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Internal Control -- It's Importance to those Within the Business and FInancial Community

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INTERNAL CONTROL--ITS IMPORTANCE TO
THOSE WITHIN THE BUSINESS AND
FINANCIAL COMMUNITY

by

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CHAPTER I

INTRODUCTION

During the last thirty years there has been considerable interest in and concern about the subject of internal controls within the business and financial community. This has increased in recent years due to the many disclosures which have shown internal controls to have been inadequate or completely circumvented in many business operations.

Thirty years ago, the topic was of concern mainly to business firms and their independent auditors. No definition existed which could be commonly applied. Businesses were growing and they wanted guidance in this area. Auditors wanted a specific definition to bring more uniformity to auditing applications. In 1947, in response to these concerns, the American Institute of Accountants[1] created a commission to study the subject of internal controls.

The purpose of the study was to establish a usable definition of internal control and make recommendations for its use in practice. In 1949, the study was completed. It provided this definition:

> Internal control comprises the plan of organization and all of the coordinated methods and measures adopted within a business to safeguard its assets, check the accuracy and reliability of its accounting data, promote operational

[1]The American Institute of Accountants is the predecessor organization of the American Institute of Certified Public Accountants.

> efficiency, and encourage adherence to prescribed managerial policies. This definition possibly is broader than the meaning sometimes attributed to the term. It recognizes that a "system" of internal control extends beyond those matters which relate directly to the functions of the accounting and financial departments.[2]

The appropriateness of this definition can be seen as it has continued to be used by authors as part of their discussion of internal control. It has also been incorporated into authoritative accounting literature as part of Statements On Auditing Standards Number One (SAS).

Although authoritative, the definition did not satisfy all of those within the business, financial and accounting community. Those involved in independent auditing believed it to be too comprehensive to be used in planning an audit. Their major objection was that the very broadness of the definition emphasized areas which were generally not covered during an audit examination.

Many authors also recognized the breadth of the definition. During the period from 1949 to 1958, discussion of internal control in the accounting literature generally concentrated on specific areas of importance to the writer. One area of particular interest to authors was safeguarding assets and those related activities within the company towards achieving this end.

The controversy continued until 1958. With the issuance of Statements on Auditing Procedure Number 33, internal control was divided into two portions, accounting control and administrative control. The

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[2]American Institute of Accountants, Internal Control--Elements of a Coordinated System And Its Importance to Management And The Independent Public Accountant (New York: American Institute of Accountants, 1949), p. 6.

accounting controls generally were those relating to the system of record keeping and the verification of it. Those classified as administrative controls related to the managerial functions needed for the accounting controls to operate. These ideas were incorporated into S.A.S. Number One and since that time have been further clarified. The current internal control definition is as follows:

> Administrative control includes, but is not limited to, the plan of organization and the procedures and records that are concerned with the decision processes leading to management's authorization of transactions. Such authorization is a management function directly associated with the responsibility for achieving the objectives of the organization and is the starting point for establishing accounting control of transactions.
>
> 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:
>
> a. Transactions are executed in accordance with management's general or specific authorization.
> b. Transactions are recorded as necessary (1) to permit preparation of financial statements in conformity with generally accepted accounting statements in conformity with criteria applicable to such statements and (2) to maintain accountability for assets.
> c. Access to assets is permitted only in accordance with management's authorization.
> d. 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]

Dividing internal control in this manner promotes the idea that controls over accounting data can be separated from other controls. Although in reality the entire system functions as a unit, this separation enables

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[3]American Institute of Certified Public Accountants, AICPA Professional Standards, Vol. 1 (New York: American Institute of Certified Public Accountants, 1977), p. 248.

auditors to test the system of accounting controls to determine the extent to which reliance can be placed on them in audit work.

The importance of the auditors evaluation of internal control is increasing as businesses grow in size and complexity. Many firms have reached the stage where they are dependent on the reports and analyses produced from internal accounting data. In addition to the firm itself, other interested parties such as investors, governmental units and regulatory agencies are also dependent on the integrity of the controls system. Without a properly functioning system, little reliance can be placed on the information produced.

The business community is concerned about its reliability for other reasons. The most important factor is the rising number of cases in which the internal control system is the subject of abuse.

> Recent events have contributed to a growing awareness of the importance of internal controls in the functioning of a corporation.
>
> The failures of companies such as National Student Marketing, Equity Funding and W. T. Grant, and the severe problems encountered by others, all later attributed (at least in part) to weaknesses in internal controls, have caused securities analysts to become increasingly conscious of the importance of internal controls.[4]

In the early 1970's the disclosure of illegal campaign contributions and bribery during the Watergate era caused closer scrutiny of the operation of the internal control system and its supervision. Particular emphasis is now being placed on the internal accounting controls which are in place.

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[4]Marilyn V. Brown, "Auditors and Internal Control: An Analyst's View," CPA Journal 47 (September 1977): 27.

The purpose of this paper is to examine how internal controls are designed and established within the business invironment with particular attention given to those labeled internal accounting controls. In addition, the effects of recent actions by the Securities and Exchange Commission (SEC), the U. S. Congress and the American Institute of Certified Public Accountants (AICPA) and their potential effects on the operation of internal control systems in the future will be studied.

The definition of internal control which has been presented is of little value to the business unless it is converted into a system of interrelated internal controls. The first area of study will concentrate on the establishment of the system and the factors which will affect it.

CHAPTER II

HOW A SYSTEM OF INTERNAL CONTROLS IS ESTABLISHED

The definitions of internal control previously provided are general guidelines to be achieved when designing a system to control the operations within a company. These guidelines are applicable to every company regardless of size. Before they can be applied through the installation of an internal control system, the answers to three critical questions must be understood. They are:

1. Who bears the responsibility for deciding on the specific internal controls required?

2. How are the desired internal controls achieved?

3. What factors will ultimately affect the effectiveness of the internal controls system once it has been installed?

Who Bears The Responsibility for The Internal Control System?

As with other decisions affecting total company operations, management must bear the responsibility for determining which controls will most effectively guide and motivate those within the organizational structure. The term management can be interpreted in several different ways. For purposes of this paper it shall mean the board of directors and any of its committees as well as the operating management of the company.

While every member of the management group will have different duties to perform, all are responsible for the functioning of the internal control system. An expansion of the definitions previously presented shows the scope of management's coverage and sets forth many of their duties.

> Management has the responsibility for devising, installing and currently supervising a system of internal control adequate to: (1) safeguard the assets of an organization; (2) check the accuracy and reliability of accounting data; (3) promote operational efficiency; and (4) encourage adherence to prescribed managerial policies; and, for these purposes, to provide an appropriate plan of organization; and adequate system of authorization and record procedures; sound practices and, lastly, personnel of appropriate number and capabilities. . . . The broad design, considerations of detail, and the integration of the whole system of internal control demand careful planning.[5]

These duties can be restated to recognize factors which can cause losses for the company.

1. The erroneous recording of accounting transactions (i.e., a recording that is contrary to generally accepted accounting principles, a recording that, although complying with GAAP, deviates from management's prescribed policies, or a recording that is outright fraudulent).
2. Unintentional or intentional expropriation/destruction of assets.
3. Less than optimal management decisions (caused by information that is misleading, incomplete, inappropriate, or untimely).
4. The interruption of usual business operations.
5. Avoidable excessive costs or loss of revenue.
6. Penalties by various governmental bodies.[6]

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[5]American Institute of Accountants, Internal Control--Elements of a Coordinated System And Its Importance to Management And The Independent Public Accountant, p. 17.

[6]Computer Control and Audit, cited by Michael A. Pearson, "Internal Control Concepts and An Approach to Evaluation," Wisconsin CPA 118 (March 1978): 18.

While all of the preceding duties define important management obligations, there are also other areas of attention to be considered. These will include long and short term planning, all types of budgets and forecasts as well as timely reports to shareholders and others who have an interest in the progress of the company. Each company will be able to identify other management responsibilities which are dictated by their own unique set of circumstances.

How Are Internal Controls Achieved?

Once those in management understand the scope of their responsibility, the design of the internal control system can begin. Before any specific controls can be instituted, management's duties must be converted into objectives which can be carried out by the system. Inputs on the objectives should be solicited from many levels within the company even though management retains the final responsibility for the success or failure of the controls established.

When the objectives are prepared for a system of internal control, they will generally be divided into the two sections that are found in the authoritative literature. Although specific objectives can be assigned to both administrative and internal accounting control, it must be remembered that they do not operate independently but interact.

A number of authors have suggested that the objectives which are stated for administrative control will dictate the organizational structure within which the accounting controls will operate. These objectives will set forth the company policies on many matters, including the rules for authorizing transactions, employment of personnel, as well as proper preparation of budget and financial reports. They will also encompass a mechanism to insure proper functioning of the system and for its revision by management as required.

As found in the writings of a majority of authors, the internal accounting objectives deal specifically with assuring the adequacy of the records maintained by the company. There is general agreement in terms of the major control. They include proper authorization for transactions and activities, adequate record keeping responsibilities, and safeguarding of company assets.

Once the objectives have been identified, specific controls can be established to implement them.

Administrative controls will vary from company to company. The organizational structure will be dependent on the type of business operations and includes the budgets, forecasts and other reports required. Specific areas of control will dictate the frequency, type and distribution of the reports to be produced. Personnel controls will mandate the criteria of employment such as qualifications required, pay rates, promotions, special benefits and termination actions. The lines of authorization for responsibilities and activities should be clearly designated. They should encourage communication within the company and include means to see that the authority is not misused.

The internal accounting controls will be more uniform among various companies. Controls for the authorization objective must provide assurance that only properly authorized procedures are followed. The accounting objective controls will implement adequate segregation of duties among the various duties, and insure that the documents to be used are sufficient for the system. By providing proper procedures for the accounting system, some safekeeping of assets will be provided. The safekeeping objective controls will also provide adequate physical control over the assets and records.

Once the general controls for the internal accounting control system have been defined, they must be applied to the entire system of the company. For many companies, the controls will be enumerated in terms of their general audit categories such as cash, inventories or accounts receivable. Although this is a logical way to approach the problem, recently the Arthur Anderson Company suggested a slightly different way of looking at them. They define the entire internal accounting control system in terms of cycles. The cycles are groupings of similar transactions. They are used as a method to provide a common basis for discussing the operation of the system. For most companies the entire range of business activities fit into one of these major accounting categories.[7]

Since the Arthur Anderson study was first published, other authors have adopted the cycle concept as a means of describing, evaluating, and setting objectives for the internal accounting control system. To understand how the system functions, it is first necessary to group the transactions of a company by cycle. An example of this is as follows:

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[7] Arthur Anderson and Company, A Guide for Studying and Evaluating Internal Accounting Controls (n.p.: Arthur Anderson and Company, 1978), p. 14.

Economic Events that are Converted into Transactions	What is Accomplished:
1. Capital funds are received from investors and creditors 2. Capital funds are temporarily invested until needed for operation	Treasury Activity
3. Resources (goods and services) are acquired from vendors and employees in exchange for obligations to pay. 4. Obligations to vendors and employees are paid.	Expenditure Activity
5. Resources are held, used, or transformed.	Conversion Activity
6. Resources are distributed to outsiders in exchange for promises of future payments 7. Outsiders pay for resources distributed to them.[8]	Revenue Activity

By defining the entire system in terms of four basic activities or cycles the system is greatly simplified and two things are accomplished:

Concentration on those types of transactions and related systems of control that materially affect the entity's financial statements.

Segregation of the entity's business, and the related accounting systems, into a financial planning and control function and a limited number of interrelated cycles.[9]

To understand the internal accounting controls system when using cycles, the general system controls and objectives must be applied to each of the major cycles, treasury, expenditure, conversion, and revenue.

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[8]Ibid., p. 14.

[9]Ibid., p. 9.

The treasury cycle has also been called the financing cycle by other authors. It involves exchanges with those outside the company such as banks, other financing institutions, and investors. Liabilities such as long term notes, leases or mortgages as well as capital stock are exchanged for cash or other assets.

The control objectives for appropriate authorization occur mainly in two areas. For capital stock the necessary authorizations are for the issuance of stock, its redemption, and payments of dividends. The addition of debts requires controls for the type, amount of indebtedness, and terms of the agreement. The potential uses for the assets received must also be controlled.

To properly control accounting for the treasury cycle, techniques must be developed to control how the classification and recording of transactions should function.

Safeguarding treasury cycle assets acquired requires appropriate segregation of duties both in the handling of the assets as well as in issuing capital stock or debt instruments.

The expenditures cycle involves the exchange of company assets or liabilities for outside resources needed within the business to conduct operations. To relate the three control objectives to this cycle requires subdividing it into three parts, purchasing, payroll and disbursements.

The purchasing authorizations are necessary in two areas, specification for goods required and accounts payable. Specification for goods will include the type, exact goods required as well as procedures for ordering, inspection of goods received and their acceptance by the company. Accounts payable controls will relate to approving vendors, establishing credit limits and terms of purchase including discounts.

Purchasing controls will encompass proper classification and recording of all purchases and related accounts payable.

Safeguarding purchased assets requires limiting access to both the goods obtained as well as the resulting records. This includes the accounts payable records to avoid improper payments.

Authorizations for payroll controls includes all aspects of employee relations. This cycle implements personnel decisions enumerated by the administrative control system. Selection, hiring, termination, promotion, salaries, commission rates, and specific employee benefits are some of the authorizations made.

Payroll accounting control incorporates determining the appropriate payroll incurred and recording it against the parts of the company properly affected such as office salaries. For each employee it must be determined that the work actually is performed, that the work performed is recorded against the proper time period, and it is properly authorized. Payroll deductions must be verified and recorded to the proper employee.

Controls for safeguarding assets for payroll involves limiting access to the payroll records and determining that only authorized employees are paid.

Authorization for disbursements requires that payments are made only for authorized expenditures.

Accounting control for disbursements includes verification that all amounts disbursed are correct and, for valid debts, have been recorded to the appropriate period.

Controls for safeguarding assets include controlling access to cash or other methods of disbursements and their related records to protect against unauthorized disbursements.

The conversion cycle which has also been termed the production cycle involves exchanges within the organization in order to produce the goods or services available for sale. Besides making use of purchased raw materials, some of the useful life of depreciable assets will be expended.

Conversion authorization will provide specifications for the types and quantities of goods available to be produced or services to be provided. Policies on the levels of inventory to be maintained, disposal of property, scrap, or obsolete inventory must be controlled.

Accounting control sets procedures for recording transactions including proper classification for all of the resources used in productions. It will include labor and depreciation, as well as materials.

Safeguarding manufactured assets involves controlling access to all types of inventories as well as related records to prevent losses.

During the revenue cycle the resources of the corporation, or its goods and services, are exchanged for cash or accounts and notes receivable from customers.

For proper revenue authorization controls, criteria must be established for any customer credit allowed. This will involve all activities connected with the customer accounts such as customer approval, extension of credit and returns policy. Other revenue decisions will relate to the prices for the goods to be sold and sale policies including commissions for sales personnel and warranties.

Proper accounting for revenue includes controls for recording revenue in the appropriate accounts, accounting for all cash, insuring that billings are made and posted to customer accounts, and verification of all returns and costs to be recorded.

Safeguarding assets involves separating custody of assets and record keeping as well as periodic reconciliations of the various accounts.

Arthur Anderson and Company as well as others also include a fifth cycle called the financial reporting cycle. It does not process transactions but serves to record through the statements what has occurred within the other four cycles. It is the bridge that ties together the accounting controls and administrative controls. Through the reports it informs management and other interested parties of the results of operations.

Like the other four cycles it also makes use of the major objectives of internal accounting control.

Authorizations in this cycle involve determining the accounting policies to be used, valuation methods, and any estimation decisions.

The accounting objectives to be met include review responsibilities in relation to the other cycles as well as policies to be followed in the preparation of the financial statements and other reports.

To safeguard assets during the financial reporting cycle, policies are established to protect the records of the company while they are used to prepare reports.

Regardless of how an internal control system is viewed, it is impossible to establish any one specific set of rules which can be applied by every company. Because of the wide diversity of businesses both in terms of size and the rules under which they operate, no one set of rules is feasible. Each one must evaluate and tailor the system of controls to accomodate what exists. This fact was recognized in the 1949 study.

> It is impossible to devise any one system of internal control which will provide all the safeguards, and meet the requirements of every company, irrespective of size and type. Each company has its own peculiar problems, and measures adequate in one instance will not suffice in another. Controls, likewise, must be considered in the light of their economic utility. In instances where the cost of protection would far outweigh the possible losses, or where certain controls may retard operations to the point of adversely affecting production or sales, management may decide that such controls are not fesible.[10]

This caution has been repeated in most discussions of internal controls from the time of the 1949 study until the present day.

What Factors Will Affect The Internal Control System?

Although a good internal control system will allow the production of financial statements that are reliable, it does not guarantee

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[10] American Institute of Accountants, Internal Control--Elements of a Coordinated System And Its Importance to Management And The Independent Public Accountant, pp. 17-18.

their reliability. Judgements and evaluations by management can substantially affect them.

A consensus of the authors consulted indicates there are three major factors which can each alter the system of internal control and make it operate at less than total efficiency. They are time, personnel, and management.

Time

The simple passage of time can change the system's characteristics. One which is not responsive to changing conditions will employ controls which no longer perform any useful function. Flexibility in the internal control system will permit the necessary adjustments to meet current needs and conditions. Continuing evaluation of the controls in place by management will prevent the system from becoming obsolete.

Personnel

In the area of personnel, problems can occur regardless of the diligence of management in establishing high standards for those they employ. The people involved within a system are the key to its operation. Human error through carelessness, mistakes in judgement, as well as personal factors such as health conditions, can render the most elaborate system inoperable. People can also contrive to circumvent the system either alone or with the help of others.

Introduction of new controls can also create problems with employees. Old habit patterns as well as personal preferences can prevent controls from operating properly. The use of supervisors for operations will prevent many abuses, but management must continually review critical areas to insure that control functions are operational.

Management

The most difficult area to evaluate is that of management. Because they are responsible for the design of the system, all of its weak areas are known to them. Circumvention of the internal control system is more easily accomplished by those in the management group because their authority to do so is not likely to be questioned by their subordinates.

For those who are on the receiving end of the internal control system, the users of the financial statements, trust must be placed in the basic honesty of those in charge of company operations until such time as proven otherwise.

Because management can circumvent the controls system, several different regulatory bodies have taken steps to control this type of abuse. The next chapter will consider those actions.

CHAPTER III

NEW RULINGS TO BE IMPLEMENTED THROUGH THE INTERNAL CONTROLS SYSTEM

As previously stated, management can circumvent the internal controls system. That some managements have abused their power in this manner has become a matter of great concern among those in the business and financial community. During the last thirty years, instances where managements have misused their authority to the detriment of both the company and the investor have become increasingly common.

The greatest number of cases came to public awareness in the period which followed the Watergate burglary. Since 1974, various probes and investigations have disclosed many instances where companies were involved in foreign bribery and payoff schemes as well as making illegal political campaign contributions. These actions were generally accomplished through the use of collusion and management fraud.

Because of these events, users of financial statements have lost some of the confidence which they had placed in a company's financial statements and other information. In the past, internal controls were of concern mainly to the company and its independent auditors. It became of interest to others only if major lapses caused a modification of the auditor's opinion. The magnitude of the Watergate disclosures has served to reaffirm the importance of managements responsibilities in the area of internal controls. It has caused the reliability of a company's internal controls system to become of concern to all.

Three major entities, the Securities and Exchange Commission, the U. S. Congress, and the American Institute of Certified Public Accountants have all taken action to attempt to prevent future reoccurrences of internal control abuses by management and others within the company.

The Securities and Exchange Commission

The securities laws which originally established the SEC were a means of protecting, to some degree, those who chose to invest in public corporations by mandating disclosure of all relevant facts about the corporation.

Because of this function, the disclosures of Watergate lead the SEC to institute a study to determine the extent of the illegal activities. They provided for a program of voluntary disclosure of all illegal activities for companies under Commission jurisdiction. When the results were compiled in 1976, it was determined that over 400 companies had engaged in some form of illegal activities.

A report showing the results of the study was submitted to the Senate through the Banking, Housing and Urban Affairs Committee on May 12, 1976. Study of the materials within the report reveal that illegal activities can be categorized into four different groups:

1. Foreign political contributions . . .
2. Payments to agents and foreign government officials for the purpose of obtaining favorable treatment for the company . . .
3. Domestic political contribution on both the state and federal levels . . .
4. Other domestic matters of a questionable or illegal nature . . . .[11]

These activities required management involvement in order for controls to be circumvented and the acts accomplished. While some of the management group may have had only knowledge, others actively approved of and participated in the events. In addition:

> . . . most of the instances of reported abuse also involved some falsification of corporate records or the maintenance of records that appear to be inadequate. In many of the reports submitted voluntarily by corporations, the description of the payments and their documentation appears to have been inadequate to permit ready identification or verification of the purpose of the payments. Similarly, the reports the Commission obtained as a result of enforcement actions disclose flagrant instances of abuse of the system of corporate accountability, including the establishment and maintenance of substantial off-book funds that were used for various purposes, some questionable and some clearly illegal.
>
> Many of the defects and evasions of the system of financial accountability represented intentional attempts to conceal certain activities. Not surprisingly, corporate officials are unlikely to engage in questionable or illegal conduct and simultaneously reflect it accurately on corporate books and records.[12]

Because the underlying records were not correct, any published financial statements prepared from them were in violation of securities regulations. The reports were both misleading and inaccurate as they did not show the true condition of the company.

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[11]U.S. Congress, Senate, Report of the Securities and Exchange Commission on Questionable and Illegal Corporate Payments and Practices, S. Dc. 71-389, 94th Cong. 2d Sess., 1976, pp. 37-40.

[12]Ibid., pp. 41-42.

After studying the large quantity of materials which indicated circumvention of the systems of internal controls, the SEC concluded that corrective legislative action was necessary to act as a deterrent to future abuses. The May 12 report ended by proposing an amendment to the Securities Exchange Act of 1934. Its major components were:

> 1. To make and keep accurate books and records . . .
> 2. To devise and maintain an adequate system of internal accounting records controls . . .
> 3. To prohibit falsification of accounting records and materials . . .
> 4. To make giving false or misleading statements to accountants illegal . . . .[13]

In providing this legislation the SEC stated:

> The legislation we have proposed should remedy the most pervasive characteristic of the cases brought to the Commission's attention in this area, namely, the deliberate falsification of corporate books and records and other methods of disguising the source of disbursements of corporate funds.[14]

The bill was introduced to Congress on May 12, 1976 by Senator William Proxmire, the Chairman of the Senate Banking, Housing, and Urban Affairs Committee. It received the approval of the full Senate but did not reach action of the House before adjournment.

The Commission was dissatisfied that the legislation was not implemented and took action on its own. On January 19, 1977 it published for comment Release No. 13185. The language of the proposed regulation was similar to the legislation proposed in the May 12 report. If adopted, the new regulations would place a greater emphasis on the

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[13]Ibid., pp. 63-64.

[14]Ibid., p. 67.

system of internal accounting controls. The text of the proposal as it relates to internal accounting controls is as follows:

Regulation 13B: Accuracy of Books, Records and Reports

§240. 13 b-1 Accounting Records.

Every issuer which is required to file any report pursuant to Section 13 or 15(d) of the Act (and the Commission's rules and regulations thereunder) shall make and keep books, records, and accounts which accurately and fairly reflect the transactions of the issuer and the dispositions of its assets.

§240. 13 b-2 Internal Controls System for Accounting Records.

(a) incident to the making and keeping of such books, records, and accounts as are required pursuant to Rule 13 b-1 of this regulation, every issuer shall devise and maintain an adequate system of internal accounting controls sufficient to provide reasonable assurance that

(1) transactions are executed in accordance with management's general or specific authorization;

(2) transactions are recorded (as necessary) (i) to permit preparation of financial statements or any other creteria applicable to such statements, and (ii) to maintain accountability for assets;

(3) access to assets is permitted only in accordance with managements authorization;

(4) the recorded accountability for assets is compared with the existing assets at reasonable intervals and appropriate action is taken with respect to any differences.

(b) As used in (a) of this rule, the term "reasonable assurance" shall mean that the cost of internal accounting control need not exceed the benefits expected to be derived. The benefits consist of reductions in the risk of failing to achieve the objectives implicit in the definition of accounting control.

§240. 13 b-3 Falsification of Accounting Records.

It shall be unlawful for any person, directly or indirectly, to falsify or cause to be falsified, any book, record, account, or document, made or kept pursuant to Rule 13 b-1 of this regulation.

§240. 13 b-4 Obsturction of Accountants.

It shall be unlawful for any director or officer of, or any owner of any securities issued by any issuer

(a) directly or indirectly, to make, or cause to be made, a materially false or misleading statement; or

(b) directly or indirectly, to omit to state, to cause another person to omit to state, any material fact necessary in order to make statements, in the light of the circumstances, under which such statements were made, not misleading, to an

> accountant in connection with (1) any audit or examination of the financial statements of the issuer required to be made pursuant to this subpart, or (2) the preparation or filing of any document or report required to be filed with the Commission pursuant to this subpart or otherwise.[15]

The period for public comment ended in April 1977. While the Commission in the release showed understanding that a system no matter how well constructed will not prevent those whose intent it is to circumvent controls, they believed that the additional regulations would act to prevent abuses. No criteria were specified for judgement of a system's adequacy.

The comments submitted by the AICPA summarized the major problems which were perceived by both themselves and others. They agreed with the SEC contention that the responsibility for effective internal control does rest with management. Their objections to the regulations fell into three areas.[16]

First, they reminded the Commission that the requirement of internal accounting control as stated in the regulation was taken directly from the authoritative auditing literature. The intention of the literature was not to be the total answer for internal control construction and use, but as a guide to those engaged in auditing in determining their responsibilities in defining the nature and scope of the internal control examination.

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[15]Securities and Exchange Commission, <u>SEC Docket</u> 11 (February 1, 1977): 1520-1521.

[16]U.S. Congress, Senate, Committee on Banking, Housing, and Urban Affairs, <u>Foreign Corrupt Practices and Domestic Foreign Investment Disclosure, Hearings Before the Committee on Banking, Housing, and Urban Affairs Committee on S. 305</u>, 95th Cong. 1st Sess., 1977, pp. 225-240.

Second, the definition provides no means of determining the adequacy of any system. They suggested that criteria should be developed before the regulation was adopted.

Third, they expressed a concern that by including "any person" in the regulation, people would be held liable in the same capacity as those involved in fraudulent acts for unintentional errors and honest mistakes.

The SEC has taken all of the comments received under advisement but as of the end of 1977, no further action had resulted on the proposed regulation. In promulgating these regulations the commissioners noted that:

> . . . the proposals herein codify existing law rather than create new obligations. One who, for example, falsified corporate records or deceives corporate auditors would, depending on the facts and circumstances involved, have engaged under present law in a violation of the antifraud provisions of the federal securities laws.[17]

The United States Congress

The disclosures of Watergate prompted the introduction of several bills dealing with both the internal accounting controls issue as well as with the prevention of future foreign payments. The bill suggested by the SEC was one of these. During the 1976 session several bills received affirmative action in their respective bodies. However, action on them was not completed due to the adjournment of the legislative session.

[17] Securities and Exchange Commission, SEC Docket 11 (February 1, 1977): 1521.

In January 1977, almost at the same time as the SEC Release, Senate Bill 305 was introduced. It embodied the intent of all of the bills acted on in the previous session. It was composed of two major sections, internal accounting controls and prevention of foreign payments. The language of the internal controls section differed in only minor respects from the SEC regulation. After introduction it was referred to the Senate Banking, Housing and Urban Affairs Committee for further action.

During the hearings held on the bill, the major objections voiced by interested parties were similar to those received as comments by the SEC. In addition, concern was expressed that because of the language used there was "no assurance that the proposal would be administered and enforced in a reasonable way."[18] Others objected to the law in total stating that these requirements "are already implicit in the requirements of the Securities Acts."[19]

At the conclusion of the hearings it was clear that the Committee viewed the breach of internal controls and the resulting illegalities as:

> . . .: (a) unethical and reprehensible; (b) inconsistent with the principles of a free market economy; (c) unnecessary to the successful conduct of business; and (d) a source of serious difficulties with respect to conduct of the nation's foreign policy.[20]

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[18]U.S. Congress, Senate, Committee on Banking, Housing, and Urban Affairs, Foreign Corrupt Practices and Domestic Foreign Investment Disclosure, Hearings Before the Committee on Banking, Housing, and Urban Affais Committee on S. 305, 95th Cong. 1st Sess., 1977, p. 193.

[19]Ibid., p. 192.

[20]Ibid., SEC Docket 16 (March 6, 1979): 1146.

After considering the accumulated evidence, the senate committee concluded that the bill was necessary to emphasize the responsibilities of management and prevent, if possible, further abuses.

After the bill was passed by the senate and referred to the house for action, the conference committee decided on a compromise bill in late November, 1977. The compromise bill deleted from the internal controls section two portions. The parts deleted were 13 b-3, falsification of accounting records, 13 b-4, obstruction of accountants. The bill received final passage in this form and became Public Law 95-213 on December 19, 1977.

The American Institute of Certified Public Accountants

The accounting profession did not remain unconcerned about all of the foregoing events. Besides providing their views to both the SEC on the proposed regulation and to the Senate during the hearings on S. 305, they had been working to provide guidance to the accounting community in dealing with these types of problems.

In 1977, three Statements on Auditing Standards (SAS) were added to the authoritative literature. They were as follows:

SAS No. 16--Responsibility for Detection of Errors or Irregularities.
SAS No. 17--Illegal Acts by Clients.[21]
SAS No. 20--Required Communication of Material Weakness in Internal Accounting Control.[22]

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[21]American Institute of Certified Public Accountants, <u>AICPA Professional Standards, Vol. 1</u>, pp. 323, 323-9.

[22]"Statement on Auditing Standards No. 20--Required Communication of Material Weakness in Internal Accounting Control," <u>Journal of Accountancy</u> 145 (November 1977): 118.

All three of these are of importance because they define the responsibilities of the auditor and his relationship with management in the matter of irregularities, illegal acts and material weaknesses. A brief description of each will show their application to the area of internal control.

SAS No. 16 begins its discussion of the area of errors and irregularities by defining them. Errors are seen as unintentional mistakes while irregularities are those which involve deliberate falsifications of the accounting records. Management's responsibility for the installation of an appropriate system of internal control, its continuing review, as well as for any errors and irregularities that arise is discussed.

The auditor's examination of internal control is described as for the purpose of determining which internal controls can be relied upon during the examination of the financial records to limit the work done by the auditors and reduce the cost to the company. During the examination, the condition of the financial records may lead the auditor to believe material errors and irregularities exist. His course of action should be to:

> . . . consider their implications and discuss the matter and the extent of any further investigation with an appropriate level of management that is at least one level above those involved. . . . he should attempt to obtain sufficient evidential matter to determine whether in fact material errors or irregularities exist and, if so, their effect.[23]

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[23]American Institute of Certified Public Accountants, AICPA Professional Standards, Vol. 1, p. 323-7.

The existence of material errors or irregularities generally causes the modification of the auditor's opinion.

The auditor may discover immaterial errors or irregularities during his examination. The Institute recommends that their effect on other areas should be considered and their existence should be reported to management for corrective action.

The fact that errors or irregularities are not found during an examination is no guarantee they do not exist. The auditor must judge the integrity of management and without evidence to the contrary assume that they have not abused their authority.

SAS No. 17 deals specifically with illegal acts by clients. Illegal acts are not only those involving tampering with accounting records but also engaging in any acts which will affect the results of company operations. The existence of illegal acts indicates a circumvention of the internal control system has taken place.

Again it is repeated that an audit examination performed by following generally accepted auditing standards cannot guarantee that illegal acts have not been committed. Many illegal acts leave no trail of evidence. It is suggested that the auditor protect himself through the use of management inquiries and representation letters.

Any illegal acts found, regardless of their materiality must be reported to the appropriate level of management for corrective action. Depending on the materiality of the act, adjustments may be made or disclosure of the condition may be required in the financial statements. An act which is material may cause a modification of opinion.

SAS No. 20 requires a report to management on any material weakness in internal accounting control found during the audit examination. A material weakness is defined as:

> . . . a condition in which the auditor believes the prescribed procedures or the degree of compliance with them does not provide reasonable assurance that errors or irregularities in amounts that would be material in the financial statements being audited would be prevented or detected within a timely period by employees in the normal course of performing their assigned functions.[24]

Material weaknesses found during the audit examination are not the result of searching for them directly; they are incident to the work performed. The auditors can become aware of them at any time during their field work. Any material weaknesses which are found must be reported to management either orally or in writing.

Again it is stated that management must bear the responsibility to assure themselves that the system is appropriate and functioning. Communications with the auditors on the results of the examination is one way they can determine if the system needs modification.

The SAS provides a suggested format for auditors to use when reporting material weaknesses. It also includes a suggested format for external reporting. The external report includes three parts, a description of the objectives of an internal control system, a discussion of its limitations and the auditor's evaluation of it.

All three of these pronouncements reiterate that the internal control function is the responsibility of management. They also restated that auditors cannot be expected to find all of the deviations

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[24] Ibid., p. 261.

that might exist during the normal course of the audit examination. This limitation exists because the purpose of examining internal control is to determine the basis of reliance that can be placed on the system to plan the extent of the other audit tests. Not all parts of the internal control system will be studied during an audit.

During this same period two studies were begun under the auspices of the AICPA, The Commission on Auditors Responsibilities and the Advisory Committee to Study Internal Accounting Control.

The Commission on Auditors Responsibilities was set up to investigate the need within the business community for audit committees as a part of the board of directors and also to study the advisability of external management reporting on the condition of various aspects within the company. One important feature to be given treatment in the management letter would be their opinion on the condition of the internal accounting control system. The final report of the Commission had not been completed at the end of 1977.

Late in 1977, the Advisory Committee on Internal Accounting Control was established. Their purpose was to provide guidance in the area of internal accounting control and to assist auditors and others by providing a means of evaluating existing internal control systems. At the end of 1977, their work was continuing.

The year 1977 brought several significant changes to the area of internal control. The Foreign Corrupt Practices Act made an adequate system internal accounting controls a requirement for publicly owned companies. While some actions were completed by the SEC and the AICPA, other work remained to be finished. The next chapter will study the

the efforts that are being made to comply with the new law as well as the continuing work of the SEC and the AICPA.

CHAPTER IV

COMPLIANCE WITH THE NEW RULES

The activities of the SEC, the U. S. Congress, and the AICPA in promulgating new rules has left those in the business and financial community in a state of confusion. The major questions yet to be answered are:

1. How will companies comply with the act?
2. What added responsibilities will be required of their advisors?
3. What other actions can be expected from the regulatory bodies?
4. How do the new rules affect privately owned companies?

The answers to these questions will shape the direction of the efforts of companies to comply with the new rulings on internal control.

Efforts to Comply with the Act

With the enactment of the Foreign Corrupt Practices Act, having an adequate system of internal accounting control system became a matter of law. Although a requirement of law, the questions raised during the Congressional hearings still remain. No definitive guidelines have been established to help companies determine what constitutes an adequate system, how they are to establish compliance with the Act, or if

Reaction to the lack of concrete guidelines had led some companies to assume that an extensive program to reevaluate and document their system is required to indicate compliance with the law.[25] While many authors concede some action may be necessary, they generally advocate a more moderate effort.

Some action to indicate compliance is advisable. However, those who completely revamp their systems may be expending valuable time and money providing documentation and controls beyond those contemplated by the law. Those who make little effort to provide evidence of compliance may invite problems, as the SEC has already begun using the new provisions in their enforcement actions.

As an example, in March 1978 just three months after the law was enacted, the SEC instituted an action against Aminex Corporation for illegal bookkeeping practices. Proceedings have also been brought against Citibank as well as Schenly Industries, and Rapid American. The actions taken thus far have not resulted in the application of criminal penalties; however, administrative injunctions have been issued.

How are companies to protect themselves? A middle of the road policy has been suggested by the Arthur Young Company. Until such time as guidelines are issued, they believe companies should adopt the following program:

1 - Assignment of qualified people to oversee the development, staffing, and execution of the compliance program.

2 - Assessment of the quality of the company's internal control environment--that is, the importance attached to internal accounting controls throughout the company--its "control consciousness."

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[25]"An Arthur Young View: Congress Didn't Invent Controls With the Foreign Corrupt Practices Act," <u>Forbes</u>, March 5, 1979, p. 65.

3 - Assessment of existing control systems through a review of comments reported previously by independent and internal auditors, and by other means including selected special reviews.

4 - Correction of significant control weaknesses that are identified.

5 - Continuous monitoring of the operation and suitability of the system.[26]

By performing a thorough review of company procedures, management can satisfy themselves that the system of internal accounting control has not been breached. Those most concerned with the review will be the management group, but it should also be of interest to the company's internal auditors and independent auditors. Because management, the internal auditors, and the independent auditors view the system from different perspectives, each can provide valuable insights in terms of the way it is functioning.

The first phase of management's review should be to evaluate the system objectives to make sure they adequately state what is expected. They will next examine the system itself for any signs of weakness or possible violations. The system will be revised as required by the circumstances after a judgement has been made on the basis of the costs versus benefits. The review should also include an evaluation of documentation of the system and consideration given to any additional clarification needed.

The internal auditors are in a position to observe the extent of compliance with management's policies. In addition they are able to provide assistance in making special investigations to insure compliance or to verify if a breach of internal control has occurred.

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[26]Ibid., p. 65.

The independent auditor is able to assist management in two ways. First, although the auditor's examination of internal control is performed to determine the extent of reliance for the design of the audit program, any errors, irregularities, or weaknesses detected are communicated to management for correction. Second, through a special engagement to study the internal control system, the auditor can provide an analysis of how the system is functioning and make recommendations for areas which could benefit from improvement.

Areas which the auditor will examine during a special review can include examining objectives, documentation of the system, training manuals and techniques, and company personnel policies. He can also inspect and evaluate the procedures currently being followed for internal controls review and correction.

In addition to the internal review and documentation, such as that suggested by the Arthur Young and Company, some firms have chosen to show evidence of compliance by including a Report of Management in their annual reports. The report contains the explanation of management on significant accounting policies and other matters of concern including an evaluation of internal control. One such report appeared in the annual report for 1978 of the Federal National Mortgage Association. The section pertaining to internal accounting control conveys their opinion of the internal control system within their company and is an example of what might be seen in the future.

> The corporation utilizes a system of internal accounting controls to provide reasonable assurances that transactions are executed in accordance with appropriate authorization, to permit preparation of financial statements in conformity with

> generally accepted accounting principles, and to establish accountability for the assets of the corporation.
>
> The system of internal accounting controls includes written policies and procedures for the execution, documentation and recording of transactions, and an organizational structure which provides an effective segregation of duties and responsibilities. The corporation has an Internal Audit Division whose responsibilities include monitoring compliance with established policies and procedures and evaluating the corporation's system of internal accounting controls. Organizationally, the Internal Audit Division is independent of the activities it reviews.
>
> The Board of Directors of the corporation exercises its oversight of the accounting system and related controls through an audit committee which is composed solely of directors who are not officers or employees of the corporation. The Audit Committee meets with Management and the internal auditors periodically to review the work of each and to evaluate the effectiveness with which they discharge their respective responsibilities. In addition, the committee meets periodically with the independent public accountants, Peat, Marwick, Mitchell and Co., who have free access to the committee, without management present, to discuss internal accounting controls, the quality of financial reporting, and other matters relative to their examination of the corporation's financial statements . . . .[27]

Management reports as well as a variety of other procedures to indicate compliance will continue to be used until such time as definitive standards are issued.

The Assumption of Added Responsibilities by Company Advisors

The lack of definitive standards or guidelines for compliance has become a concern of many besides the management group. The Act has become of particular interest to those in the accounting and legal professions. Strong opinions have been expressed by those at both extremes of the issue. Some would like very detailed standards to

[27]Federal National Mortgage Association, Annual Report For 1978: The First Ten Years (Washington, D.C.: Federal National Mortgage Association, 1979), p. 17.

serve as a benchmark for performance. Others believe no standards will serve the professions best.

Many of the articles surveyed indicated specific standards are necessary to avoid the extremes in compliance efforts. Those who support the idea of specific standards want to be able to judge what needs to be done by the companies they are advising, to satisfy SEC requirements.

Those who believe no standards are best, are concerned that whatever standards are forthcoming, especially those promulgated by the AICPA, will be adopted by the SEC as part of the regulations.[28]

Another concern of advisors is the extent of their liability under the new laws. Because their actions are largely a result of professional judgement, those within the accounting and legal professions believe it will be difficult to uniformly provide advice in terms of the best way to indicate compliance. As an example, two professionals who are viewing the same situation can come up with different interpretations.

A major consideration expressed is that the Act would prohibit free communication between clients and their advisors.[29] Auditors particularly express concern that in reporting a material weakness in internal accounting control they will find it used against them and the company they are examining in an action imposing liability for breach

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[28]Michael J. Cook and Thomas P. Kelley, "Internal Accounting Control: A Matter of Law," Journal of Accountancy 147 (January 1979): 63.

[29]S. Thomas Moser, "The Foreign Corrupt Practices Act of 1977: An Auditors Perspective," CPA Journal 48 (May 1978): 74.

of internal controls. They also express concern that the implications of the report could be misunderstood if it were presented to those outside the company.

Other Actions of the Regulatory Bodies

As yet the actions against companies for violating the internal accounting control regulations have not been severe. However, additional rulings are being considered which would add to the burden of management and their advisors.

During the period from January 1978 until the present time, both the AICPA and the SEC have continued to move forward in this area. The AICPA study groups finished their reports, one in 1978 and the other in April 1979. The SEC has recently published two releases, one a final ruling on future internal accounting control requirements, the other a preliminary regulation mandating external reporting on internal accounting controls. Each of the actions by the AICPA and the SEC will be discussed separately.

Actions by the AICPA

The completed study of the AICPA Commission on Auditors Responsibilities was published in 1978. In the area of internal control, the commission suggested the expansion of the audit function to include a review of the system to determine how it is functioning.[30]

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[30]American Institute of Certified Public Accountants, Commission on Auditors Responsibilities: Report, Conclusions and Recommendations (New York: American Institute of Certified Public Accountants, 1978), p. 60.

A report would be made by the auditor on his findings. It would be accomplished through the modification of the standard opinion. The Committee provided a suggested format to be used in making the modification.[31]

The management report would more highly publicize the responsibilities of management for protection of company assets and the results of operation. It would provide their view of the policies in use and the condition of the existing internal control system. The report of the Commission provided a suggested format for the external report for management.[32]

The Advisory Committee on Internal Accounting Controls published a tentative report in late 1978 and the final report in early 1979. The report supported the use of the definition of internal accounting control as contained in the auditing standards. The Committee expands the definition of the internal controls system in terms of the environment in which it operates.[33]

Those factors within the environment which the Advisory Committee deemed important to the system of internal accounting controls have been discussed previously. They are the organizational structure, delegation of authority and communication of responsibilities to those within the system, personnel policies, the application of budgets and

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[31]Ibid., pp. 77-79.

[32]Ibid., pp. 79-80.

[33]American Institute of Certified Public Accountants, Report of the Special Advisory Committee on Internal Accounting Control (New York: American Institute of Certified Public Accountants, 1979), p. 12.

financial reports, and checks and balances within the system such as internal auditing, as well as the EDP environment if one exists.[34]

The elements of the environment are defined in terms of objectives for the internal accounting control system. The Committee chose to demonstrate their use through the five cycles which were previously described. They believe the use of the accounting cycles permits a comprehensive description of the system in use and a means of designing procedures to evaluate it.

<u>Actions by the SEC</u>

The SEC was disappointed in the Foreign Corrupt Practices Act in two respects. First, it did not contain the requirements which made falsification of records and false statements to accountants illegal. Second, it contained no requirement to make reporting on the condition of internal controls by management mandatory.

The SEC recently completed action on one of these objections. On February 15, 1979 they issued Release No. 15579 which amended the Securities Exchange Act of 1934. The regulation replaced Release No. 13185 issued in January 1977. It incorporated into the SEC regulations those two provisions of the Foreign Corrupt Practices Act which had been deleted by the conference committee of the Congress. They were presented earlier in Release No. 13185 and are labeled "Falsification of Accounting Records and Obstruction of Accountants." The SEC believes this ruling is necessary to reinforce the requirements set forth in the Act.

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[34]Ibid., pp. 13-19.

The requirement for reporting by management on the condition of the internal control system is still in the discussion stage. On April 30, 1979 SEC Release No. 15772 was issued for comment. Its title is "Statement of Management on Internal Accounting Control." If enacted, the new regulations would require management reports to be included in the 10 K report and also in reports to stockholders. Its impact would affect both management and their independent auditors. The purpose of the regulations would be to standardize the rules for reporting by management both in terms of the information to be disclosed and the types to be included.

The regulations begin by restating the basic principles of management responsibilities for protection of assets and authorization for access to them. These are the same principles found in both the auditing literature and the Foreign Corrupt Practices Act in describing internal accounting control. The other requirements for the management and auditors' reports are as follows:

> For statements of management on internal accounting control as of dates after December 15, 1979 and prior to December 16, 1980, describe any material weaknesses in internal accounting control which have been communicated by the independent accountants of the registrant or its subsidiaries which have not been corrected, and state the reasons why they have not been corrected.
>
> For periods ending after December 15, 1980, the statement of management on internal accounting control shall be examined and reported on by an independent public accountant to express an opinion as to (1) whether the representations of management in response to paragraph (a) are consistent with the results of management's evaluation of the systems of internal accounting control; and (2) whether such representations of management are, in addition, reasonable with respect to transactions

> and assets in amounts which would be material when measured in relation to the registrant's financial statements.[35]

Although, as before, no detailed instructions are provided, some very basic criteria are included both for management and the auditor.

Management's report must include reasonable assurance that the objectives for the internal accounting control system have been met, their evaluation of it, and a description of any existing uncorrected material weaknesses discovered by the auditors, and reasons why they have not been corrected. This report is to accompany the financial statements.

To accomplish these goals will require management's written documentation of the system they are using. The material should include all authorizations and responsibilities, company policies and procedures as well as reporting responsibilities. Any changes made in the system as well as any uncorrected material weaknesses found in the future will necessitate documentation of the cost/benefit calculations.

The auditor's responsibilities will be increased as well. Until 1980, the auditor's status continues much as it is now. He will report any material weaknesses found to management and suggest corrective action. Any weaknesses which remain uncorrected would require specific disclosure.[36]

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[35] Securities and Exchange Commission, SEC Docket 16 (May 15, 1979): 433-434.

[36] Ibid., p. 422.

After 1980, he will be required to extend the scope of his audit and be prepared to evaluate the representations made by management concerning the internal accounting control system. He will be required to evaluate the methods used by management to review and monitor the system as well as make judgements about the materiality of weaknesses discovered and the cost/benefit analysis presented by management. The auditor will be required to report on the system, either in a separate report or within the audit opinion.[37]

In the explanatory comments included with the regulation, the SEC acknowledges that an internal accounting control system cannot prevent all errors. It does insist, however, that the installation of a proper system, its continuing review and updating is an important management responsibility.

This regulation will mandate the documentation and review of internal accounting control and a report on its condition by management. The independent auditor will add new review and reporting obligations to his duties. To assist the auditor, the AICPA currently has under consideration new standards in this area. Further action by the SEC on this regulation is still unknown as the comment period extends to July 31, 1979.

How the New Rules Affect Privately Owned Companies

How do the new rules on internal accounting controls affect those companies who are not under the jurisdiction of the Securities

[37] Ibid., pp. 429-431.

and Exchange Commission? In general, there is no direct effect on the type of system which the companies must have or the attention that must be given to it in terms of the accounting control and reporting requirements. However, the part of the Foreign Corrupt Practices Act which prohibits foreign payments does apply to all companies. Thus privately owned companies still come under the act to a limited degree.

Many privately owned firms will comply with the rules indirectly. Those who have annual audits conducted by Certified Public Accountants must comply both with generally accepted accounting principles and generally accepted auditing standards (GAAS). The SASs' which govern the conduct of an audit through GAAS, now contain requirements for reports on irregularities and weaknesses in internal control. The AICPA currently has under study standards which will be used for reporting on internal accounting controls systems. These, if adopted, would be applicable to private firms having regular audits.

CHAPTER V

CONCLUSION

Over the past thirty years the definition of internal control has changed. Attitudes toward it in the business and financial community have also changed. Where it once was the primary concern of management and their advisors, it is now the concern of all.

The purpose of this paper has been to examine how internal controls are designed and established within the business environment with particular attention given to those labeled internal accounting controls. In addition, the effects of recent actions by the SEC, the U.S. Congress and the AICPA and their potential effects on the operation of internal control systems in the future has been studied.

The original definition of internal control encompassed the entire range of provisions for control within the company. Because many believed it to be too broad, it was split into two portions, administrative control and accounting control. The main distinction between the two terms is, administrative control relates largely to managerial policies while internal accounting control implements them through the record keeping arrangements. While the definition draws a distinction between them, they are in reality interrelated and are the responsibility of management.

Internal control, to function properly, must have identified systems of objectives and controls. These are further described by the system itself. Two major methods of describing internal accounting control are in use. One shows the controls applicable to the system by dividing it into the major areas of interest covered by an audit program. The other describes it in terms of five cycles. They are treasury, expenditure, conversion, revenue and financial reporting. This method groups similar transactions together for the application of controls and objectives.

Regardless of how well organized and highly documented the system is, three factors can cause it to function improperly. They are time, personnel, and management. To avoid the first two of these problems requires continual monitoring, evaluation and updating of the system to assure its integrity. Management, however, is difficult to monitor. Because they are responsible for the design and function of the system, they will know of the weak areas and how to circumvent them. Users of financial information are forced to rely on the honesty of management for the integrity of the underlying records.

Because of management's unique position, many have been able to abuse their power in circumventing the internal control system. This has caused increasing concern within the business and financial community. Of particular concern are those cases uncovered during the Watergate investigations where large numbers of companies engaged in various types of illegal acts including foreign bribery and illegal campaign contributions.

The magnitude of the Watergate disclosures brought concern and action from three major groups, the SEC, the U. S. Congress, and the AICPA. In December 1977, the enactment of the Foreign Corrupt Practices Act brought a major change in the securities laws. With this action, having an adequate system of internal accounting control became a matter of law. This law was jointly the result of the SEC and Congressional actions.

The Institute, to aid auditors in defining their responsibilities in the area of illegal acts, made three additions to the auditing standards. They are: SAS 17 on Responsibility for Detection of Errors and Irregularities, SAS 17 on Illegal Acts by Clients, and SAS 20, Required Communications of Material Weakness in Internal Control. They also commissioned two studies to provide help in the internal control area. They were the Commission on Auditors Responsibilities, and the Advisory Committee on Internal Accounting Control.

The enactment of the Foreign Corrupt Practices Act left confusion in the business and financial community as it specified no instructions or standards for compliance. Business firms and their advisors were left to use their judgement. Although some firms assume elaborate reevaluation and documentation programs are required, a middle of the road approach has been suggested until guidelines are established.

The Foreign Corrupt Practices Act gave the SEC new powers which it promptly began using. No heavy penalties have yet been imposed, however that is no guarantee that they will not be used in the future.

Since the end of 1977 both the AICPA and the SEC have continued their activities in the area of internal control. The study committees, which were commissioned earlier by the Institute, completed their work. The SEC issued two releases, one a new regulation and the other proposed new rules.

The Commission on Auditors Responsibilities suggested the expansion of the audit function and the related opinion to include an evaluation of management's representations concerning the functioning of the internal control system. I also suggested that a management report detailing company policies, including a discussion of internal control, be included with future financial statements. Just recently the Advisory Committee on Internal Accounting Control completed its work.

The Advisory Committee on Internal Accounting Control stated the definition of internal accounting control found in the auditing standards was sound but needed to be explained in terms of the environment in which it was used. They suggested application of the objectives developed to the five cycles discussed earlier.

The SEC, because it was not completely satisfied with the Foreign Corrupt Practices Act, recently completed two actions of importance. First, final enactment of the rules released concurrently with the introduction of S. 305; the second, to mandate reporting on internal control.

The release in February 1979 added to the securities law the two sections which had been deleted by the conference committee during the course of action on S. 305, the Foreign Corrupt Practices Act. The two provisions were Falsification of Accounting Records and

Obstruction of Accountants. The Commission believed these were necessary to completely state the obligations of those connected with company policies.

In late April 1979, the Commission introduced proposed regulations which required external reporting on the state of the internal accounting control system by both management and the independent auditors. This rule would add new obligations for the public accountant, however, the AICPA has rules under advisement to assist them in this area.

While private companies do not have to comply with the regulations of the SEC, those who engage Certified Public Accountants to perform annual audits of their records will follow the rules set forth by the AICPA.

The focus of the internal control definition has changed from the total system of controls to that which encompasses the basic records of the company, the internal accounting control system. Emphasis on this aspect will continue in light of the new rules which have been enacted and those which are still under study. The extent of application of the rules in total has yet to be determined.

To date the SEC has not used the full extent of the powers granted to it under the new regulations. In addition, it has not been determined if individuals will be allowed to bring legal actions for the lack of stewardship over internal accounting control systems.

The final determination of what constitutes an adequate system of internal accounting control and where the liability for it will rest, will ultimately be decided by the SEC and the court system in the years to come.

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