Report of the Special Advisory Committee on Internal Accounting Control

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Report of the Special Advisory Committee on Internal Accounting Control

American Institute of Certified Public Accountants
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Appendix: An Illustration of Specific Objectives and Examples of Selected Control Procedures and Techniques by Cycle
Foreword

The AICPA Special Advisory Committee on Internal Accounting Control was formed in August 1977. The AICPA recognized that the broad guidance in professional auditing literature had been developed for a limited purpose and that there was a need to provide guidance that would be helpful to management. Accordingly, the Institute appointed an advisory group consisting of financial executives, internal auditors, CPAs engaged in management advisory services, and one CPA engaged in the practice of auditing to develop the desired guidance. The committee issued a tentative report for public comment in September 1978.

The Foreign Corrupt Practices Act of 1977 became law after the committee had begun its work. The act imposes, among other things, internal accounting control requirements on certain issuers of securities (public companies). Although the committee was not formed because of the act, this final report should be useful to management and boards of directors in considering whether their companies comply with the internal accounting control provisions of the act.

The committee gratefully acknowledges the contributions made to the development of its report by Marguerite H. Fisher (Carnegie-Mellon University), Jesse R. Foster (The Times Mirror Co.), Russell B. Mallett (U. S. Industries, Inc.), William H. Sachau (Cities Service Company), and William E. Thompson (Alabama Bancorp) as well as the assistance of many individuals and organizations in industry, public accounting, and academia.

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Executive Summary

The Need for Guidance

There is an increased interest by management and boards of directors in evaluating internal accounting control. There are several reasons for this, two of which are particularly important. First, the independent Commission on Auditors’ Responsibilities has suggested that there be a management report on the financial statements and that it “present management’s assessment of the company’s accounting system and controls over it . . . .” The Financial Executives Institute has lent its support to this suggestion. Second, the SEC has stated that public companies should “review their accounting procedures, systems of internal accounting controls and business practices” in order to take any actions necessary to comply with the requirements of the Foreign Corrupt Practices Act of 1977. Among other things, that act requires public companies to “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 to—

. . . 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 (I) to permit preparation of financial statements in conformity with generally accepted accounting principles or any other criteria applicable to such statements, and (II) 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.

The act gives explicit recognition to internal accounting controls to the exclusion of all others, and the objectives in the act were taken almost verbatim from professional auditing literature. Those objectives—categorized by the committee as authorization, accounting, and asset safeguarding objectives—were originally developed to provide broad professional guidance on the independent auditor’s study and evaluation of
internal accounting control, which is made for the limited purpose of serving as a basis for setting the scope of the examination of financial statements. The auditor tests only those controls on which he intends to rely. Management is concerned with all of its internal accounting controls and needs to identify and communicate objectives in more specific terms. To do that, it is first necessary to consider what is encompassed by the term *internal accounting control*.

**The Scope of Internal Accounting Control**

A company typically has in place an organizational structure, control procedures, and techniques that will help it safeguard its assets, check the accuracy and reliability of its accounting data, promote operational efficiency, and encourage adherence to prescribed managerial policies. Management is concerned with the effectiveness of all of the company's controls, but not all of them are internal *accounting* controls.

It is not possible to prepare a comprehensive list of internal accounting controls because circumstances vary so much between companies. The committee believes that an internal accounting control is one that is concerned with the reliability of the financial statements and/or with the broad internal accounting control objectives of authorization, accounting, and asset safeguarding, and, further, that accounting controls should extend to external reports of historical financial information, such as the historical financial information included in the financial highlights section of a report, in the president's letter, and in earnings releases.

**The Internal Accounting Control Environment**

Internal accounting controls cannot be evaluated in a vacuum. Several factors have a significant impact on the selection and effectiveness of a company's accounting control procedures and techniques.

The committee has found the term *internal accounting control environment* to be a convenient way to describe those factors, including organizational structure, personnel, delegation of authority, communication of responsibility, budgets and financial reports, organizational checks and balances, and EDP considerations, which contribute to an appropriate atmosphere of control consciousness. It is important to recognize that a poor internal accounting control environment would make some control procedures inoperative for all intents and purposes because, for example, individuals would hesitate to challenge a management override of a specific control procedure. However, even a strong control environment cannot provide absolute assurance that control procedures will not be circumvented by employee collusion or management override.
Other Considerations and Limitations

While the implications of the 1977 Foreign Corrupt Practices Act and the possibility of public representations on internal accounting control need to be considered, a careful balance must be struck between those concerns and the wider range of management’s business concerns. In particular, the committee wishes to emphasize that effective internal accounting control does not preclude management from taking the prudent business risks deemed necessary to achieve corporate objectives.

Professional auditing literature and the Foreign Corrupt Practices Act include the concept of “reasonable assurance,” which involves cost-benefit considerations; that is, consideration of the aggregate cost of specific controls in relation to the benefits expected to be derived. However, significant aspects of costs and of risks or benefits cannot be reduced to monetary terms without using subjective business judgment.

In addition, there are inherent limitations on a system of internal accounting control. Limitations of control procedures include, for example, the possibility of circumvention by employee collusion or management override and changes in the degree of compliance because conditions within a company are not static.

Evaluating Internal Accounting Control

The committee believes that management should initiate a preliminary assessment of the internal accounting control environment and of the appropriateness and effectiveness of existing accounting control procedures and techniques based on its overall knowledge of the company. On the basis of that preliminary assessment, management should plan the manner, extent, and timing of other procedures deemed appropriate. Those procedures should relate to—

a. A reexamination of the accounting control procedures in place and the ongoing process of evaluating them.

b. The need for more explicit documentation of those control procedures and the process of evaluating them.

The committee’s report presents suggestions on performing a preliminary assessment, on performing an evaluation of specific accounting control procedures and techniques, and on monitoring compliance with established procedures.

Some companies have indicated that they perform, on a continuing basis, procedures that meet the objectives of a preliminary assessment, evaluation of specific control procedures and techniques, and compliance monitoring. The committee’s recommendations should not necessarily
cause those companies to change their procedures, although the committee suggests the reexamination of documentation needs.

The Preliminary Assessment

A preliminary assessment should consider the degree to which compliance with accounting control procedures is enforced and reinforced by the internal accounting control environment—through an appropriate organizational structure, use of sound management practices, accountability for performance, and requirements for adherence to appropriate standards for ethical behavior, including compliance with applicable laws and regulations. Management should also consider matters such as the extent to which important corporate and accounting policies and procedures have been formalized, the extent to which internal audits or other supervisory reviews are used, the internal accounting control weaknesses that have been identified in the normal course of business or by audit findings and the corrective action taken, and the degree to which changes have taken place in the company's operations, organizational structure, accounting system, and personnel.

Evaluating Specific Control Procedures and Techniques

On the basis of its preliminary assessment, and recognizing the continuing nature of an effective evaluation of internal accounting control, management would plan the manner, extent, and timing of its evaluations of specific control procedures and techniques. When it is determined that such evaluations should be made over a period of time, initial attention should be directed to those areas where the preliminary assessment indicates there may be greater exposure to significant control breakdowns.

The evaluations should include (1) deciding on the appropriate approach, (2) obtaining an understanding of the flow of transactions and of the accounting control procedures in place, and (3) concluding whether those controls, giving appropriate consideration to the environment in which they operate, provide reasonable assurance that the criteria deemed necessary to achieve the broad objectives of authorization, accounting, and asset safeguarding have been met.

The committee believes that an effective way for management to approach an evaluation of control procedures and techniques is to (a) classify transactions by, for example, functions, operating units, or cycles, (b) convert the broad objectives of internal accounting control into relevant specific objectives appropriate for those classifications of transactions, and (c) identify and evaluate the control procedures and techniques in place to determine whether they meet specific objectives, giving appropriate consideration to the internal accounting control environment.
The manner in which a company decides to classify its transactions will vary depending on its specific circumstances. The committee has found the cycle approach to be a convenient way for it to develop illustrative specific objectives and examples of control procedures and techniques. The Appendix includes illustrative specific objectives developed from the perspective of a hypothetical manufacturing company and examples of selected control procedures and techniques for each of five illustrative cycles identified by the committee (revenue, expenditures, production or conversion, financing, and external financial reporting).

The committee recognizes that some companies may wish to approach their evaluations of specific control procedures and techniques in another way, for example, by function or by operating unit. Those approaches are not incompatible with the cycle approach. What is important is that the appropriate specific objectives be identified.

**Monitoring Compliance**

Management should monitor compliance with established accounting control procedures to obtain reasonable assurance that controls in place continue to be appropriate and controls in effect continue to function properly. Monitoring takes place through such actions as management supervision, representations, audits or other compliance tests, and approval and control of changes in procedures. Monitoring is an integral part of the continuing process of evaluating the control environment and the effectiveness of control procedures.

* * *

The approach briefly highlighted above reflects the majority view within the committee. The complexity of the issues is demonstrated by the fact that the members are not unanimous in their support for all of the recommendations. Furthermore, the wide range in the size of the thousands of publicly held companies in the United States, in their operating styles, in the complexity of their transactions, in the diversity of their products and services, and in the geographical dispersion of their operations clearly makes it impossible to enumerate specific controls that will be responsive to all circumstances and meet all of the needs of all companies. Thus, the committee's report is a first step in what should be an ongoing, coordinated effort by companies, public accounting firms, academics, and professional organizations to study internal accounting control requirements.
Introduction

The need for additional guidance on internal accounting control has been emphasized by several recent developments, two of which are particularly important:

(1) Publication of the Report, Conclusions, and Recommendations of the Commission on Auditors’ Responsibilities.


Recommendations of the Commission on Auditors’ Responsibilities

The final report of the independent Commission on Auditors’ Responsibilities includes a recommendation for a report by management on the financial statements and suggests that the report "present management's assessment of the company's accounting system and controls over it, including a description of the inherent limitations of control systems and a description of the company’s response to material weaknesses identified by the independent auditor." (The Financial Executives Institute has lent its support to this recommendation.) However, the commission's report does not suggest what management should do to support a public representation on internal accounting control.

Requirements of the Foreign Corrupt Practices Act

The Foreign Corrupt Practices Act of 1977, as explained in Accounting Series Release no. 242 (ASR no. 242), requires "every issuer which has a class of securities registered pursuant to Section 12 of the Securities Exchange Act, and every issuer which is required to file reports pursuant to Section 15(d) of the Securities Exchange Act, to comply with certain
accounting standards." Those standards are set forth in section 102(2) of the act and require issuers to—

(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 (I) to permit preparation of financial statements in conformity with generally accepted accounting principles or any other criteria applicable to such statements, and (II) 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.

ASR no. 242 states that "because the Act became effective upon signing, it is important that issuers subject to the new requirements review their accounting procedures, systems of internal accounting controls and business practices in order that they may take any actions necessary to comply with the requirements contained in the Act." However, ASR no. 242 does not specify what should be involved in such a review.

The Need for Guidance

The internal accounting control provisions of the act, as indicated in the legislative history, recognize the importance of professional auditing literature. In fact, the language of section 102(2)(B) of the act is taken almost verbatim from the broad objectives of internal accounting control (which the committee has categorized as authorization, accounting, and asset safeguarding objectives) set forth in Statement on Auditing Standards no. 1 (SAS no. 1), section 320.28. However, those objectives were originally developed to provide broad professional guidance on the independent auditor's study and evaluation of internal accounting control, which is made for the limited purpose of serving as a basis for setting the scope of the examination of financial statements. The auditor tests only those controls on which he intends to rely. Management, on the other hand, is concerned with all of its internal accounting controls and needs to identify and communicate objectives in more specific terms.

For example, the first objective is: "Transactions are executed in accordance with management’s general or specific authorization." In ap-
Applying this objective to sales transactions, personnel within the company might have questions such as the following:

- What aspects of the transactions should be authorized—customer acceptance, shipment, credit terms, prices, other matters?
- If, for example, credit terms should be authorized, should that authorization be general (criteria that can be applied to classes of customers) or specific (credit terms individually authorized for each customer)?
- Should authorizations be in writing?
- What steps, if any, should be taken to review transactions for proper authorization?

Management needs to identify and deal with many such questions. However, there are thousands of publicly held companies in the United States. The wide range in the size of those companies, in their operating styles, in the complexity of their transactions, in the diversity of their products and services, and in the geographical dispersion of their operations clearly makes it impossible to enumerate specific controls that will answer every question and meet all of the needs of all companies. Therefore, the approach to evaluating internal accounting control suggested in this report is not the only way an evaluation can be performed, and the specific objectives and examples of control procedures and techniques included in the Appendix are necessarily illustrative and not detailed rules. However, the committee believes that the recommendations in this report should help management appraise the effectiveness of its continuing evaluation and monitoring of internal accounting control. Thus, this report should be useful to management in considering whether the company complies with the internal accounting control provisions of the act.

Scope of Internal Accounting Control

Historical Perspective

In 1949, a special report by the AICPA Committee on Auditing Procedure defined internal control as follows:

Internal control comprises the plan of organization and all of the coordinate methods and measures adopted within a business to safeguard its assets, check the accuracy and reliability of its accounting data, promote operational 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.
Independent auditors found that definition too broad for their purposes, and internal control was subdivided into *administrative control* and *accounting control* to clarify the scope of the auditor's study and evaluation as it pertains to his examination of financial statements. Those types of controls are defined in sections 320.27-.28 of SAS no. 1 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 principles or any other 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.

Auditors recognized that the distinction between an administrative control and an accounting control would not always be clear, and SAS no. 1 provides the following amplification: "The foregoing definitions are not necessarily mutually exclusive because some of the procedures and records comprehended in accounting control may also be involved in administrative control."

SAS no. 1 further states that "For practical purposes, this is tantamount to including within the definition of accounting controls any administrative controls that have an important bearing on the reliability of the financial statements."

**Discussion**

The existing definition of internal accounting control was developed by independent auditors for their own purposes. Management is necessarily concerned about all of the controls contemplated in the 1949 definition of "internal control." For example, controls that help to promote efficient and effective operations have been, and will continue to be, of vital importance
to management. Also, certain administrative controls may have a bearing on the selection and effectiveness of a company's accounting control procedures and techniques. For example, administrative and operating procedures focusing upon specific business activities often complement accounting control procedures. To illustrate, capital expenditure projects might be subject to specific marketing, engineering, technological, and legal evaluations during the planning, authorization, and development stages. Such procedures complement accounting control procedures for approval and monitoring of the funds expended. As business transactions and the procedures necessary to execute them become more complex, the difficulty of distinguishing between accounting controls and administrative controls is increased.

It must also be recognized that the Foreign Corrupt Practices Act gives explicit recognition to internal accounting controls to the exclusion of all others, and the objectives in the act were taken almost verbatim from professional auditing literature. Further, the Commission on Auditors' Responsibilities suggests that managements report to shareholders on the "accounting system and related controls" (emphasis added).

Also, while the implications of the act and the possibility of public representations on internal accounting control need to be considered, a careful balance must be struck between those concerns and the wider range of management's business concerns. In particular, effective internal accounting controls should not preclude management from taking the prudent business risks deemed necessary to achieve corporate objectives.

**The Committee's Conclusions**

Although the professional auditing literature identifies reliability of financial records as an overriding objective of internal accounting control, the committee believes that an internal accounting control is one that is concerned with the reliability of financial statements and with the broad internal accounting control objectives of authorization, accounting, and asset safeguarding and, further, that accounting controls should extend to all external reports of historical financial information.

External reports of historical financial information include the financial statements and related notes, other accounting or financial information included elsewhere in a document containing financial statements (such as a registration statement, proxy statement, or annual report), and other forms of financial reporting to the public, such as interim reports and earnings releases. For example, the committee believes that accounting controls should extend to historical financial information presented in the financial highlights section of a report, in management's analysis of changes in earnings, and in comments on the financial statements in the president's letter.
In the normal course of business many financial records and reports are prepared for internal management purposes. The committee believes that when the use of such reports and records is necessary to achieve the broad objectives of authorization, accounting, and asset safeguarding, they are an integral part of the system of internal accounting control.

The Internal Accounting Control Environment

Internal accounting controls cannot be evaluated in a vacuum. Several factors have a significant impact on the selection and effectiveness of a company's accounting control procedures and techniques.

The committee has found the term *internal accounting control environment* to be a convenient way to describe these factors. Some are clearly visible, like a formal corporate conduct policy statement or an internal audit function. Some are intangible, like the competence and integrity of personnel. Some, like organizational structure and the way in which management communicates, enforces, and reinforces policy, vary so widely among companies that they can be contrasted more easily than they can be compared.

Although it is difficult to measure the significance of each factor, it is generally possible to make an overall evaluation. The committee believes that an overall evaluation of a company's internal accounting control environment is a necessary prelude to the evaluation of control procedures and techniques.

A poor control environment would make some accounting controls inoperative for all intents and purposes because, for example, individuals would hesitate to challenge a management override of a specific control procedure. On the other hand, a strong control environment, for example, one with tight budgetary controls and an effective internal audit function, can significantly complement specific accounting control procedures and techniques.

Although it is possible for accounting control procedures and techniques to be working in a company that has a poor control environment, the committee believes it is unlikely that management can have reasonable assurance that the broad objectives of internal accounting control are being met unless the company has an environment that establishes an appropriate level of control consciousness.

The control environment involves all the employees of a company. However, the role of the board of directors in establishing an appropriate control environment cannot be overemphasized. Leadership in formulating and communicating an appropriate atmosphere of control consciousness must come from the board and top management. That leadership involves creating an appropriate organizational structure, using sound manage-
merit practices, establishing accountability for performance, and requiring adherence to appropriate standards for ethical behavior, including compliance with applicable laws and regulations. Many companies have found it necessary to formalize such guidance through written policies and procedures. Formalization of such matters is conducive to an environment in which internal accounting controls are likely to be understood and to operate effectively.

The remainder of this section discusses some of the more significant factors that shape the internal accounting control environment.

Organizational Structure

The organizational structure of a company provides the overall framework for the planning, direction, and control of its operations. In general, it involves reporting relationships, functions to be performed by organizational units, and the authority, responsibilities, and constraints of key positions.

The effectiveness of a company's organizational structure depends on how well it serves as a framework for direction and control of company activities. An effective structure would give appropriate consideration to the following matters:

- Competence of personnel and provision of appropriate resources to discharge the responsibilities assigned, together with a system of measurement of, and accountability for, performance.
- Assignment of responsibility and delegation of authority to deal with matters such as goals and objectives, operating functions, organization form, management style, regulatory requirements, and financial reporting standards.
- Budgets and financial reports to facilitate the discharge of assigned responsibilities and monitor the activities at each level in the organizational structure.
- Checks and balances that separate incompatible activities to preclude absolute control by any single individual or unit, provide for supervision by higher levels of management, and provide for monitoring of overall company activities.

The more responsive a company's organizational structure is to its external and internal requirements, the more likely it is to strengthen the accounting control procedures in place. For example, when responsibility is assigned for marketing and production activities but not for inventory management, there may be less control consciousness than when all three are addressed. An effective organizational structure should minimize gaps and overlaps in responsibility assignment.
The larger a company and the more complex its operations, the more desirable it is to document the organizational structure. Organization charts, position descriptions, policy statements, and similar documents are frequently used for that purpose.

Personnel

The internal accounting control environment and the control procedures themselves are highly dependent on the competence and integrity of the company’s personnel. Professional auditing literature states that “reasonable assurance that the objectives of accounting control are met depends on the competence and integrity of personnel, the independence of their assigned functions, and their understanding of the prescribed procedures.”

The committee agrees that those factors are particularly important to the maintenance of an appropriate internal accounting control environment. (Independence of functions and understanding of prescribed procedures are discussed in more detail under “Delegation of Authority and Communication of Responsibility.”) Dishonest or incompetent employees can make most control procedures inoperative. For example, misunderstanding of instructions, mistakes of judgment, carelessness, or other personal factors related to competence and integrity can result in errors in the performance of control procedures. Collusion between employees can circumvent certain control procedures. Similarly, management personnel may often be in a position to circumvent or override control procedures intentionally. Accordingly, management should consider whether the company’s policies and procedures with respect to hiring, evaluation, compensation, promotion, training, and so forth, are conducive to the employment of competent, honest personnel.

Delegation of Authority and Communication of Responsibility

Management should delegate or limit authority in a manner that provides assurance that its responsibilities are effectively discharged. Thus, authority for specific matters should be assigned and limited in a manner that permits an effective review of decisions made. For example, the board of directors may choose to retain direct authority to approve or disapprove long-term loan agreements of all types, but may decide to delegate authority to approve or disapprove capital expenditures within established limits. The board might obtain reasonable assurance as to the appropriate exercise of delegated authority through such measures as appropriate reports (for example, external and internal audit reports and financial statements and reports), observation, discussion, consultation, and the organizational
structure itself. Each level of management should operate in a similar fashion, delegating authority within reasonable limits while retaining final responsibility. This results in a network of personnel who are specifically authorized to approve or disapprove designated transactions and who are prohibited from engaging in or approving other specified transactions.

At each level in the organization, there is a need for a clear understanding of the authority delegated and the relationships individuals have with respect to others in the organization. There is also a need to know the policies, procedures, and activities that directly and indirectly affect individual responsibilities. Appropriate communication is therefore essential to control consciousness. Communication about the assignment of responsibility and the delegation of authority and related policies and procedures should be explicit to be effective. Communication need not be written to be explicit, although that may be helpful. The critical test is that those who need to be informed are, in fact, properly informed.

**Budgets and Financial Reports**

The formulation and communication of company goals and objectives enables managers to propose courses of action, receive approval and direction, know what is expected of them, and perform in a complementary, unified manner. Budgets and financial reports are tools used in that process. When approved, budgets and longer-range plans constitute a form of general authorization. Although the specifics set forth in such budgets and plans will vary with the company's specific circumstances, they should—

- Present for each level of management all material aspects of planned operations for which it has either direct or oversight responsibilities.
- Be segmented in a manner that reflects the assigned responsibilities set forth in the plan of organization.
- Be updated to reflect management's decisions relative to changes in conditions and circumstances.

Financial reports that compare budgeted and actual results and analyze variances and the managerial action that results from that analysis may enable management to identify areas where controls may need to be strengthened. They also provide a means for evaluating performance, help provide reasonable assurance that transactions are being executed in accordance with management's authorization, and help develop an attitude of accountability at all levels of the company.

Appropriate reports are a key form of control over the exercise of authority that has been delegated to others. Accordingly, they assume increased significance to management at higher levels in the company, whose involvement in day-to-day transactions tends to lessen significantly.
Organizational Checks and Balances

The concept of checks and balances is inherent in all aspects of the internal accounting control environment—organizational structure, delegation of authority and communication of responsibility, and budgets and financial reports. The concept has specific application as a general control technique applicable to all accounting cycles. (See the introduction to the Appendix, where the concept is discussed under the heading “Segregation of Duties.”)

In evaluating checks and balances in an organization, two particular functions should be carefully considered—the financial control and internal audit functions. Those two functions stand apart from others in the organizational structure in that an important purpose of both is to establish and maintain an appropriate level of control consciousness in the company.

Financial Control Function. The activities of this function might be performed by a combination of organizational segments, for example, controllership, treasury, planning, and information systems. Such activities will also involve different arrays of reporting relationships depending on the company’s organizational structure. The specifics of an effective organizational structure must permit the corporate level executive(s) responsible for the financial control function to discharge his responsibilities to the chief executive and the board.

The financial control function is by its nature concerned with the establishment and continuous supervision of the control environment. Activities for which this function should be responsible include the following:

- Design of control procedures and techniques applicable to specific transactions.
- Oversight of specific transactions to ensure that they are properly recorded and otherwise satisfy specific control objectives.
- Design of financial planning and reporting systems that appropriately capture management’s plans and the results of actual performance.
- Issuance of reports that appropriately present both planned and actual financial performance.
- Identification and communication of significant variances from management’s plan.

Internal Auditing. According to the Standards for the Professional Practice of Internal Auditing, adopted by the Institute of Internal Auditors (IIA), internal auditing is “an independent appraisal function established within an organization to examine and evaluate its activities as a service to the organization.” The standards provide, among other things, that “internal auditors should be independent of the activities they audit.” An effective
internal auditing function can serve as a high-level organizational control, as well as a constructive and protective link between policy-making levels and operating levels of an organization.

When an internal audit function is being operated in substantial compliance with the IIA standards, the function can be a key element in the evaluation of internal controls (which include internal accounting controls) and the determination of whether these controls are functioning effectively. Thus, an internal audit function may provide assurance to management and the board of directors that the broad objectives of internal accounting control are being achieved.

Some companies may elect to operate without a formal internal audit function either because they are too small to justify the function or because they have elected to use alternative methods.

EDP Considerations

The method used to process information in a company may influence its organizational structure and the procedures and techniques used to accomplish the broad objectives of internal accounting control. A company's use of electronic data processing entails special considerations that play an important role in evaluating its control environment and its control procedures. Some of those considerations are listed below.

- There is often less documentary evidence of the performance of control procedures in computer systems than in manual systems.
- Information in manual systems can be read by the user without the aid of a machine. Files and records in EDP systems are usually in machine-sensible form and often cannot be read without the use of a computer.
- Information in an EDP system can be more vulnerable to physical disaster, human error, unauthorized manipulation, or mechanical malfunction than information in a manual system. Concentration of data, multiple users, and multiple access are characteristics which may increase the vulnerability of EDP systems.
- Computer processing of individual transactions may require better anticipation of potential problems. Manual systems often rely on human judgment to identify problems as they occur.
- Various functions may be concentrated in an EDP system, thus reducing traditional segregation of duties. A single individual may be able to make unauthorized changes (for example, modifying a program, data base, or master file) that negate internal accounting controls or permit improper access to assets. Appropriate segregation of EDP functions may overcome this weakness.
• Additional specialized knowledge may be required to evaluate internal accounting controls in an EDP environment.
• Changes to the system are often more difficult to implement in an EDP system than in a manual system.
• With proper controls in place, EDP systems can provide greater consistency than manual systems because they uniformly subject all transactions to the same controls.

The characteristics of EDP systems and computerized controls indicate the need for management to understand the exposures and controls for specific business applications and to understand the controls in the computer processes themselves. The degree of reliance that can be placed on controls exercised by the EDP system is dependent on the degree of control exercised by management over the development, installation, maintenance and use of the computer equipment and software. Control procedures and techniques that management may exercise over the development and use of EDP systems are covered in discussions of general and application controls in documents such as SAS no. 3, *The Effects of EDP on the Auditor's Study and Evaluation of Internal Control*, certain AICPA guides and guidelines, including *The Auditor's Study and Evaluation of Internal Control in EDP Systems* and *Management, Control, and Audit of Advanced EDP Systems*, as well as various current texts and reports on the subject such as *Systems Auditability and Control: Data Processing Control Practices Report*, published by the Institute of Internal Auditors.

Some of the tasks frequently performed using the EDP process itself are listed below.

• Initiation, authorization, execution, and reporting of transactions according to preestablished rules. Examples might include interest and depreciation calculations, orders to purchase or ship merchandise, and automatic preparation of checks for repetitive payments, such as dividends, employee benefits, or freight settlements.
• Preparation of documents or processing of documents that authorize the use or disposition of assets. This indirect access to assets may occur in connection with transactions that are computer initiated.
• Performance of the full range of accounting functions, that is, recording, classifying, summarizing, and reporting transactions.
• Performance of accounting controls. Those controls may relate to internally generated transactions, internal processing, or internal files, as well as data submitted for processing.
The wide range of tasks that may be performed by the EDP process emphasizes the importance of—

- Proper systems development methods and the participation of management in the development process.
- Controls over changing computer programs. If the change process (or program maintenance) is not controlled, an individual can make unauthorized changes or can make incorrect changes that can have an unpredictable effect on the data files. For example, internal transactions may be generated; assets may be indirectly accessed by individuals responsible for accounting for the assets; and editing and reporting of errors or exceptions may be subverted. Similarly, to the extent that supervisory programs are changed and the change process itself is not controlled, unauthorized transactions may be initiated and the reporting of those transactions suppressed.
- Procedures to control the use of programs. To the extent that direct unauthorized access to the computer equipment, programs, and documentation can occur, and, to the extent that operating instructions and policies are inadequate, data or programs can be accidentally or intentionally modified or destroyed.

In considering its organizational structure, management should recognize that the development of modern EDP systems consists of identifying the company’s business requirements from diverse sources and users throughout the company and translating them into operational computer instructions. This requires a substantially higher level of coordination among groups within the organization and among technical disciplines than was previously required when systems simply supported individual departments.

Evaluating Internal Accounting Control

There are various ways to design and evaluate internal accounting control procedures and techniques. Sections 320.65–.66 of SAS no. 1 suggest that independent auditors consider the types of errors and irregularities that could occur with respect to each significant class of transactions and related assets; determine the accounting control procedures that should prevent or detect such errors and irregularities; determine whether the necessary procedures are prescribed and are being followed satisfactorily; and evaluate any weaknesses.
Considering the types of errors and irregularities that could occur with respect to each significant class of transactions is a formidable task. In an effort to provide guidance that is helpful to management, the committee has developed illustrative specific objectives, included in the Appendix, for a hypothetical manufacturing company. These specific objectives are the converse of the "types of errors and irregularities that could occur" and should prove useful to management as a guide in developing its own specific objectives or as a reference to assist in identifying specific objectives that may have been omitted by management. In addition, the Appendix presents examples of selected control procedures and techniques for general guidance.

Developing Specific Objectives

The committee believes that an effective way for management to approach an evaluation of accounting control procedures and techniques is to (a) classify transactions by, for example, functions, operating units, or cycles, (b) convert the broad objectives of internal accounting control (authorization, accounting, and asset safeguarding) into relevant specific objectives appropriate for those classifications of transactions, and (c) identify and evaluate the control procedures and techniques in place to determine whether they meet those specific objectives. The evaluation should also take into account other broad considerations, for example, cost-benefit relationships and environmental factors such as competence and integrity of personnel, extent of documentation, and supervision and review. (For purposes of this report, "transactions" include exchanges of assets or services with parties outside the business entity and transfer or use of assets or services within it.) Developing specific control objectives for groupings of transactions provides a bridge that can be useful in evaluating whether specific control procedures and techniques meet the broad objectives of authorization, accounting, and asset safeguarding.

The manner in which a company decides to group its transactions will vary depending on its specific circumstances. For example, some companies may wish to group transactions on a functional basis and may wish to consider similar types of transactions on a company-wide basis, while others may prefer to consider them on a departmental basis at the local operating level. Some companies may wish to use a cycle approach. The overall approach (functional, departmental, cycle, and so forth) is not important; what is important is that the appropriate specific objectives be identified.

The committee has found the cycle approach to be a convenient way for it to develop illustrative specific objectives and examples of control procedures and techniques.
procedures and techniques. The cycle approach transcends the differences in the ways companies are organized and results in an overview of all the effects of a transaction that frequently cross functional lines within a company.

One method of grouping the transactions of a company into cycles is set forth below.

1. The company enters into CAPITAL AND DEBT transactions at inception and thereafter as necessary to permit it to engage in
   a. PURCHASE transactions,
   b. PAYROLL transactions, and
   c. PRODUCTION AND INVENTORY transactions.
2. These activities permit the execution of
   a. SALES transactions, which may be or evolve into
   b. CASH RECEIPT transactions.
3. Cash receipts in turn permit CASH DISBURSEMENT transactions for purchases and payroll, and also for
   a. PROPERTY transactions,
   b. INVESTMENT transactions, and
   c. CAPITAL AND DEBT transactions.

A company following that method might state that it had nine cycles. A similar company might, however, classify its transactions in broader or narrower groups and use fewer or more than nine cycles.

Although the cycles identified above may include almost all of the repetitive transactions in which an entity engages, there are other transactions and events that do not fall neatly within transaction cycles. For example, matters such as unusual or nonrecurring transactions or events ordinarily would be beyond the scope of controls designed to apply to normal transactions in the accounts. Similarly, control procedures and techniques established to deal with transactions may not be responsive to control needs related to certain financial statement disclosure decisions, such as those related to disclosures of loss contingencies. The committee believes that there should be a somewhat different “cycle”—the “external financial reporting cycle”—to accommodate those different situations.

The committee has concluded, solely for the purpose of developing illustrative specific objectives and examples of selected control procedures and techniques that can be applied by the widest range of companies, that the transactions of most companies can be grouped into five cycles.
<table>
<thead>
<tr>
<th>Cycles</th>
<th>Examples of Functions/Activities Involved</th>
</tr>
</thead>
<tbody>
<tr>
<td>Revenue</td>
<td>Customer acceptance, credit, shipping, sales, sales deductions, cash receipts, receivables, allowance for doubtful accounts, sales warranties, etc.</td>
</tr>
<tr>
<td>Expenditures</td>
<td>Purchasing, payroll, cash disbursements, accounts payable, accrued expenses, etc.</td>
</tr>
<tr>
<td>Production or Conversion</td>
<td>Production and inventory planning, property and deferred costs, cost accounting, inventory valuation, cost of sales, etc.</td>
</tr>
<tr>
<td>Financing</td>
<td>Capital stock and debt, investments, treasury stock, stock options, dividends, etc.</td>
</tr>
<tr>
<td>External Financial Reporting</td>
<td>Preparation of financial statements and related disclosures of other financial information, including, for example, controls over financial statement valuation and estimation decisions, selection of accounting principles, unusual or nonrecurring activities and decisions, and those which are not transactional in nature, such as contingencies.</td>
</tr>
</tbody>
</table>

As previously indicated, the Appendix includes illustrative specific objectives developed from the perspective of a hypothetical manufacturing company, and examples of selected control procedures and techniques for each of those five cycles. The specific objectives and examples are classified within each cycle by the broad objectives of authorization, accounting, and asset safeguarding.

**The Preliminary Assessment**

Management should initiate a preliminary assessment of the internal accounting control environment and the effectiveness of existing accounting control procedures based on its overall knowledge of the company. In making that assessment, matters such as the following might be considered:

- The extent to which compliance with accounting control procedures is enforced and reinforced through the maintenance of an appropriate internal accounting control environment.
- The extent to which important corporate and accounting policies and procedures have been formalized.
- The extent to which internal audits or other supervisory reviews are used.
- The lines of business, number of locations, and materiality of assets at risk.
• Internal control weaknesses that have come to management's attention, for example, by operating results (such as inventory shortages) or by internal or external audit findings.

• Unusual or unexplained variances in the trend of operating results and balance sheet ratios compared to plan or to prior periods.

• Changes in organizational structure, accounting systems, or personnel.

On the basis of its preliminary assessment, and recognizing the continuing nature of an effective evaluation of internal accounting control, management would plan the manner, extent, and timing of its evaluation of specific control procedures and techniques. When it is determined that such evaluations should be made over a period of time, initial attention should be directed to those areas where the preliminary assessment indicates there may be greater exposure to significant control breakdowns.

Evaluating Specific Control Procedures and Techniques

Recognizing the significant differences between companies, the committee has necessarily suggested an approach to an evaluation of specific control procedures and techniques which requires the exercise of judgment about the extent of detail that will be involved in the evaluation. The approach, outlined below, emphasizes the importance of the internal accounting control environment. In some cases, evaluations may be performed by corporate personnel or internal auditors; in other cases, initial evaluations might be performed, or representations might be made, by division personnel using guidelines established by management, with subsequent review by internal or external auditors.

• Consider the environment in which the accounting control procedures operate, including the nature of the company's business and the industry in which it operates, management's philosophy of operations, and related policies. This might entail review of corporate and division organization charts, plans and operating reports, policy statements, procedures manuals, internal audit reports, minutes of meetings of the audit committee, and so forth. The evaluation should consider whether the environment encourages compliance with accounting control procedures and reinforces appropriate behavior. The evaluator should also consider whether company objectives, policies, and procedures are communicated to middle management and to other employees with the formality appropriate to the circumstances.

• Consider the transactions in which the company engages and classify them by, for example, functions, operating units, or cycles. For illustrative purposes, the Appendix groups transactions into cycles. Managements that elect to use a cycle approach should consider whether to
modify the cycles illustrated because of the company's particular circumstances.

- Develop specific objectives for each grouping of transactions as necessary to achieve the broad objectives of authorization, accounting, and asset safeguarding. The illustrative specific objectives in the Appendix may be helpful in this regard.

- Obtain an understanding of the flow of transactions within each grouping and of the accounting control procedures and techniques in place. This may be obtained by interviewing personnel, reviewing written procedures, forms, and job descriptions, studying the results of periodic internal audits, flowcharting the accounting systems, using questionnaires, and obtaining representations from key personnel. These methods should be used in appropriate combinations. The methods selected should consider the significance of the accounts affected by the transactions. The evaluator should ordinarily trace different types of transactions through the related documents and records maintained to obtain an adequate understanding of the flow of transactions.

- Consider whether the accounting control procedures and techniques in place, giving appropriate consideration to the environment in which they operate, provide reasonable assurance that the specific objectives deemed necessary to achieve the broad objectives of authorization, accounting, and asset safeguarding have been met (see "Cost-Benefit Considerations"). The Appendix provides examples of selected illustrative control procedures and techniques that may be helpful in making this evaluation.

Monitoring Compliance

Management should monitor compliance with established accounting control procedures to obtain reasonable assurance that controls in effect continue to function properly. Monitoring takes place through such actions as management supervision, representations, audits or other compliance tests, and approval and control of changes in procedures. Monitoring is an integral part of the continuing process of evaluating the control environment and the effectiveness of control procedures.

* * *

The internal accounting control provisions of the Foreign Corrupt Practices Act have increased the significance to management of the results of an evaluation of internal accounting control. Accordingly, management should consider the appropriate level of documentation of its evaluation of internal accounting control. Such documentation would provide an important support for representations about the company's internal accounting control. The quantity, type, and content of the documentation
retained will vary with the circumstances. Documentation might include memoranda concerning audit or other findings, management and audit committee deliberations, and resulting actions. Some companies have indicated that they perform on a continuing basis procedures that meet the objectives of a preliminary assessment, evaluation of specific control procedures and techniques, and monitoring compliance. The committee's recommendations should not necessarily cause those companies to change their procedures, although the committee suggests the re-examination of documentation needs.

Cost-Benefit Considerations

The concept of reasonable assurance recognizes that the costs of specific controls should not exceed the benefits expected to be derived. Measuring the direct cost of a control ordinarily is feasible. Measuring the indirect cost is more difficult. Determining whether the control creates a new cost because it slows the decision-making process or stifles initiative is clearly a subjective judgment. This is particularly important, because the first cost-benefit decision management must make relates to the selection of a proper internal accounting control environment in keeping with efforts to achieve overall corporate objectives.

Measuring the benefits a control is designed to provide ordinarily involves estimates and judgments no matter what mathematical techniques are applied. For example, consider the problem of estimating the amount of revenue that might not be recorded, either intentionally or unintentionally, because a control weakness might permit a shipment not to be billed and recorded. The effect of the factors listed below, among others, would have to be considered. Most involve subjective judgments. No way has yet been developed to weigh and measure the factors with precision.

- What is the average value of individual shipments and the aggregate value of shipments during a specified period?
- What has been the company's past experience with inventory adjustments or losses?
- What is the likelihood of shipping tickets not being prepared or being lost or destroyed?
- What is the likelihood of customers advising that shipments were not billed?
- What is the likelihood of detecting such errors or irregularities through salespersons' complaints about unpaid commissions?
- What is the likelihood of detecting such errors or irregularities through reports or other means (for example, by monthly sales comparisons, by the ratio of sales to cost of sales or to shipping expense, by periodic physical inventories, by periodic internal audits, and so forth)?
• What other potential costs may be involved (for example, damage to customer relations or to the company’s reputation)?

Measuring the cost-benefit relationship is an important subject for research. For the present, final decisions relative to an evaluation of internal accounting control requirements in areas where exposure could be material should be carefully reviewed and approved by an appropriate level of management.

Limitations of Internal Accounting Control

The committee believes that there are inherent limitations that should be recognized by management in its evaluation of internal accounting control.

A major limitation of control procedures is the possibility of circumvention, either by employee collusion or management override, as discussed earlier. Those situations can render accounting control ineffective. It may be impracticable or impossible to prevent or detect circumvention of control procedures. There is also a trade-off to be considered between operating efficiency and the increasingly complex control procedures necessary to reduce exposures. Furthermore, there is generally some materiality limit below which it may be impractical to institute control procedures and techniques. Those limitations should be considered when management analyzes the cost-benefit relationship between a control procedure and the benefits expected to be derived.

Another limitation is caused by the fact that conditions within a company are not static; for example, personnel turnover is common. As a result, compliance with control procedures may worsen (or improve) in future periods. Management has the responsibility to maintain internal accounting control and, accordingly, should institute procedures that will provide appropriate review and authorization of changes affecting internal accounting control and appropriate training of new personnel.

Management should also recognize that the control procedures over external financial reporting typically involve subjective judgments to a greater extent than control procedures over processing routine transactions, some of which may be relatively mechanical.

Concluding Remarks

Most companies have long recognized the importance of internal accounting control. However, public companies are now required by law to design and maintain “a system of internal accounting controls” that provides reasonable assurance that the broad objectives of internal accounting control (authorization, accounting, and asset safeguarding) are met. Fur-
thermore, companies may be called upon to make public representations about their internal accounting control.

The definition, objectives, and concepts of internal accounting control in common use (and in the Foreign Corrupt Practices Act of 1977) have been developed to meet the specialized needs of auditors. There has been little material adapting existing auditing literature to the broader needs of management. Although the committee hopes its report will begin to fill part of this void, it is important to emphasize some points.

- Control procedures and techniques have evolved over the years based on the judgments of individual managements of their necessity or usefulness in specific circumstances.
- Subjective knowledge, experience, specific industry and business conditions, management style, cost-benefit judgments, among other factors, affect the selection of appropriate control procedures and techniques. Although illustrative specific objectives are presented in the Appendix, there is a necessary element of subjectivity inherent in an evaluation by management of internal accounting control.
- At this point, there is not sufficient empirical knowledge of how extensively control procedures and techniques are employed, in what combinations, in which industries, in companies of what size, and so forth. Although knowledge of current practices is not the only basis on which management should make judgments, the lack of knowledge about what a majority of companies have found necessary for purposes of effective internal accounting control further complicates the task of evaluation.
- Companies do not have a comprehensive theoretical model to use in making informed, supportable judgments on the cost-benefit decisions implicit in developing their accounting control procedures and techniques.

The committee received numerous helpful suggestions and comments from respondents to its September 15, 1978, Tentative Report. A number of changes have been made to take into consideration certain of those suggestions and comments. However, the committee's report is the first step in what should be an ongoing effort by companies, public accounting firms, academics, and professional organizations to study internal accounting control requirements. The committee believes there are many research projects that could be undertaken that would benefit managements and urges interested individuals and groups to coordinate their efforts in this regard.
The Report of the Special Advisory Committee on Internal Accounting Control was adopted unanimously by the twelve members of the committee, of whom two, Messrs. Carolus and Wood, assented with qualifications.

Mr. Carolus assents to the publication of this report because it provides guidance that will be useful to management and other interested parties. However, he qualifies his assent because he believes that the report does not significantly advance—especially from an organizational and/or management viewpoint—the “state of the art” relative to the basic concepts, scope, and objectives of a system of internal accounting control, and its design, maintenance, and evaluation.

Mr. Carolus believes that the scope of internal accounting control discussed in the report is too heavily influenced by existing auditing literature. He believes the scope and objectives of internal accounting control should have been significantly expanded and consequently would have been more useful to management. In particular, Mr. Carolus believes that certain elements found in what the committee describes as the “internal accounting control environment” are an integral part of a well-designed, effective system of internal accounting control. Examples of such elements are (1) a plan of organization, (2) the assignment of responsibility and delegation of authority, (3) a process of budgeting and budgetary control, (4) a program of hiring and developing competent financial personnel, and even (5) the process of ensuring a high level of ethical conduct by all employees involved in authorizing and recording transactions, safeguarding assets, and reporting financial information. From a management viewpoint (and that of many interested third parties), the distinction between accounting and administrative controls is usually not recognized or even acknowledged, particularly in the current environment in which business operates, and therefore the distinction is, more often than not, academic when it comes to establishing, maintaining, and evaluating internal accounting controls.

The report also states that EDP systems and operations are factors which “influence” procedures and techniques used to accomplish the broad objectives of internal accounting control,” and consequently should be treated as “considerations” in evaluating such controls. Mr. Carolus believes that many current EDP systems fully integrate accounting, operating, and management-oriented data into one system and that the report should have explicitly stated that EDP operations and systems are an integral part of an organization’s system of internal accounting control.

The report has categorized the broad objectives of internal accounting control as authorization, accounting, and asset safeguarding. Mr. Carolus believes that the first two are actually more the means to accomplishing the objectives of a system rather than objectives themselves. Furthermore, he believes that the report should have provided additional guidance on the scope and intent of those terms, as well as a more clearly stated revision of the existing definition of internal accounting control.

Mr. Wood qualifies his assent to the report because he believes that it extends internal accounting control to matters not within the control of management or the board of directors and provides no concept of materiality or significance to assist
management or the board of directors in its consideration of internal accounting control systems.

While agreeing that management is concerned with the reliability of external financial statements, Mr. Wood believes that this responsibility involves two different sets of judgments, only one of which is an activity comprehended by internal accounting control.

Internal accounting control is concerned with summarizing and controlling past transactions and events. In that context, it does relate to external financial reporting. However, external financial reports also include estimates and judgments about future transactions or events—for example, contingencies. Future events are never entirely within management's control, and Mr. Wood believes their effects are not within a reasonable concept of internal accounting control. The failure to draw attention to this basic distinction appears to make management responsible for controlling what it cannot control and seriously compromises the usefulness of the report.

Mr. Wood believes that it is unfortunate that the report does not explicitly recognize materiality or significance in relation to management's responsibilities to achieve the objectives of internal accounting control. While such concepts can (and Mr. Wood predicts will) be interpreted as being inherent in the cost-benefit discussion, the report could have been more specific on this point and would then have been more realistic and helpful.

All effective managements apply some concepts of significance or materiality in organizing their efforts and resources. Yet, the report provides no insights to use of such an approach in reviewing internal accounting control. While judgment always is required, decisions concerning controls will naturally reflect significance or materiality.

On balance, Mr. Wood believes the report should have provided some guidelines useful to management in developing approaches and making judgments concerning control systems in actual situations.
An Illustration of Specific Objectives and Examples of Selected Control Procedures and Techniques by Cycle

This appendix illustrates specific objectives and examples of selected control procedures and techniques for each of five cycles identified by the committee. These introductory remarks, as well as the discussions in the text, particularly those in "The Internal Accounting Control Environment” and “Evaluating Internal Accounting Control,” are essential to an understanding of the information in this illustrative appendix.

The illustrative specific objectives have been developed from the perspective of a hypothetical manufacturing entity and may not be comprehensive. In particular, some businesses may have to develop additional specific objectives to recognize their special characteristics. Also, some of the specific objectives may not be applicable to some companies because of the absence of the specific transactions.

The examples of selected control procedures and techniques are not necessarily typical of those found in most companies. They are not a complete list from which a company may select appropriate procedures and techniques, nor are they intended to suggest whether such procedures would be implemented manually or through the use of EDP. They are basically intended to clarify and illustrate the specific objectives. For example, the first illustrative procedure in the revenue cycle is “procedures for acceptance and approval of orders for nonstandard goods or services and for unusual delivery arrangements.” One company may have a number of procedures and techniques that fall within this broad description. Another company may have only one policy: “Orders are accepted only for goods included in the company’s current sales catalog and all orders are shipped parcel post.” The important point is that all companies should establish effective procedures to deal with deviations from the norm; that is, “nonstandard goods” or “unusual delivery arrangements.”

The illustrative specific objectives and examples are arranged by the broad objectives of authorization, accounting, and asset safeguarding. The committee has attempted to avoid duplication and, as a result, some readers may differ with the classification of certain specific objectives and examples. For example, policies on acceptance and approval of checks and credit cards relate to asset safeguarding as well as authorization, but are included only under “Authorization Objectives” in the revenue cycle. The committee believes that the important point is that significant internal accounting control specific objectives are not omitted; their classification is of secondary importance. In that connection, the general comments accompanying each cycle attempt to summarize the functions comprehended within the cycle and the range of internal accounting control concerns.

There are a great number and variety of accounting control procedures and techniques that, singly or in combination, will satisfactorily attain specific control objectives. Many procedures and techniques have a similar conceptual basis that
is important either in making them effective or in ensuring that they function properly. The committee found it practical to discuss some of those concepts in general terms in this introduction, and thereby limit repetition throughout this appendix.

**Segregation of Duties**

Segregation of duties involves the assignment of responsibilities in such a way that different employees handle different parts of the same transaction. Anyone who records transactions or has access to assets ordinarily is in a position to perpetrate errors or irregularities. Appropriate segregation of duties helps to detect errors in a timely manner and deter improper activities. For example, when an employee with no cash receipts or disbursements responsibility performs the bank reconciliation, that procedure should be considerably more effective in meeting the applicable specific internal accounting control objectives. Similarly, internal accounting control is enhanced when the employee who handles the accounting for an asset, such as cash, is denied access to the asset; for example, the employee who maintains cash records should not be authorized to sign checks without a responsible cosigner. An EDP system may reduce segregation of duties by concentrating accounting functions within the EDP department. Controls should be designed into the system to overcome such a weakness.

**Documentation**

Proper documentation of transactions helps to fix approval and checking responsibility, permits proper accounting, aids in the control of transactions, and reduces the chance of errors. Documentation of transactions is essential to internal accounting control.

Important aspects of documentation include a description of the transaction, written approval authorizing the transaction, and written evidence that any necessary subsequent steps, such as comparison to other documents and checking clerical accuracy and coding, were performed. The written indication of work performed helps to fix employee responsibility and disclose those transactions on which required procedures were not applied.

Accounting control procedures and techniques should provide reasonable assurance that all transactions are accounted for. Prenumbered documents, control totals, and holding files (such as files of unmatched purchase orders) facilitate achieving that objective.

Since the use of the proper form is frequently part of the approval process, it is necessary to maintain control over blank critical forms.

**Supervision and Review**

Systematic and thoughtful supervision and review of employees' work helps to ensure that accounting control procedures are in fact understood and followed. Although the frequency and extent of supervision and review will depend on many factors, such as the sensitivity and risk of the transactions and the ability and experience of the employee, its systematic and well-conceived use by all levels of
supervisory employees helps to detect and correct misunderstandings, errors, and improper practices in a timely manner and, at the same time, improve employee performance. Supervisory personnel should satisfy themselves, for example, that control accounts are properly reconciled to supporting details, that transactions are being accounted for, that errors are appropriately investigated and corrected, and, in a more general sense, that established policies and procedures are being followed. It is often desirable to document specific acts of supervision and review.

Timeliness

It is important that reports, reconciliations, document reviews, and other procedures and techniques that are intended to meet specific internal accounting control objectives be prepared or performed on a timely basis. The importance of the degree of timeliness will vary with each circumstance, and management will want to assess this factor in evaluating its control procedures and techniques. For example, exception reports should be reviewed and investigated promptly, and general ledger control and bank reconciliations need to be prepared and differences resolved expeditiously, so any necessary corrective actions can be taken without unnecessary exposure to loss.
The Revenue Cycle

The revenue cycle covers the functions involved in receiving and accepting requests for goods or services; delivering or otherwise providing goods or services; credit granting, cash receipts, and collection activities; billing; accounting for revenues, accounts receivable, commissions, warranties, bad debts, returned goods, and other adjustments.

“Authorization” in the revenue cycle encompasses the types of products and services provided; classes of customers serviced (including related and foreign parties); distribution channels used; prices, credit, and other terms of sale; individual customer acceptance; sales-related adjustments and policies with respect thereto, such as policies on acceptance of returned goods; services furnished to customers, including warranty policies; billing and collection practices; sales compensation policies.

“Accounting” encompasses the procedures and techniques used to control the recording and classification of transactions that relate to revenue and cash receipts, deductions from revenue (for example, sales taxes, commissions, bad debts), and the distribution of such transactions to individual accounts receivable records and other subsidiary records.

“Asset Safeguarding” relates primarily to controls that safeguard cash receipts and protect important records.

Authorization Objectives

<table>
<thead>
<tr>
<th>Specific Objective</th>
<th>Examples of Selected Control Procedures and Techniques</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. The types of goods and services to be provided, the manner in which they will be provided, and the customers to which they will be provided should be properly authorized.</td>
<td>• Procedures for acceptance and approval of orders for nonstandard goods or services and for unusual delivery arrangements.</td>
</tr>
<tr>
<td></td>
<td>• Policies on export sales and sales to related parties.</td>
</tr>
<tr>
<td></td>
<td>• Policies on customer acceptance, including policies on acceptance and approval of checks and credit cards.</td>
</tr>
<tr>
<td></td>
<td>• Use of an approved customer list.</td>
</tr>
</tbody>
</table>
2. Credit terms and limits should be properly authorized.

3. The prices and other terms of sale of goods and services should be properly authorized.

4. Sales-related deductions and adjustments should be properly authorized.

- Assigned responsibility and established procedures for approval of customer orders (customer acceptance, credit-worthiness, prices, and other terms of sale).
- Established credit policies.
- Policies for investigating credit-worthiness of prospective customers.
- Periodic review of credit limits.
- Approved sales catalogs or similar documents containing current price information and policies on matters such as discounts, sales taxes, freight, service, warranties, and returned goods.
- Use of appropriate contract forms.
- Procedures for approval of individually priced sales.
- Approved commission schedules.
- Procedures for approval of “no charge” service invoices and services performed under a warranty.
- Procedures for approval of bad debt write-offs and other credits to customer accounts, including credits given for returned goods.

Accounting Objectives

<table>
<thead>
<tr>
<th>Specific Objective</th>
<th>Examples of Selected Control Procedures and Techniques</th>
</tr>
</thead>
</table>
| 5. Deliveries of goods and services should result in preparation of accurate and timely billing forms. | - Shipping and billing procedures that provide for the means to account for all goods shipped or services delivered and comparisons of shipments to billings, perhaps individually or through a form of batch control.  
- Policies covering the types of “memo billings” that may be issued and approval procedures over such billings.  
- Check of quantities of goods shipped by, for example, independent counts by common carriers or double counting of shipments.  
- Independent follow-up on customer complaints. |
Examples of Selected Control Procedures and Techniques

- Policies and procedures covering accounting routines and related approval procedures for the major functions within the revenue cycle.
- A suitable chart of accounts and standard journal entries.
- Written, properly communicated sales (and cost of sales) cut-off procedures and review of the cut-off.
- Reconciliation of the accounts receivable subsidiary ledger to the general ledger on a regular basis.
- Independent mailing of statements to customers on a monthly basis.
- Comparison of initial record of cash receipts to bank deposits and accounting entries and investigation of any unusual delays in depositing receipts.

Asset Safeguarding Objectives

Specific Objective
8. Access to cash receipts and cash receipts records, accounts receivable records, and billing and shipping records should be suitably controlled to prevent or detect within a timely period the interception of unrecorded cash receipts or the abstraction of recorded cash receipts.
The expenditures cycle is subdivided into purchasing, payroll, and disbursement functions.

Purchasing covers the functions involved in initiating requests for goods, other assets, and services ("goods"); obtaining information as to available vendors, prices, and other specifications; placing orders for goods; receiving and inspecting or otherwise accepting the goods delivered or provided; accounting for amounts payable to vendors, including freight-in, cash discounts, returned goods, and other adjustments. Payroll covers the functions involved in hiring employees and deciding their compensation, direct and indirect; reporting attendance and work performed; accounting for payroll costs, payroll deductions, employee benefits, and other adjustments. Disbursement covers the functions involved in preparing, signing, and issuing checks or distributing cash.

"Authorization" in the expenditures cycle encompasses the types and specifications of goods to be obtained; vendors used (including related parties); prices, specifications, credit, and other terms of purchase; the selection, hiring, termination, and promotion of employees; wages, salaries, and commission rates; types and amount of employee benefits; signing and issuance of checks; adjustments to vendor, payroll, and cash accounts, and policies with respect thereto, such as quality control policies for goods accepted, and policies for termination pay and other special employee payments.

"Accounting" encompasses the procedures and techniques used to control the recording and classification of transactions that relate to purchases, payroll, and cash disbursements, including accounts payable, purchase discounts lost, freight-in, gross payroll, payroll deductions, accruals related to such accounts, and the distribution of such transactions to the appropriate accounts, including individual payroll records.

"Asset Safeguarding" relates primarily to controls that provide reasonable assurance that payments are made only for authorized goods and authorized employees and that protect important records.
PURCHASING FUNCTIONS

Authorization Objectives

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<thead>
<tr>
<th>Specific Objective</th>
<th>Examples of Selected Control Procedures and Techniques</th>
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</table>
| 1. The types of goods, other assets, and services to be obtained, the manner in which they are obtained, the vendors from which they are obtained, the quantities to be obtained, and the prices and other terms of sale should be properly authorized. | • Use of purchase requisitions.  
• Guidelines for vendor acceptability, based on considerations such as past performance, reputation, and credit standing; ability to meet delivery, quality, and service specifications; price competitiveness; legal restrictions; and policies on related party transactions.  
• Use of an approved vendor list based on established guidelines.  
• Use of priced purchase orders.  
• Procedures for prior review of contracts with vendors.  
• Established procedures for approval of purchase requisitions and purchase orders, and changes thereto, including the establishment of reasonable limitations on the approval authority of specific individuals or classes of individuals.  
• Assigned responsibility for effecting compliance with purchasing policies. |
| 2. Adjustments to vendor accounts and account distributions should be properly authorized. | • Use and approval of debit memos to notify vendors of goods returned to them and other adjustments to their accounts.  
• Assigned responsibility for approval of changes in account distribution. |

Accounting Objectives

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<tr>
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| 3. All goods, other assets, and services received should be accounted for properly on a timely basis. | • Use of receiving reports.  
• Timely review of all unmatched receiving reports and purchase orders.  
• Accounting for all issued vouchers. |
4. Amounts payable for goods and services received should be recorded at the appropriate amounts and in the appropriate period and should be properly classified in the accounts.

- Policies and procedures covering accounting routines and related approval procedures for the major purchasing functions.
- Review of vendor statements for past-due items.
- Comparison of vendor invoices to receiving reports and purchase orders.
- Clerical check of vendor invoices.
- Written, properly communicated cut-off procedures and review of the cut-off.
- Procedures for making appropriate financial statement accruals based on unmatched receiving reports and, where appropriate (certain other assets and services), unmatched purchase orders.
- A suitable chart of accounts and standard journal entries.
- Established guidelines for determining account distribution (capital vs. expense, overhead vs. administrative, etc.).
- Insertion of account distribution on purchasing documents.
- Reconciliation of accounts payable subsidiary ledger to the general ledger on a regular basis.
- Independent follow-up of overdue items on vendor statements, payment requests, complaints, etc.

**Asset Safeguarding Objectives**

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</table>
| 5. Access to purchasing, receiving, and accounts payable records should be suitably controlled to prevent or detect within a timely period duplicate or improper payments. | - Cancellation of supporting documents upon payment.  
- Approval of vouchers and supporting documents prior to payment.  
- Segregation of duties between access to cash disbursements (issuing checks or handling signed checks) and keeping purchases and accounts payable records. |
Specific Objective

6. Only authorized goods, other assets, and services should be accepted and/or paid for.

Examples of Selected Control Procedures and Techniques

- Receiving procedures that provide for an independent count of quantities received.
- Comparison of specifications and quantities of goods, other assets, and services received to approved purchase orders.
- Testing procedures appropriate in the circumstances for goods, other assets, and services received.

PAYROLL FUNCTIONS

Authorization Objectives

Specific Objective

7. Employees, employee benefits, and perquisites should be properly authorized.

Examples of Selected Control Procedures and Techniques

- Procedures for hiring and terminating employees.
- Policies on vacation pay, overtime pay, sick pay, and other similar benefits.
- Establishment by the board of overall policies for employee benefits and perquisites, such as company cars and use of company airplane.
- Approval by the board or a committee thereof of significant individual benefits or perquisites.
- Assigned responsibility for effecting compliance with company guidelines.
- Assigned responsibility for approval of wages, salaries, and commission rates.
- Assigned responsibility for approval of additions, deductions, and other changes to basic payroll information.
- Maintenance of personnel files, including support for payroll deductions.
- Supervisory approval of time cards or sheets.
- Periodic comparison, possibly on a test basis, of rates paid to (a) individual approvals or (b) overall approvals, such as a union contract or commission policy statement.
- Assigned responsibility for approval of adjustments of specific types (for example, accounting errors, termination payments, special payments).
### Accounting Objectives

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| 9. Recorded payroll should be for work actually performed. | - Policies and procedures covering accounting routines and related approval procedures for the major payroll functions.  
- Use of time clocks or timekeepers.  
- Reconciliation of payroll records to production records when employee pay is based on output.  
- Review of payroll register by individuals at a responsible level of management.  
- Comparison of actual payroll to budgeted amounts.  
- Reconciliation of payroll register to independent controls (such as hash totals) over source data.  
- Assigned responsibility for preparation of payroll tax returns.  
- Review of payroll source data by supervisors.  
- Reconciliation of payroll distribution to gross pay.  
- Guidelines for determining account distribution (capital vs. expense, inventory vs. expense, etc.).  
- A suitable chart of accounts and standard journal entries.  
- Procedures for making appropriate financial statement accruals. |
| 10. Payroll and related withholdings should be correctly computed and remitted when due. | |
| 11. Payroll costs should be recorded at the appropriate amounts and in the appropriate period and should be properly classified in the accounts. | |
Asset Safeguarding Objectives

12. Access to personnel and payroll records should be suitably controlled to prevent or detect within a timely period duplicate or improper payments.

13. Payments should be made only to authorized employees.

DISBURSEMENT FUNCTIONS

Authorization Objectives

14. Disbursements should be made only for properly authorized expenditures.

15. Adjustments to cash accounts should be properly authorized.
Accounting Objectives

Specific Objective

16. Disbursements should be recorded at the appropriate amount and in the appropriate period and should be properly classified in the accounts.

Examples of Selected Control Procedures and Techniques

- Policies and procedures covering accounting routines and related approval procedures for the major disbursement functions.
- Accounting for all checks issued.
- A suitable chart of accounts and standard journal entries.

Asset Safeguarding Objectives

Specific Objective

17. Access to cash and cash disbursements records should be suitably controlled to prevent or detect within a timely period duplicate or improper payments.

Examples of Selected Control Procedures and Techniques

- Segregation of duties between the accounts payable and cash disbursements functions; segregation of duties within the cash disbursements function between the issuance of checks or disbursement of cash and the maintenance of cash disbursements records.
- Safekeeping procedures for blank checks and facsimile signature plates.
- Safekeeping procedures over the signing of checks (dual signatures, control over signing equipment and signature plates).
- Reconciliation of the number of checks issued on a facsimile signature machine to the number of checks prepared.
- Mutilation and retention of spoiled checks.
- Independent bank reconciliations, including (a) comparison, possibly on a test basis, of paid checks with cash disbursements records and (b) examination, possibly on a test basis, of paid checks for alterations, unauthorized signatures, and unusual endorsements.
- Surprise counts of cash funds on hand.
The production or conversion cycle covers the functions involved in production planning and control, inventory planning and control, property and deferred cost accounting, and cost accounting.

"Authorization" in the production or conversion cycle encompasses the types and quantities of goods to be manufactured or services to be provided; the methods and materials to be used; the inventory levels or service capabilities to be maintained; the scheduling of goods to be produced or services to be provided; adjustments and policies with respect thereto, such as provisions for obsolete inventory or write-downs of deferred costs; dispositions of property, scrap, and obsolete or excessive inventory.

"Accounting" encompasses the procedures and techniques used to control the recording and classification of transactions that relate to resources used, completed production, and inventory, and includes depreciation, amortization, and gain or loss on the sale or disposition of property.

"Asset Safeguarding" relates (a) to protecting the company from loss of inventory on property and (b) to protecting important records.

### Authorization Objectives

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| 1. The types and quantities of goods to be manufactured or services to be provided, the methods and materials to be used, the inventory levels or service capabilities to be maintained, and the scheduling of goods to be produced or services to be provided should be properly authorized. | • Preparation and review of sales forecasts.  
• Establishment of a production control function.  
• Approval of an overall production and inventory control plan, and of changes thereto.  
• Bills of material for goods to be produced.  
• Requirement for capital expenditure requests over a specified amount to include a documented cost-benefit analysis. |
2. Adjustments to inventory, property, deferred costs, and cost of sales should be properly authorized.

3. Dispositions of property, scrap, and obsolete or excessive inventory should be properly authorized.

- Policies for determining excess or obsolete inventory quantities.
- Assigned responsibility for review and approval of adjustments, including adjustments to standard costs.
- Periodic review of the reasonableness of lives assigned to classes of property and to deferred costs, and of the methods of depreciation and amortization.
- Requirement for all movements or shipments of merchandise and assets out of the physical facility to be accompanied by appropriate documentation.
- Periodic follow-up on disposition of inventory identified as obsolete or excessive.

**Accounting Objectives**

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| 4. Resources used and completed production should be properly recorded on a timely basis. | - Inventory released to production based on bills of material that are used as sources for postings to inventory records.  
- Additional inventory transfers to production based on documents approved by a designated employee, which would include review of scrap reports.  
- Physical transfer of completed production on hand to a storeroom.  
- Independent check of quantities transferred to storerooms and quantities shipped.  
- Comparison of quantities transferred to storerooms to production reports.  
- Perpetual inventory records.  
- Periodic physical inventories or cycle counts.  
- Reconciliation of payroll costs to labor charged to inventory.  
- Investigation of significant amounts of over- and underabsorbed overhead.  
- Periodic physical inventory (where existence cannot be determined by other means) of property and equipment. |
Examples of Selected Control Procedures and Techniques

- Inventory pricing policies that are in conformity with generally accepted accounting principles.
- Policies and procedures covering accounting routines and related approval procedures for the major functions within the conversion cycle, including sales or other dispositions of property.
- Use of a cost system (job cost, process cost) that accumulates and allocates production costs in an appropriate manner (by cost center, department, and/or product) and that provides information adequate for pricing inventories, appropriate to the manufacturing process.
- Use of standard costs with investigation of variances.
- Periodic comparison of standard costs to actual costs (comparison of material costs to vendor invoices, comparison of labor rates and hours to actual rates and results of time studies, analysis of over- or underabsorbed overhead).
- A suitable chart of accounts and standard journal entries.
- Written, properly communicated cut-off procedures on transfers among inventory accounts, and review of compliance with procedures. (Purchase and sales cut-offs are covered in the expenditures and revenue cycles.)
- Review of priced inventory listings for conformity with established pricing policies.
- Individual records for items of property that include description, location, cost, depreciation, tax, and investment credit information.
- Maintenance of appropriate records to support amortization of deferred charges.
- Periodic review of appropriateness of depreciation and amortization rates.

Specific Objective

5. Inventory, production costs, depreciation of property, and amortization of deferred costs should be properly accumulated and classified in the accounts.
6. All costs of sales should be recorded at the appropriate amounts and in the appropriate periods and should be properly classified in the accounts.

- Procedures that provide for the same document (e.g., a sales invoice) to serve as the source document for the recognition of revenue and the related receivable and for the recognition of cost of sales and the related reduction of inventory.
- Reconciliation of inventory records to the general ledger on a regular basis.
- Physical inventories at the end of annual reporting periods and/or on a cycle basis.

### Asset Safeguarding Objectives

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| 7. Inventory should be protected from unauthorized use or removal. | - Physical controls (fences, restricted-access storerooms, guards, inspection of personnel, independent storeroom clerks).
- Physical control procedures that vary with the individual dollar value of inventory items and with the volume of transactions. |
| 8. Items of property should be properly controlled. | - Identification tags affixed upon acquisition.
- Physical security procedures in plants and offices (fences, guards, etc.).
- Periodic physical inventories of items susceptible to removal, giving due regard to the cost and lives of such items. |
| 9. Access to inventory, property, cost, and production control records should be suitably controlled to prevent or detect within a timely period improper dispositions of inventory and property. | - Segregation of duties between those who have access to inventories and those responsible for inventory, cost, and production control records. ("Those who have access to inventories" includes those who physically receive, handle, and ship; it also includes those who prepare shipping orders or other disposal authorizations.)
- Periodic physical inventories under the supervision of personnel other than those who have access to inventories.
- Investigation of significant physical inventory differences by those who do not have access to inventories.
- Segregation of duties between those who have custody of movable property and those who maintain the property records. |
The Financing Cycle

The financing cycle covers the functions involved with the issuance and redemption of capital stock and the recording of transactions therein; the payment of dividends; the investigation and selection of appropriate forms of financing, including lease transactions; debt management, including monitoring compliance with covenants; investment management; and physical custody of securities.

"Authorization" in the financing cycle encompasses the sources, nature, and terms of equity and debt financing and any changes therein, and the nature and terms of investments, dividends, and other transactions affecting capital accounts.

"Accounting" encompasses the procedures and techniques used to control the recording and classification of those transactions.

"Asset Safeguarding" relates primarily to safekeeping procedures and segregation of duties with respect to investments, debt, and capital stock.

Authorization Objectives

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| 1. The sources, nature, and terms associated with equity and debt financings (including lease transactions) and any adjustments or changes therein should be properly authorized. | • Approval by the board of guidelines for selection among financing alternatives based upon such factors as covenants of existing financial arrangements, rating agency considerations, existing banking relationships, internal cost of capital, and corporate financial objectives.  
• Approval by the board of significant financing transactions.  
• Assignment of approval authority for less significant financing transactions to specific members of management. |
2. The nature and terms of investments, dividends, and other transactions affecting capital accounts and related adjustments should be properly authorized.

Accounting Objectives

- Maintenance and review of loan covenant checklists.
- Preparation and review of projected cash requirements with respect to payouts relating to existing loans and equity securities.
- Preparation and regular review of key financial ratios and statistics.
- Legal review of all loan agreements prior to signing.
- Approval by the board of guidelines for selection among investment alternatives based upon such factors as corporate charter and bylaws, legal restrictions, required rates of return, risk, cash flow, and portfolio diversification.
- Preparation and review of financial forecasts, including cash flow analyses.
- Preparation and review of lease versus buy analyses.
- Approval by the board of dividends, stock splits, treasury stock transactions, and significant investments.
- Assignment of approval authority for less significant investments to specific members of management.

Specific Objective

3. Financing, investing, and capital transactions should be promptly recorded and properly classified in the accounts.

Examples of Selected Control Procedures and Techniques

- Policies and procedures covering accounting routines and related approval procedures for the major functions within the financing cycle.
- Schedules of notes, interest payable, and commitments.
- Schedules of marketable securities, including certificate numbers and tax and dividend information.
- Procedures to accumulate and review financial data of investees on a regular basis.
- A suitable chart of accounts and standard journal entries.
- Policies governing the valuation of investments and treasury stock.
Examples of Selected Control Procedures and Techniques

- Reconciliation of dividends paid with shares outstanding.
- Reconciliation of interest accruals on debt and interest and dividends earned on investments with terms of individual notes or securities.
- Comparison of recorded transactions with minutes of meetings of the board or a committee thereof.
- Review of interest income and expense and cash flow analyses by reference to budgets and prior period amounts.
- Procedures to account for the registration and transfer of issued shares.
- Utilization of banks, brokers, independent registrars and transfer agents, and other third parties to account for changes in investments, changes in the company's capital stock accounts, and changes in ownership of the company's issued shares.
- Prompt review of broker's advice.

Specific Objective

4. Access to debt, equity, and investment records and to investment securities and capital stock records should be suitably controlled to prevent or detect within a timely period improper dispositions of investments or of funds from debt or equity transactions.

5. Segregation of duties between access to cash receipts from investments, debt, and equity, and keeping the related cash receipts records.
The External Financial Reporting Cycle

The external financial reporting cycle covers the functions involved in preparing journal entries and posting transactions to the general ledger (to the extent such functions are not performed within other cycles); deciding the generally accepted accounting principles that the company should follow; gathering and consolidating the information required for the preparation of financial statements and other external historical financial reports, including related disclosures; preparing and reviewing the financial statements and other external reports.

"Authorization" in the external financial reporting cycle encompasses the company's accounting policies; major valuation, adjustment, and estimation decisions; and decisions with respect to the proper accounting for unusual or nonrecurring transactions or events.

"Accounting" encompasses a supervisory or review responsibility with respect to the procedures followed within other cycles as well as direct responsibility for the preparation of financial statements and reports and the accounting procedures and routines used in their preparation.

"Asset Safeguarding" relates primarily to controls that restrict access to important records and to appropriate physical safekeeping procedures.

Authorization Objectives

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<tr>
<td>1. Accounting policies, including selection among alternative accounting principles, should be properly authorized.</td>
<td>• Written policy statements.</td>
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<td>• Written procedures manuals.</td>
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<td>• Assigned responsibility for approval of accounting policies.</td>
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<td>• Timely review of the selection of accounting principles with independent auditors.</td>
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</table>
Examples of Selected Control Procedures and Techniques

- Assigned individuals to approve adjustments and write-offs.
- Requirements for documentation, including supporting calculations, of adjustments and write-offs.
- Assigned responsibility for independent review and approval of adjustments and write-offs.
- Use of standard journal entries.
- Assigned responsibility for approval of standard and nonstandard journal entries.
- Policies requiring the reporting of significant unusual or nonrecurring transactions or events to top management.
- Timely review of the accounting recognition appropriate for such transactions and events by independent auditors.
- Approval of the accounting treatment for such transactions or events by a senior financial officer.
- Assigned responsibility for advising management of requirements of existing and new accounting rules and of the rules and regulations of appropriate regulatory bodies.
- Assigned responsibility for accumulating information for disclosure.
- Assigned responsibility for reviewing all external financial reports.
- Policies and procedures governing the preparation and presentation of financial statements.
- Requirement for written representations on financial statement matters from responsible employees.
- Review by management and the board of directors relative to presentation and disclosure of external financial reports.
Accounting Objectives

Specific Objective

6. Financial statements, including related disclosures, should be prepared in conformity with generally accepted accounting principles or any other criteria applicable to such statements.

Examples of Selected Control Procedures and Techniques

- Written financial statement closing schedule with assignment of specific responsibilities, including review responsibilities.
- Forms that identify for subsidiaries, branches, departments, etc., the data that is to be reported.
- Overall review of the consolidated and consolidating financial statements, including comparisons to the prior year and budgeted amounts.
- Reconciliation of general ledger balances to subsidiary ledgers or records.
- Standard elimination, currency translation, and reclassification entries.
- Procedures for an independent comparison of the financial statement working papers to source data and a comparison of elimination, currency translation, and reclassification entries to those made in prior periods.
- Examinations by internal and external auditors.
- Designation of individuals permitted to discuss financial results with individuals outside of the company.
- Assigned responsibility for preparation of government and regulatory reports and for preparation procedures (similar to those in item 6, above) to the extent necessary.
- Assigned responsibility for reviewing all financial information presented outside of the financial statements.

7. Other external financial reports, including other information included in documents containing financial statements, should be prepared in conformity with generally accepted accounting principles or any other criteria applicable to such reports, and should be consistent with the financial statements, where applicable.
### Asset Safeguarding Objectives

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<td>8. Adjustments and write-offs made to the account balances should not impair the accountability for actual amounts.</td>
<td>• Use of contra accounts for valuation adjustments.</td>
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<td>9. Access, direct and indirect, to accounting and financial records used in the preparation of external financial reports should be suitably controlled to guard against physical hazards and to prevent or detect within a timely period unauthorized entries.</td>
<td>• Use of memorandum accounts to control adjustments such as bad debt write-offs.</td>
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<td>• Suitable restrictions on access to work papers used in preparing financial statements.</td>
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<td>• Suitable safekeeping facilities for work papers, supporting documentation, etc., to guard against physical hazards.</td>
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<td>• Suitable records retention program.</td>
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<td>• Assigned responsibility for approval of all changes in policies and procedures covering accounting routines and related approval procedures.</td>
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