INTERNAL CONTROL AND SEC ENFORCEMENT ACTIONS

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The assessment of control risk and the information provided by obtaining an understanding of the internal-control structure assist the auditor in determining the nature, timing, and extent of substantive tests (SAS 55). Because the assessment of control risk affects the attest function, auditors need to be aware of the actions taken by the SEC in enforcement actions in the internal control area. A review of *SEC Accounting and Auditing Enforcement Releases* from June 1987 through December 1991 reveals problems that should be brought to the attention of CPAs performing audits.

Internal Control Provisions

The Securities and Exchange Act of 1934 was amended by the Foreign Corrupt Practices Act (FCPA) of 1977 which dealt with, among other issues, companies' failure to "keep books and records that accurately and fairly reflect its transactions and dispositions of its assets" and "devise and maintain a system of internal accounting controls sufficient to provide reasonable assurance" that the objectives of internal control are being met. Rule 13b2-2 prohibits "officers from, directly or indirectly, making or causing to be made false or misleading statements or failing or causing the failure to disclose material information to auditors. . ."

The Omnibus Trade and Competitiveness Act of 1988 (1988 Trade Act) further amended the FCPA. The 1988 Trade Act makes three substantive amendments to the FCPA's accounting provisions and clarifies the terms "reasonable assurances" and "reasonable detail" as used in Sec. 13 (b)(2) of the SEC Act of 1934. The FCPA requires issuers to make and keep books, records, and accounts, which, in reasonable detail, accurately and fairly reflect transactions and dispositions of the issuer's assets, and to devise and maintain a system of internal accounting controls sufficient to provide reasonable assurances that corporate assets are properly accounted for as specified in the statue. The 1988 Trade Act clarified these provisions by stating that these terms mean "such level of detail and degree of assurance as would satisfy prudent officials in the conduct of their affairs."

Review of AAERs

Of the 208 *Accounting and Auditing Enforcement Releases* (AAERs) issued from 1987 to 1991, 34 (16%) dealt with violations of the internal-control provisions. In addition, 76 cases (37%) involved revenue recognition problems, and 85 cases (41%) involved management misrepresentations.

Four of the cases merit a more detailed discussion to highlight problems that could be encountered in an audit, and the need for auditors to be aware certain conditions could exist.

Erroneous Accrual Periods

According to AAER #181, during the period 1983-85 the controller of a Federally insured savings and loan association incorrectly accrued interest on mortgage-backed securities issued or guaranteed by the Federal National Mortgage Association (FNMA), the Government National Mortgage Association (GNMA), and the Federal Home Loan Mortgage Association (FHLMC). According to the release, the controller either recorded, or instructed his subordinates to record, accrued interest on FNMA and GNMA instruments for 60 days when he knew the correct accrual period was 30 days, and interest on the FHLMC instruments on a 90-day instead of 60-day basis. These incorrect accruals had the effect of causing pre-tax net income to be overstated by $2.9 million in 1983, $2.4 in 1984, and $14 million in the first three quarters of 1985. The complaint charged the controller falsified journal entries and worksheets given to the auditors as well as telling them the wrong periods were the proper accrual periods for these instruments. During the 1983 audit, the auditors found interest on certain instruments was 329% higher than the previous year, even though the principal had increased only 162%. When asked to explain the discrepancies, the controller provided a falsified worksheet that contained the increase of 30 days' interest in the interest receivable account. Early in 1986, the auditors reviewed a schedule of interest receivable and determined that the balance seemed unusually high. Upon further investigation, the auditors found several unsupported entries made by the controller. When confronted, he admitted he could not support these entries with proper documentation. From the facts of the case, the internal controls were overridden by the controller's ability to prepare false journal entries or to direct his subordinates to prepare false journal entries with no supporting documentation.

Overstated Inventory

In another complaint (AAER #137), the controller of a manufacturing and distribution company was charged with withholding $250,000 of accounts payable invoices when asked to do so by the company's president. Other company employees were instructed to say nothing to the auditors about these withheld invoices. The inventory associated with these invoices was included in the year-end inventory, and, as a result, operating results were materially overstated. The company's controls were deficient because there was no system for physical control over accounts payable invoices or files and there were no procedures for logging in invoices and processing them as they were received. This same company was the subject of a subsequent AAER #138 involving the falsification of inventory tags that caused a $1.6 million overstatement of inventory.

Revenue Recognition

AAER #175 and AAER #178 involve a company whose primary business was to provide computer equipment to

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financial institutions. In March 1983, the company agreed to "sell" 40 automatic teller machines for almost $1.2 million. The sales were recognized for the year ended January 31, 1983. The transactions did not constitute sales but were actually financing agreements. The CFO was a CPA knowledgeable about accounting and disclosure requirements of a public company, but at the direction of the CEO, caused the books and records to reflect the desired sales. In addition, the CFO provided the auditors documents and letters to confirm the sales dates.

Unrecorded Shipments

The case described in AAER #252 involved approximately $610,000 of unbilled shipments to a particular customer over a three-year period. According to the complaint, the chairman of the board and a director concealed the transaction documents from the controller, bookkeeping staff, and auditors. They also instructed the shipping clerk not to enter the shipments in the shipping log. The SEC complaint alleged as a result of these actions the books and records of the company did not adequately reflect the transactions, and the company failed to maintain a system of internal controls sufficient to that end.

Implications for Practitioners

In addition to the cases just outlined, extensive review of other AAERs revealed companies that had inadequate procedures and controls over—

- Provisions for doubtful accounts and loans,
- Obsolete inventory,
- Capitalization of interest,
- Personal use of company assets by executives,
- Classification of transactions, and
- Revenue recognition.

The importance of understanding the control environment cannot be overstated. Management override of controls appears to be the area of greatest weakness. The potential for management override always exist. An important consideration in understanding the control environment is an evaluation of the likelihood of override in the circumstances. The ability of management to delegate authority, delineate specific duties, and authorize transactions can strengthen or destroy the official internal control mechanism. Auditors must look beyond the accounting system and specific control procedures to the control environment.

Control procedures, however, are also important. In many of the cases reviewed, adequate cutoff procedures, extension of confirmation procedures, close attention to inventory counts and values, and scrutiny of revenue recognition criteria would have revealed uncovered violations. Ultimately, a healthy dose of "professional skepticism" is always called for in any audit situation. ❑