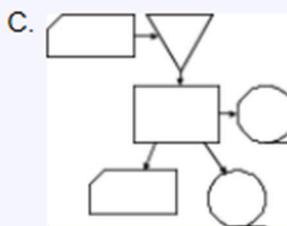
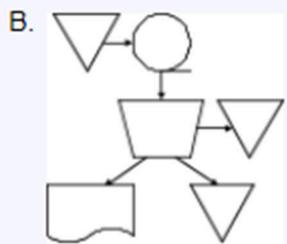
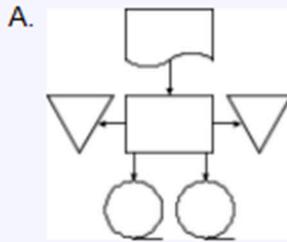
- A. Approval by credit department of a sales order prepared by the sales department.
- B. Shipping of goods by the shipping department that have been retrieved from stock by the finished goods storeroom department.
- C. Invoice preparation by the billing department and posting to customers' accounts by the accounts receivable department.
- D. Approval of a sales credit memo because of a product return by the sales department with subsequent posting to the customer's account by the accounts receivable department.

Answer (D) is correct.

Allowing a sales department employee to approve a credit memo without a receiving report would be unacceptably risky. Sales personnel could overstate sales in one period and then reverse them in subsequent periods. Thus, a copy of the receiving report for returned goods should be sent to billing for preparation of a credit memo after approval by a responsible supervisor who is independent of sales.

- A. Ensuring that a sales order is for a legitimate, creditworthy customer is a function of the credit department.
- B. To maintain proper segregation of functions, goods should be pulled by the storeroom department and shipped by the shipping department.
- C. Invoice preparation and account updating should be performed by two different departments.

60. Which of the following symbolic representations indicates that new payroll transactions and the old payroll file have been used to prepare payroll checks, prepare a printed payroll journal, and generate a new payroll file?



Answer (D) is correct.

The new payroll transactions and the old payroll file are represented by the magnetic tape symbols. These files are entered into the process function (the rectangle). The output is a new payroll file on magnetic tape and payroll checks and a printed payroll journal represented by the document symbols.

A. Two magnetically stored payroll files and two offline storage files are produced from a single document form.

B. Two offline storage files and one document are produced (manually) from an offline storage file and a tape file.

C. Two magnetically stored files and a punchcard are produced from the processing of a punchcard and an offline storage file.

**61. Which of the following control procedures provides the greatest assurance that all donations to a not-for-profit organization are immediately deposited in its account?**

A. Use a lockbox to receive all donations.

B. Perform periodic reviews of the organization's cash receipts by tracing deposits to the original posting in the cash receipts records.

C. Require that all donations be made by check.

D. Require issuance of a confirmation receipt to all donors, with the receipt issued by the person who opens and deposits the cash receipts.

Answer (A) is correct.

A lockbox system expedites receipt of funds and provides effective control over cash receipts. Donors send their payments to lockboxes, often in numerous locations, that are checked by a bank several times a day. Thus, payments are deposited before being processed by the organization's accounting system.

B. Tracing deposits to the original posting in the cash receipts records focuses only on deposits that were made. The concern is that cash receipts might not have been deposited.

C. The fact that a donation is made by check does not ensure the check is accounted for as a donation rather than a debt or liability. Also, a requirement for all donations to be in the form of a check does not provide assurance that checks will be deposited immediately.

D. The same person should not be responsible for the cash receipts and the confirmations. The person could confirm receipts even if they were diverted.

**62. Reviewing an edit listing of payroll changes processed during each payroll cycle is most likely to detect**

A. Labor hours charged to the wrong account in the cost reporting system.

B. Inaccurate payroll deductions.

C. Undetected errors in the payroll rates of new employees.

D. A failure to offer employees an opportunity to contribute to their pension plan.

Answer (C) is correct.

A category such as new employee should generate a change in payroll information and therefore should be detected.

A.Charging labor hours to the wrong account does not involve a change in (edit of) payroll information.

B.Inaccurate payroll deductions do not involve a change in (edit of) payroll information.

D.A failure to offer employees an opportunity to contribute to their pension plan does not involve a change in (edit of) payroll information.

**63.The most appropriate method to prevent fraud or theft during the frequent movement of trailers loaded with valuable metal scrap from the manufacturing plant to the organization's scrap yard about 10 miles away would be to**

A.Perform complete physical inventory of the scrap trailers before leaving the plant and upon arrival at the scrap yard.

B.Require existing security guards to log the time of plant departure and scrap yard arrival. The elapsed time should be reviewed by a supervisor for fraud.

C.Use armed guards to escort the movement of the trailers from the plant to the scrap yard.

D.Contract with an independent hauler for the removal of scrap.

Answer (B) is correct.

The cost of internal control must not be greater than its benefits. Logging the times of departure and arrival, and reviewing the elapsed time for material variances from the expected travel time, are cost-effective controls to prevent and detect fraud or theft during the movement of the scrap.

A.The cost of internal control must not be greater than its benefits. The cost of performing a complete physical inventory of scrap at both locations would likely exceed its benefits.

C.Hiring armed guards to escort the scrap trailers is unlikely to be cost-effective unless the scrap is extremely valuable. Logging departures and arrivals will be sufficient in most cases.

D.Using an independent hauler would provide no additional assurance of prevention or detection of wrongdoing.

**64.Which of the following would minimize defects in finished goods caused by poor quality raw materials?**

A.Documented procedures for the proper handling of work-in-process inventory.

B.Required material specifications for all purchases.

C.Timely follow-up on all unfavorable usage variances.

D.Determination of the amount of spoilage at the end of the manufacturing process.

Answer (B) is correct.

A preventive control is required in this situation, i.e., one that ensures an unwanted event does not take place. The most cost-effective way of achieving the goal is to keep poor quality raw materials from entering the warehouse to begin with. Of the controls listed, only required specifications will accomplish this.

A.Documented procedures for handling work-in-process inventory do not ensure that materials are of sufficient quality.

C.Follow-up on unfavorable usage variances may lead to detection and correction of use of substandard materials but does not prevent or minimize defects in products already processed.

D.Determination of spoilage after raw materials have been used in production is not a preventive control.

**65.An internal auditor notes year-to-year increases for small tool expense at a manufacturing facility that has produced the same amount of identical product for the last 3 years. Production inventory is kept in a controlled staging area adjacent to the receiving dock, but the supply of small tools is kept in an unsupervised area near the exit to the plant employees' parking lot. After determining that all of the following alternatives are equal in cost and are also feasible for local management, the internal auditor would best address the security issue by recommending that plant management**

A.Move the small tools inventory to the custody of the production inventory staging superintendent and implement the use of a special requisition to issue small tools.

B.Initiate a full physical inventory of small tools on a monthly basis.

C.Place supply of small tools in a secured area, install a key-access card system for all employees, and record each key-access transaction on a report for the production superintendent.

D.Close the exit to the employee parking lot and require all plant employees to use a doorway by the receiving dock that also provides access to the plant employees' parking area.

Answer (A) is correct.

Minimizing the loss of assets requires a preventive control. Giving responsibility for custody of small tools to one individual establishes accountability. Requiring that requisitions be submitted ensures that their use is properly authorized.

B.A full physical inventory of small tools on a monthly basis is a periodic, detective control that is effective only in determining the amount of losses.

C.Placing small tools in a secured area, installing a key-access system, and recording access transactions are preventive and detective controls but do not record the amount of tools removed from the inventory.

D.Closing the exit to the employee parking lot does not limit access to the small tools inventory.

**66.A utility with a large investment in repair vehicles would most likely implement which internal control to reduce the risk of vehicle theft or loss?**

A.Review insurance coverage for adequacy.

B.Systematically account for all repair work orders.

C.Physically inventory vehicles and reconcile the results with the accounting records.

D.Maintain vehicles in a secured location with release and return subject to approval by a custodian.

Answer (D) is correct.

Physical safeguarding of assets is enacted through the use of preventive controls that reduce the likelihood of theft or other loss. Keeping the vehicles at a secure location and restricting access establishes accountability by the custodian and allows for proper authorization of their use.

A.Insurance provides for indemnification if loss or theft occurs. It thus reduces financial exposure but does not prevent the actual loss or theft.

B.An internal control designed to ensure control over repair work performed has no bearing on the risk of loss.

C. Taking an inventory is a detective, not a preventive, control.

**67. Obsolete or scrap materials are charged to a predefined project number. The materials are segregated into specified bin locations and eventually transported to a public auction for sale. To reduce the risks associated with this process, an organization should employ which of the following procedures?**

1. **Require managerial approval for materials to be declared scrap or obsolete.**
2. **Permit employees to purchase obsolete or scrap materials prior to auction.**
3. **Limit obsolete or scrap materials sales to a pre-approved buyer.**
4. **Specify that a fixed fee, rather than a commission, be paid to the auction firm.**

A. 2 and 3.

B. 1 only.

C. 2 and 4.

D. 1, 3, and 4.

Answer (B) is correct.

A preventive control is needed. Management approval for materials to be declared scrap or obsolete reduces the risk of misappropriation. Otherwise, materials may be more easily misclassified.

A. Permitting employees to purchase obsolete or scrap materials prior to auction provides even more incentive for misappropriation. Limiting obsolete or scrap materials sales to a pre-approved buyer does not mitigate the risk of misappropriation before the materials are sold. Moreover, these procedures may be less effective than an auction for obtaining the best price.

C. Permitting employees to purchase obsolete or scrap materials prior to auction provides even more incentive for misappropriation. Specifying that a commission be paid to the auction firm creates an incentive to maximize the organization's return.

D. Limiting obsolete or scrap materials sales to a pre-approved buyer does not mitigate the risk of misappropriation before the materials are sold. It also may be less effective than an auction for obtaining the best price. Specifying that a commission be paid to the auction firm creates an incentive to maximize the organization's return.

**68. A recent inventory shortage at XYZ Corp., an unaffiliated supplier, contributed to production failures at OPS Corp. in the current period. To avoid future production failures because of supplier inventory shortages, the most appropriate method is for OPS to**

A. Establish an inventory control framework at XYZ.

B. Increase the size of orders.

C. Produce the inventory items instead of purchasing from suppliers.

D. Inform XYZ about its risk appetite regarding supply failures.

Answer (D) is correct.

The risk appetite is the level of risk that an organization is willing to accept (The IIA Glossary). Thus, communicating about the risk appetite with external parties is an important aspect of risk management. It allows the organization to develop strategies to work with suppliers who may have different objectives.

A. OPS has no authority to establish an inventory control framework at XYZ.

B. Increasing order size does not address the cause of supplier failures.

C. Although in-house production will eliminate the external parties, it may not be the most cost-effective method. The external party may have cost advantages the organization does not.

**69. A system of internal control includes physical controls over access to and use of assets and records. A departure from the purpose of such procedures is that**

A. Access to the safe-deposit box requires two officers.

B. Only storeroom personnel and line supervisors have access to the raw materials storeroom.

C. The mailroom compiles a list of the checks received in the incoming mail.

D. Only salespersons and sales supervisors use sales department vehicles.

Answer (B) is correct.

Storeroom personnel have custody of assets, and supervisors are in charge of execution functions. To give supervisors access to the raw materials storeroom is a violation of the essential internal control principle of segregation of functions.

A. It is appropriate for two officers to be required to open the safe-deposit box. One supervises the other.

C. The mailroom typically compiles a prelisting of cash. The list is sent to the accountant as a control for actual cash sent to the cashier.

D. Use of sales department vehicles by only sales personnel is appropriate.

**70. Fact Pattern:** The marketing department for a major retailer assigns separate product managers for each product line. Product managers are responsible for ordering products and determining retail pricing. Each product manager's purchasing budget is set by the marketing manager. Products are delivered to a central distribution center where goods are segregated for distribution to the company's 52 department stores. Because receipts are recorded at the distribution center, the company does not maintain a receiving function at each store. Product managers are evaluated on a combination of sales and gross profit generated from their product lines. Many products are seasonal and individual store managers can require that seasonal products be removed to make space for the next season's products.

**Q. Which of the following is a control deficiency in this situation?**

A. The store manager can require items to be removed, thus affecting the potential performance evaluation of individual product managers.

B. The product manager negotiates the purchase price and sets the selling price.

C. Evaluating product managers by total gross profit generated by product line will lead to dysfunctional behavior.

D. There is no receiving function located at individual stores.

Answer (D) is correct.

The receiving function verifies that the goods received are those actually sent by the shipper. Without this function being performed at the store, goods could be lost, pilfered, or simply sent to the wrong store without it being discovered.

A. Goods are seasonal, and store space is limited. This is a constraint that is consistent with maximizing revenue and profitability for the organization.

B. The product manager is evaluated based on sales and gross profit; thus, performing both of these duties is not a conflict.

C. Evaluating the product managers on gross profit and budgeted sales holds them accountable for profitability. This approach is consistent with their authority over ordering and pricing.

**71. Fact Pattern: The marketing department for a major retailer assigns separate product managers for each product line. Product managers are responsible for ordering products and determining retail pricing. Each product manager's purchasing budget is set by the marketing manager. Products are delivered to a central distribution center where goods are segregated for distribution to the company's 52 department stores. Because receipts are recorded at the distribution center, the company does not maintain a receiving function at each store. Product managers are evaluated on a combination of sales and gross profit generated from their product lines. Many products are seasonal and individual store managers can require that seasonal products be removed to make space for the next season's products.**

**Q. Requests for purchases beyond those initially budgeted must be approved by the marketing manager. This procedure**

**Should provide for the most efficient allocation of scarce organizational resources.**

**Is a detective control procedure.**

**Is unnecessary because each product manager is evaluated on profit generated.**

A. 1 only.

B. 3 only.

C. 2 and 3 only.

D. 1, 2, and 3.

Answer (A) is correct.

The organization has two scarce resources to allocate: its purchasing budget and the space available in its retail stores. The marketing manager is high enough in the organization to coordinate this allocation. Allowing individual product managers to approve their own requests to exceed budget would almost certainly result in misallocation. Thus, Item 1 is a valid choice. Item 2 is not a valid choice because the marketing manager asserts his or her authority before an unwanted event has taken place. Item 3 is not a valid choice because product managers may be tempted to commit the company to buy more product than it can finance. The marketing manager is in a position to coordinate these requests and reconcile them with the budget.

B. The gross profit evaluation is effective in evaluating product managers, but it does not necessarily restrain excess spending.

C. Approval by the marketing manager is a preventive control, which deters undesirable events from occurring. A detective control detects and corrects undesirable events that have occurred. Also, the gross profit evaluation is effective only in evaluating the manager.

D. Approval by the marketing manager is a preventive control, which deters undesirable events from occurring. A detective control detects and corrects undesirable events that have occurred. Also, the gross profit evaluation is effective only in evaluating the manager.

**72.Fact Pattern:** While performing analytical procedures related to an engagement involving a social services agency of a government entity, the internal auditor noted an unusually large increase in payments to individual recipients who are under the direction of a particular social worker in the agency.

**Q.**The internal auditor is considering making a recommendation about appropriate controls to address a potential problem of fictitious recipients. The internal auditor has identified the following control procedures as potential items to include in the recommendation.

1. Require that all additions to the recipient file be independently investigated and approved by a supervisor of the social workers.
2. Require the use of self-checking digits on the account numbers of all recipients so that any duplicates will be immediately noted by the system.
3. Incorporate a code into the computer program to search for duplicate names and addresses. Develop an exception report that will go to the section supervisor whenever duplicates are noted.
4. Require that social workers be rotated among recipients.

**Which of the following control combinations would effectively address the internal auditor's concerns and improve control over valid recipients?**

A.1, 2, 3, and 4.

B.1, 2, and 3.

C.1 and 4.

D.1, 3, and 4.

Answer (D) is correct.

Under these facts, an effective control assists in preventing or detecting payments to fictitious recipients. Requiring a social worker supervisor to investigate and approve all additions to the recipient file assists in preventing a social worker from adding fictitious recipients. Incorporating a code into the computer system to search for duplicate names and addresses and developing an exception report for the section supervisor assist in detecting fictitious recipients. Rotating social workers among recipients assists in preventing and detecting fictitious recipients. Self-checking digits, however, are online input controls used to detect incorrect identification numbers, not prevent or detect duplicate account numbers. Consequently, this control would be ineffective in preventing or detecting fictitious recipients.

A.Under these facts, an effective control assists in preventing or detecting payments to fictitious recipients. Although fictitious recipients could be created by using duplicate accounts, the use of self-checking digits on the account numbers is not a control that would prevent or detect duplicate accounts. Rather, self-checking digits are online input controls used to detect incorrect identification numbers. Consequently, this control would be ineffective in preventing or detecting fictitious recipients.

B.Self-checking digits are online input controls used to detect incorrect identification numbers, not prevent or detect duplicate account numbers. Consequently, this control would be ineffective in preventing or detecting fictitious recipients. However, rotating social workers among recipients would be an effective control to prevent or detect fictitious recipients because each succeeding social worker will likely verify whether the new recipients under his or her direction are valid.

C.A programmed control that searches for and reports exceptions (e.g., duplicate names and addresses) detects payments to multiple recipients at a single or a few addresses and therefore also would be an effective control.

**73.Which of the following controls could be used to detect bank deposits that are recorded but never made?**

- A.Establishing accountability for receipts at the earliest possible time.
- B.Linkng receipts to other internal accountabilities, for example, collections to either accounts receivable or sales.
- C.Consolidating cash receiving points.
- D.Having bank reconciliations performed by a third party.

Answer (D) is correct.

Having an independent third party prepare the bank reconciliations would reveal any discrepancies between recorded deposits and the bank statements. A bank reconciliation compares the bank statement with organization records and resolves differences caused by deposits in transit, outstanding checks, NSF checks, bank charges, errors, etc.

- A.Early establishment of accountability will not help detect bank deposits recorded on the books but not deposited in the bank.
- B.The issue is not accountability for receipts but detection of failure to make deposits.
- C.The number of receiving points does not impact the failure to make recorded deposits.

**74.To minimize the risk that agents in the purchasing department will use their positions for personal gain, the organization should**

- A.Rotate purchasing agent assignments periodically.
- B.Request internal auditors to confirm selected purchases and accounts payable.
- C.Specify that all items purchased must pass value-per-unit-of-cost reviews.
- D.Direct the purchasing department to maintain records on purchase prices paid, with review of such being required each 6 months.

Answer (A) is correct.

The risk of favoritism is increased when buyers have long-term relationships with specific vendors. Periodic rotation of buyer assignments will limit the opportunity to show favoritism. This risk is also reduced if buyers are required to take vacations.

- B.Confirmation does not enable internal auditors to detect inappropriate benefits received by purchasing agents or deter long-term relationships.
- C.Value-per-unit-of-cost reviews could be helpful in ensuring a certain level of value received for price paid but do not directly focus on receipt of inappropriate benefits by purchasing agents.
- D.Review of records every 6 months does not enable the organization to detect receipt of inappropriate benefits by an agent or deter relationships that could lead to such activity.

**75.Management can best strengthen internal control over the custody of inventory stored in an off-site warehouse by implementing**

- A.Reconciliations of transfer slips to/from the warehouse with inventory records.
- B.Increases in insurance coverage.
- C.Regular reconciliation of physical inventories to accounting records.
- D.Regular confirmation of the amount on hand with the custodian of the warehouse.

Answer (C) is correct.

A detective control that will reveal, on a regular basis, any discrepancies between the inventory records and the actual inventory on hand is needed. Periodic comparison of the recorded accountability for inventory with the actual physical inventory will accomplish this.

A.A control over the movement of inventory to and from the warehouse provides no assurance over the custody of the inventory while in the warehouse.

B.Increasing insurance coverage helps protect the organization against losses but does not strengthen internal control over the custody of inventory.

D.Confirming with the custodian the amount of inventory on hand does not verify that the inventory is actually at the warehouse.

**76.When a supplier of office products is unable to fill an order completely, it marks the out-of-stock items as back ordered on the customer's order and enters these items in a back order file that management can view or print. Customers are becoming disgruntled with the supplier because it seems unable to keep track of and ship out-of-stock items as soon as they are available. The best approach for ensuring prompt delivery of out-of-stock items is to**

- A.Match the back order file to goods received daily.
- B.Increase inventory levels to minimize the number of times that out-of-stock conditions occur.
- C.Implement electronic data interchange with supply vendors to decrease the time to replenish inventory.
- D.Reconcile the sum of filled and back orders with the total of all orders placed daily.

Answer (A) is correct.

A directive control is appropriate, i.e., one designed to cause or encourage the occurrence of a desirable event. Matching the back order file with goods received daily is the surest way of facilitating prompt delivery of out-of-stock items.

B.An increase in inventory minimizes out-of-stock conditions but has no effect on tracking and shipping goods as soon as they are available.

C.More efficient replenishment of its own inventory has no effect on tracking and shipping goods as soon as they are available.

D.Reconciling the sum of filled and back orders with the total of all orders placed daily ensures that orders were either filled or back ordered but will not affect delivery of the items that are out of stock.

**77.Which of the following observations by an auditor is most likely to indicate the existence of control weaknesses over safeguarding of assets?**

- 1) A service department's location is not well suited to allow adequate service to other units.
- 2) Employees hired for sensitive positions are not subjected to background checks.

- 3) **Managers do not have access to reports that profile overall performance in relation to other benchmarked organizations.**
- 4) **Management has not taken corrective action to resolve past engagement observations related to inventory controls.**

A.1 and 2 only.

B.1 and 4 only.

C.2 and 3 only.

D.2 and 4 only.

Answer (D) is correct.

Internal auditors evaluate risk exposures and the adequacy and effectiveness of controls relating to, among other things, safeguarding of assets (Perf. Std. 2130.A1). Lack of background checks for employees hired for sensitive positions and failure to take corrective action on past engagement observations relating to safeguarding of assets are red flags signifying control weaknesses. Regular reference and background checks, integrity tests, and drug screening are hiring procedures that may be part of an effective ethical culture. Furthermore, internal auditors follow up on engagement results to determine what corrective actions have been taken or whether management or the board has assumed the risk of not taking action. If the CAE believes the risk assumed may be unacceptable to the organization, (s)he must discuss the matter with senior management and the board (Perf. Stds. 2500.A1 and 2600).

A.A service department's location concerns achieving organizational objectives, not safeguarding of assets.

B.A service department's location concerns achieving organizational objectives, not safeguarding of assets. But failure to do background checks is a control weakness related to asset security.

C.Managers not having access to reports profiling overall performance concerns achieving organizational objectives.

**78.A control likely to prevent purchasing agents from favoring specific suppliers is**

A.Requiring management's review of a monthly report of the totals spent by each buyer.

B.Requiring buyers to adhere to detailed material specifications.

C.Rotating buyer assignments periodically.

D.Monitoring the number of orders placed by each buyer.

Answer (C) is correct.

The risk of favoritism is increased when buyers have long-term relationships with specific vendors. Periodic rotation of buyer assignments will limit the opportunity for any buyer to show favoritism to a particular supplier.

A.Requiring review of a monthly report of the totals spent by each buyer does not enable the organization to detect receipt of inappropriate benefits by an agent or deter relationships that could lead to such activity.

B.Detailed material specifications will not prevent buyer favoritism in placing orders.

D.The number of orders placed is not relevant to preventing favoritism.

**79.Appropriate internal control for a multinational corporation's branch office that has a monetary transfer unit requires that**

A.The individual who initiates wire transfers not reconcile the bank statement.

B.The branch manager receive all wire transfers.

C.Foreign currency rates be computed separately by two different employees.

D.Corporate management approve the hiring of monetary transfer unit employees.

Answer (A) is correct.

A control is any action taken by management to enhance the likelihood that established goals and objectives will be achieved. Controls include segregation of duties to reduce the risk that any person may be able to perpetrate and conceal errors or fraud in the normal course of his or her duties. Different persons should authorize transactions, record transactions, and maintain custody of the assets associated with the transaction. Independent reconciliation of bank accounts is necessary for good internal control.

B.Having the branch manager receive all wire transfers is not an important internal control consideration.

C.Foreign currency translation rates are verified, not computed. Having two employees in the same department perform the same task will not significantly enhance internal control.

D.Corporate management approval of hiring monetary transfer unit employees is not an important internal control consideration.

**80.An internal auditor is assigned to perform an engagement to evaluate the organization's insurance program, including the appropriateness of the approach to minimizing risks. The organization self-insures against large casualty losses and health benefits provided for all its employees. The organization is a large national firm with over 15,000 employees located in various parts of the country. It uses an outside claims processor to administer its healthcare program. The organization's medical costs have been rising by approximately 8% per year for the past 5 years, and management is concerned with controlling these costs. The healthcare processor wishes to implement controls that would help prevent fraud by dentists who are submitting billings for services not provided. Assume further that all the claims are submitted electronically to the healthcare processor. Which of the following control procedures would be the most effective?**

A.Develop a program that identifies procedures performed on an individual in excess of expectations based on the age of the employee, whether a similar procedure was performed recently, or the average cost per claim.

B.Require all submitted claims to be accompanied by a signed statement by the dentist testifying that the claimed procedures were performed.

C.Send confirmations to the dentists requesting them to confirm the exact nature of the claims submitted to the healthcare processor.

D.Develop an integrated test facility and submit false claims to verify that the system is detecting such claims on a consistent basis

A.Answer (A) is correct.

Under this detective control, unusual claims could be identified and followed up to determine if they are legitimate. This control is a type of IT input control known as a reasonableness test.

B. Requiring a signed statement does not prevent the dentist from filing a false claim.

C. Sending confirmations to the dentists does not prevent the filing of false claims or a false response to the confirmation.

D. An integrated test facility would only provide information about the correctness of the processing of the claim or a false response to the confirmation, not on the propriety of the claim.

**81. An internal auditor is reviewing the organization's policy regarding investing in financial derivatives. The internal auditor normally expects to find all of the following in the policy except**

A. A statement indicating whether derivatives are to be used for hedging or speculative purposes.

B. A specific authorization limit for the amount and types of derivatives that can be used by the organization.

C. A specific limit on the amount authorized for any single trader.

D. A statement requiring board review of each transaction because of the risk involved in such transactions.

Answer (D) is correct.

A policy requiring board review of every derivatives transaction is cost ineffective. Management is responsible for daily operations and is expected to conform to the policies of the board.

A. A policy specifying whether derivatives are to be used for hedging or speculating is a crucial directive control.

B. A policy specifying the authorization limits for derivatives is an appropriate directive control.

C. A policy specifying the authorization limits for derivatives is an appropriate directive control.

**82. A rental car agency's fleet maintenance division uses a different code for each type of inventory transaction. A daily summary report lists activity by part number and transaction code. The report is reconciled by the parts room supervisor to the day's material request forms and is then forwarded to the fleet manager for approval. The reconciliation of the summary report to the day's material request forms by the parts room supervisor**

A. Verifies that all material request forms were approved.

B. Provides documentation as to what material was available for a specific transaction.

C. Confirms that all material request forms are entered for all parts issued.

D. Ensures the accuracy and completeness of data input.

Answer (D) is correct.

This reconciliation is an input control to verify that data entry is accurate and complete. The parts requested should be consistent with the parts used in the maintenance activities. Unexplained variances should be investigated.

A. This reconciliation would not necessarily include a review of authorizations.

B. The material available for a specific transaction is not part of the reconciliation.

C. Not all request forms may have been submitted.

**83. During an engagement involving a construction contract, the internal auditor discovered that the contractor was being paid for each ton of dirt removed. The contract called for payment based on cubic yards removed. Which internal control might have prevented this error?**

A. Comparison of invoices with purchase orders or contracts.

B. Comparison of invoices with receiving reports.

C. Comparison of actual costs with budgeted costs.

D. Extension checks of invoice amounts.

Answer (A) is correct.

This detective control would have revealed that the contractor's invoice used a unit of measure different from that in the contract. Thus, the basis of payment was not what was called for in this unit-price contract.

B. The dirt removed would not have been received by the organization. Hence, no receiving reports would have existed.

C. This comparison would not have detected the specific reason for a variance.

D. The problem was not a mathematical error but an erroneous basis for payment.

**84. During an engagement involving a purchasing department, an internal auditor discovered that many purchases were made (at normal prices) from an office supplier whose owner was the brother of the director of purchasing. Controls were in place to restrict such purchases and no fraud appears to have been committed. In this case, the internal auditor should recommend**

A. The development of an approved-vendor file initiated by the buyer and approved by the director of purchasing.

B. Establishment of a price policy (range) for all goods.

C. The initiation of a conflict-of-interest policy.

D. The inspection of all receipts by receiving inspectors.

Answer (C) is correct.

A policy is one means of achieving control. It is a general guide to and limit on action that should be clearly stated in writing and systematically communicated to appropriate parties. A conflict-of-interest policy should contain directives that restrict business dealings with relatives unless otherwise disclosed to and approved by senior management.

A. An approved-vendor file approved by the director would not prevent a conflict of interest.

B. Price is not a factor when dealing with conflicts of interest.

D. The inspection of all receipts by receiving inspectors is an appropriate receiving control that does not pertain to this situation.

**85. Which of the following policies and procedures is consistent with effective administration of the insurance function?**

A. Billings for insurance coverage are received and payments disbursed by the insurance manager.

- B. Policy coverages are adjusted each year by applying a price index to previous year coverages.
- C. Final settlements are negotiated after claims are developed and submitted.
- D. Policies are always placed with the carrier that offers the lowest rate for a specified level of coverage.

Answer (C) is correct.

The claims handling process begins with prompt reporting by the affected operational unit of the organization of any basis for a claim. Prompt reporting is required to permit the insurer to take whatever steps it may deem necessary to reduce the ultimate compensable loss. The insurance function then cooperates with the operational unit to document and formally submit the claim to the carrier. Subsequently, the insurance function will be involved in any required review of the claim and negotiation of a settlement.

- A. The manager has too many responsibilities; there is no separation of duties. The receipt of billings and the disbursement of payments should be done by different people.
- B. While policy coverages should be systematically evaluated each year to assure appropriate coverage, mere adjustment for inflation is not adequate to determine the degree of risk that should be insured.
- D. Prudence dictates that other factors, e.g., the financial resources of the carrier and the fairness and efficiency of claims handling, be considered in addition to rates.

**86. An employee should not be able to visit the organization's safe deposit box containing investment securities without being accompanied by another employee. What would be a possible consequence of an employee's being able to visit the safe deposit box unaccompanied?**

- A. The employee could pledge organizational investments as security for a short-term personal bank loan.
- B. The employee could steal securities and the theft would never be discovered.
- C. It would be impossible to obtain a fidelity bond on the employee.
- D. There would be no record of when organizational personnel visited the safe deposit box.

Answer (A) is correct.

The bank should maintain a record, which can be inspected by organizational personnel, of all safe deposit box visits. Access should be limited to authorized officers. Organizations typically require the presence of two authorized persons for access to the box. This precaution provides supervisory control over, for example, the temporary removal of the securities to serve as a pledge for a loan (hypothecation of securities).

- B. An engagement involving investment securities would eventually uncover an outright theft assuming no alteration of the asset records.
- C. Obtaining a fidelity bond is contingent upon the character of the employee, not the presence of a specific control.
- D. The bank maintains a record of visits.

**87. One of two office clerks in a small organization prepares a sales invoice; however, the invoice is incorrectly entered by the bookkeeper in the general ledger and the accounts receivable subsidiary ledger for a smaller amount resulting from a transposition of digits. The customer subsequently remits the amount on the monthly statement. Assuming only three employees are in the department, the most effective control to prevent this type of error is**

A. Assigning the second office clerk to make an independent check of prices, discounts, extensions, footings, and invoice serial numbers.

B. Requiring that monthly statements be prepared by the bookkeeper and verified by one of the other office clerks prior to mailing.

C. Using predetermined totals to control posting routines.

D. Requiring the bookkeeper to perform periodic reconciliations of the accounts receivable subsidiary ledger and the general ledger.

Answer (C) is correct.

A control total (total amount of sales invoices) should be generated for the transactions to be posted. It should then be compared with the total of items posted to the individual accounts (total of amounts posted to the general ledger and the accounts receivable subsidiary ledger).

A. The misposting was an error that occurred subsequent to this step.

B. These controls will not detect an initial misposting. The statements and the reconciliation are based on the misposted records.

D. These controls will not detect an initial misposting. The statements and the reconciliation are based on the misposted records.

**88. Which of the following aspects of the administration of a compensation program is the most important control in the long run?**

A. An informal wage and salary policy to be competitive with the industry average.

B. A plan of job classifications based on predefined evaluation criteria.

C. A wage and salary review plan for individual employee compensation.

D. A level of general compensation that is reasonably competitive.

Answer (B) is correct.

Job classifications and grades are established during the job analysis phase and the general level of compensation in the community and in the industry must be determined. Compensation is then fixed based on the plan of job classifications, usually within a range for each grade. A range is necessary to allow for flexibility. Compensation should be low enough to avoid excess cost and to permit competitive pricing but high enough to attract needed personnel.

A. A vague policy would contribute little if anything to the fair administration of compensation programs.

C. A plan for reviewing individual compensation presupposes a classification plan.

D. Reasonably competitive compensation is predicated on a classification plan.

**89. To minimize potential financial losses associated with physical assets, the assets should be insured in an amount that is**

A. Supported by periodic appraisals.

B. Determined by the board of directors.

- C. Automatically adjusted by an economic indicator such as the consumer price index.
- D. Equal to the book value of the individual assets.

A. Answer (A) is correct.

Based on the results of the risk assessment, the internal audit activity should evaluate the adequacy and effectiveness of controls encompassing the organization's governance, operations, and information systems. This should include, among other things, safeguarding of assets (Impl. Std. 2120.A1). Safeguarding assets includes insuring them. The types and amounts of insurance should be supported by periodic appraisals.

- B. The determination of insurance coverage is not a function of the board of directors.
- C. The consumer price index generally does not provide an appropriate adjustment factor for fixed assets.
- D. Book values may not reflect the replacement or real value of an asset.

**90. One control objective of the financing or treasury cycle is the proper authorization of transactions involving debt and equity instruments. Which of the following controls would best meet this objective?**

- A. Segregation of responsibility for custody of funds from recording of the transaction.
- B. Written policies requiring review of major funding or repayment proposals by the board.
- C. Use of an underwriter in all cases of new issue of debt or equity instruments.
- D. Requiring two signatures on all checks of a material amount.

Answer (B) is correct.

The control objective of authorization relates to the proper execution of transactions in accordance with management's wishes. One means of achieving this control objective is the establishment of policies as guides to action. When a decision affects the capitalization of the entity, a policy should be in force requiring review at the highest level.

- A. Segregation of responsibility for custody of funds from recording of the transaction concerns the objective of safeguarding of assets, not authorization.
- C. Use of an underwriter in all cases of new issue of debt or equity instruments does not state a control but rather a specific means of issuing securities.
- D. In most organizations, the authorization occurs at a managerial level above that at which transactions are executed. For example, certain employees may be authorized to make payments up to a certain amount. The second signature is by another employee who thereby confirms that the entity's policies and procedures have been followed.

**91. Which of the following describes a control weakness?**

- A. Purchasing procedures are well designed and are followed unless otherwise directed by the purchasing supervisor.
- B. Prenumbered blank purchase orders are secured within the purchasing department.
- C. Normal operational purchases fall in the range from US \$500 to US \$1,000 with two signatures required for purchases over US \$1,000.

D.The purchasing agent invests in a publicly traded mutual fund that lists the stock of one of the organization's suppliers in its portfolio.

Answer (A) is correct.

Well-designed procedures that are set aside at management's discretion are not adequate controls. Control procedures must be followed consistently to be effective. However, the possibility of management override is an inherent limitation of internal control.

B.Use of prenumbered blank purchase orders secured within the purchasing department is a common control.

C.Requiring a more stringent authorization procedure for larger purchases is an appropriate control as long as documentation supports the purchases.

D.The purchasing agent's mutual fund investment should not be a conflict of interest. The relationship between the return on the investment and any possible action by the agent to favor the supplier is very weak.

**92.A manufacturer uses large quantities of small, inexpensive items, such as nuts, bolts, washers, and gloves, in the production process. As these goods are purchased, they are recorded in inventory in bulk amounts. Bins are located on the shop floor to provide timely access to these items. When necessary, the bins are refilled from inventory, and the cost of the items is charged to a consumable supplies account, which is part of shop overhead. Which of the following would be an appropriate improvement of controls in this environment?**

A.Relocate bins to the inventory warehouse.

B.Require management review of reports on the cost of consumable items used in relation to budget.

C.Lock the bins during normal working hours.

D.None of these controls are needed for items of minor cost and size.

Answer (B) is correct.

In accordance with the cost-benefit criterion, control expenditures for manufacturing supplies (nuts, bolts, etc.) should be minimal. Nevertheless, some controls should be implemented. For example, usage should be estimated and compared with stock balances and also with the number of using personnel. Moreover, variances should be calculated for the difference between costs incurred and budgeted amounts.

A.The bins should be on the shop floor where the nuts, bolts, etc., are needed.

C.Locking the bins would limit the efficiency and effectiveness of shop personnel.

D.Controls are needed even for items of minor cost and size.

**93.During the preliminary survey for an audit of one of an organization's manufacturing plants, an auditor discovers that the plant experiences production problems with costs far in excess of those budgeted and with finished goods inventory levels that are clearly excessive. Which of the following management control procedures would have best brought the problems to management's attention earlier?**

A.Implementing standard costing procedures at each plant, with a summary of variances reported to management on a weekly basis.

B.Establishing perpetual inventory control procedures at each plant, with a report detailing any inventory items with levels in excess of two weeks' production provided to management on a weekly basis.

C.Planning monthly production based on management forecasts, with a report comparing actual production with forecasted production and actual costs with budgeted costs provided to management on a weekly basis.

D.Comparing actual sales with forecasted sales and budgeted gross margin with actual gross margin, with a report provided to management on a weekly basis.

Answer (C) is correct.

Comparing actual production with management forecasts detects whether finished goods inventory is excessive, and comparing actual costs with budgeted costs detects unfavorable cost variances.

A.Standard costing detects unfavorable cost variances but not excess finished goods inventory.

B.Perpetual inventory control procedures detect excess finished goods inventory but not unfavorable cost variances.

D.Because cost of goods sold is a component of gross margin, comparing actual and budgeted sales and actual and budgeted gross margin procedures may detect unfavorable cost variances, not excess finished goods inventory.

**PART-1 UNIT 7**

**1. One factor that distinguishes fraud from other employee crimes is that fraud involves**

- A. Intentional deception.
- B. Personal gain for the perpetrator.
- C. Collusion with a party outside the organization.
- D. Malicious motives.

Answer (A) is correct.

Fraud is defined in The IIA Glossary as “any illegal act characterized by deceit, concealment, or violation of trust. These acts are not dependent upon the threat of violence or physical force.”

- B. Fraud may be perpetrated for the organization’s benefit or for otherwise unselfish reasons.
- C. An employee may act alone
- D. Fraud may be perpetrated for the organization’s benefit or for otherwise unselfish reasons.

**2. In the course of their work, internal auditors must be alert for fraud and other forms of white-collar crime. The important characteristic that distinguishes fraud from other varieties of white-collar crime is that**

- A. Fraud is characterized by deceit, concealment, or violation of trust.
- B. Unlike other white-collar crimes, fraud is always perpetrated against an outside party.
- C. White-collar crime is usually perpetrated for the benefit of an organization, but fraud benefits an individual.
- D. White-collar crime is usually perpetrated by outsiders to the detriment of an organization, but fraud is perpetrated by insiders to benefit the organization.

Answer (A) is correct.

Fraud is defined in The IIA Glossary as “any illegal act characterized by deceit, concealment, or violation of trust. These acts are not dependent upon the threat of violence or physical force.”

- B. Fraud may be perpetrated internally.
- C. Fraud may be perpetrated for the organization's benefit or for otherwise unselfish reasons.
- D. Fraud may be perpetrated by insiders and outsiders, and it may be either beneficial or detrimental to an organization.

**3. A key feature that distinguishes fraud from other types of crime or impropriety is that fraud always involves the**

- A. Violent or forceful taking of property.
- B. Deceitful wrongdoing of management-level personnel.
- C. Unlawful conversion of property that is lawfully in the custody of the perpetrator.
- D. False representation or concealment of a material fact.

Answer (D) is correct.

Fraud is defined in The IIA Glossary as "any illegal act characterized by deceit, concealment, or violation of trust. These acts are not dependent upon the threat of violence or physical force."

- A. Fraud usually does not involve force or violence.
- B. Employees at any level in an organization can commit fraud.
- C. Embezzlement is the unlawful conversion of property that is lawfully in the custody of the perpetrator.

**4. What is the responsibility of the internal auditor with respect to fraud?**

- A. The internal auditor should have sufficient knowledge to identify the indicators of fraud but is not expected to be an expert.
- B. The internal auditor should have the same ability to detect fraud as a person whose primary responsibility is detecting and investigating fraud.
- C. An internal auditor should have sufficient knowledge and training so that (s)he is able to detect fraud.
- D. An internal auditor's primary role is to detect and investigate fraud.

Answer (A) is correct.

Internal auditors must have sufficient knowledge to evaluate the risk of fraud and the manner in which it is managed by the organization. They are not expected to have the expertise of a person whose primary responsibility is detecting and investigating fraud (Impl. Std. 1210.A2).

B.The internal auditor is not expected to have the expertise of a person whose primary responsibility is detecting and investigating fraud.

C.An internal auditor must have sufficient knowledge to identify the indicators of fraud but is not required to have sufficient knowledge and training to be able to detect fraud.

D.Detecting and investigating fraud is not a primary role of an internal auditor.

**5.Internal auditors should have knowledge about factors (red flags) that have proven to be associated with management fraud. Which of the following factors have generally not been associated with management fraud?**

A.Generous performance-based reward systems.

B.A domineering management.

C.Regular comparison of actual results with budgets.

D.A management preoccupation with increased financial performance.

Answer (C) is correct.

Regular comparison of actual results to budgets provides feedback and is a normal and necessary part of the control loop. Ineffective control is an indicator of possible fraud.

A.Generous reward systems provide incentives for management to distort performance

B.Pressure from superiors provides an incentive for management to distort performance

D.A management preoccupation with increased financial performance provides an incentive for managers to distort performance.

**6.When auditing the award of a major contract, which of the following should an internal auditor suspect as a red flag for a bidding fraud scheme?**

A.Subsequent change orders increase requirements for low-bid items.

B.Material contract requirements are different on the actual contract than on the request for bids.

C.A high percentage of employees are charged to indirect accounts.

D.Losing bidders are not given feedback.

Answer (B) is correct.

The internal audit activity must evaluate the potential for the occurrence of fraud and how the organization manages fraud risk (Impl. Std. 2120.A2). According to The IIA Glossary, fraud is any illegal act characterized by deceit, concealment, or violation of trust. It is fraudulent for the material contract requirements on the request for bids to differ from the actual contract. This type of fraud

inflates bid amounts by having more bidder friendly requirements on the request for bids than on the actual contract.

- A. Subsequent change orders that increase requirements for low-bid items are routine occurrences.
- C. A high percentage of employees may perform work resulting in costs properly classified as overhead.
- D. Not providing losing bidders with feedback is a common business practice.

**7. A medium-sized regional firm distributes packaged snack foods to convenience stores. A routine inventory has revealed significant amounts of inventory missing from the delivery trucks. Which of the following suggests a control weakness that may provide an opportunity for fraud?**

- A. The policy and procedure manual clearly defines allowed and prohibited actions.
- B. Careful counts are made as inventory is loaded on the trucks.
- C. Access to the warehouse is restricted to a few trusted employees.
- D. Truck drivers are allowed to use the trucks for personal reasons, including taking them home at night, as a benefit of employment.

Answer (D) is correct.

Unrestricted access to the trucks creates opportunities for theft of merchandise by the drivers.

- A. A detailed policy and procedure manual is a control strength.
- B. Inventory counts made at the time the trucks are loaded will help to bring the shortages to management's attention but will not prevent them.
- C. Restricting access to the warehouse is a control strength.

**8. In an organization with a separate division that is primarily responsible for the prevention of fraud, the internal audit activity is responsible for**

- A. Examining and evaluating the adequacy and effectiveness of that division's actions taken to prevent fraud.
- B. Establishing and maintaining that division's system of internal control.
- C. Planning that division's fraud prevention activities.
- D. Controlling that division's fraud prevention activities.

Answer (A) is correct.

Control is the principal means of preventing fraud. Management is primarily responsible for the establishment and maintenance of control. Internal auditors are primarily responsible for preventing fraud by examining and evaluating the adequacy and effectiveness of control.

- B. Establishing and maintaining control is a responsibility of management.
- C. Planning fraud prevention activities is a responsibility of management.
- D. Controlling fraud prevention activities is a responsibility of management.

**9. Which of the following wrongful acts committed by an employee constitutes fraud?**

- A. Libel.
- B. Embezzlement.
- C. Assault.
- D. Harassment.

Answer (B) is correct.

Fraud is defined in The IIA Glossary as “any illegal act characterized by deceit, concealment, or violation of trust. These acts are not dependent upon the threat of violence or physical force. Frauds are perpetrated by parties and organizations to obtain money, property, or services; to avoid payment or loss of services; or to secure personal or business advantage.” Embezzlement is the intentional appropriation of property entrusted to one’s care. The embezzler converts property to his or her own use and conceals the theft.

- A. Libel is defamation published in a relatively permanent form (newspaper, letter, film, etc.)
- C. The tort of assault entails placing another in reasonable fear of a harmful or offensive bodily contact.
- D. Harassment is the act of persistently annoying another.

**10. The chief of an organization’s security received an anonymous call accusing a marketing manager of taking kickbacks from a media outlet. Thus, the marketing department is on the list of possible engagement clients for the coming year. The internal audit activity is assigned responsibility for investigating fraud by its charter. If obtaining access to outside media outlet records and personnel is not possible, the best action an internal auditor could take to investigate the allegation of marketing kickbacks is to**

- A. Search for unrecorded liabilities from media outlets.
- B. Obtain a list of approved media outlets.
- C. Develop a financial and behavioral profile of the suspect.
- D. Vouch any material past charge-offs of receivables.

Answer (C) is correct.

A common indicator of fraud by an employee is an unexplained change in his or her financial status. A standard of living not commensurate with the employee's income may signify wrongdoing. The employee's behavior may also be suspicious (for example, constant association with, and entertainment by, a member of the media outlet's staff). The profile may help to corroborate illegal income and thereby provide a basis for tracing illegal payments to the employee.

A.If the employee is taking kickbacks, unrecorded liabilities are not being created.

B.A list of approved media outlets would not provide any information about kickbacks.

D.The receipt of kickbacks would have no effect on accounts receivable.

**11.After noting some red flags, an internal auditor has an increased awareness that fraud may be present. Which of the following best describes the internal auditor's responsibility?**

A.Expand activities to determine whether an investigation is warranted.

B.Report the possibility of fraud to senior management and the board and ask them how they would like to proceed.

C.Consult with external legal counsel to determine the course of action to be taken, including the approval of the proposed engagement work program to make sure it is acceptable on legal grounds.

D.Report the matter to the audit committee and request funding for outside service providers to help investigate the possible fraud.

Answer (A) is correct.

An internal auditor's responsibilities for detecting fraud include evaluating fraud indicators and deciding whether any additional action is necessary or whether an investigation should be recommended.

B.The internal auditor should notify the appropriate authorities within the organization if (s)he has determined that the indicators of fraud are sufficient to recommend an investigation.

C.The internal auditor is responsible for determining the appropriate response to indicators of fraud. Legal counsel can act only in an advisory capacity.

D.The internal auditor should report the matter and request funding for outside service providers only if (s)he has determined that the indicators of fraud are sufficient to recommend an investigation.

**12.An internal auditor who suspects fraud should**

A.Determine that a loss has been incurred.

B.Interview those who have been involved in the control of assets.

C.Identify the employees who could be implicated in the case.

D.Recommend an investigation if appropriate.

Answer (D) is correct.

An internal auditor's responsibilities for detecting fraud include evaluating fraud indicators and deciding whether any additional action is necessary or whether an investigation should be recommended.

A.Determining the loss could alert the perpetrator of the fraud. The perpetrator could then destroy or compromise evidence.

B.Interviewing those who have been involved in the control of assets is part of the fraud investigation.

C.Identifying the employees who could be implicated in the case is part of the fraud investigation

**13.Fact Pattern: An international nonprofit organization finances medical research. The majority of its revenue and support comes from fundraising activities, investments, and specific grants from an initial sponsoring corporation. The organization has been in operation over 15 years and has a small internal audit department. The organization has just finished a major fundraising drive that raised US \$500 million for the current fiscal period.**

**The following are selected data from recent financial statements (US dollar figures in millions):**

	<b>Current Year</b>	<b>Past Year</b>
<b>Revenue</b>	<b>US \$500</b>	<b>US \$425</b>
<b>Investments (average balances)</b>	<b>210</b>	<b>185</b>
<b>Medical research grants made</b>	<b>418</b>	<b>325</b>
<b>Investment income</b>	<b>16</b>	<b>20</b>
<b>Administrative expense</b>	<b>10</b>	<b>6</b>

**Q.Auditors must always be alert for the possibility of fraud. Assume the controls over each risk listed below are marginal. Which of the following possible frauds or misuses of organization assets should be considered the area of greatest risk?**

A.The president is using company travel and entertainment funds for activities that might be considered questionable.

B.Purchases of supplies are made from fictitious vendors.

C.Grants are made to organizations that might be associated with the president or are not for purposes dictated in the organization's charter.

D.The payroll clerk has added ghost employees.

Answer (C) is correct.

Grants represent 83.6% ( $\text{US } \$418 \div \$500$ ) of current revenue. Consequently, fraudulent grants constitute a much greater risk exposure than any of the other items listed.

A.Administrative expense is 2% ( $\text{US } \$10 \div \$500$ ) of current revenue.

B.Purchases of supplies from fictitious vendors involve risk exposures that are far smaller than those arising from inappropriate grants.

D.The payroll clerk's addition of ghost employees involves risk exposures that are far smaller than those arising from inappropriate grants.

14.Internal auditors are more likely to detect fraud by developing/strengthening their ability to

A.Recognize and question changes that occur in organizations.

B.Interrogate fraud perpetrators to discover why the fraud was committed.

C.Develop internal controls to prevent the occurrence of fraud.

D.Document computerized operating system programs.

Answer (A) is correct.

An internal auditor's responsibilities for detecting fraud include evaluating fraud indicators and deciding whether any additional action is necessary or whether an investigation should be recommended.

B.Interrogation of fraud perpetrators occurs after detection. The danger signals of fraud often involve negative organizational changes.

C.The controls mentioned are preventive, not detective.

D.Documentation of operating systems is not within the scope of internal auditing and would do little to enhance fraud detection skills.

**15.When an internal auditor identifies multiple factors that have been linked with possible fraudulent conditions and suspects that fraud has taken place, the auditor should**

A.Immediately report to senior management and the board.

- B.Immediately report to the board.
- C.Recommend an investigation.
- D.Extend tests to determine the extent of the fraud.

C.Answer (C) is correct.

An internal auditor's responsibilities for detecting fraud include evaluating fraud indicators and deciding whether any additional action is necessary or whether an investigation should be recommended.

- A.Immediate reporting by the CAE to senior management and the board is required only after a sufficient investigation has been made to establish reasonable certainty that a significant fraud has occurred. Thus, reasonable certainty is necessary before any fraud reporting is made.
- B.Immediate reporting by the CAE to senior management and the board is required only after a sufficient investigation has been made to establish reasonable certainty that a significant fraud has occurred. Thus, reasonable certainty is necessary before any fraud reporting is made.
- D.Extended tests to determine the extent of fraud are performed after the fraud has in fact been determined, not suspected.

**16..An internal auditor suspects that a mailroom clerk is embezzling funds. In exercising due professional care, the internal auditor should**

- A.Reassign the clerk to another department.
- B.Institute stricter controls over mailroom operations.
- C.Evaluate fraud indicators and decide whether further action is necessary.
- D.Confront the clerk with the auditor's suspicions.

Answer (C) is correct.

An internal auditor's responsibilities for detecting fraud include evaluating fraud indicators and deciding whether any additional action is necessary or whether an investigation should be recommended.

- A.Personnel assignments are the responsibility of management.
- B.The system of internal controls is management's responsibility.
- D.An internal auditor should not confront a suspect until the proper authorities have been notified and have determined the appropriate action.

**17.An internal auditor's field work uncovers a series of transactions that indicate a possible embezzlement. Which of the following actions should the chief audit executive take?**

- A. Confront the suspected embezzler to determine that the facts are correct.
- B. Review the finding with the suspect's fellow workers to see whether the workers can furnish additional evidence.
- C. Decide whether to recommend an investigation.
- D. Discuss the case with the board.

Answer (C) is correct.

An internal auditor's responsibilities for detecting fraud include evaluating fraud indicators and deciding whether any additional action is necessary or whether an investigation should be recommended.

- A. The internal auditor should avoid confronting suspected employees. Employees suspected of theft or fraud have certain common law and statutory rights that, if infringed upon, can be costly to the organization.
- B. Fellow workers may also be involved in the embezzlement.
- D. The CAE should determine the extent, if any, of the fraud before presenting it to the board.

**18. Which of the following best describes an auditor's responsibility after noting some indicators of fraud?**

- A. Expand activities to determine whether an investigation is warranted.
- B. Report the possibility of fraud to senior management and ask how to proceed.
- C. Consult with external legal counsel to determine the course of action to be taken.
- D. Report the matter to the audit committee and request funding for outside specialists to help investigate the possible fraud.

Answer (A) is correct.

An internal auditor's responsibilities for detecting fraud include evaluating fraud indicators and deciding whether any additional action is necessary or whether an investigation should be recommended.

- B. The internal auditor should notify senior management and the board only if (s)he has determined that the indicators of fraud are sufficient to recommend an investigation.
- C. The internal auditor does not have the authority to consult with external legal counsel.
- D. The internal auditor should notify the audit committee only if (s)he has determined that the indicators of fraud are sufficient to recommend an investigation.

**19. Which of the following policies is most likely to result in an environment conducive to the occurrence of fraud?**

- A. Budget preparation input by the employees who are responsible for meeting the budget.
- B. Unreasonable sales and production goals.
- C. The division's hiring process frequently results in the rejection of adequately trained applicants.
- D. The application of some accounting controls on a sample basis.

Answer (B) is correct.

Unrealistically high sales or production quotas can be an incentive to falsify the records or otherwise take inappropriate action to improve performance measures so that the quotas appear to have been met.

A. Participatory budgeting can reduce resistance to budgets and reduce the likelihood of inappropriate means being taken to meet the budget.

C. Hiring policies should be based on factors other than adequate training, such as the applicants' personal integrity. Furthermore, hiring of all adequately trained applicants is unlikely to be necessary.

D. Under the reasonable assurance concept, the cost of controls should not exceed their benefits. The cost of applying controls to all relevant transactions rather than a sample may be greater than the resultant savings.

**20. The following are facts about a subsidiary:**

- 1. The subsidiary has been in business for several years and enjoyed good profit margins although the general economy was in a recession, which affected competitors.**
- 2. The working capital ratio has declined from a healthy 3:1 to 0.9:1.**
- 3. Turnover for the last several years has included three controllers, two supervisors of accounts receivable, four payables supervisors, and numerous staff in other financial positions.**
- 4. Purchasing policy requires three bids. However, the supervisor of purchasing at the subsidiary has instituted a policy of sole-source procurement to reduce the number of suppliers.**

**When conducting a financial audit of the subsidiary, the internal auditor should**

- A. Most likely not detect 1, 2, or 3.
- B. Ignore 2 since the economy had a downturn during this period.
- C. Consider 3 to be normal turnover, but be concerned about 2 and 4 as warning signals of fraud.
- D. Consider 1, 2, 3, and 4 as warning signals of fraud.

Answer (D) is correct.

The organization's reporting of high profits when competitors have not may indicate a material misstatement in the financial statements. Insufficient working capital may indicate such problems as overexpansion, decreases in revenues, transfers of funds to other organizations, insufficient credit, and excessive expenditures. The internal auditor should be alert for the diversion of funds for personal use through such methods as unrecorded sales and falsified expenditures. Rapid turnover in financial positions may signify existing problems with which the individuals feel uncomfortable but that they do not want to disclose. Accountability for funds and other resources should be determined upon termination of employment. Use of sole-source procurement does not encourage competition to ensure that the organization is obtaining the required materials or equipment at the best price. Sole-source procurement, if not adequately justified, indicates potential favoritism or kickbacks.

A. The items described can be detected through usual procedures in a financial audit.

B. Although the economy suffered a downturn, the change in working capital is unusual in light of the continuing strong profit margins and should be investigated.

C. The working capital ratio, the high employee turnover rate, and the sole-source procurement policy are all warning signals of fraud.

**21. When comparing perpetrators who have embezzled an organization's funds with perpetrators of financial statement fraud (falsified financial statements), those who have falsified financial statements are less likely to**

A. Have experienced an autocratic management style.

B. Be living beyond their obvious means of support.

C. Rationalize the fraudulent behavior.

D. Use organizational expectations as justification for the act.

Answer (B) is correct.

Living beyond one's means has been linked to employee fraud (embezzlement), not to financial statement fraud. Fraud perpetrated for the benefit of the organization ordinarily benefits the wrongdoer indirectly, whereas fraud that is detrimental to the organization provides immediate, direct benefits to the employee.

A. Autocratic management styles have been linked to management (financial statement) fraud.

C. Rationalization is common to all fraud.

D. High expectations are often given as a motivating factor by those who have committed financial statement fraud.

**22. Internal auditors have been advised to consider red flags to determine whether management is involved in a fraud. Which of the following does not represent a difficulty in using the red flags as fraud indicators?**

- A.Many common red flags are also associated with situations in which no fraud exists.
- B.Some red flags are difficult to quantify or to evaluate.
- C.Red flag information is not gathered as a normal part of an engagement.
- D.The red flags literature is not well enough established to have a positive impact on internal auditing.

Answer (D) is correct.

The state of red flags literature is an aid, not a difficulty, in internal auditing. It is well established and will be refined in the future as research is done.

- A.Red flags are developed by correlation analysis, not necessarily by causation analysis.
- B.Many red flags, such as management's attitude, are difficult to quantify.
- C.Internal auditors should be able to identify fraud indicators and should be alert to opportunities that could allow fraud. However, internal auditors do not normally perform procedures specifically to gather red flag information.

**23.An internal auditor should be concerned about the possibility of fraud if**

- A.Cash receipts, net of the amounts used to pay petty cash-type expenditures, are deposited in the bank daily.
- B.The monthly bank statement reconciliation is performed by the same employee who maintains the perpetual inventory records.
- C.The accounts receivable subsidiary ledger and accounts payable subsidiary ledger are maintained by the same person.
- D.One person, acting alone, has sole access to the petty cash fund (except for a provision for occasional surprise counts by a supervisor or auditor).

Answer (A) is correct.

Making petty cash expenditures from cash receipts facilitates the unauthorized removal of cash before deposit. All cash receipts should be deposited intact daily. Petty cash expenditures should be handled through an imprest fund.

- B.The monthly bank reconciliation should not be performed by a person who makes deposits or writes checks, but the inventory clerk has no such responsibilities.
- C.There is no direct relationship between the transactions posted to the accounts receivable and accounts payable subsidiary ledgers; having the same person maintain both does not create a control weakness.

D.To establish accountability for petty cash, only one person should have access to the fund.

**24.Fact Pattern:** Randy and John had known each other for many years. They had become best friends in college, where they both majored in accounting. After graduation, Randy took over the family business from his father. His family had been in the grocery business for several generations. When John had difficulty finding a job, Randy offered him a job in the family store. John proved to be a very capable employee. As John demonstrated his abilities, Randy began delegating more and more responsibility to him. After a period of time, John was doing all of the general accounting and authorization functions for checks, cash, inventories, documents, records, and bank reconciliations. (1) John was trusted completely and handled all financial functions. No one checked his work.

Randy decided to expand the business and opened several new stores. (2) Randy was always handling the most urgent problem . . . “crisis management” is what his college professors had termed it. John assisted with the problems when his other duties allowed him time.

Although successful at work, John had (3) difficulties with personal financial problems.

At first, the amounts stolen by John were small. John didn’t even worry about making the accounts balance. But John became greedy. “How easy it is to take the money,” he said. He felt that he was a critical member of the business team (4) and that he contributed much more to the success of the company than was represented by his salary. “It would take two or three people to replace me,” he often thought to himself. As the amounts became larger and larger, (5) he made the books balance. Because of these activities, John was able to purchase an expensive car and take his family on several trips each year. (6) He also joined an expensive country club. Things were changing at home, however. (7) John’s family observed that he was often argumentative and at other times very depressed.

The fraud continued for 6 years. Each year, the business performed more and more poorly. In the last year, the stores had a substantial net loss. Randy’s bank required an audit. John confessed when he thought the auditors had discovered his embezzlements.

When discussing frauds, the pressures, opportunities, and rationalizations that cause/allow a perpetrator to commit the fraud are often identified. Symptoms of fraud are also studied.

**Q:**Number 1, “John was trusted completely . . .,” is an example of a(n)

- A.Document symptom.
- B.Situational pressure.
- C.Opportunity to commit.
- D.Physical symptom.

Answer (C) is correct.

Complete trust in an individual is an opportunity to commit fraud. John's actions went unscrutinized because of the absence of an appropriate segregation of functions and his ability to override whatever control procedures were in place.

A. Complete trust is an opportunity to commit a fraud.

B. Complete trust is an opportunity to commit a fraud.

D. Complete trust is an opportunity to commit a fraud.

**25. Fact Pattern:** Randy and John had known each other for many years. They had become best friends in college, where they both majored in accounting. After graduation, Randy took over the family business from his father. His family had been in the grocery business for several generations. When John had difficulty finding a job, Randy offered him a job in the family store. John proved to be a very capable employee. As John demonstrated his abilities, Randy began delegating more and more responsibility to him. After a period of time, John was doing all of the general accounting and authorization functions for checks, cash, inventories, documents, records, and bank reconciliations. (1) John was trusted completely and handled all financial functions. No one checked his work.

Randy decided to expand the business and opened several new stores. (2) Randy was always handling the most urgent problem . . . "crisis management" is what his college professors had termed it. John assisted with the problems when his other duties allowed him time.

Although successful at work, John had (3) difficulties with personal financial problems.

At first, the amounts stolen by John were small. John didn't even worry about making the accounts balance. But John became greedy. "How easy it is to take the money," he said. He felt that he was a critical member of the business team (4) and that he contributed much more to the success of the company than was represented by his salary. "It would take two or three people to replace me," he often thought to himself. As the amounts became larger and larger, (5) he made the books balance. Because of these activities, John was able to purchase an expensive car and take his family on several trips each year. (6) He also joined an expensive country club. Things were changing at home, however. (7) John's family observed that he was often argumentative and at other times very depressed.

The fraud continued for 6 years. Each year, the business performed more and more poorly. In the last year, the stores had a substantial net loss. Randy's bank required an audit. John confessed when he thought the auditors had discovered his embezzlements.

When discussing frauds, the pressures, opportunities, and rationalizations that cause/allow a perpetrator to commit the fraud are often identified. Symptoms of fraud are also studied.

**Q:** Number 2, "Randy was always handling the most urgent . . .," is an example of a(n)

A. Opportunity to commit.

- B. Analytical symptom.
- C. Situational pressure.
- D. Rationalization.

Answer (A) is correct.

When a manager continually handles the most pressing issues of an organization, an opportunity for the manager to commit fraud is created. The lack of long-range planning creates a potential for fraud because organizational objectives may have been replaced with individual initiatives.

- B. Crisis management provides an opportunity to commit fraud.
- C. Crisis management provides an opportunity to commit fraud
- D. Crisis management provides an opportunity to commit fraud.

**26. Fact Pattern:** Randy and John had known each other for many years. They had become best friends in college, where they both majored in accounting. After graduation, Randy took over the family business from his father. His family had been in the grocery business for several generations. When John had difficulty finding a job, Randy offered him a job in the family store. John proved to be a very capable employee. As John demonstrated his abilities, Randy began delegating more and more responsibility to him. After a period of time, John was doing all of the general accounting and authorization functions for checks, cash, inventories, documents, records, and bank reconciliations. (1) John was trusted completely and handled all financial functions. No one checked his work.

Randy decided to expand the business and opened several new stores. (2) Randy was always handling the most urgent problem . . . “crisis management” is what his college professors had termed it. John assisted with the problems when his other duties allowed him time.

Although successful at work, John had (3) difficulties with personal financial problems.

At first, the amounts stolen by John were small. John didn’t even worry about making the accounts balance. But John became greedy. “How easy it is to take the money,” he said. He felt that he was a critical member of the business team (4) and that he contributed much more to the success of the company than was represented by his salary. “It would take two or three people to replace me,” he often thought to himself. As the amounts became larger and larger, (5) he made the books balance. Because of these activities, John was able to purchase an expensive car and take his family on several trips each year. (6) He also joined an expensive country club. Things were changing at home, however. (7) John’s family observed that he was often argumentative and at other times very depressed.

The fraud continued for 6 years. Each year, the business performed more and more poorly. In the last year, the stores had a substantial net loss. Randy’s bank required an audit. John confessed when he thought the auditors had discovered his embezzlements.

**When discussing frauds, the pressures, opportunities, and rationalizations that cause/allow a perpetrator to commit the fraud are often identified. Symptoms of fraud are also studied.**

**Q: Number 3, “Difficulties with personal financial problems,” is an example of a(n)**

- A. Behavioral symptom.
- B. Situational pressure.
- C. Rationalization.
- D. Opportunity to commit.

Answer (B) is correct.

Financial difficulties create situational pressures or temptations that may contribute to fraud. These situational pressures result from high personal indebtedness, extravagant lifestyles, gambling problems, etc.

- A. Personal financial problems are a situational pressure to commit a fraud.
- C. Personal financial problems are a situational pressure to commit a fraud.
- D. Personal financial problems are a situational pressure to commit a fraud.

**27. Fact Pattern:** Randy and John had known each other for many years. They had become best friends in college, where they both majored in accounting. After graduation, Randy took over the family business from his father. His family had been in the grocery business for several generations. When John had difficulty finding a job, Randy offered him a job in the family store. John proved to be a very capable employee. As John demonstrated his abilities, Randy began delegating more and more responsibility to him. After a period of time, John was doing all of the general accounting and authorization functions for checks, cash, inventories, documents, records, and bank reconciliations. (1) John was trusted completely and handled all financial functions. No one checked his work.

Randy decided to expand the business and opened several new stores. (2) Randy was always handling the most urgent problem . . . “crisis management” is what his college professors had termed it. John assisted with the problems when his other duties allowed him time.

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At first, the amounts stolen by John were small. John didn’t even worry about making the accounts balance. But John became greedy. “How easy it is to take the money,” he said. He felt that he was a critical member of the business team (4) and that he contributed much more to the success of the company than was represented by his salary. “It would take two or three people to replace me,” he often thought to himself. As the amounts became larger and larger, (5) he made the books balance. Because of these activities, John was able to purchase an expensive car and take his family on several trips each year. (6) He also joined an expensive country club. Things

were changing at home, however. (7) John's family observed that he was often argumentative and at other times very depressed.

The fraud continued for 6 years. Each year, the business performed more and more poorly. In the last year, the stores had a substantial net loss. Randy's bank required an audit. John confessed when he thought the auditors had discovered his embezzlements.

When discussing frauds, the pressures, opportunities, and rationalizations that cause/allow a perpetrator to commit the fraud are often identified. Symptoms of fraud are also studied.

**Q:**Number 4, "and that he contributed much more . . ." is an example of a

- A. Rationalization.
- B. Behavioral symptom.
- C. Situational pressure.
- D. Physical symptom.

Answer (A) is correct.

Rationalization occurs when a person attributes his or her actions to rational and creditable motives without analysis of one's true and especially unconscious motives. Feeling that one is not being paid as much as one is worth is a common rationalization for low-level fraud.

- B. The belief that compensation is inadequate is a possible rationalization for improprieties.
- C. The belief that compensation is inadequate is a possible rationalization for improprieties.
- D. The belief that compensation is inadequate is a possible rationalization for improprieties.

**28. Fact Pattern:** Randy and John had known each other for many years. They had become best friends in college, where they both majored in accounting. After graduation, Randy took over the family business from his father. His family had been in the grocery business for several generations. When John had difficulty finding a job, Randy offered him a job in the family store. John proved to be a very capable employee. As John demonstrated his abilities, Randy began delegating more and more responsibility to him. After a period of time, John was doing all of the general accounting and authorization functions for checks, cash, inventories, documents, records, and bank reconciliations. (1) John was trusted completely and handled all financial functions. No one checked his work.

Randy decided to expand the business and opened several new stores. (2) Randy was always handling the most urgent problem . . . "crisis management" is what his college professors had termed it. John assisted with the problems when his other duties allowed him time.

Although successful at work, John had (3) difficulties with personal financial problems.

At first, the amounts stolen by John were small. John didn't even worry about making the accounts balance. But John became greedy. "How easy it is to take the money," he said. He felt that he was a critical member of the business team (4) and that he contributed much more to the success of the company than was represented by his salary. "It would take two or three people to replace me," he often thought to himself. As the amounts became larger and larger, (5) he made the books balance. Because of these activities, John was able to purchase an expensive car and take his family on several trips each year. (6) He also joined an expensive country club. Things were changing at home, however. (7) John's family observed that he was often argumentative and at other times very depressed.

The fraud continued for 6 years. Each year, the business performed more and more poorly. In the last year, the stores had a substantial net loss. Randy's bank required an audit. John confessed when he thought the auditors had discovered his embezzlements.

When discussing frauds, the pressures, opportunities, and rationalizations that cause/allow a perpetrator to commit the fraud are often identified. Symptoms of fraud are also studied.

**Q: Number 5, "he made the books balance," is an example of a(n)**

- A. Physical symptom.
- B. Analytical symptom.
- C. Lifestyle symptom.
- D. Document symptom.

Answer (D) is correct.

Tampering with accounting records is a document symptom. The indicator of fraud consists of the changes in actual company records.

- A. Making the "books balance" is an example of a document symptom.
- B. Making the "books balance" is an example of a document symptom.
- C. Making the "books balance" is an example of a document symptom.

**29. Fact Pattern:** Randy and John had known each other for many years. They had become best friends in college, where they both majored in accounting. After graduation, Randy took over the family business from his father. His family had been in the grocery business for several generations. When John had difficulty finding a job, Randy offered him a job in the family store. John proved to be a very capable employee. As John demonstrated his abilities, Randy began delegating more and more responsibility to him. After a period of time, John was doing all of the general accounting and authorization functions for checks, cash, inventories, documents, records, and bank reconciliations. (1) John was trusted completely and handled all financial functions. No one checked his work.

Randy decided to expand the business and opened several new stores. (2) Randy was always handling the most urgent problem . . . “crisis management” is what his college professors had termed it. John assisted with the problems when his other duties allowed him time.

Although successful at work, John had (3) difficulties with personal financial problems.

At first, the amounts stolen by John were small. John didn't even worry about making the accounts balance. But John became greedy. “How easy it is to take the money,” he said. He felt that he was a critical member of the business team (4) and that he contributed much more to the success of the company than was represented by his salary. “It would take two or three people to replace me,” he often thought to himself. As the amounts became larger and larger, (5) he made the books balance. Because of these activities, John was able to purchase an expensive car and take his family on several trips each year. (6) He also joined an expensive country club. Things were changing at home, however. (7) John's family observed that he was often argumentative and at other times very depressed.

The fraud continued for 6 years. Each year, the business performed more and more poorly. In the last year, the stores had a substantial net loss. Randy's bank required an audit. John confessed when he thought the auditors had discovered his embezzlements.

When discussing frauds, the pressures, opportunities, and rationalizations that cause/allow a perpetrator to commit the fraud are often identified. Symptoms of fraud are also studied.

**Q: Number 6, “He also joined an expensive country club,” is an example of a**

- A. Rationalization.
- B. Lifestyle symptom.
- C. Behavioral symptom.
- D. Physical symptom.

Answer (B) is correct.

John was living beyond his means. The change in lifestyle was a symptom that indicated the presence of fraud.

- A. Joining an expensive country club is an example of a lifestyle symptom.
- C. Joining an expensive country club is an example of a lifestyle symptom.
- D. Joining an expensive country club is an example of a lifestyle symptom.

**30.Fact Pattern:** Randy and John had known each other for many years. They had become best friends in college, where they both majored in accounting. After graduation, Randy took over the family business from his father. His family had been in the grocery business for several generations. When John had difficulty finding a job, Randy offered him a job in the family store. John proved to be a very capable employee. As John demonstrated his abilities, Randy began delegating more and more responsibility to him. After a period of time, John was doing all of the general accounting and authorization functions for checks, cash, inventories, documents, records, and bank reconciliations. (1) John was trusted completely and handled all financial functions. No one checked his work.

Randy decided to expand the business and opened several new stores. (2) Randy was always handling the most urgent problem . . . “crisis management” is what his college professors had termed it. John assisted with the problems when his other duties allowed him time.

Although successful at work, John had (3) difficulties with personal financial problems.

At first, the amounts stolen by John were small. John didn’t even worry about making the accounts balance. But John became greedy. “How easy it is to take the money,” he said. He felt that he was a critical member of the business team (4) and that he contributed much more to the success of the company than was represented by his salary. “It would take two or three people to replace me,” he often thought to himself. As the amounts became larger and larger, (5) he made the books balance. Because of these activities, John was able to purchase an expensive car and take his family on several trips each year. (6) He also joined an expensive country club. Things were changing at home, however. (7) John’s family observed that he was often argumentative and at other times very depressed.

The fraud continued for 6 years. Each year, the business performed more and more poorly. In the last year, the stores had a substantial net loss. Randy’s bank required an audit. John confessed when he thought the auditors had discovered his embezzlements.

When discussing frauds, the pressures, opportunities, and rationalizations that cause/allow a perpetrator to commit the fraud are often identified. Symptoms of fraud are also studied.

**Q:**Number 7, “John’s family observed that he was often argumentative . . .,” is an example of a

- A.Rationalization.
- B.Lifestyle symptom.
- C.Behavioral symptom.
- D.Physical symptom.

Answer (C) is correct.

A drastic change in an employee's behavior may indicate the presence of fraud. The guilt and the other forms of stress associated with perpetrating and concealing the fraud may induce noticeable changes in behavior.

- A. Being argumentative is an example of a behavioral symptom
- B. Being argumentative is an example of a behavioral symptom.
- D. Being argumentative is an example of a behavioral symptom.

**31. Which of the following is an indicator of possible financial reporting fraud being perpetrated by management of a manufacturer?**

- A. A trend analysis discloses (1) sales increases of 50% and (2) cost of goods sold increases of 25%.
- B. A ratio analysis discloses that cost of goods sold is 50% of sales.
- C. A cross-sectional analysis of common size statements discloses that (1) the firm's percentage of cost of goods sold to sales is 40% and (2) the industry average percentage of cost of goods sold to sales is 50%.
- D. A cross-sectional analysis of common size statements discloses that (1) the firm's percentage of cost of goods sold to sales is 50% and (2) the industry average percentage of cost of goods sold to sales is 40%.

Answer (A) is correct.

An increase in sales far out of proportion to the increase in cost of goods sold is an indicator of possible fraud. Increases in sales are usually accompanied by close to proportional increases in cost of goods sold. Examples of situations in which increases in sales can be disproportionately larger than increases in cost of goods sold include (1) operations within the realm of economies of scale (increasing returns to scale) and (2) the introduction of a highly accepted fashion item. Cases in which disproportionately large sales increases indicate fraudulent conduct include (1) collusion by the host firm's sales personnel and the buying firm's purchasing personnel and (2) collusion by members of two departments within the host firm, such as sales and transportation. Because the internal auditor would not know whether the disproportionately large increase in sales is legitimate, the auditor should view this condition as an indicator of possible fraud.

B. A gross profit margin of 50% is not an indicator of fraud. Manufacturers can expect a range of 40-60% for this ratio.

C. These data indicate an industry gross profit margin of 50% and host firm gross profit margin of 60%. The greater gross profit margin realized by the host firm may result from any number of reasonable causes. These include (1) greater efficiencies exercised by the host firm, (2) greater sales effort (or a more highly accepted product), and (3) measurement errors.

D. These data indicate an industry gross profit margin of 60% and a host firm gross profit margin of 50%. The lower gross profit margin realized by the host firm may result from such causes as (1) host firm inefficiencies; (2) less acceptance of host firm product, or less sales effort; and (3) measurement errors.

**32. Which of the following would indicate that fraud may be taking place in a marketing department?**

- A. There is no documentation for some fairly large expenditures made to a new vendor.
- B. A manager appears to be living a lifestyle that is in excess of what could be provided by a marketing manager's salary.
- C. The control environment can best be described as "very loose." However, this attitude is justified by management on the grounds that it is needed for creativity.
- D. All of the answers are correct.

Answer (D) is correct.

An internal auditor's responsibilities for the detection of fraud include having sufficient knowledge to identify indicators that fraud may have been committed; being alert to opportunities, such as control weaknesses, that could allow fraud to occur; and evaluating the indicators of fraud sufficiently to determine whether any further action is needed or whether a fraud investigation should be recommended. Among the many such indicators are lack of timely and appropriate documentation (including information about authorization) for material transactions, suspicious lifestyle characteristics of employees in a position to commit fraud, and management's failure to display and communicate an appropriate attitude toward internal control.

- A. A manager's excessive lifestyle and a loose control environment are also possible fraud indicators.
- B. Large undocumented purchases and a loose control environment are also possible fraud indicators.
- C. Large undocumented purchases and a manager's excessive lifestyle are also possible fraud indicators.

**33. Fact Pattern:** When an internal auditor followed up on a significant increase in maintenance supplies during the past year, a purchasing agent explained to the internal auditor that the primary reason for the increase was painting services and supplies. The internal auditor found a blanket purchase order without the normal bid or quote documentation. The blanket purchase order had been signed by the general manager and named the general manager's father as the sole contractor for painting services on the organization's projects. The auditor also found a number of large invoices, authorized for payment by the general manager, that showed the general manager's father as the person who signed for the receipt of the material at the supplier.

**Q: Which is not a symptom of fraud as described in this situation?**

- A. Purchased material is not received by authorized organizational personnel.
- B. Routine controls are suspended for certain transactions.

- C. Purchased material is not delivered to a central location on the organization's premises.
- D. The use of blanket purchase orders.

Answer (D) is correct.

Fraud is characterized by intentional deception and can be perpetrated for the benefit or to the detriment of the organization. The use of blanket purchase orders is a normal business practice.

- A. The receipt of goods or services by non-organizational personnel is a symptom of fraud
- B. Suspension of normal and appropriate procedures is a fraud indicator.
- C. The receipt of goods or services off-site is a symptom of fraud.

**34. Fact Pattern:** When an internal auditor followed up on a significant increase in maintenance supplies during the past year, a purchasing agent explained to the internal auditor that the primary reason for the increase was painting services and supplies. The internal auditor found a blanket purchase order without the normal bid or quote documentation. The blanket purchase order had been signed by the general manager and named the general manager's father as the sole contractor for painting services on the organization's projects. The auditor also found a number of large invoices, authorized for payment by the general manager, that showed the general manager's father as the person who signed for the receipt of the material at the supplier.

**Q:** What is the common indicator of fraud recognized by the internal auditor in this scenario?

- A. Analytical procedures revealed an extraordinary increase in account balances.
- B. Paint and supplies are being purchased for a contractor.
- C. The purchasing agent is selecting the contractor on the basis of a blanket purchase order.
- D. Invoices are being authorized for payment by the general manager.

Answer (A) is correct.

Analytical procedures are commonly performed by internal auditors to assess information collected in an engagement. The assessment results from comparing information with expectations identified or developed by the internal auditor. Thus, an extraordinary increase in an account balance should be detected and investigated as the result of applying analytical methods.

- B. The provision of paint is not an issue.
- C. The purchasing agent is fulfilling this responsibility in accordance with the authority of a purchasing agent's position.
- D. The general manager may appropriately authorize payment.

**35.Fact Pattern:** Bank management suspects that a bank loan officer frequently made loans to fictitious entities, disbursed loan proceeds to personally established accounts, and then let the loans go into default. Some pertinent facts about the loan officer include

**A high standard of living, explained as the result of sound investments and not taking vacations;**

**An expensive personal car obtained through business contacts;**

**Gasoline and repair bills submitted for a car assigned by the bank that are higher than the organization's average (mileage logs were submitted on a quarterly basis); and**

**Marked annoyance with questions from internal auditors.**

**Q:In this situation, typical indicators of the suspected fraud include all of the following except**

- A. Not taking an annual vacation.
- B. Becoming easily annoyed with auditor inquiries about questionable loans.
- C. Explaining a high standard of living as the result of investments.
- D. Submitting gasoline and repair bills that are higher than company average.

Answer (D) is correct.

Submitting gasoline and repair bills that are higher than average is not correlated with making fraudulent loans. These factors are not controllable by the loan officer, so they cannot be indicators of unusual activity by him or her.

- A. Not taking an annual vacation suggests that the loan officer fears discovery of wrongdoing in his or her absence.
- B. Becoming defensive may indicate a guilty conscience.
- C. A high standard of living may be inconsistent with the loan officer's income.

**36.Which of the following is an indicator of increased risk of fraud? The controller**

- A. Takes all vacations and has just accepted a promotion to vice president of finance.
- B. Takes no vacations and has just accepted a promotion to vice president of finance.
- C. Takes all vacations and has refused promotion to vice president of finance.
- D. Takes no vacations and has refused promotion to vice president of finance.

Answer (D) is correct.

Not taking vacations and refusing a promotion may indicate a fear of detection. The apparent lack of ambition is inconsistent with the controller's diligence.

- A. This combination of behaviors is not unusual.
- B. This combination of behaviors is not unusual.
- C. This combination of behaviors is not unusual.

**37. An engagement had been scheduled by the chief audit executive to address unusual inventory shortages revealed in the annual physical inventory process at a large consumer goods warehouse operation. A cycle count program had been installed in the storeroom at the beginning of the year in place of the disruptive process of counting one entire product line at the end of each month. The cycle count program appeared effective because only nine minor adjustments had been made for the entire year on the several thousand different products located in the storeroom. The storeroom supervisor explained that each of the 15 stockroom personnel selected one item each day for cycle count based on how efficiently the item could be counted. The opportunity for control-related problems including fraud has been increased in the stockroom because**

- A. Items for cycle count are selected by stockroom personnel.
- B. A cycle count program has been installed in place of a less efficient program.
- C. Only nine minor adjustments have been recorded as a result of the cycle count process.
- D. Stockroom personnel record cycle count information.

Answer (A) is correct.

The opportunity for fraud has been increased because stockroom personnel select the items for cycle count (poor internal control). Selection of items should be based on relative values or the relationship of an item to the total volume of transactions. Moreover, personnel who do not have custodial or recordkeeping responsibilities should control the counts.

- B. An appropriate and effective cycle count process should improve control.
- C. The number of adjustments is not indicative of the level of control in this situation.
- D. A properly controlled cycle count process could involve stockroom personnel in performing counts

**38. Fact Pattern:** The internal audit activity has been assigned to perform an engagement involving a division. Based on background review, the internal auditor knows the following about management policies:

- **Organizational policy is to rapidly promote divisional managers who show significant success. Thus, successful managers rarely stay at a division for more than 3 years.**

- **A significant portion of division management's compensation comes in the form of bonuses based on the division's profitability.**

**The division was identified by senior management as a turnaround opportunity. The division is growing but is not scheduled for a full audit by the external auditors this year. The division has been growing about 7% per year for the past 3 years and uses a standard cost system.**

**During the preliminary review, the internal auditor notes the following changes in financial data compared with the prior year:**

- **Sales have increased by 10%.**
- **Cost of goods sold has increased by 2%.**
- **Inventory has increased by 15%.**
- **Divisional net profit has increased by 8%.**

**Q:Which of the following items might alert the internal auditor to the possibility of fraud in the division?**

A.The division is not scheduled for an external audit this year.

B.Sales have increased by 10%.

C.A significant portion of management's compensation is directly tied to reported net profit of the division.

D.All of the answers are correct.

Answer (C) is correct.

The internal auditor's responsibilities for detecting fraud include having sufficient knowledge of fraud to be able to identify indicators that fraud may have been committed. This knowledge includes the characteristics of fraud, the techniques used to commit fraud, and the types of frauds associated with the activities reviewed. For example, performance may be distorted because promotion and compensation (e.g., bonuses) are tied to profitability.

A.Lack of an external audit this year has not been identified as a significant red flag. In addition, the division is reviewed by the internal audit activity.

B.Sales have normally been increasing by about 7% at this division. Thus, an increase of 10%, by itself, is not unexpected and does not raise a red flag.

D.Not all responses are red flags.

**39.An internal auditor is investigating the performance of a division with an unusually large increase in sales, gross margin, and profit. Which of the following indicators is least likely to indicate the possibility of sales-related fraud in the division?**

- A. A significant portion of divisional management's compensation is based on reported divisional profits.
- B. There is an unusually large amount of sales returns recorded after year end.
- C. The internal auditor has taken a random sample of sales invoices but cannot locate a shipping document for a number of the sales transactions selected for November and December.
- D. One of the division's major competitors went out of business during the year.

Answer (D) is correct.

A decrease in the number of competitors during the year is a potential explanation for the increase in sales and profits.

- A. Basing management compensation on reported profits creates an incentive for fraud.
- B. An unusually large amount of sales returns after year end may indicate that invalid sales were recorded near the end of the year.
- C. The lack of shipping documents may indicate that invalid sales were recorded during November and December.

**40. Which of the following is most likely to be considered an indication of possible fraud?**

- A. The replacement of the management team after a hostile takeover.
- B. Rapid turnover of the organization's financial executives.
- C. Rapid expansion into new markets.
- D. A government audit of the organization's tax returns.

Answer (B) is correct.

Even the most effective internal control can sometimes be circumvented, perhaps by collusion of two or more employees. Thus, an auditor must be sensitive to certain conditions that might indicate the existence of fraud, including high personnel turnover. In the case of financial executives, high turnover may suggest a pattern of inflation of profits to obtain bonuses or other benefits, to secure advantages in the marketplace, or to conceal incompetence or rash actions.

- A. The replacement of the management team after a hostile takeover is not unusual.
- C. Rapid expansion into new markets is not unusual.
- D. A government audit of the organization's tax returns is not unusual.

**41. Red flags are conditions that indicate a higher likelihood of fraud. Which of the following is not considered a red flag?**

- A. Management has delegated the authority to make purchases under a certain value to subordinates.

B. An individual has held the same cash-handling job for an extended period without any rotation of duties.

C. An individual handling marketable securities is responsible for making the purchases, recording the purchases, and reporting any discrepancies and gains/losses to senior management.

D. The assignment of responsibility and accountability in the accounts receivable department is not clear.

Answer (A) is correct.

Delegating the authority to make purchases under a certain value to subordinates is an acceptable and common practice intended to limit risk while promoting efficiency. It is not, by itself, considered a red flag.

B. Lack of rotation of duties or cross-training for sensitive jobs is a red flag. Such a person may have a greater opportunity to commit and conceal fraud.

C. An inappropriate segregation of duties is an identified red flag. The same person should not authorize, execute, and account for transactions and have custody of the assets.

D. Establishing clear lines of authority and accountability not only helps to assign culpability but also has preventive effects.

**42. The most common motivation for management fraud is the existence of**

A. Vices, such as a gambling habit.

B. Job dissatisfaction.

C. Financial pressures on the organization.

D. The challenge of committing the perfect crime.

Answer (C) is correct.

Management fraud benefits organizations rather than individuals, so the existence of financial pressures is the most common motivation. Management perpetrators attempt to make their financial statements appear more attractive because of the financial pressures of restrictive loan covenants, a poor cash position, loss of significant customers, etc.

A. Vices are an example of motivators of fraud perpetrated for the benefit of individuals and to the organization's detriment.

B. Job dissatisfaction is an example of motivators of fraud perpetrated for the benefit of individuals and to the organization's detriment.

D. The challenge of committing the perfect crime is an example of motivators of fraud perpetrated for the benefit of individuals and to the organization's detriment.

**43. Which of the following fraudulent entries is most likely to be made to conceal the theft of an asset?**

- A. Debit expenses and credit the asset.
- B. Debit the asset and credit another asset account.
- C. Debit revenue and credit the asset.
- D. Debit another asset account and credit the asset.

Answer (A) is correct.

Most fraud perpetrators attempt to conceal their theft by charging it against an expense account. The result is that the recorded asset balance equals the actual amount on hand, and applying procedures to it will not detect the theft.

- B. Debiting the stolen asset account simply increases the discrepancy between the recorded amount and the amount on hand.
- C. An entry decreasing revenue is unusual and would attract attention
- D. This entry would not permanently conceal the fraud. It would simply shift the irreconcilable balance to another asset account.

**44. An upcoming internal audit engagement involves the possibility of fraud. The Standards require the internal auditors to possess which of the following skills?**

- A. To hold a current Certified Fraud Examiner certification.
- B. To hold a current Certified Internal Auditor certification.
- C. To be able to identify indicators that fraud may have been committed.
- D. To possess technical expertise in a particular area of fraud examination, such as computer hacking

Answer (C) is correct.

An internal auditor's responsibilities for the detection of fraud include (1) having sufficient knowledge to identify indicators that fraud may have been committed, (2) being alert to opportunities that could allow fraud (e.g., control weaknesses), and (3) being able to evaluate the indicators of fraud sufficiently to determine whether a fraud investigation should be conducted.

- A. The Standards do not require an internal auditor to hold a Certified Fraud Examiner certification to serve on an engagement in which possibility of fraud exists.
- B. The Standards do not require an internal auditor to hold a Certified Internal Auditor certification to serve on an engagement in which possibility of fraud exists.

D.The Standards do not require an internal auditor to have technical expertise in a particular area of fraud examination to serve on an engagement in which a possibility of fraud exists.

**45.Which of the following is a financial statement fraud?**

- A.An employee sells an organization’s customer list to a competitor.
- B.A contractor always bids last, bids lowest, and regularly receives contracts.
- C.Senior management overstates assets and conceals liabilities.
- D.An employee submits an invoice to the employer for a personal purchase.

Answer (C) is correct.

Fraud is any illegal act characterized by deceit, concealment, or violation of trust. The person perpetrates the fraud with the knowledge of possibly receiving some unauthorized benefit. Moreover, fraud can be accomplished by persons outside and inside the organization. Financial statement fraud involves deceiving financial statement users by purposely misstating amounts shown in the financial statements or completely omitting necessary information.

- A.The sale of an organization’s customer list to a competitor is theft of assets.
- B.Bribery and corruption include bid rigging, such as one contractor being able to bid last, bid lowest, and regularly receive contracts from an organization.
- D.An employee’s submission of an invoice to the employer for a personal purchase is fraudulent disbursement.

**46.Which of the following factors might best indicate the possibility of fraudulent activity in the production process?**

- A.Employee overtime has increased 50 percent during the past year.
- B.Although scrap is generated, there is no income reported from scrap sales.
- C.Interviews with employees indicate that they have a general dissatisfaction with management and believe that productivity could be greatly improved if management listened to the employees.
- D.Inventory has decreased at the same time that the cost of goods sold has increased.

Answer (B) is correct.

Asset misappropriation is a type of fraud that involves the theft of cash or other assets. Scrap consists of leftover material from production. It is sold if not reused. Thus, an indication of scrap misappropriation is a lack of income reported from scrap sales.

- A.Overtime hours may vary significantly from period to period due to staff size, deadlines, projects, or other factors.

- C. By itself, employee dissatisfaction is not an indication of fraud.
- D. As inventory decreases, cost of goods sold should increase.

**47. Which of the following is an example of skimming?**

- A. The organization issued payroll checks weekly. However, due to cash flow issues, the organization kept the amounts withheld from the employee paychecks (federal withholding, Social Security, Medicare, etc.) for its own use.
- B. The auditor discovered one of the managers was including personal items on the organization's weekly vendor orders. There was no evidence the manager had reimbursed the organization for the expense.
- C. Two friends who work together have an arrangement that the first to arrive to work for the day punches in using the time clock for both of them, and the last one to leave punches out for both of them.
- D. As an incentive to limo drivers, an organization promised \$25 for each \$250 helicopter tour sold. After hearing several customer complaints, the manager discovered that one of the drivers was charging the customers \$300 per tour and pocketing the difference.

Answer (D) is correct.

Skimming is a theft of cash before the accounting entry is recorded. Examples include accepting payment from a customer but not reporting the sale and overcharging the customer for the sale and keeping the difference. Skimming is very difficult to detect as there is no audit trail.

- A. The illegal nonpayment or underpayment of tax is considered tax evasion. Intentionally falsifying a tax return, failing to remit taxes, and failing to report taxes are examples.
- B. Payment fraud involves payment for fictitious goods or services, overstatement of invoices, or use of invoices for personal reasons. The manager was using the organization, through vendor invoices, to purchase items for his or her personal use.
- C. Payroll fraud is a false claim for compensation. It can include, for example, falsifying timesheets, claiming overtime for hours not worked, and payments to fictitious or terminated employees. An employee punching the time clock for another employee is an example of payroll fraud.

**48. The organization contracted with an outside vendor to maintain food items for employee purchase in the dining room. Payment for food was through a kiosk and was on the honor system. After several weeks of shortages, two employees were fired for taking food without paying for it. This is an example of what type of fraud?**

- A. Expense reimbursement fraud.
- B. Asset misappropriation.
- C. Wrongful use.
- D. Diversion.

Answer (B) is correct.

Asset misappropriation fraud is stealing cash or other assets, such as supplies, inventory, equipment, and information. The theft may be concealed by adjusting records. Employees taking food and not paying for it would be considered asset misappropriation fraud.

A. Expense reimbursement fraud is when payment is made for fictitious or inflated expenses, for example, when an employee submits an expense report that includes personal travel, nonexistent meals, or extra mileage.

C. Wrongful use of confidential or proprietary information is considered fraudulent. Confidential or proprietary information can often be the organization's most valued asset. Because of this, employees are routinely asked to sign confidentiality agreements as a condition of their employment.

D. A diversion fraud involves a third party and redirects to an employee or outsider a transaction that normally benefits the organization. For example, accounts payable receives a phone call from an impostor, pretending to be from one of the organization's vendors. The impostor gives new payment instructions to accounts payable and redirects future organization payments.

**49. Which of the following statements about check kiting is false?**

A. Check kiting is when a person with access to customer payments and accounts receivable records steals a customer's payment.

B. Check kiting exploits the float time between the deposit of the check and the check clearing the bank.

C. Electronic check kiting is difficult due to the widespread use of electronic funds transfer and other networked computer safeguards.

D. The check kiting process can proceed in a circle of accounts at any number of banks.

Answer (A) is correct.

Lapping receivables, not check kiting, is when a person (or persons) with access to customer payments and accounts receivable records steals a customer's payment. The shortage in that customer's account is later covered by a subsequent payment from another customer. The process continues until (1) a customer complains about his or her payment not being posted, (2) an absence by the perpetrator allows another employee to discover the fraud, or (3) the perpetrator covers the amount stolen. Check kiting exploits the delay between depositing a check in one bank account and clearing the check through the bank on which it was drawn. Check kiting is when the kiter writes an insufficient funds check from the first bank and deposits the check in a second bank. The second bank immediately credits the account for some or all of the amount of the check, enabling the kiter to write other checks or withdraw cash on the nonexistent balance.

B. Check kiting exploits the float time between the deposit of the check and the check clearing the bank. At one time, float times ranged from 2 days to 10 days. Technology has resulted in drastically reduced float times.

C.The widespread use of electronic funds transfer and other networked computer safeguards make electronic kiting difficult.

D.A check kiting scheme requires two accounts and usually involves several accounts at several banks. The nonexistent cash is constantly moved from one bank to another, rotating in a circular fashion.

**50.A significant employee fraud took place shortly after an internal auditing engagement. The internal auditor may not have properly fulfilled the responsibility for the prevention of fraud by failing to note and report that**

A.Policies, practices, and procedures to monitor activities and safeguard assets were less extensive in low-risk areas than in high-risk areas.

B.A system of control that depended upon separation of duties could be circumvented by collusion among three employees.

C.There were no written policies describing prohibited activities and the action required whenever violations are discovered.

D.Divisional employees had not been properly trained to distinguish between bona fide signatures and cleverly forged ones on authorization forms.

Answer (C) is correct.

Management is responsible for establishing and maintaining internal control. Thus, management also is responsible for the fraud prevention program. The control environment element of this program includes a code of conduct, ethics policy, or fraud policy to set the appropriate tone at the top. Moreover, organizations should establish effective fraud-related information and communication practices, for example, documentation and dissemination of policies, guidelines, and results.

A.For cost-benefit reasons, controls should be more extensive in high-risk areas.

B.Even the best system of control can often be circumvented by collusion.

D.Forgery, like collusion, can circumvent even an effective control

**51. Internal auditors have a responsibility for helping to deter fraud. Which of the following best describes how this responsibility is usually met?**

A. By coordinating with security personnel and law enforcement agencies in the investigation of possible frauds.

B. By testing for fraud in every engagement and following up as appropriate.

C. By assisting in the design of control systems to prevent fraud.

D. By evaluating the adequacy and effectiveness of controls in light of the potential exposure or risk.

Answer (D) is correct.

Control is the principal means of preventing fraud. Management is primarily responsible for the establishment and maintenance of control. In an assurance engagement, internal auditors are primarily responsible for preventing fraud by examining and evaluating the adequacy and effectiveness of control (Impl. Std. 2130.A1).

- A. Investigating possible frauds involves detection, not deterrence.
- B. Testing for fraud in every engagement is not required.
- C. Designing control systems impairs an internal auditor's objectivity.

**52. Which of the following describes one of the responsibilities of the internal auditor for the deterrence of fraud in an organization?**

- A. Implementation of systems to discourage fraud.
- B. Prosecuting perpetrators of fraud.
- C. Reporting suspected fraud to law enforcement personnel.
- D. Evaluating the adequacy of controls to prevent fraud.

Answer (D) is correct.

The internal audit activity assists the organization in maintaining effective controls (e.g., to prevent or detect fraud) by evaluating their effectiveness and efficiency and by promoting continuous improvement (Perf. Std. 2130).

- A. Implementing systems is an operating function for which management is responsible.
- B. Prosecuting perpetrators of fraud is a responsibility of management.
- C. Reporting suspected fraud to law enforcement personnel is a responsibility of management.

**53. Internal auditing is responsible for assisting in the prevention of fraud by**

- A. Informing the appropriate authorities within the organization and recommending whatever investigation is considered necessary in the circumstances when wrongdoing is suspected.
- B. Establishing the organization's governance, operations, and information systems concerning compliance with laws, regulations, and contracts.
- C. Examining and evaluating the adequacy and the effectiveness of control, commensurate with the extent of the potential exposure or risk in the various segments of the organization's operations.
- D. Determining whether operating standards are acceptable and are being met.

Answer (C) is correct.

The internal audit activity assists the organization in maintaining effective controls (e.g., to prevent or detect fraud) by evaluating their effectiveness and efficiency and by promoting continuous improvement (Perf. Std. 2130).

- A. Informing appropriate authorities in the organization when the internal auditor suspects wrongdoing relates to the internal auditor's obligation for detecting, not preventing, fraud.
- B. Management is responsible for establishing these systems.
- D. These standards are criteria to determine whether operational objectives have been accomplished. They do not apply to prevention of fraud.

**54. The internal auditors' responsibility regarding fraud includes all of the following except**

- A. Determining whether the control environment sets the appropriate tone at top.
- B. Ensuring that fraud will not occur.
- C. Being aware of activities in which fraud is likely to occur.
- D. Evaluating the effectiveness of control activities.

Answer (B) is correct.

Control is the principal means of preventing fraud, and management is responsible for establishing and maintaining internal control. Thus, internal auditors cannot give absolute assurance that noncompliance or fraud does not exist.

- A. Internal auditing is responsible for evaluating the organization's control environment.
- C. The internal auditor should have sufficient knowledge of fraud indicators and be alert to opportunities that could allow fraud.
- D. Assessing the design and operating effectiveness of fraud-related controls is the responsibility of internal auditing.

**55.Fact Pattern:** A purchasing agent acquired items for personal use with the organization's funds. The organization allowed designated employees to purchase a specified amount per day in merchandise under open-ended contracts. Supervisory approval of the purchases was required, but that information was not communicated to the vendor. Instead of reviewing and authorizing each purchase order, supervisors routinely signed the authorization sheet at the end of the month without reviewing any of the supporting documentation. Because purchases of this nature were not subject to normal receiving policies, the dishonest employee picked up the supplies at the vendor's warehouse. All purchases were for items routinely ordered by the organization. During the past year, the employee amassed enough merchandise to start a printing and photography business.

**Q.Which of the following controls would have been most effective in preventing this fraud?**

- A. Allowing purchases only from a list of pre-approved vendors.
- B. Requiring the use of prenumbered purchase orders for all purchases of merchandise.

- C. Canceling supporting documents, such as purchase orders and receiving reports, at the time invoices are paid.
- D. Establishing separation of duties between the ordering and receiving of merchandise.

Answer (D) is correct.

Separating the purchasing and receiving functions would have improved internal control. If the supplies in question had been sent to the organization, and a receiving report had been prepared by an employee other than the one ordering the goods, the fraud could not have occurred. Moreover, the receiving department should not accept goods unless it has a blind copy of a properly approved purchase order for the items.

- A. The facts do not suggest that the vendor's actions were inappropriate.
- B. Prenumbering would not have prevented the fraud. The weakness is in the authorization and receiving procedures.
- C. Canceling supporting documents when invoices are paid prevents the same document from being used to support two identical payments, but that is not the abuse here.

**56.Fact Pattern:** A purchasing agent acquired items for personal use with the organization's funds. The organization allowed designated employees to purchase a specified amount per day in merchandise under open-ended contracts. Supervisory approval of the purchases was required, but that information was not communicated to the vendor. Instead of reviewing and authorizing each purchase order, supervisors routinely signed the authorization sheet at the end of the month without reviewing any of the supporting documentation. Because purchases of this nature were not subject to normal receiving policies, the dishonest employee picked up the supplies at the vendor's warehouse. All purchases were for items routinely ordered by the organization. During the past year, the employee amassed enough merchandise to start a printing and photography business.

**Q.Which of the following engagement procedures, performed by the internal auditor, is most likely to detect this fraud?**

- A. Tracing selected canceled checks to the cash payments journal and to the related vendors' invoices.
- B. Performing a trend analysis of printing supplies expenses for a 2-year period.
- C. Tracing prices and quantities on selected vendors' invoices to the related purchase orders.
- D. Recomputing the clerical accuracy of selected vendors' invoices, including discounts and sales taxes.

Answer (B) is correct.

A basic premise underlying the application of analytical procedures is that plausible relationships among data may reasonably be expected to exist and continue in the absence of known conditions to the contrary. Thus, performing a trend analysis of printing supplies expenses for a 2-year period should identify an excess use of supplies.

- A. A legitimate vendor's invoice existed for each cash payment related to this fraud.
- C. The issue is not whether the quantities ordered by the customer were billed but whether the transactions are authorized.
- D. The issue is not whether the invoices are accurate but whether the transactions are authorized.

**57. A programmer's accumulation of roundoff errors into one account, which is later accessed by the programmer, is a type of computer fraud. The best way to prevent this type of fraud is to**

- A. Build in judgment with reasonableness tests.
- B. Independently test programs during development and limit access to the programs.
- C. Segregate duties of systems development and programming.
- D. Use control totals and check the results of the computer.

Answer (B) is correct.

Programmers should not have access to programs used in processing. The accumulation of roundoff errors into one person's account is a procedure written into the program. Independent testing of a program will lead to discovery of this programmed fraud.

- A. Reasonableness tests will not detect this irregularity. In this particular type of fraud, all of the amounts will balance.
- C. Segregation of duties between systems development and programming would not prevent this type of error. The skills required to construct the program are possessed by programmers.
- D. This particular fraud will result in balanced entries. Thus, control totals would not detect the fraud.

**58. A purchasing agent received expensive gifts from a vendor in return for directing a significant amount of business to that vendor. Which of the following organizational policies most effectively prevents such an occurrence?**

- A. All purchases exceeding specified monetary amounts should be approved by an official who determines compliance with budgetary requirements.
- B. Important high-volume materials should regularly be purchased from at least two different sources in order to afford supply protection.
- C. The purchasing function should be decentralized so each department manager or supervisor does his or her own purchasing.
- D. Competitive bids should be solicited on purchases to the maximum extent that is practicable.

Answer (D) is correct.

In the absence of special circumstances, competitive bidding is a legitimate and effective means of obtaining the lowest price consistent with quality. It is a practice that exploits competition in the market place. Competitive bidding also serves as a control over fraud by restricting the ability of a purchasing agent to reward a favored vendor.

- A. The problem is vendor selection, not authorization of purchases.
- B. A purchasing agent could still display favoritism to one of the vendors.
- C. Decentralization creates more opportunities for buyer fraud.

**59. Which of the following controls is the least effective in preventing a fraud conducted by sending purchase orders to bogus vendors?**

- A. Require that all purchases be made from an authorized vendor list maintained independently of the individual placing the purchase order.
- B. Require that only approved vendors be paid for purchases, based on actual production.
- C. Require contracts with all major vendors from whom production components are purchased.
- D. Require that total purchases for a month not exceed the total budgeted purchases for that month.

Answer (D) is correct.

Requiring that total purchases for a month not exceed the total budgeted purchases for that month controls the total amount of expenditures, not whether a purchase has been requested and authorized, with whom the purchase orders are placed, or whether goods purchased are received.

- A. Segregating the selection and approval of reputable vendors from placement of actual orders is an effective means of preventing fraud.
- B. Restricting payment to approved vendors is an effective means of preventing fraud.
- C. Requiring contracts with major vendors is an effective means of preventing fraud.

**60. A potential problem for a manufacturer is that purchasing agents may take kickbacks or receive gifts from vendors in exchange for favorable contracts. Which of the following is the least effective in preventing this problem?**

- A. A specific organizational policy prohibiting the acceptance of anything of value from a vendor.
- B. An organizational code of ethics that prohibits such activity.
- C. A requirement for the purchasing agent to develop a profile of all vendors before the vendors are added to the authorized vendor list.
- D. The establishment of long-term contracts with major vendors, with the contract terms approved by senior management.

Answer (C) is correct.

A requirement for the purchasing agent to develop a profile of all vendors is the least effective approach. It applies only to the authorization of vendors, a function that should be performed independently of the purchasing agent. It does not address the purchasing agent's relationships with approved vendors.

- A. A policy prohibiting kickbacks and gifts from vendors provides guidance and influences behavior.

- B. A code of ethics gives direction to the purchasing agents and is helpful in influencing behavior.
- D. Approval of long-term vendor contracts by senior management is an effective procedure that is increasingly being used by many organizations.

**61. Fact Pattern:** A fraud was perpetrated in a moderate-sized organization when the accounting clerk was delegated too much responsibility. During the year, the organization switched suppliers of a service to a new vendor. The accounting clerk continued to submit fraudulent invoices from the “old supplier.” Because contracting for services and approval of supplier invoices had been delegated to the clerk, it was possible for the clerk to continue billings from the old supplier and deposit the subsequent checks, which the clerk was responsible to mail, into a new account the clerk opened in the name of the old supplier. The clerk was considered an excellent employee and eventually was improperly given the added responsibility of preparing the department budgets. This added responsibility allowed the clerk to budget for the amount of the fraudulent payments.

**Q. Which of the following controls would have been least likely to prevent or detect the fraud described?**

- A. Requiring authorization of payments by someone other than the clerk negotiating the contract.
- B. Comparison by the person signing checks of invoices with an independent verification of services received.
- C. Budget preparation by someone other than the person signing contracts and approving payment.
- D. Mailing of checks by someone other than the person responsible for check signing or invoice approval.

Answer (D) is correct.

After invoices have been approved, and checks prepared and signed, the mailing of the check by an independent person provides no means of preventing improper payments. The person responsible for the treasury function should sign the checks, transmit them, and cancel the supporting documents.

- A. Separating contracting for services and approval of invoices would have prevented the fraud.
- B. An independent verification of services received reviewed by the check signer would have prevented payment for services not received.
- C. Independent budget preparation would have allowed an actual-with-budget comparison to detect the payments.

**62. Fact Pattern:** A fraud was perpetrated in a moderate-sized organization when the accounting clerk was delegated too much responsibility. During the year, the organization switched suppliers of a service to a new vendor. The accounting clerk continued to submit fraudulent invoices from the “old supplier.” Because contracting for services and approval of supplier invoices had been delegated to the clerk, it was possible for the clerk to continue billings from the old supplier and deposit the subsequent checks, which the clerk was responsible to mail, into a new account the clerk opened in the name of the old supplier. The clerk was considered an excellent employee and eventually was improperly given the added responsibility of preparing the department budgets. This added responsibility allowed the clerk to budget for the amount of the fraudulent payments.

**Q. Which of the following engagement procedures is most likely to detect the fraud?**

- A. Take a sample of paid invoices and verify receipt of services by departments involved.
- B. Trace a sample of checks disbursed to approved invoices for services.
- C. Perform a bank reconciliation and account for all outstanding checks.
- D. Trace a sample of receiving documents to invoices and to checks disbursed.

Answer (A) is correct.

Confirming with the using department the receipt of services that have been paid for would uncover the fraud.

- B. The fraudulent invoices were approved by the clerk, and each check is therefore supported by an approved invoice.
- C. Bank reconciliations do not test the validity of the cash payments.
- D. Beginning with valid receiving reports will not detect the fraud. The direction of testing is inappropriate.

**63. The internal audit activity's responsibility for preventing fraud is to**

- A. Establish internal control.
- B. Maintain internal control.
- C. Evaluate the system of internal control.
- D. Exercise operating authority over fraud prevention activities.

Answer (C) is correct.

Control is the principal means of preventing fraud. Management, in turn, is primarily responsible for the establishment and maintenance of control. In an assurance engagement, internal auditors are primarily responsible for preventing fraud by examining and evaluating the adequacy and effectiveness of control (Impl. Std. 2130.A1).

- A. Establishing internal control is management's responsibility.
- B. Maintaining internal control is management's responsibility.
- D. Operating authority is a management function.

**64. The risk of the addition of fictitious employees to the payroll by the person performing the payroll processing function is reduced by**

- A. Requiring that payroll additions be approved by the controller.
- B. Requiring the same employee to perform the monthly payroll bank reconciliation.
- C. Performing periodic floor checks of employees on the payroll.

D. Requiring a reconciliation of hours between time cards and hours paid.

Answer (C) is correct.

One control used to detect the addition of fictitious persons to the payroll is for the auditor to make a periodic comparison of the names on the payroll with persons observed working for the company. Observation of payroll distribution is such a control.

A. Payroll additions should be authorized by the personnel department, not by the controller (chief accounting officer), an official with record keeping responsibility.

B. For a proper segregation of functions, the reconciliation should be performed by someone who has no payroll processing duties.

D. The amount, not the validity, of the payment is verified.

**65. During an engagement involving the purchasing department, an internal auditor learned that one vendor rewarded buyers in proportion to the size of the orders received. What recommendation should the internal auditor make to reduce the likelihood of future acceptance of such rewards by the buyers?**

A. Establishing an employee counseling program.

B. Periodic review of buyer lifestyles.

C. A policy of identifying and reducing buyer situational pressures.

D. A strong, written statement of management's commitment to organizational ethics.

Answer (D) is correct.

A strong commitment by management to ethical conduct reflected in its written policies, personnel practices, interest in effective control, etc., will foster creation of the appropriate environment.

A. Counseling is unlikely to change the behavior of dishonest employees.

B. Such review is a detective control that would not uncover fraud unless a lifestyle change occurred.

C. Situational pressures external to the organization may be beyond its control. Pressures within the organization, e.g., to improve performance, should not cause a buyer to take bribes from vendors.

**66. Fraudulent use of the organization's credit cards is minimized by which of the following internal control procedures?**

A. Establishing an organizational policy on the issuance of credit cards to authorized employees.

B. Reviewing the validity of credit card need at executive and operating levels on a periodic basis.

C. Reconciling the monthly statement from the credit card issuer with the submitted copies of the cardholder's charge slips.

D. Subjecting credit card charges to the same expense controls as those used on regular organizational expense forms.

Answer (D) is correct.

The problem of charging the organization for unauthorized expenditures is the same for any type of expense account, whether credit card or cash. Thus, normal expense controls should preclude credit card fraud by employees.

- A. Establishing a policy on the issuance of credit cards relates to appropriate issuance, not fraudulent use.
- B. Reviewing the validity of credit card need at executive and operating levels relates to appropriate issuance of credit cards, not fraudulent use.
- C. The reconciliation tests correct invoicing by the credit card issuers for credit charges. It would not necessarily detect personal or fraudulent use if the payees and amounts were not suspicious.

**67. An organization hired a highly qualified accounts payable manager who had been terminated from another organization for alleged wrongdoing. Six months later, the manager diverted US \$12,000 by sending duplicate payments of invoices to a relative. A control that might have prevented this situation is to**

- A. Adequately check prior employment backgrounds for all new employees.
- B. Not hire individuals who appear overqualified for a job.
- C. Verify educational background for all new employees.
- D. Check to see whether close relatives work for vendors.

Answer (A) is correct.

Honest and capable personnel also help create an environment promoting effective internal control. Accordingly, hiring policies and procedures are crucial. Background checks, for example, may screen out potential hires of questionable character and serve to prevent potential fraud.

- B. Being overqualified is not an indicator of bad character.
- C. Checking prior employment is more likely to uncover prior fraudulent behavior.
- D. Checking to see whether close relatives work for vendors is not an adequate control in this scenario.

**68. Internal auditors and management have become increasingly concerned about computer fraud. Which of the following control procedures is least important in preventing computer fraud?**

- A. Program change control requiring a distinction between production programs and test programs.
- B. Testing of new applications by users during the systems development process.

- C. Segregation of duties between the applications programmer and the program librarian function.
- D. Segregation of duties between the programmer and systems analyst.

Answer (D) is correct.

Segregation of the programming and systems analysis functions is of least concern given that the analyst is responsible for communicating the nature of the design to the programmer. Programmer-analyst is a common job title.

- A. A program should be redesigned using a working copy, not the version in use.
- B. Testing of new applications by users is one of the most important controls to help prevent computer fraud.
- C. Adequate control over program changes is one of the most important control procedures in a computerized environment. Programmers should not have access to operational progress, and librarians should not be able to program.

**69. A means of ensuring that payroll checks are drawn for properly authorized amounts is to**

- A. Conduct periodic floor verification of employees on the payroll.
- B. Require that undelivered checks be returned to the cashier.
- C. Require supervisory approval of employee time cards.
- D. Witness the distribution of payroll checks.

Answer (C) is correct.

Review and approval of time cards by line supervisors is appropriate because they should know whether work has been performed. Also, because they do not distribute paychecks, they are not in a position to divert falsely authorized checks.

- A. Employees may be properly included on payroll, but the amounts paid may be unauthorized
- B. Returning undelivered checks to the cashier provides no information regarding the validity of the amounts of checks.
- D. Witnessing a payroll distribution does not assure that the amounts paid are authorized

**70. A payroll clerk working through a computerized payroll system increased the hourly pay rate of two employees and shared the resulting overpayments with the employees. Which of the following would have best served to prevent this illegal act?**

- A. Requiring that all changes to pay records be recorded on a standard form.
- B. Limiting access to master payroll records to supervisory personnel in the payroll department.
- C. Reconciling pay rates per personnel records with those of the payroll system annually.
- D. Monitoring of payroll costs by department heads on a monthly basis.

Answer (B) is correct.

The best preventive control is to restrict the ability of employees to gain access to sensitive information. The computer security system should therefore incorporate measures (such as password protection and device authorization tables) that will prevent an unauthorized person from changing stored information.

- A. Requiring a standard form does not prevent an unauthorized pay rate change if it can be made without the form. The requirement that all changes to pay records be recorded on a standard form does not restrict access to the computer files. Hence, unauthorized changes could still be made.
- C. Annual reconciliation of pay rates per personnel records with those of the payroll system is detective rather than preventive.
- D. Monitoring of payroll costs by department heads on a monthly basis is detective rather than preventive.

**71. Which of the following statement(s) is (are) true regarding the deterrence of fraud?**

- 1. The primary means of deterring fraud is through effective controls initiated by senior management.
  - 2. Internal auditors are responsible for assisting in the deterrence of fraud by examining and evaluating the adequacy of controls.
  - 3. Internal auditors are responsible for designing and implementing fraud prevention controls.
  - 4. Internal auditors should determine whether communication channels provide management with adequate and reliable information about the effectiveness of controls and the occurrence of unusual transactions.
- A. 1 only.
  - B. 2 only.
  - C. 2 and 3 only.
  - D. 1, 2, and 4 only.

Answer (D) is correct.

Controls are the principal means of preventing fraud. The internal audit activity assists the organization in maintaining effective controls (e.g., to prevent or detect fraud) by evaluating their effectiveness and efficiency and by promoting continuous improvement (Perf. Std. 2130). Moreover, internal auditors should determine whether communication channels provide management with reliable information about the effectiveness of controls and the occurrence of unusual transactions.

- A. The internal auditors are also responsible for (1) assisting in the deterrence of fraud by examining and evaluating the adequacy of controls and (2) determining whether communication channels provide management with adequate and reliable information about the effectiveness of controls and the occurrence of unusual transactions.
- B. The primary means of deterring fraud is through effective controls. Internal auditors also should determine whether communication channels provide management with reliable information about the effectiveness of controls and the occurrence of unusual transactions.
- C. Internal auditors are not responsible for designing and implementing fraud prevention controls. Management is primarily responsible for establishing and maintaining controls.

**72. Fact Pattern:** During an engagement performed at a smaller division, the internal auditor notes the following regarding the purchasing function:

**There are three purchasing agents. Agent 1 is responsible for ordering all large component parts, agent 2 for electric motors, and agent 3 for smaller parts such as fasteners.**

**There are separate accounts payable and receiving departments.**

**In order to hold vendors more responsible, all invoices are sent to the purchasing agent placing the order. The purchasing agent matches the vendor invoice, receiving slip, and purchase order. If all match, the purchasing agent sends the documents forward to the accounts payable department. Differences are investigated by the purchasing agent.**

**Only the accounts payable department has the ability to authorize an item for payment.**

**All recorded receipts are immediately recorded into a perpetual inventory record by the department to which the goods are transferred after receipt.**

**The internal auditor interviewed both management and the purchasing agents. Both groups were very satisfied with the current system because it helps maintain vendor accountability and provides sufficient segregation of duties given that only the accounts payable department can authorize an item for payment.**

**The internal auditor is responsible for evaluating internal control to determine whether it allows undetected fraud. Based on the information presented, the most likely undetected fraud, if any, is that the**

- A. Purchasing agent is purchasing the majority of products from a favorite vendor because rotation among purchasing agents is not mandatory.
- B. Purchasing agent is sending fake purchase orders to a dummy vendor, inserting a receiving slip, and having payments made to the dummy vendor.
- C. Receiving department is diverting receipts to different locations and failing to create receiving reports.
- D. Production department is deflating the price of products purchased and thereby increasing the reported gross margin of sales.

Answer (B) is correct.

Internal control is unlikely to detect the purchasing agent's fraud because this individual is in a position to perpetrate and conceal irregularities. Receiving documents and vendors' invoices should be sent to accounts payable, not to the purchasing agent.

- A. Purchasing most goods from a particular vendor may be justified.
- C. This possible fraud should be detected by the absence of receiving reports to support vendors' invoices.
- D. This response is unrelated to the purchasing environment.

**73. Which of the following is not a responsibility of internal auditors regarding fraud prevention, deterrence, and detection?**

- A. Develop an approach the organization can use to sustain antibribery principles in every country in which the organization operates.
- B. Support audit committee oversight in ensuring management has implemented an effective system of internal controls.
- C. Monitor the annual disclosure of whether the organization has a code of ethics that covers its chief executive officer (CEO) and senior financial officers.
- D. Raise fraud awareness within the organization, including encouraging the audit committee and senior management to set the proper “tone at the top.”

Answer (A) is correct.

Management, not the internal auditors, is responsible for establishing and maintaining effective controls to deter and prevent fraud. Translating the organization’s corruption prevention principles across operations is a management responsibility.

- B. Internal auditors are responsible for supporting audit committee oversight in ensuring management has implemented effective internal controls regarding fraud prevention.
- C. Internal auditors are responsible for monitoring the annual disclosure of whether the organization has a code of ethics that covers its CEO and senior financial officers.
- D. Internal auditors are responsible for raising fraud awareness within the organization, including encouraging the audit committee and senior management to set the proper “tone at the top.”

**74. The primary purpose of operating a fraud hotline within an organization is to**

- A. Reduce total costs of operations.
- B. Concentrate on areas that deserve attention.
- C. Establish channels of communication for people to report suspected improprieties.
- D. Measure how well organizational units are achieving the organization’s goals.

Answer (C) is correct.

Fraud-related information and communication practices promote fraud risk management. For example, hotlines are a convenient way for employees to report suspected improprieties.

- A. Reducing total costs of operating the organization is not the primary purpose of a fraud hotline.
- B. Concentrating on areas that deserve attention and less attention on areas operating as expected is not the primary purpose of a fraud hotline.
- D. The primary purpose of operating a fraud hotline is not to measure how well organizational units are achieving the organization’s goals.

**75. Fact Pattern:** During an engagement performed at a smaller division, the internal auditor notes the following regarding the purchasing function:

**There are three purchasing agents. Agent 1 is responsible for ordering all large component parts, agent 2 for electric motors, and agent 3 for smaller parts such as fasteners.**

**There are separate accounts payable and receiving departments.**

**In order to hold vendors more responsible, all invoices are sent to the purchasing agent placing the order. The purchasing agent matches the vendor invoice, receiving slip, and purchase order. If all match, the purchasing agent sends the documents forward to the accounts payable department. Differences are investigated by the purchasing agent.**

**Only the accounts payable department has the ability to authorize an item for payment.**

**All recorded receipts are immediately recorded into a perpetual inventory record by the department to which the goods are transferred after receipt.**

**The internal auditor interviewed both management and the purchasing agents. Both groups were very satisfied with the current system because it helps maintain vendor accountability and provides sufficient segregation of duties given that only the accounts payable department can authorize an item for payment.**

**Q. Which of the following controls, if properly implemented, is most likely to decrease the likelihood of fraud?**

- A. Require periodic rotation of purchases among different vendors.
- B. Require rotation of duties among the three purchasing agents.
- C. Require that receiving reports be sent directly to accounts payable.
- D. Require that the updates to the perpetual inventory record be made by the receiving department.

Answer (C) is correct.

This change in procedures prevents the purchasing agent from falsifying receiving reports. An even better procedure is to have both the receiving reports and the vendors' invoices sent to accounts payable.

A. Rotation of vendors might partially alleviate the problem, but the purchasing agent could develop new dummy vendors.

B. Rotation of duties will not affect the type of fraud that could occur in this environment. The purchasing agent could develop another dummy vendor for the new product line.

D. This procedure will create an additional opportunity for fraud by the receiving department.

**76. Which of the following statements is (are) true regarding the prevention of fraud?**

**The primary means of preventing fraud is through internal control established and maintained by management.**

Internal auditors are responsible for assisting in the prevention of fraud by examining and evaluating the adequacy of the internal control system.

Internal auditors should assess the operating effectiveness of fraud-related communication systems.

- A. 1 only.
- B. 1 and 2 only.
- C. 2 only.
- D. 1, 2, and 3.

Answer (D) is correct.

Control is the principal means of preventing fraud. Management, in turn, is primarily responsible for the establishment and maintenance of control. Internal auditors are primarily responsible for preventing fraud by evaluating the effectiveness and efficiency of controls. Internal auditors also should assess the operating effectiveness of fraud-related communication systems and practices, and they should support fraud-related training.

A. Internal auditors are responsible for assisting in the prevention of fraud by examining and evaluating the adequacy of the internal control system, and internal auditors should assess the operating effectiveness of fraud-related communication systems.

B. Internal auditors should assess the operating effectiveness of fraud-related communication systems.

C. The primary means of preventing fraud is through internal control established and maintained by management, and internal auditors should assess the operating effectiveness of fraud-related communication systems.

**77. How does fraud awareness training support fraud prevention?**

- A. Limits rationalization.
- B. Reduces opportunities to commit fraud.
- C. Helps develop credible responses to potential risks.
- D. Facilitates the testing of controls.

Answer (A) is correct.

An individual justifies fraudulent actions by rationalization. Fraud awareness training minimizes rationalization by (1) supporting the ethical tone at the top, (2) promoting an anti-fraud environment, and (3) emphasizing that the organization does not tolerate misconduct of any kind.

B. Fraud awareness training does not reduce opportunities to commit fraud.

C. Controls help develop credible responses to potential risks, not fraud awareness training.

D. Fraud awareness training does not facilitate the testing of controls.

**78. Which of the following gives the internal auditor the authority to investigate fraud?**

- A. The Standards.
- B. Common law.
- C. Management.
- D. The IIA's Code of Ethics.

Answer (C) is correct.

Any fraud investigation undertaken by internal auditors must be authorized by management

- A. The internal auditor has authority only to recommend an investigation.
- B. An internal auditor has no authority under common law.
- D. The IIA's Code of Ethics does not mention fraud investigation.

**79. When conducting fraud investigations, internal auditors should**

- A. Clearly indicate the extent of the internal auditors' knowledge of the fraud when questioning suspects.**
- B. Assign personnel to the investigation in accordance with the engagement schedule established at the beginning of the fiscal year.
- C. Perform its investigation independently of lawyers, security personnel, and specialists from outside the organization who are involved in the investigation.
- D. Assess the probable level of, and the extent of complicity in, the fraud within the organization.

Answer (D) is correct.

When conducting fraud investigations, internal auditors or others should assess the level of, and the extent of complicity in, the fraud within the organization. This assessment can be critical to ensuring that (1) crucial evidence is not tainted or destroyed and (2) misleading information is not obtained from persons who may be involved.

- A. By always giving the impression that additional evidence is in reserve, the internal auditors are more apt to obtain complete and truthful answers.
- B. Fraud investigations usually occur unexpectedly and cannot be scheduled in advance. Also, the fraud investigation must be conducted by individuals having the appropriate expertise, even if another engagement must be delayed.
- C. The internal auditors should coordinate their activities with management, legal counsel, and other specialists.

**80. Questions used to interrogate individuals suspected of fraud should**

- A. Adhere to a predetermined order.
- B. Cover more than one subject or topic.

- C. Move from the general to the specific.
- D. Direct the individual to a desired answer.

Answer (C) is correct.

Internal auditors should be skilled in dealing with people and in communicating effectively. One important communications skill is the ability to conduct an effective interview. For example, initial questions in a fraud interview should be broad. In contrast with a directive approach emphasizing narrowly focused questions, this nondirective approach is more likely to elicit clarifications and unexpected observations from employees who are under suspicion.

- A. The interviewee's answer may suggest a follow-up question that should be asked before asking the next planned question.
- B. This interviewing technique may be confusing for the respondent.
- D. The interrogator should avoid leading questions, that is, questions that suggest an answer.

**81. The internal audit activity has concluded a fraud investigation that revealed a previously undiscovered materially adverse impact on the financial position and results of operations for 2 years on which financial statements have already been issued. The chief audit executive should immediately inform**

- A. The external auditing firm responsible for the financial statements affected by the discovery.
- B. The appropriate governmental or regulatory agency.
- C. Senior management and the board.
- D. The internal accounting function ultimately responsible for making corrective journal entries.

Answer (C) is correct.

The CAE is responsible for timely reporting of any incident of significant fraud or erosion of trust to senior management and the board. This includes a previously undiscovered materially adverse effect on the financial position and results of operations of an organization for 1 or more years on which financial statements have already been issued.

- A. Management should communicate with the external auditors.
- B. Management should communicate with the governmental agencies.
- D. Management should communicate with the accounting function.

**82. After completing an investigation, internal auditing has concluded that an employee has stolen a significant amount of cash receipts. A draft of the proposed communication on this observation should be submitted for review to**

- A. Legal counsel.
- B. The board.

- C. The chief executive officer of the organization.
- D. The organization's outside auditors.

Answer (A) is correct.

The internal auditor must be concerned about the possibility of inclusion (and dissemination) of a statement for which the accused employee could sue the organization. Thus, a draft of the proposed final communications on fraud should be submitted to legal counsel for review. If the internal auditor wants to invoke client privilege, consideration should be given to addressing the report to legal counsel.

- B. The board should receive a final draft of the report after it has been reviewed and approved by legal counsel.
- C. If appropriate, the CEO may receive a final draft of the report after it has been reviewed and approved by legal counsel.
- D. If it is customary to send the outside auditors copies of all internal auditing reports, they should receive a final draft that has been reviewed and approved by legal counsel.

**83. If an internal auditor is interviewing three individuals, one of whom is suspected of committing a fraud, which of the following is the least effective approach?**

- A. Ask each individual to prepare a written statement explaining the individual's actions.
- B. Take the role of one seeking the truth.
- C. Listen carefully to what each interviewee has to say.
- D. Attempt to get the suspected individual to confess.

Answer (D) is correct.

Internal auditors often should defer to security specialists because of potential legal liability and their lack of expertise. An attempt to obtain a confession is threatening, contrary to the presumption of innocence, and not likely to gain the confidence of the interviewee.

- A. A written statement by the interviewee provides admissions of fact that may be compared with other evidence for possible inconsistencies or that may provide starting points for further investigation.
- B. The interviewer should be objective, unemotional, and nonthreatening.
- C. Effective listening is a vital communication skill in many situations.

**84. Which of the following statements is correct regarding audit engagement workpaper documentation for a fraud investigation?**

1. All incriminating evidence should be included in the workpapers.
2. All important testimonial evidence should be reviewed to ensure that it provides sufficient basis for the conclusions reached.

3. If interviews are held with a suspected perpetrator, written transcripts or statements should be included in the workpapers.

- A. 1 only.
- B. 2 only.
- C. 2 and 3 only.
- D. 1, 2, and 3.

Answer (D) is correct.

Internal auditors must document relevant information to support the conclusions and engagement results (Perf. Std. 2330). Incriminating evidence, important testimonial evidence, and interviews with suspected perpetrators are clearly relevant and should be documented.

A. All important testimonial evidence should be reviewed to ensure that it provides sufficient basis for the conclusions reached, and if interviews are held with a suspected perpetrator, written transcripts or statements should be included in the workpapers.

B. All incriminating evidence should be included in the workpapers, and if interviews are held with a suspected perpetrator, written transcripts or statements should be included in the workpapers.

C. All incriminating evidence should be included in the workpapers.

**85. An auditor uncovers a plan to overstate inventory and thereby increase reported profits for a division. The auditor has substantial evidence that the divisional manager was aware of and approved the plan to overstate inventory. There is also some evidence that the manager may have been responsible for the implementation of the plan. The auditor should**

A. Continue to conduct interviews with subordinates until a definite case is made and then report the case to the audit committee.

B. Inform senior management and the audit committee of the findings and discuss possible further investigation.

C. Inform the divisional manager of the auditor's suspicions and obtain the manager's explanation of the findings before pursuing the matter further.

D. Document the case thoroughly and report the suspicions to the external auditor for further review.

Answer (B) is correct.

Once the internal auditor is satisfied that an act of fraud has occurred, informing senior management and the audit committee and determining how to proceed is the appropriate action.

A. The internal auditor has determined that an act of fraud is underway. Delaying the act of informing senior management and the audit committee would be inappropriate.

C. The auditor has reason to believe that the divisional manager may be involved in the fraud. Therefore, the auditor's suspicions must be reported to a higher level of management.

D. Reporting the auditor's suspicions to outside parties is inappropriate.

**86. Upon obtaining factual documentation of unethical business conduct by the vice president to whom the chief audit executive (CAE) reports, the CAE should**

- A. Conduct an investigation to determine the extent of the vice president's involvement in the unethical acts.
- B. Confront the vice president with the facts before proceeding.
- C. Schedule an audit of the business function involved.
- D. Report the facts to the chief executive officer and the audit committee.

Answer (D) is correct.

After the internal audit activity discovers that fraud or unethical business conduct has taken place, the CAE reports these facts to senior management and the board.

- A. The CAE reports his or her findings with regard to fraud or unethical business conduct to senior management and the board, who then determine the appropriate course of action.
- B. Senior management and the board determine the appropriate course of action.
- C. Once the internal audit activity discovers that fraud or unethical business conduct has taken place, the CAE reports these facts to senior management and the board, who determine the appropriate course of action.

**87. When interviewing an individual suspected of fraud, the interviewer should**

- A. Ensure the suspect's supervisor is present during the interview.
- B. Lock the door to ensure no one will interrupt the interview.
- C. Pay attention to the wording choices of the suspect.
- D. Ask if the suspect committed the fraud.

Answer (C) is correct.

Through his or her choice of words, a suspect can reveal much without meaning to. Excessive and/or inappropriate use of the passive voice or of impersonal pronouns may indicate a desire to be detached from the topic.

- A. The presence of the suspect's supervisor may inhibit honest communication on the suspect's part.
- B. Although the area in which the fraud interview takes place should be private, the suspect should not feel that (s)he is in a room in which no one can come to his or her aid.
- D. Directly asking the suspect if (s)he committed the fraud is not appropriate. The questioner should appear confident that (s)he already has all the relevant facts and not provide the suspect with an opportunity to deny the fraud.

**88. A chief audit executive (CAE) suspects that several employees have used desktop computers for personal gain. In conducting an investigation, the primary reason that the CAE chose to engage a forensic information systems auditor rather than using the organization's information systems auditor is that a forensic information systems auditor would possess**

- A. Knowledge of the computing system that would enable a more comprehensive assessment of the computer use and abuse.
- B. Knowledge of what constitutes evidence acceptable in a court of law.
- C. Superior analytical skills that would facilitate the identification of computer abuse.
- D. Superior documentation and organization skills that would facilitate in the presentation of findings to senior management and the board.

Answer (B) is correct.

The distinguishing characteristic of forensic auditing is the knowledge needed to testify as an expert witness in a court of law. Although a forensic auditor may possess the other attributes listed, the organization's information systems auditor may also possess these skills or knowledge elements.

- A. The organization's information systems auditor would probably have more knowledge of the organization's computing systems than a forensic auditor.
- C. A forensic auditor would not necessarily have analytical skills that are superior to those of the organization's auditor.
- D. A forensic auditor would not necessarily have organizational skills that are superior to those of the organization's auditor.

**89. Forensic auditing differs from internal auditing because forensic auditing**

- A. Relies more heavily on investigative skills.
- B. Focuses on error identification and prevention.
- C. Concentrates less on legal issues.
- D. Places less emphasis on communication skills.

Answer (A) is correct.

Forensic auditing is the use of accounting and auditing knowledge and skills in matters having civil or criminal legal implications. Engagements involving fraud, litigation support, and expert witness testimony are examples. Forensic auditing requires investigative and accounting skills. The investigative skills are required to collect, analyze, and evaluate financial evidence. These skills differentiate forensic auditing from internal auditing.

- B. Internal auditing, not forensic auditing, focuses on error identification and prevention.

C. Forensic auditing applies accounting facts gathered through auditing procedures to legal problems. Thus, forensic auditing focuses heavily on legal issues.

D. Although both forensic and internal auditing require written and oral communication skills, these skills are more critical in forensic auditing.

**90. Prior to issuing a final communication on a fraud investigation, the internal auditor should submit a proposed draft for review by the**

- A. Organization's legal counsel.
- B. Engagement client's management.
- C. Organization's public relations department.
- D. Board.

Answer (A) is correct.

A draft of the proposed final communications on fraud should be submitted to legal counsel for review. When the internal auditor wants to invoke client privilege, consideration should be given to addressing the report to legal counsel.

B. An identifiable auditee does not always exist, and review by such auditee is not always appropriate.

C. Publicity is inappropriate when the final communication has not been completed.

D. The board should receive the final communication, not the proposed draft.

**91. Fact Pattern: An internal auditor is performing an operational engagement at a division and observes that an unusually large quantity of goods is on hand in the shipping and materials rework areas. The items are labeled as re-ship items. Upon inquiry the internal auditor is told that these are goods that have been returned by customers and have either been repaired and shipped back to the original customer or repaired and shipped out as new products because they are fully warranted.**

**Assume that subsequent investigation shows that previously issued financial statements were materially misstated due to the improper recognition of sales. The internal auditor's next step should be to**

- A. Immediately inform the external auditor and the divisional manager.
- B. Inform divisional management of the preliminary observation, but wait until a formal engagement communication is issued to inform the board.
- C. Inform the external auditor, senior management, and the board.
- D. Inform senior management and the board.

Answer (D) is correct.

The results of a fraud investigation may indicate that fraud has had a previously undiscovered materially adverse effect on the financial position and results of operations of an organization for 1 or

more years on which financial statements have already been issued. Internal auditors should inform appropriate management and the audit committee of the board of directors of such a discovery.

- A. The auditor should inform senior management, the board, and the audit committee.
- B. The auditor should inform senior management, the board, and the audit committee.
- C. The auditor should inform senior management, the board, and the audit committee.

**92. During a review of contracts, a chief audit executive (CAE) suspects that a supplier was given an unfair advantage in bidding on a contract. After learning that the chief executive officer (CEO) of the company is a member of the supplier's board of directors, how should the CAE proceed?**

- A. Submit a draft report to senior management, excluding the CEO.
- B. Contact the organization's external auditors for assistance.
- C. Obtain supporting documentation and present the finding to the chair of the audit committee.
- D. Immediately notify the board of directors.

Answer (C) is correct.

A conflict of interest is an undisclosed, personal economic interest in a transaction that adversely affects the organization. After determining the existence of such a conflict on the part of a senior manager, the CAE should obtain supporting documentation and present the finding to the chair of the audit committee.

- A. The CEO is a member of senior management. Other members of senior management may receive a final report that has been reviewed and approved by legal counsel.
- B. External auditors should not be contacted. External auditors may be given a final report that has been reviewed and approved by legal counsel.
- D. The CAE should obtain supporting documentation before informing the audit committee or the board.

**93. Why does The IIA's Code of Ethics in Rule of Conduct 4.2 require that due professional care be used in obtaining information to support an engagement opinion?**

- A. Sufficient, reliable, relevant, and useful information lends credibility to the opinion.
- B. To preclude any conflict of interest.
- C. To require honesty in performing work.
- D. If internal auditors were permitted to communicate engagement results without obtaining sufficient information, they would be in a position to accept fees or gifts from engagement clients.

Answer (A) is correct.

Engagements must be performed with proficiency and due professional care (Attr. Std. 1200), and the engagement results must be communicated (Perf. Std. 2400). Engagement results include observations, conclusions, opinions, recommendations, and action plans. If internal auditors expressed opinions or otherwise communicated engagement results without substantive investigation and compliance with the Standards, such communications would be meaningless. The Standards are therefore incorporated by reference into The IIA's Code of Ethics by Rule of Conduct 4.2. Thus, internal auditors must identify sufficient, reliable, relevant, and useful information to achieve the engagement's objectives (Perf. Std. 2310).

B. A separate ethics rule prohibits conflicts of interest. Rule of Conduct 2.1 states, "Internal auditors shall not participate in any activity or relationship that may impair or be presumed to impair their unbiased assessment. This participation includes those activities or relationships that may be in conflict with the interests of the organization."

C. Rule of Conduct 1.1 requires honesty, diligence, and responsibility in the performance of work.

D. Rule of Conduct 2.2 prohibits accepting anything that may impair or be presumed to impair the professional judgment of an internal auditor.