

Internal control over financial reporting



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KEY FACTS?? The teacher has the option of utilizing two versions (i. e. . negative and positive) of the instance. Simply Steam provides the negative tone or frame while so following instance. Easy Clean. provides the positive frame. The instances are indistinguishable except for the tone of the interview and some name alterations. ?? Easy Clean/Simply Steam (EC/SS) . Co. is in the concern of supplying industrial and domestic rug steam-cleaning services. ?? EC/SS is a privately-held company and has ne'er been audited. ?? The audit director late conducted an interview with direction in order to obtain an apprehension of EC/SS's control environment. This interview duologue is what pupils rely on to measure EC/SS's control environment. ?? EC/SS has grown quickly since it began operations less than six old ages ago. ?? The instance indicates that the teacher will advise the pupils whether to do all the component appraisals or merely the overall control environment appraisal.

Use OF CASE1The rich content of the EC/SS instance can be used to advance interesting treatments of a broad assortment of subjects associating to the appraisal of a client's control environment. The EC/SS exercising actively involves pupils in issues that call for professional judgement. This is a important portion of their audit instruction that is non frequently covered by traditional methods. Involving pupils in this active acquisition experience should assist develop their competency. rise their sense of professional incredulity and heighten their ability to exert professional judgement. This instance exercising provides an chance 1 This instance and the instruction notes have been adapted from the " Steam-Vac. Inc. " instance included in the article " Instructional Case: Using Professional Judgment in Control

Environment Evaluation. ” by R. E. Marden. S. L. Schneider. and G. L. Holstrum. published in Issues in Accounting Education. Vol. 11. No. 2. Fall 1996. The instance was prepared by Mark S. Beasley. Ph. D. and Frank A. Buckless. Ph. D. of North Carolina State University and Steven M. Glover. Ph. D. and Douglas F. Prawitt. Ph. D. of Brigham Young University. as a footing for category treatment. Simply Steam is a fabricated company. All characters and names represented are fabricated ; any similarity to bing companies or individuals is strictly coinciding.

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subdivision 5: internal control over fiscal coverage to pattern doing hard judgements and to critically measure the issues environing professional judgement. The exercising involves the rating of the control environment (CE) . Prior to SarbanesOxley and PCAOB Auditing Standard No. 2 (superseded by Auditing Standard No. 5) . the rating of CE seldom received the attending it deserved in the professional literature and hearer preparation. However. a proper apprehension of CE is one of the most of import facets of the audit. Lack of attending to CE is a possible subscriber to several known alleged audit failures. Increased sensitiveness to the CE may better students’ ability to acknowledge those conditions in which the hazards of fraud and stuff misstatements are high. The EC/SS exercising is intended to show some of the troubles that hearers. every bit good as pupils. can hold in utilizing professional judgement when measuring the unwritten averments

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of direction. The primary map of the exercising is to promote pupils to prosecute in critical thought about audit judgement and to get down developing a sense of professional incredulity.

This instance is designed for usage in-class. Students should already be familiar with the constructs covered in a text edition chapter covering internal control and/or constructs in AU Section 314. " Performing Audit Procedures in Response to Assessed Risks and Measuring the Audit Evidence Obtained. " and PCAOB Auditing Standard No. 5. " An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audited account of Fiscal Statements. " In other words. the instance exercising is non intended to present pupils to the control environment. Rather. it is intended to let them to use what they have already learned. In the exercising. pupils are told they will be asked to measure facets of a little service company's CE. trusting chiefly on the unwritten averments provided by direction. The pupils are so presented with a conjectural scenario portraying an interview with an audit client about the CE of a little rug cleaning company named either " Easy Clean. Co. " or " Simply Steam. Co. " The Easy Clean and Simply Steam instances are about indistinguishable with the primary difference being two versions of the interview duologue. Both interviews include management's description of the same CE. In Easy Clean. management's description of the CE is cast in a comparatively positive visible radiation (i. e. . the positive version) . In Simply Steam. management's description is cast in a comparatively negative visible radiation (i. e. . the negative version) . Both versions represent the same nonsubjective conditions (see illustration extracts in Exhibit 1) .

vitamin E x H ib it 1 A Selected Example of Framing Manipulations from the Positively and Negatively framed Interviews Positive Frame (Easy Clean) : “ Mr. Day developed this gross revenues system himself and it’s working instead good. He’s presently in the procedure of making the user manual for the system. I’ve besides noticed that he sometimes makes accommodations to better the system. which makes the accounting procedure more efficient. We’ve agreed that he’ll re-evaluate the procedure at least one time every eight hebdomads. ” Negative Frame (Simply Steam) : “ Mr. Day pieced together this gross revenues system himself. and so far it’s working reasonably good. He hasn’t had a opportunity to complete a user manual for the system yet. I’ve besides discovered that he sometimes alters the system. He says he does this to do the accounting procedure more efficient. I’ve told him to re-evaluate the procedure at least one time every twosome of months. ”

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instance 5. 1-2: easy clean/simply steam. co. Teachers have the option to utilize one or both versions of the instance. Teachers taking to utilize both versions will inquire that half the category complete Easy Clean and the other half complete Simply Steam. Before inquiring the pupils to get down reading the interview scenario. we encourage pupils to reexamine the CE “ decision aid” or rating signifier. which is included in the instance. The pupils are told that the rating signifier consists of an organized series of points depicting typical CE factors and a evaluation graduated table for measuring

the impact of the factors within the scenario on EC/SS's CE. The pupils are given a minute or two to look over the rating signifier before get downing to measure the background information and interview grounds. Once the pupils have had an chance to look over the rating signifier. they are asked to read the Easy Clean (or Simply Steam) scenario. The interview duologue should take pupils about 10 proceedings to read. After holding read the scenario. the pupils are asked to make full out the CE rating signifier. The teacher can inquire the pupils to do all the preliminary appraisals (i. e. . assess the assorted constituents of CE) or inquire them to merely do the overall rating of the control environment (we discuss the possible deductions of these different rating options below) . After pupils have completed their CE evaluations. a schoolroom treatment follows. Students are encouraged to support their places with sound statements and based on available grounds. Depending on clip restraints and the deepness of coverage desired. the treatments can concentrate on one or all of the content countries suggested below. If the teacher wishes to utilize less than a full category period on the exercising. he or she would discourse merely a subset of the available subjects. In the exercising. pupils must cover with enquiries. The profession recognizes enquiries as of import beginnings of grounds. However. it is all excessively easy to accept unwritten grounds at face value. excessively swearing its dependability. Particularly when covering with unwritten averments. hearers may be susceptible to prejudices from information framing. Student ratings at the terminal of our class where we have used instances like EC/SS suggest that the huge bulk of pupils find the instances both oculus gap and gratifying. We have received pupil feedback proposing that when they study the stuff from their text edition they sometimes get the

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sense that scrutinizing is a “cookbook” exercising. In other words, pupils frequently believe that the occupation of an hearer is to follow a list of pre-established audit processes, non recognizing the extent of professional judgement required.

Professional Standard Relevant professional criterions for this assignment are AU Section 316. “Consideration of Fraud in a Financial Statement Audit.” AU Section 318. “Performing Audit Procedures in Response to Assessed Risks and Measuring the Audit Evidence Obtained.” AU Section 333. “Management Representations.” AU Section 326. “Audit Evidence.” and PCAOB AS5. “An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audited account of Fiscal Statements.” (AS5 is relevant from an informational position, but is non required since EC/SS is non a public company).

SUGGESTED SOLUTION/DISCUSSION TOPICS Obviously, there is non one “correct” reply to this instance. The undermentioned three subdivisions provide a foundation for schoolroom treatment. Thesetreatment countries are non intended to be across-the-board, but instead should be supplemented by relevant text and other schoolroom stuffs. In each subdivision we offer a short debut to the subject along with high spots to heighten schoolroom treatment. Suggested inquiries for treatment are provided in each subdivision. Because the three content countries are closely related, there is likely to be considerable convergence of treatment subjects.

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Discussion Topic # 1—The Control Environment

Because the CE is a primary constituent in the rating of control hazard, it can hold a permeant consequence on the full audit procedure. Students must recognize that the dependability of the accounting system and other internal controls will be tenuous if management's unity and ethical values are fishy. If the CE is weak, the chance for fraud additions because fraud becomes easier to perpetrate and because sensing of the fraud is less likely. In this exercising, pupils are exposed non merely to several CE constituents, but they are besides encouraged to do systematic judgements of CE's strength utilizing a determination assistance. After reading the EC/SS interview and measuring the CE's status, the teacher can raise any of a figure of issues to get down the treatment. Exhibit 2 provides several illustrations of inquiries that can be used to discourse CE subjects. In our categories, we have pupils discourse the implicit in facets of CE to foreground the fact that certain constituents tend to be more subjective and abstract in nature than others are. For case, we find that pupils by and large have greater trouble happening grounds that straight bears on management's doctrine than they do happening grounds for direction control methods. This provides an first-class chance to inform pupils that the more abstract CE constituents, even though they are harder to document, be given to be the 1s that have the most permeant consequence on the strength of the CE. Some of these abstract constituents combine to organize what has been referred to as the "tone at the top" of an organisation.

A firm's "tone at the top" may supply the footing on which all other controls are evaluated. For illustration, hearers can hold small religion in a client's internal controls if there is a sensible likeliness that these controls can and will be overridden by direction for the incorrect grounds. In our treatments of the CE, we find that many pupils well underestimate the figure of factors that need to be taken into consideration to organize accurate decisions. Students become sensitized to cost-benefit issues environing information assemblage, and they become cognizant of the jobs associated with the handiness and quality of confirming grounds. This exercising

vitamin E x H ib it 2 Discussion Topics for Measuring the Control Environment

1. How interconnected are the assorted CE constituents and points? Find an illustration in the scenario that illustrates an interrelatedness. Why might these interrelatednesss be of import? 2. Does the importance of the different CE constituents vary across industry and house size? Do you believe the interview should concentrate on the same issues for EC/SS as it should for a larger house, or for a house in another industry (e. g. . banking) ? 3. What is "tone at the top" ? Which CE constituents and points represent the "tone at the top" ? How would you depict EC/SS's "tone at the top" ? 4. Make you believe the CE constituent appraisals (e. g. . unity and ethical values, committedness to competency, etc.) helped you in your rating of EC/SS's CE? Why or why non? In general, what are some of the pros and cons of doing appraisals of the constituent parts of CE in measuring a firm's CE? 5. What grounds from the scenario did you utilize to measure each of the points on the CE determination assistance? Are there grounds why different pupils rated a given point otherwise? 6. Is it likely that concentrating on CE

strengths versus CE weaknesses influences the manner that grounds is evaluated? Did you happen yourself concentrating on one or the other? If so, make you believe it act upon your rating of the CE point? Why or why non? 7. What is the CE's impact on the rating of control hazard? What have you learned from the interview about EC/SS's degree of control hazard? What else do you necessitate to cognize?

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instance 5. 1-2: easy clean/simply steam. co. helps pupils derive a more balanced position on issues of effectivity and efficiency in CE information assemblage. It is common for pupils to inquire what the right overall control environment appraisal is. Obviously, there is no 1 correct reply. nevertheless appraisals within the scope of 3 to 5 are better than appraisals at the extremes. We ask pupils if they think different hearers finishing the instance would do precisely the same appraisals. Students rapidly respond that they would anticipate some differences. Then we ask pupils if they would anticipate large (e. g. . state 5 or 6 point) differences between hearers. This treatment allows us to turn to issues of consensus. single differences due to past experience and preparation. differences in construing the graduated table. etc. While there is no right reply. Exhibit 3 provides properties of EC/SS's control environment that pupils should hold considered in their appraisal (s) .

vitamin E x H ib it 3 Strengths and Weaknesses of EC/SS's Control

Environment Control Environment Component 1. Integrity and Ethical Values

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Factors that Strengthen • Owners (Phil and Doug) are extremely involved in running the concern and they appear to be people of unity • The company has experienced strong growing chiefly through viva-voce advertisement which indicates the company (proprietors) operates ethically and delivers a valuable service • Employees seem to have sufficient preparation and look to understand their duty • Office staff are mostly made up of college accounting pupils. Therefore while the staff has small anterior work experience they can use constructs from their concern instruction to EC/SS's processes • There is an active BOD • Board members are knowing about the concern and the industry • BOD have the flexibleness to run into when needed

Factors that Weaken • High employee turnover • Gross saless people are paid on committee and can negotiate particular pricing

2. Committedness to Competence

- Most employees have small or no old experience
- No formal occupation descriptions have been developed
- Office staff experience confusion sing their occupation responsibilities

3. BOD or Audit Committee Participation

- The BOD meetings are scheduled merely one time per twelvemonth

There are no board members independent of direction

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Control Environment Factors that Strengthen Component 4. Management's •
 Phil and Doug maintain an "open door" policy Philosophy and • Employees
 are encouraged to show Operating Style their concerns to direction • Doug
 and Phil are the lone people authorized to subscribe cheques • EC/SS is a
 focussed. well-run organisation • The battle of CPAs for a fiscal statement
 audit signals management's (1) desire to bring forth just fiscal statements.
 (2) involvement in controls. (3) desire to supervise concern hazards. and
 (4) desire to continuously better

Factors that Weaken • Phil and Doug have small apprehension of accounting
 and finance issues • Office director paid a % of gross revenues •
 Management does non officially specify ends • No budgets are prepared •
 Management appears to stress efficiency and end product over controls •
 Office employees indicate there are jobs in treating trade receivables
 (direction does non look to portion the concern) • No separate physical
 controls over of import paperss or computing machine equipment • Gross
 saless people are paid on committee and can negotiate particular pricing •
 Office director is paid a per centum of entire gross revenues

5. Organizational Structure

- Owners and office director are extremely involved in daily operations •
- Duties and governments of proprietors and office director are clearly
 established • Office director straight supervises informations treating •
- Operating policies and processs are determined by proprietors and office
 director • Owners are extremely involved in daily operations • Office director

approves all gross revenues • Exception studies are generated for specially priced gross revenues • Computer system and gross revenues procedure is re-evaluated every eight hebdomads

6. Assignment of Authority and Responsibility

7. Human Resource Policies and Practices

- New hires receive immediate preparation • New employees in operations are assigned to work with more experient employees • Owners and office director are extremely involved in daily operations
- Computer system was developed by office director • No user manual or other system certification exists for computing machine system • Office director makes comparatively frequent alterations to the system • Office employees experience confusion sing their occupation responsibilities and duties • New hires have small or no anterior experience • Employee turnover is high • Workloads can acquire heavy • Office employees have to assist “cover” other places when work load is busy • Office employees experience confusion sing their occupation responsibilities and duties

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instance 5. 1-2: easy clean/simply steam. carbon monoxide.

Discussion Topic # 2—Inquiries

Harmonizing to the 3rd GAAS criterion of fieldwork, enquiry is one of the four basic types of evidentiary affair, along with reviews, observations and verifications. Although enquiries can be enlightening, they are frequently less dependable than other signifiers of grounds because they are subjective and easy manipulated. The nature of enquiries makes it easy to show that the consideration given to a piece of grounds is likely to differ from one hearer to another, even when they both face the same audit state of affairs. This exercising can assist pupils develop their professional incredulity. Students will hold to believe through the job of proposing ways to confirm unwritten averments with other grounds. The EC/SS instance can besides be used to increase students' consciousness of (a) the necessity of roll uping information consistently and (B) the importance of holding structured interviews. Exhibit 4 provides a list of possible inquiries for opening a treatment on enquiries. e ten H ib it 4

Discussion Subjects for Using Inquiries as Evidence 1. Why is it of import to roll up information consistently? What are some of the different ways to do information-gathering more systematic? Was Ted/Tina (the scenario hearer for Easy Clean/Simply Steam) well-organized and systematic in his/her information assemblage? 2. Would an interviewer privation to inquire " yes/no" inquiries or open-ended inquiries? Why might the interviewer ask a inquiry such as " What is your biggest headache" ? 3. How much dependability can be put on unwritten averments? Looking through the interview duologue, how confident can you be about the truth of management's averments? Are some sorts of averments likely to be more dependable than others? 4. Does the quality of unwritten averments change

with direction rank? Is Mr. Day (the director) probably to be more or less accurate than one of the parttime EC/SS clerks? Are at that place cues that one might utilize to assist measure the quality of unwritten averments? 5. Can direction consensus be used as a signifier of proof? For case. when Doug. EC/SS's proprietor. and Mr. Day independently agree on the same unwritten averment. does that increase the likeliness that the statement is accurate? 6. What function does professional judgement drama in measuring unwritten averments? Is it likely that hearers may differ about the value of an unwritten averment? If so. what implications does this hold for the usage of enquiries as a signifier of grounds?

We find that pupils need to be made cognizant of the troubles associated with trusting on unwritten testimony. particularly when confirming grounds is non available. A speedy mention to the tactics of the proverbial " used auto salesman" immediately makes the point. The interview exercising can be used to exemplify the importance of inquiring the right inquiries. keeping control of the interview. and doing certain that inquiries are pointed and bring forth sufficient item. Students come to acknowledge that the weight of evidentiary affair is non a affair of absolutes. but a affair of grade of strength.

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Discussion Topic # 3—Framing Effectss

Framing effects occur whenever a individual is influenced in either thought or behavior by the manner in which information is described or framed. The framing of information can act upon audit determination devising, and bordering effects have been documented in a assortment of audit contexts. 2 Framing effects are most disposed to happen when covering with determination contexts that are equivocal or lack feedback. These potentially harmful prejudices seem particularly likely given the subjective nature of most CE factors and the demand to trust on enquiries as a primary signifier of evidentiary affair. Because most information can be communicated in any figure of ways, hearers routinely receive client information in a manner that reflects the perceptual experiences, attitudes and communicating wonts of the individual who supplies the information. This job is compounded if direction is intentionally seeking to act upon the auditor's judgement. Our exercising demonstrates how the same information can be communicated in different ways, and it shows pupils that their ain judgement can be influenced by these differences. Suggested inquiries for taking a treatment on bordering appear in Exhibit 5. vitamin E x H ib it 5 Discussion Topics for Becoming Aware of Biases in Framing and Hypothesis Testing

1. How do the CE evaluations for the positively and negatively framed interview versions differ from one another? Should they differ? Why or why non?
2. What are some of the ways one can bias the positions of others? Are there illustrations in the interview? Is it harder to bias some types of information than others?
3. In comparing the interviews, are the two different frames given to a peculiar piece of information truly tantamount? If

non. what makes them different? Either manner. could the frame influence what the hearer comes to believe about Easy Clean? 4. Are directors and others who communicate information to hearers likely to be sensitive to the elusive differences in intending that different frames may advance? How about the auditor—will he or she be cognizant that the information could hold been presented in a different manner? 5. Using an illustration of bordering from the interview. seek to province how the information could be communicated in a wholly “ objective” manner. Is the “ objective truth” underlying the two interview versions easy to pass on in a impersonal manner? 6. What are some ways to minimise or get the better of prejudices in communicating? How can one communicate information in a more “ objective” manner? On a larger graduated table. how can one avoid biases in hypothesis testing? 7. Should an hearer examine grounds in footings of its strengths or in footings of its failings? 8. Is utilizing a systematic determination assistance probably to diminish the influence of bordering? Why or why non?

We find that one of the first things pupils need to be cognizant of is the significance of bordering. Possibly the easiest manner to exemplify a framing consequence is to depict a glass of H₂O as “ half full” or “ half empty. ” In both versions. the nonsubjective province or fact state of affairs is indistinguishable. It is of import for pupils to acknowledge that state of affairss or “ fact” forms are communicated from a peculiar position or with a peculiar “ frame. ” After the glass illustration. pupils can be asked to pass several proceedingss comparing the Easy Clean and Simply Steam interviews with a neighbour that completed a different version than they did

(i. e. . as a little group undertaking) to detect all of the topographic points that the information has been framed otherwise across the “ positive’ and “ negative” versions. This comparing undertaking is non merely merriment for the pupils. but it is a genuinely eye-opening experience. Some pupils are excited to 2 For a reappraisal of bordering research see“ Instructional Case: Using Professional Judgment in Control Environment Evaluation. ” by R. E. Marden. S. L. Schneider. and G. L. Holstrum. published in Issues in Accounting Education. Vol. 11. No. 2. Fall 1996.

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instance 5. 1-2: easy clean/simply steam. co. discover how different frames can be used to pass on the same point. whereas others argue that a alteration in frame may affect a alteration in significance every bit good as diction. It is besides interesting to witness the scope of pupil beliefs and consciousness of prejudices in communicating. Some pupils can supply legion illustrations of “ framed” communications both in and out of an scrutinizing context. whereas others seem truly surprised to larn of the being or impact of fluctuations in how something is said. As the treatment evolves. the built-in trouble of seeking to pass on information in a wholly nonsubjective manner should go readily evident. The resulting treatment should do it clear that there frequently is no 1 wholly nonsubjective manner to pass on information. and that the inevitable framing of information is likely to hold unforeseen effects on judgement. Introducing the function of professional incredulity in scrutinizing adds another of import dimension to

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this treatment. The exercising stimulates critical thought by disputing students' premises about the built-in objectiveness of information. The strength of treatment we have observed is grounds of this. Students voluntarily search to compare and contrast the different versions of the scenarios to find if the differences are fiddling or substantial. The exercising sensitizes pupils to subtle differences in position and to the value of sing alternate positions. As an extension of the instance (possibly an excess recognition chance) . teachers may see giving pupils the chance to show what they had learned about framing by happening an illustration in a newspaper or magazine. Students could so re-write the illustration from an alternate position. and remark on the influence that the original frame was likely to hold had on readers. Experience suggests pupil involvement in an extension of this kind is likely to be high. Empirical Evidence and the Impact of the Decision Aid. Our experiences with the Easy Clean/Simply Steam instance scenarios have been really honoring. Results of an empirical survey utilizing a instance similar to Easy Clean are reported in " Instructional Case: Using Professional Judgment in Control Environment Evaluation. " by R. E. Marden. S. L. Schneider. and G. L. Holstrum. published in Issues in Accounting Education. Vol. 11. No. 2. Fall 1996. In that survey. students' responses to the CE determination assistance were analyzed to find if pupils who responded to the positively framed scenario evaluated the CE more favourably than pupils who responded to the negatively framed scenario. The analysis identified important differences between the positive and the negative versions. Items were rated as lending more positively to CE strength when the interview was presented in a positive frame instead than a negative frame. In our experience. when we have had pupils make merely

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the overall rating of the control environment the mean appraisal for the positive (negative) instance has been merely under 5 (over 3) . The difference is important at the $P & It ; . 01$ degree. When we have pupils make all the appraisals. we find that the difference in the overall rating of the control environment is less (merely over 3 for the negative instance and merely under 4 for the positive instance) . While this difference is smaller. it is besides extremely important ($p & It ; . 01$) . This determination that the difference between the positive and negative frames is smaller when both intermediate and overall appraisals are made suggests that doing intermediate appraisals may be one effectual manner to extenuate the effects of bordering. Such an empirical presentation can be used in the schoolroom to (a) provide pupils with direct grounds of the impact of contrasting positions in determining judgement. and (B) exemplify how reacting to detailed intermediate appraisals of CE can act upon judgement. While the differences are statistically important. some pupils will oppugn the economic import of a difference between a 3 and a 5 evaluation on the graduated table. We by and large ask from a normative position whether there should be any difference (presuming the lone difference between the positive and negative instance is bordering) . The pupils understand that there should non be. Then we discuss how a difference in evaluation could impact an audit. We discuss the possibilities of thresholds. For illustration suppose evaluations over 4 consequence in audit testing (i. e. . nature. timing. extent) that is different when theevaluation is under 4. After the treatment pupils by and large understand that it is imaginable that bordering could really impact of import audit determinations. teacher resource Manual — do non copy or redistribute 163

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5. 3

set uping effectual internal control in a little concernMark S. Beasley · Frank
A. Buckless · Steven M. Glover · Douglas F. Prawitt

To assist pupils understand types of frauds that can happen in a little
concern environment due to the deficiency of effectual internal controls.

[2]

To assist pupils use their general concern cognition, concluding abilities, and
understanding of internal controls to place controls that would be effectual
and efficient in cut downing hazards of stuff misstatements due to fraud.

KEY FACTS?? Matthew Franklin late invested in a little 18-room motel and
cafe in a distant tourist country in Southern Utah. Matt lives in Northern Utah,
some five hours from the motel, and merely programs to see the motel
sporadically. ?? Matt hired a immature twosome to pull off the motel and
cafe . They will populate on-site and will hold complete control over day-to-
day activities and record maintaining. ?? Matt is concerned about holding
small control over the operations of the motel and cafe . He has requested
aid in placingpossible ways the concern could be defrauded and in set uping
originative internal controls to discourage such fraud.

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Use OF CASE This instance provides an first-class chance for pupils to understand the importance of internal controls in a little concern environment and to exert their logical thinking abilities and general concern cognition in bring forthing suggestions for internal control betterments. Generating thoughts for developing internal controls helps pupils intensify their general concern intuition when it comes to planing effectual trials of controls in a fiscal statement audit. The instance has been designed to assist pupils acknowledge types of frauds that can happen with the absence of certain internal controls. The instance besides provides pupils the chance to place internal controls that specifically address peculiar fraud hazards. In add-on, the instance allows for a treatment of the restrictions and options that little concerns face when seeking to implement controls in a cost-efficient mode. Finally, the instance allows pupils the chance to research possible effects of identified controls on employee morale. The instance is short plenty to be used as an in-class activity to advance treatment, but can besides be used as a more in-depth out-of-class composing assignment.

Professional Standard Relevant professional criterions for this assignment are found in AU Section 314 " Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement. "

The instance was prepared by Mark S. Beasley, Ph. D. and Frank A. Buckless, Ph. D. of North Carolina State University and Steven M. Glover, Ph. D. and Douglas F. Prawitt, Ph. D. of Brigham Young University, as a footing for category treatment. Red Bluff is a fabricated company. All characters and names represented are fabricated ; any similarity to bing companies or individuals is strictly coinciding.

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What are your two biggest concerns associating to possible fraud for the motel portion of the concern? For each concern. bring forth two or three controls that could efficaciously cut down hazard related to your concerns. Use common sense and be originative! Because this assignment is designed to promote pupils to utilize their intuition and common sense in planing internal controls. there will probably be many different responses with regard to possible frauds in the motel. Below are some of the more obvious concerns: ?? The twosome could steal some of the gross collected from the lease of motel suites. ?? The twosome could let friends/family to remain in the motel without charge or at an unapproved price reduction. ?? The twosome might maintain false records that do non accurately show the public presentation of the motel. ?? The twosome might enter personal disbursals as disbursals of the motel. With regard to the concerns listed supra. below are some possible controls that could efficaciously. but with variable degrees of efficiency. extenuate the possibility of fraud at the motel: ?? Require the twosome and the cleansing staff to maintain separate records of the motel's tenancy and sporadically look into to do certain these records lucifer. The cleaning staff could straight get off a transcript of the cleansing studies to Matthew on a hebdomadal footing. The couple's tenancy records

should fit with the cleaning staff 's records of suites cleaned. ?? Establish a set of policies and processs that require good record maintaining and that clearly stipulate appropriate utilizations of motel resources. ?? Require all cheques (including paysheet) over \$ 500 to be signed by Matthew. ?? Require a bank history leger to be kept on all sedimentations and cheques. Mathew could utilize this information along with the monthly bank statement. which could be sent straight to him from the bank. to execute the monthly bank history rapprochement. An imprest bank history could besides be used. ?? During his periodic visits to the motel. Matthew can reexamine the records and other grounds of the motel's disbursals to verify everything was used for legitimate concern intents. ?? Require grosss to be given to allclients and that a transcript of all grosss be kept at the motel. ?? Require all cheques. when received. to be instantly stamped with information instructing that the cheque be deposited merely in the motel's history. ?? Install a security camera that continuously records a position of the client and registry countries. ?? Hire an confidence supplier to execute periodic. unheralded " independent cheques. "

[2]

What are your two biggest concerns associating to possible fraud for the cafe portion of the concern? For each concern. bring forth two or three controls that could efficaciously cut down hazard related to your concerns. Use common sense and be originaive! Again. because this assignment encourages pupils to utilize their creativeness many different responses will be provided with regard to possible fraud in the cafe . Below are some of the more likely concerns: ?? The twosome could steal some of the gross brought

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in from the sale of nutrient in the cafe . ?? The twosome could let friends/family to eat in the cafe without charge or at an unapproved price reduction. ?? The twosome might maintain false records that do not accurately show the public presentation of the cafe .

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instance 5. 3: ruddy bluff hostel & A ; cafe ?? The twosome might enter personal disbursements as disbursements of the cafe . ?? The twosome could utilize nutrient points from the eating house for their own personal usage. ?? The twosome could buy and function cheaper, hapless quality nutrient and do records look as if they had purchased more expensive, higher quality nutrient. With regard to the concerns listed supra, below are some possible controls that could efficaciously, but with variable degrees of efficiency, extenuate the possibility of fraud in the cafe : ?? Necessitate a reception to be given to all clients. Put a mark in the cafe advising clients that if they do not have a reception, they can name Matthew's telephone figure for a free repast and a \$ 10 gift certification. ?? Establish a set of policies and processes that require good recordmaintaining and that clearly stipulate appropriate utilizations of cafe resources. ?? Require all nutrient and supplies received from providers to be recorded. A periodic stock list can be performed and compared against purchases and estimated use based on records of repasts served to place misallocation of stock list. ?? Periodically reconcile waiters'/waitresses' records of repasts served with the chef 's records of repasts cooked and with registry gross. ?? Require all cheques (including

paysheet) over \$ 500 to be signed by Matthew. ?? Require a bank history ledger to be kept on all sedimentations and cheques. Mathew can utilize this information along with the monthly bank statement to execute the monthly bank history rapprochement. ?? During his periodic visits to the cafe . Matthew can reexamine records and other grounds of the cafe's disbursements to verify everything was used for legitimate concern intents. ?? Do not let the teller to be the same individual responsible for entering day-to-day hard currency gross. ?? Require all cheques. when received. to be instantly stamped with information teaching the cheque be deposited merely in the cafe's history. ?? Contract individually with a nutrient provider to present nutrient to the eating house. and have the nutrient provider send transcripts of bills and listings of nutrient supplied straight to Matthew. ?? Hire an confidence supplier to execute periodic. unheralded " independent cheques. " [3]

Briefly describe the impact each proposed control would hold on the efficiency of running the concern. Are the controls you generated both effectual and efficient? While the pupils will come up with many suggested controls. it is of import for them to see whether the controls implemented are cost-beneficial. In order for a control to be effectual. it can not put an undue load on the operation of the concern. If the cost of implementing a control is greater than the cost of the possible mistake or fraud it helps forestall or observe. so the control is non efficient. However. the cost of possible fraud losings should not be underestimated. With each suggested control. the proprietor must weigh the associated costs and benefits before make up one's mind whether it is effectual and efficient for the company.

For illustration, one recommended internal control would necessitate that gross be provided to all clients. The substantial cost to that recommended control would probably associate to the free repast and \$ 10 gift certification that would be provided, if the client failed to have thereception. Another possible cost would be incurred if clients falsely claimed failure to have a reception, when in fact the clerk provided the reception. These costs would necessitate to be weighed against the benefit of a possible decrease of fraud.

[4]

Describe the possible impact of your proposed controls on the morale of the twosome in charge of the daily operations. How might Matt trade with your concerns? Another cost to see with each possible control is the consequence it could hold on employee morale. While it is necessary to minimise chance and enticement, it is besides of import to non

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subdivision 5: internal control over fiscal coverage portray a complete deficiency of trust in the employees. Constant, intrusive monitoring or surveillance could damage morale and consequence in damaging effects. The benefit of each control must be carefully weighed against the possible negative consequence it could hold on employee morale. Matthew might be able to outdo trade with the morale issue by explicating to the twosome the importance of implementing the controls. He should show to them that the

controls are not a screening of his deficiency of trust in them. but instead. they are designed to assist the concern tally every bit expeditiously as possible no affair who is running the concern today or 20 old ages from now. Additionally. he could indicate out to the twosome that the controls protect them from being unsuitably accused of incorrect making by all other parties involved with the concern. Given the nature of a little concern environment. and the fact that no set of internal controls can be perfectly effectual. Matthew will hold to demo a sensible degree of trust in the twosome and their direction of the motel and cafe . Consider. for illustration. that if employees were to conspire. many of the controls suggested supra would be uneffective. Therefore. as in larger concerns. engaging quality employees with unity is of critical importance.

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st. James haberdashers

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5. 4

rating of Manual and it-based gross revenues accounting system hazards

Mark S. Beasley · Frank A. Buckless · Steven M. Glover · Douglas F. Prawitt

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ive S [1]

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[2]

To supply experience with measuring hazards of stuff misstatements originating from accounting system lacks. To exemplify that while new information engineering (IT) -based accounting systems cut down many bing manual system hazards they besides introduce new hazards.

[3]

[4]

To exemplify issues associated with the procedure of change overing from manual to IT-based accounting systems. To supply experience in fixing a formal concern memoranda.

KEY FACTS • The St. James Clothiers is a little. one-location vesture shop located ina little Tennessee town. The shop caters to clients interested in buying high-end vesture. • The shop is entirely owned by Sally St. James. who has operated the shop for 20 old ages. • Sally late decided to change over from a comparatively simple manual gross revenues system to an IT-based gross revenues accounting bundle to be purchased from a package seller. • Anterior twelvemonth audit files contain a narrative depicting the manual gross revenues system. The narrative is included in the instance stuffs. • Joe McSweeney. a staff hearer. late visited with the client and prepared a narrative sum uping the characteristics of the proposed new IT-based gross revenues system. The narrative is included in the instance stuffs. • St. James' financial period ends December 31. 2009. Conversion to the new IT-based accounting system is scheduled for the 4th one-fourth of

2009. A Nashville, Tennessee based computing machine adviser will help with the execution.

Use OF CASE This instance assignment provides pupils the chance to measure hazards of stuff misstatements related to both manual and IT-based gross revenues accounting systems. As a consequence, pupils develop accomplishments at analysing strengths and lacks of internal controls by promoting them to believe through “ what could travel wrong” within a peculiar accounting system. The instance helps pupils pattern measuring how IT-based accounting system features cut down hazards often associated with manual accounting systems. Additionally, this instance points out that while many manual-system hazards are eliminated, the usage of an IT-based system introduces new hazards that must be considered. Finally, this instance highlights issues associated with client installings of purchased off-the-rack accounting package. The instance was prepared by Mark S. Beasley, Ph. D. and Frank A. Buckless, Ph. D. of North Carolina State University and Steven M. Glover, Ph. D. and Douglas F. Prawitt, Ph. D. of Brigham Young University. as a footing for category treatment. St. James is a fabricated company. All characters and names represented are fabricated ; any similarity to bing companies or individuals is strictly coinciding.

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subdivision 5: internal control over fiscal coverage Because St. James Clothiers is non a public company, the hearer would most likely non be <https://assignbuster.com/internal-control-over-financial-reporting/>

individually describing on internal controls over fiscal coverage. However, this instance can besides be used to exemplify how hearers of public companies must measure being internal control processes for design lacks as portion of their duties in PCAOB Auditing Standard No. 5. " An Audit of Internal Control Over Financial Reporting That is Integrated with an Audited account of Fiscal Statements. " Completion of this instance can assist pupils better accomplishments at placing internal control design lacks. We have used this instance in alumnus degree scrutinizing categories to foreground audit planning issues associated with measuring control hazard for the gross rhythm. The instance would besides be effectual for usage in an undergraduate auditing category when discoursing the consideration of internal controls during audit planning or when discoursing the gross rhythm. The instance can be completed by pupils separately or in groups as an in-class or out-ofclass assignment. For in-class usage, we recommend delegating the reading of the instance background and related internal control narratives as an out-of-class reading assignment to be completed before the twenty-four hours scheduled for in-class usage. Generally, pupils enjoy reexamining the narrative to place hazards associated with the being manual system. Many of them have shopped in little, " hometown" shops with similar simple accounting systems.

Students are besides effectual at placing ways in which the proposed new ITsystem reduces or even eliminates many of the manual-system hazards. In our experience, we find that pupils are less effectual at placing how the new IT-based accounting system introduces new hazards. Students frequently focus on the benefits of engineering and believe all information must be right

given that “ the computing machine processed it” without concentrating on hazards associated with that engineering. This instance helps indicate out those hazards. The instance besides helps pupils think through issues associated with change overing to new systems. such as the trust on package seller repute. dependance on advisers for installing. and installing during extremum runing seasons. Finally. this instance provides pupils an chance to develop formal professional authorship accomplishments when used as an out-of-class assignment. Students are asked assume the function of audit senior on the battleresponsible for fixing a memoranda to the audit spouse sketching the issues they identify. We believe it is of import to promote pupils to work on the concision of their written response. which will be expected of them in most professional scenes. Our solution contains a comprehensive set of the instance replies. which increased the length of our memoranda response. If you chose to curtail pupils to a set page bound for their response. you should non anticipate the students’ responses to incorporate a comprehensive solution including all requested points. We believe that pupils benefit as much from constructive feedback about their authorship manner as they do from feedback about the substantial content of their response.

There may be a demand to explicate the format of typical internal memos. Some pupils may non be familiar with the traditional “ To/From/Subject” format of fixing a memo to be circulated internally within an organisation. Optional extra demands that can be tailored for this assignment: You can necessitate them. either separately or in groups. to flowchart the manual and/or IT-based •? accounting systems that are described in narrative

signifier in the instance stuffs. Flowcharting package can be downloaded free from the Internet (for illustration. obtain a test version of EDGE Diagrammer package by Pacesar Software at World Wide Web. pacesar. com) . To supply pupils an exposure to related issues in the “ real universe. ” you can necessitate them •? to see with a little local retail or service concern to learn about that business’ bing gross revenues and hard currency gross system. This assignment could officially necessitate the pupils to interview concern representatives about the bing system. Alternatively. you might inquire pupils to measure current systems from a client position at a concern where they presently shop. For illustration. while standing in line at a local fast nutrient eating house. pupils could detect how gross revenues orders are captured and hard currency is handled and so measure possible hazards for misstatements in entering gross revenues minutess for that constitution. 170 teacher resource Manual — do non copy or redistribute

instance 5. 4: st. James haberdashers

Professional Standard Relevant professional criterions for this assignment are AU Section 312 “ Audit Hazard and Materiality in Conducting an Audit. ” AU Section 314 “ Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement. ” and AU Section 318. “ Performing Audit Procedures in Response to Assessed Risks and Measuring the Audit Evidence Obtained. ” and PCAOB Auditing Standard No. 5. “ An Audit of Internal Control Over Financial Reporting That is Integrated with an Audited account of Fiscal Statements. ” Q u einsteinium Ti onS and Su GG vitamin E St vitamin E vitamin D Sol ution S As noted in the pupil version of the instance. one effectual method for reacting to inquiries 1 and 2 is to unite those <https://assignbuster.com/internal-control-over-financial-reporting/>

responses. Therefore, the suggested solution is prepared in that mode. The suggested solution efforts to place all issues present and, as a consequence, the solution is long. [1]

What aspects of the current manual gross revenues accounting system create hazards that increase the likeliness of stuff misstatements in the fiscal statements? Specifically place each hazard and how it might take to a misstatement. For illustration, don't merely put " Risk: Gross saless tickets are manually prepared by the teller. " Rather, you should province why this increases hazards of stuff misstatements by adding " This increases the hazard of stuff misstatements because it increases the hazard of random mathematical mistakes by the teller. " What features, if any, of the proposed IT-based gross revenues accounting system will assist minimise the hazards identified in inquiry 1? If a lack exists that is expected to prevail under the new system, bespeak that " no computing machine controls cut down this hazard. "

[2]

The suggested solution follows.

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subdivision 5: internal control over fiscal coverage

MemoDate: To: From: July 20, 2009 Betty Watergate Audit Senior

Capable: Evaluation of St. James Clothiers' Current and Proposed Gross sales Accounting Systems I reviewed the narrative describing St. James Clothiers' current manual gross revenues accounting system and the narrative depicting their proposed new IT-based accounting gross revenues system. which is scheduled for 4th one-fourth 2009 execution. The following table high spots hazards I identified as being associated with the manual system. For each class of manual hazard. I noted how the proposed ITbased system should cut down that hazard. Manual System Risks The manual recording of the gross revenues clerk's name. merchandise figure. measure sold. and gross revenues monetary value increases the hazard of random human mistake by the teller. Related Impact on the Financial Statements This may take to an increased hazard of stuff misstatements in gross revenues. IT System Solutions The new system requires the gross revenues clerks to come in their alone watchword. which should minimise mistakes associated with come ining the gross revenues clerk's name. The gross revenues clerks will go on to input merchandise figure and measure. Invalid merchandise Numberss and merchandises without monetary values in the Price List maestro file will automatically be rejected by the computing machine. thereby cut downing mistakes. Price input mistakes should be reduced given that the computing machine uses the unit monetary value in the Price List maestro file to calculate the gross revenues sum. Gross saless clerks will no longer input unit monetary values. Alternatively. the computing machine will automatically place unit monetary values for each merchandise figure in the Price List maestro file.

The trust on monetary value tickets, newspaper ads, or gross revenues clerks to place unit monetary values for merchandises sold increases the hazard that clients may be charged wrong monetary values. The manual extension by gross revenues clerks of monetary value times measure and the entrance of drawn-out monetary value, gross revenues revenue enhancement, and entire gross revenues monetary value increases the hazards of random mathematical mistakes in calculating gross revenues sums. The hard currency drawer can be easy opened by pressing the " Total" button thereby increasing the hazard of hard currency larceny.

This may take to an wrong rating of gross revenues minutess.

This may take to an wrong rating of gross revenues minutess.

The computing machine will automatically widen monetary value times measure and calculate the pre-tax gross revenues sum, gross revenues revenue enhancement sum, and entire gross revenues sum, thereby cut downing the hazard of random mistake.

This may take to a misstatement of the hard currency balance.

The hard currency drawer, which is controlled by the computing machine, remains locked until a sale is processed. Merely the shop director has a particular watchword to open the hard currency drawer at other times.

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instance 5. 4: st. James haberdashers Manual System Risks Gross sales returns are processed by making out another gross revenues ticket utilizing negative sums. No matching of the return faux pas with returned ware is required. and a stock list count is made merely one time a month. These hazards may take to material misstatements because stock list is ill tracked and gross revenues returns are ill monitored. Cash could be misappropriated and disguised by entering fabricated gross revenues returns. Original gross revenues tickets are maintained in a box next to the hard currency registry where they could easily be misplaced/ altered. This increases the hazard of entering mistakes for gross revenues and fillips. While the accountant's rapprochement of the Gross sales Journal day-to-day gross revenues sums to the validated sedimentation faux pas should finally observe disagreements. the potency for lost gross revenues tickets adds to the trouble of deciding celebrated disagreements. The teller can manually change gross revenues tickets. This increases the hazard that perceived "errors" may be falsely processed. The ability to change minutess manually without any audit trail besides increases the possible for gross revenues to be " voided" in order to cover up a embezzlement of hard currency from the hard currency drawer. Related Impact on the Financial Statements This hazard could take to the larceny of hard currency and stock list. ensuing in possible misstatements to those histories. Additionally. fabricated gross revenues returns recorded to cover up the larceny of hard currency may take to exaggerations of the gross revenues returns account (a Contra gross history) . IT System Solutions Gross sales returns can merely be processed by the shop director utilizing a particular watchword option. The computing machine besides updates ageless stock list records daily. Furthermore. the <https://assignbuster.com/internal-control-over-financial-reporting/>

shop comptroller (McGlomm) will now be able to more closely monitor ageless stock list records by executing more frequent physical counts.

This hazard could take to a misstatement of the gross revenues and fillip histories.

The IT-based system will no longer fix gross revenues tickets. A paper hard currency reception will be generated for the client. However, no hard currency reception tape will be maintained by the computing machine. Rather, all gross revenues will be recorded internally on the computing machine difficult thrust, which is subsequently used to automatically post gross revenues sums to the Gross saless Journal and to automatically cipher fillips.

This hazard could take to If the teller makes a error while come ining a sale, misstatements in the gross revenues the shop director will hold to come in a watchword to and hard currency histories, invalidate the sale.

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subdivision 5: internal control over fiscal coverageManual System Risks The shop comptroller (McGlomm) manually prepares day-to-day gross revenues records by gross revenues clerk based on gross revenues ticket information and enters day-to-day sums by clerk in separate columns of a spreadsheet. She besides accumulates the subtotals of gross revenues by gross revenues clerk to find day-to-day shop gross revenues sums, which she manually enters into the Gross saless Journal. Monthly, the shop accountant foots the <https://assignbuster.com/internal-control-over-financial-reporting/>

Gross sales Journal and posts the history sums to the General Ledger. These manual processes increase the hazard of random, human mistake in the accounting records. The shop proprietor will merely go cognizant of disagreements between the day-to-day recorded gross revenues sum and the validated sedimentation faux pas by sporadically comparing the sedimentation faux pas to the Gross sales Journal recorded sums. In addition, there is chance for the shop comptroller (McGlomm) and the shop director (Thornberg) to conspire to embezzle hard currency without sensing by the shop proprietor (St. James) . given that the shop proprietor merely sporadically compares the sedimentation slips with the Gross sales Journal entries and does not look into the hard currency registry tape. Any employee can run the hard currency registry without any record of who prepared an single dealing. The deficiency of audit trail back to specific employees responsible for treating gross revenues minutes increases the trouble in deciding mistakes or disagreements noted. A ageless stock list record is not maintained thereby increasing the hazard of stock list shrinking and mistake. Related Impact on the Financial Statements This hazard could ensue in mistakes impacting the gross revenues and fillip histories, if falsely processed by McGlomm. IT System Solutions The computing machine automatically posts single minutes to the Gross sales Journal by gross revenues clerk, thereby extinguishing the manual readying of the Gross sales Journal and single sales representative gross revenues sums. The computing machine besides automatically posts gross revenues and stock list minutes on a monthly footing to the General Ledger. These automatic maps cut down the potency for random, human mistake.

There is a hazard that gross revenues will be misstated to coverup a embezzlement of hard currency.

The shop comptroller must come in the validated sedimentation sum into the system. which so reconciles that sum to the day-to-day recorded gross revenues sums. All differences are listed on an exclusion study automatically forwarded via electronic mail to the shop proprietor (St. James) . While there is still some possible for collusion among the shop director (Thornberg) and shop comptroller (McGlomm) . the automatic readying of the Gross saless Journal based on inputted information decreases the shop accountant's ability to change accounting records to mask an improperness.

This hazard could ensue in misstatements of hard currency and gross revenues minutess.

To treat a sale. the teller must input a three-digit watchword. which thecomputing machine records on an internal storage device that can merely be accessed by the shop director.

This hazard could ensue in misstatements to the stock list and cost of goods sold histories.

The new system updates a ageless stock list record daily and the riddance of former duties for the shop comptroller allows her to prove the ageless stock list records on a day-to-day footing. Discrepancies are forwarded to the shop director daily and to the proprietor on a trial foot