

## Control & AIS

Actg 474  
Chapter 6

## What is Internal Control?

- Internal Control is a **process** implemented by the BOD and management that gives reasonable assurance that these **objectives** are achieved:
  - Safeguard assets
  - Ensure accurate and reliable accounting (and other) information
  - Improve operational efficiency
  - Promote adherence to managerial policies
  - Financial statements are prepared using GAAP
  - Comply with laws and regulations

## Internal Control Activities

- Proper authorizations
- Adequate documents and records
  - clear and well-designed
  - serially prenumbered
- Adequate safeguards of assets and data
- Independent checks on performance
- Segregation of duties

## Internal Control Activities

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- **Segregation of duties**

## Segregation of Duties

Principle of Segregation (or Separation) of Duties is that company responsibilities should be divided in such a way that no one person has enough power to defraud the company ("creates checks and balances")



## Segregation of Duties

Applies to many areas:

- Accounting Duties
- Systems Duties
- Project Management Duties



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- **Accounting Duties**
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## Separation of Accounting Duties

### Custody

- Handling Cash
- Handling inventories, tools, or fixed assets
- Preparing checks
- Receiving checks in the mail

Prevents employees from falsifying records in order to conceal theft of assets entrusted to them

### Recording

- Preparing source documents
- Maintaining journals, ledgers or other files
- Preparing performance reports

Prevents authorization of a fictitious or inaccurate transaction as a means of concealing asset thefts

### Authorization

- Authorizations of activities or transactions
- Signs checks

Prevents an employee from falsifying records to cover up an inaccurate or false transaction that was inappropriately authorized

Romney – p. 264

## Separation of Accounting Duties at Waren Sporting Goods?

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Nancy Ford

### Recording

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Jim Adams

Ray Kramer

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## Threats to Control Objectives

- Natural disasters
- Hardware malfunctions, software errors
- Unintentional accidents, errors, lost data
- Intentional acts
  - Theft, embezzlement, fraud
  - Sabotage



## Threats are increasing

- Computers are becoming ubiquitous
- Networks are replacing centralized systems
- Computer environments are complex
- Performance pressures encourage shortcutting security procedures
- Fraud

## **Recent Frauds focused Congress on Internal Controls**

- Enron
- WorldCom
- Adelphia
- Global Crossing
- Xerox
- Qwest
- Many others (Cendant, Lincoln Savings, ESM, Anicom, Waste Management, Sunbeam, etc.)

## Regulation and Internal Controls

- Securities Exchange Acts 1933 – 1934
- Development of GAAP
- Development of GAAS (Generally Accepted Auditing Standards)
- Foreign Corrupt Practices Act 1977
- Savings and Loan Scandals - 1980s
- The Treadway Commission

## Sarbanes-Oxley (SOX) 2002

- What does SOX do?
  - It changes the law governing auditing and corporate responsibility.
- Who does it effect?
  - Boards of Directors
  - “C”-level executives (CEO, CFO, etc.)
  - Auditors
- Who benefits?
- Why should you care about SOX?

## Highlights of SOX

- Auditors lose control of auditing profession.
  - Created Public Company Accounting Oversight Board (PCAOB)
  - Sets standards for quality control, independence, ethics of auditors

## Highlights of SOX

- Regulates auditors more closely
  - Auditors must report more closely to Audit Committee
  - Prohibits much “add-on” consulting work

## Highlights of SOX

- Regulates BOD's more closely
  - Audit committee must be on the BOD
  - Audit committee members must be independent of the company (have no personal financial stake - no stock, no loans); they are “outside directors”.

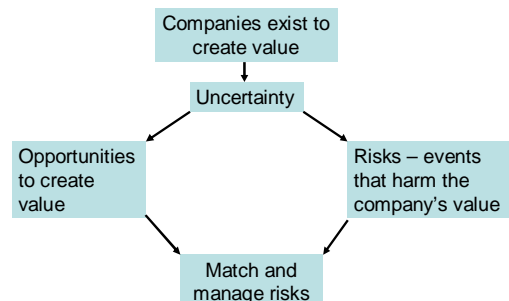
## Highlights of SOX

- Regulates management more closely. Managers must
  - **Certify** the financial statements and carry legal liability
  - Provide more financial statement **disclosures**
  - (Rule 404) issue a report about company's internal control system and publicly evaluate their company's IC system using an **internal control best practices framework, and report material weaknesses.**

## Internal Control Frameworks

- There have been several attempts to develop a standard and comprehensive approach to Internal Controls
- **COSO** (Committee of Sponsoring Organizations of the Treadway Commission)
  - 1992 – 5 part Internal Control Framework
  - 2001 – Enterprise Risk Management (ERM)
    - We will focus on this one
- **COBIT**
  - Control Objective for Information and related Technology

## ERM Framework



## ERM – 1) Internal Environment

- The “people” side
- Ethics
- Management’s philosophy and risk profile
- Organizational structure
- Audit committee
- Human resource policies

## ERM – 2) Objective Setting

- Strategic Planning – high level decisions
  - Open a foreign market
  - Use a new technology
  - Enter a new industry
  - Research a new product
  - Expand market share with advertising
- **Example: Trump International Hotel & Tower** in Chicago



## ERM – 3) Event Identification

- Occurrences that impact your strategy, especially negative occurrences
  - Interest rate changes
  - Worker accidents
  - Technology partner goes bankrupt
- Trump Tower?

## ERM – 4) Risk Assessment

- Accountant has a key role in:
  - Estimating **risks**
  - **Likelihood & Impact**
  - Estimating **exposures** – resulting \$ losses

## ERM – 5) Risk Response

After assessment what do you do?

- Reduce Risk through Control
  - Identifying needed controls
  - Estimating costs and benefits of controls
- Remaining risk
  - Accept it – move forward
  - Share it – insurance
  - Avoid it – cancel the activity
- Trump?

## ERM – 6) Control Activities

- Proper authorizations
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## ERM – 6) Control Activities

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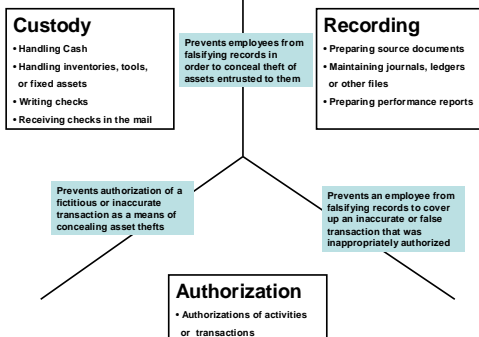
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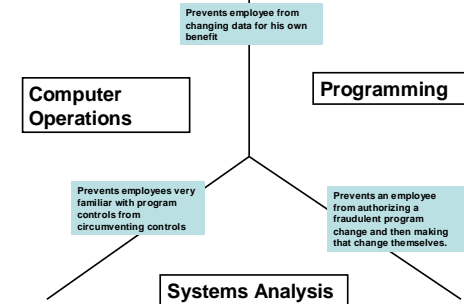


### Separation of Accounting Duties



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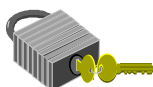
### Separation of Systems Duties – 10 duties



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## Project Management Methodology (more in Chap. 18)

Although fraud can be an issue in project management, controls over systems development projects relate more to the **efficiency and effectiveness** of the project.



## ERM –

### 7) Information & Communication

- Accountant must understand:
  - The data processing cycle
  - The transaction cycles
  - The audit trail
  - The technology

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## Internal Controls

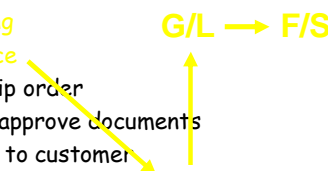
### The Audit Trail

The **Audit Trail** is the documentary evidence that links the source documents to the final numbers on the financial statements.

## Audit Trail in the SUA Credit Sale

1. Customer Purchase Order
2. Approve Credit
3. Bill of Lading
4. Sales Invoice
5. Pack and ship order
6. Review and approve documents
7. Mail invoice to customer
8. Make the entry in the Sales Journal and then update the A/R Subsidiary Ledger

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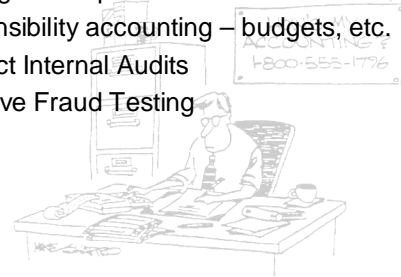
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- G/L → F/S
- 

ERM –  
8) Monitoring Performance



COSO –  
8) Monitoring Performance

- Training and supervision
- Responsibility accounting – budgets, etc.
- Conduct Internal Audits
- Proactive Fraud Testing



End of Control & AIS

Actg 474