

Tentative Report on Internal Accounting Control

The independent CPA has a role in helping clients meet the more stringent requirements of the Special Advisory Committee and the Foreign Corrupt Practices Act.

In August 1977 the AICPA established a Special Advisory Committee (the "Committee") to develop criteria for evaluating internal accounting control. In September 1978 the Committee issued their report entitled "Tentative Report of the Special Advisory Committee on Internal Accounting Control" ("the Report"). The purpose of this article is to summarize some of the major points in the Report.

Several forces have placed emphasis on internal accounting control. The Commission on Auditors' Responsibilities recommended that management issue along with the financial statements a "Report by Management" which would include a section reporting on internal accounting controls.¹ The Financial Executives Institute has given its support to this recommendation.² In addition, the Foreign Corrupt Practices Act of 1977 contains provisions on internal accounting control.

Accounting Control Defined

An early definition of internal control divided this concept into administrative control and accounting control. Though management is concerned with both administrative and accounting controls, the Report is limited to internal accounting control. Accounting control has been defined as follows:

Accounting control comprises the plan of organization and the procedures and records that are concerned with the safeguarding of assets and the reliability of financial records and consequently are designed to provide reasonable assurance that:

- Transactions are executed in accordance with management's general or specific authorization.
- Transactions are recorded as necessary (1) to permit preparation of financial statements in conformity with generally accepted accounting principles or any other criteria applicable to such statements and (2) to maintain accountability for assets.
- Access to assets is permitted only in accordance with management's authorization.
- The recorded accountability for assets is compared with the existing assets at reasonable intervals and appropriate action is taken with respect to any differences.³

Thus, as the committee indicated, internal accounting control is concerned with the objectives of authorization, accounting and asset safeguarding.

This definition of accounting control and much of the other professional literature on internal accounting control reflects the auditor's point of view rather than management's. The Report is intended to be a first step in an effort to study internal accounting control requirements in light of the broader needs of management.⁴

Foreign Corrupt Practices Act of 1977 (the "FCP Act")

In addition to its provisions against bribery, the FCP Act contains provisions on internal accounting control for publicly-held companies. These provisions are added to Section 13 (b) of the Securities Exchange Act of 1934. (See also Accounting Series Release No. 242.) The following excerpts from the FCP Act pertain to internal accounting control:

Section 102. (2) Every issuer which has a class of securities registered pursuant to section 12 of this

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¹ Commission on Auditors' Responsibilities: Report, Conclusions, and Recommendations, New York: American Institute of Certified Public Accountants, 1975, p. 79.

² Tentative Report of the Special Advisory Committee on Internal Accounting Control, New York: American Institute of Certified Public Accountants, (September 15, 1978), p. 5.

³ SAS No. 7, Section 320.28.

⁴ Tentative Report, op. cit., pp. 15-16.

title and every issuer which is required to file reports pursuant to section 15 (d) of this title shall (A) make and keep books, records, and accounts, which, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the issuer; and (B) devise and maintain a system of internal accounting controls sufficient to provide reasonable assurances that (i) transactions are executed in accordance with management's general or specific authorization; (ii) transactions are recorded as necessary (l) to permit preparation of financial statements in conformity with generally accepted accounting principles or any other criteria applicable to such statements, and (ll) to maintain accountability for assets; (iii) access to assets is permitted only in accordance with management's general or specific authorization; and (iv) the recorded accountability for assets is compared with the existing assets at reasonable intervals and appropriate action is taken with respect to any differences.⁵

As can be seen by comparison to the accounting control definition from SAS No. 1, Section (B) of the FCP Act is almost identical to Section 320.28 of SAS No. 1. Thus, the companies subject to the 1934 SEC Act are now required by law to design and maintain a system of internal accounting control that provides reasonable assurance that the objectives of authorization, accounting and asset safeguarding are met.⁶

Scope of Internal Accounting Controls

The Committee's position in the Report is that internal accounting controls should not be limited to external financial statements. Rather internal accounting control procedures should extend to *all* external reporting of historical financial information and to internal records and reports to the extent they have an important bearing on achieving the broad objectives of authorization, accounting and asset safeguarding.⁷

The Preliminary Assessment—The Internal Accounting Control Environment

The Committee believes that before an evaluation of internal accounting control procedures and techniques can be made, an overall evaluation of the company's internal accounting control environment is necessary. Though the internal accounting control environment involves all employees, it is essentially established by the board of directors, the audit committee and top management. It is the internal accounting control environment that largely determines whether the controls, procedures,

and techniques will operate effectively.⁸ The flowchart (Exhibit I) describes some of the factors that shape the internal control environment.

One factor is the firm's organizational structure. An assessment of the organizational structure is important because it provides the framework within which the company operates. In assessing the structure, the company should evaluate:

1. The competence and integrity of its personnel,
2. The clarity of delegation and communication of responsibility and authority and related policies and procedures;
3. The degree to which budgets are prepared in light of organizational lines of authority and responsibility and how effectively financial reports provide feedback on performance; and
4. The organizational checks and balances particularly the financial control function and the internal audit function.⁹

Secondly, special consideration must be given to the EDP controls in light of the wide range of tasks that may be performed in the EDP process. Here any assessment of the internal accounting control environment must consider the degree of control exercised by management over the development and maintenance of the computer system.¹⁰

Evaluating Specific Internal Accounting Controls

Following a preliminary assessment of the internal accounting control environment and the effectiveness of existing accounting control procedures, an evaluation of specific procedures and techniques begins. The Committee uses an approach which emphasizes the internal accounting control environment.

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The flowchart (Exhibit 1) shows the relevant steps in the process of evaluating specific accounting controls, procedures and techniques. While the Committee suggests a cycle approach in which related transactions are grouped together, it does not rule out other approaches such as the functional approach or an operating unit approach. The evaluating process involves first classifying transactions into cycles. As a means of illustrating their

⁵ *An Analysis of the Foreign Corrupt Practices Act of 1977*, Chicago: Arthur Andersen & Co., 1978, Subject File D1 4520, Item 135, pp. 13-14.

⁶ *Tentative Report, op. cit.*, p. 15.

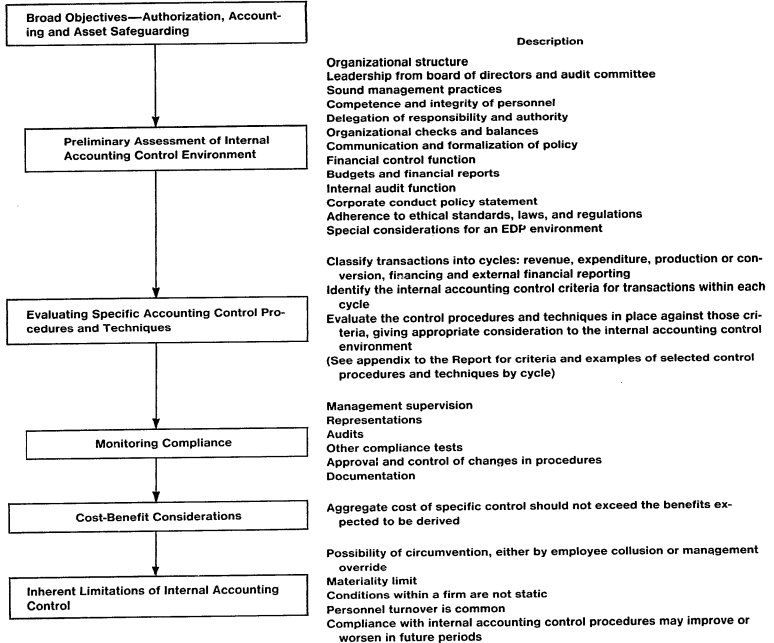
⁷ *Ibid.*, p. 9.

⁸ *Loc. cit.*

⁹ *Ibid.*, pp. 10-11.

¹⁰ *Ibid.*, pp. 11-12.

EXHIBIT I
Internal Accounting Control



approach, the Committee recognized five cycles present in most companies:

1. Revenue;
2. Expenditure;
3. Production or conversion;
4. Financing; and
5. External financial reporting.

Next, appropriate internal accounting control criteria or standards are identified. Then an evaluation of specific control procedures and techniques in place against the

criteria or standards occurs, keeping in mind at all times the internal accounting control environment.¹¹

Once the internal accounting control criteria have been identified the following should be undertaken:

1. Consider whether the company environment encourages compliance with accounting control procedures and reinforces appropriate behavior. Also, consider if company objectives, policies and procedures are commu-

¹¹ *Ibid.*, pp. 12-13.

nicated to middle management and other employees with appropriate formality.

2. Consider the transactions the company engages in and relate those transactions to a specific cycle.

3. Consider the criteria necessary to achieve the objectives of internal accounting control for each cycle and, using judgment, make any appropriate modifications necessary because of a company's particular circumstances.

4. Obtain an understanding of the flow of transactions through each cycle and the existing accounting control procedures and techniques.

5. Consider whether the existing accounting control procedures and techniques provide reasonable assurance that the criteria deemed necessary to achieve the objectives of internal accounting control have been met.¹²

The appendix to the Report includes criteria and examples of selected control procedures and techniques for each cycle for a hypothetical manufacturing company.

Monitoring Compliance

Once a specific evaluation has been completed, management should monitor compliance with accounting control procedures to be sure controls continue to function properly.¹³

Other Considerations

The Committee points out that obtaining reasonable assurance that internal accounting control objectives have been met recognizes that the cost of specific controls should not exceed the expected benefits. In addition, management must recognize the inherent limitations of internal accounting control. These limitations include: (1) the possibility of employee circumvention of controls, (2) the trade-off between operating efficiency and increasingly complex control procedures, (3) materiality limits below which control procedures may be impractical, (4) employee turnover may worsen or improve control procedures, and (5) control procedures over external financial reporting may involve more subjective judgment than control procedures over processing routine transactions.¹⁴

Implications for Management

Management is primarily responsible for the financial statements. The independent auditor is required by SAS No. 19 to obtain a written representation from management which among other items includes:

Management's acknowledgement of its responsibility for the fair presentation in the financial statements of financial position, results of operations, and changes in financial position in conformity with generally ac-

cepted accounting principles or other comprehensive basis of accounting.¹⁵

Management's responsibility for internal control and the financial statements is not new. But now with the Foreign Corrupt Practices Act management may be subject to significant penalties for violations. Penalties for violations of the accounting provisions can reach a maximum of \$10,000 for companies and \$10,000 plus five years imprisonment for company officials. Penalties for violating the corrupt practices provisions on influencing foreign government decisions provide for \$1,000,000 fines for firms and \$10,000 fines and five years imprisonment for company officials. In addition, any fines imposed on individuals may not be paid by the company.¹⁶

'... management should monitor compliance with accounting control procedures to be sure controls continue to function properly.'

Regulated companies can expect the SEC to take a more active role concerning their internal activities. The SEC's lawsuit against Aminex Resources Corporations illustrates that the SEC intends to enforce the new internal control and record keeping requirements whether foreign bribery is involved or not.¹⁷

Management will want more specific information about the adequacy of records and the system of internal control. The independent CPA's review of internal control in connection with his audit may not be sufficient to demonstrate compliance with the FCP Act. This review has a different objective, namely, to allow the auditor to determine if the system can be relied on and to determine the extent of testing necessary (the second field work standard). In doing so the auditor may or may not choose to rely on particular aspects of internal control. But the FCP Act requires that the entire system of internal control meet the broad objectives of authorization, accounting and asset safeguarding. Consequently, areas of internal control on which the external auditor did not rely in his audit or areas the auditor felt were inadequate may need to be strengthened to meet the broad objectives of the FCP Act.

Management will need to evaluate the internal control system, review any weaknesses, and take any necessary corrective action. Management should review their internal control procedures, the role of their internal audit staff, discuss internal control procedures with their em-

¹² SAS No. 19, American Institute of Certified Public Accountants, New York, 1977, paragraph 4.

¹³ *The New Management Imperative: Compliance with the Foreign Corrupt Practices Act*, Touche Ross & Co., 1977, pp. 4-5.

¹⁴ *Financial Reporting Briefs*, Ernst & Ernst, June 1978, pp. 5-6.

¹² *Ibid.*, p. 14.

¹³ *Ibid.*, pp. 14-15.

¹⁴ *Ibid.*, p. 15.

employees, and brief new employees on the system. Preventing bribery of foreign officials should be given special attention. A code of conduct for employees may be helpful. In addition, management will need to formalize their procedures and any changes in them through documentation. The use of internal control manuals may be an aid. When weakness in the internal accounting controls are found, management must be careful to take required corrective actions or to fully document and be able to defend why such action is not taken. If corrective action is not taken, management may want to consider how a third party will view their decision if the company is ever brought to court.

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Carrying out a plan of internal control could involve the use of internal auditors, a formal review by outside experts, or the independent CPAs working in conjunction with management and the audit committee of the board of directors.

The independent auditor is required by SAS No. 20 to communicate to senior management and the board of directors or its audit committee any material weaknesses in internal accounting control that come to the independent auditor's attention during an audit.¹⁸ This requirement should aid management in complying with the FCP Act.

Implications for the CPA

Performing an evaluation of internal control as part of an audit is not new for the independent CPA. The requirement in SAS No. 20 to communicate material weaknesses in internal accounting control which come to the CPA's attention during an audit should receive greater attention. This communication should be reviewed from the viewpoint that the client may use this as evidence of compliance with the FCP Act.

Management and the audit committee are likely now to be much more interested in the findings of the CPA on the internal control system. Clients under the FCP Act will probably be more receptive to implementing recommended changes or improvements. Clients may be requesting the CPA's opinion on whether the company is in

compliance with the FCP Act. If the CPA did not rely on parts of the client's system in his audit, he may need to perform additional procedures in order to evaluate compliance. The Report on internal accounting control is designed to aid in determining if a firm complies with the FCP Act.

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In evaluating internal control special attention should be given to determine compliance with provisions on bribing foreign government officials. If the company has a code of conduct for its employees, the auditor should be alert to violations. Where a code does not exist, the auditor might consider recommending that one be developed if it will strengthen internal control.

The CPA may be called on to design parts of a system of internal control for a client. Reviewing and evaluating internal control by the independent CPA is one thing. But setting up a system of internal control for a client which the CPA will or might later audit is an engagement that should be looked at carefully. The possibility of a conflict of independence "in fact" or the lack of an appearance of independence to third parties must be evaluated should the CPA firm be called on to audit that system. Statement on Management Advisory Services No. 3 covers the CPA's role in such engagements.

Conclusion

Internal accounting control is an area of concern to all business organizations. Strengthening internal control strengthens the integrity of the financial statements. The Report's tentative recommendations and the Commission's final report should be of assistance to all in evaluating internal accounting control systems. In addition, though the Special Advisory Committee on Internal Accounting Control was not formed because of the Foreign Corrupt Practices Act, the final report should be useful to management in determining whether a firm complies with the internal accounting control provisions of the FCP Act.¹⁹ □

¹⁸ SAS No. 20, American Institute of Certified Public Accountants, New York, 1977, paragraph 1.

¹⁹ Tentative Report, op. cit., p.2.