

3. Risk Assessment and Internal Control

Important Point of this chapter

1. Internal Control System
2. Sarbanes Oxley Act, 2002

Internal Control System

Nature: a set of primarily generated policies and procedures adopted by the management of an enterprise is a prerequisite for an organization efficient and effective performance. It is thus, a primary responsibility of every management to create and maintain an adequate system of internal control appropriate to the size and nature of business entity.

Scope : the scope of internal controls extends beyond mere accounting controls and includes all administrative controls concerned with the decision-making process leading to management's authorization of transaction, such controls include, production method, time and motion study, pricing policies, quality control, work standard, budgetary control, policy appraisal, quantitative control etc.

Objectives: the basic objectives related to the accounting system are as follows

- I. Transactions are executed through general or specific management authorization.
- II. All transactions are promptly recorded in an appropriate manner to permit the preparation of financial information and to maintain accountability of assets.
- III. Assets and records are safeguarded from unauthorized access, use or disposition.
- IV. Assets are verified at reasonable intervals and appropriate action is taken with regard to the discrepancies.

Structure: most of the policies and procedures covered under this are as follows

- I. Segregation of duties: transactions are allocated to different persons in such a manner that no one person can carry through the completion of a transaction from start to finish or the work of one person is made complementary to the work of another person.
- II. Authorization of transaction: delegation of authority to different levels and to particular persons is required to be established by the management for controlling the execution of transaction in accordance with prescribed conditions.
- III. Adequacy of record and documents
- IV. Accountability and safeguarding of assets: the process of accountability of assets commences from acquisition of its use and final disposal. Safeguarding of assets requires appropriate maintenance of records, their periodic reconciliation with the related assets.
- V. Independent checks: independent verification of the control system, designed and implemented by the management, involves periodic or regular review by independent persons to ascertain whether the internal control procedures are operating effectively or not.

Components of Internal Controls

1. Internal Check system: internal check system implies organization of the overall system of book-keeping and arrangement of staff duties in such a way that no one person can carry through a transaction and record every aspect thereof.
2. Internal audit: it may be defined as, an independent appraisal function established within an organization to examine and evaluate its activities as a service to the organization.

Internal Check System

Objectives:

1. To detect error and frauds with ease
2. To avoid and minimize the possibility of commission of errors and fraud by any staff.
3. To increase the efficiency of the staff working within the organization.
4. To locate the responsibility area or the stages where actual fraud and error occurs.
5. To protect the integrity of the business by ensuring the accounts are always subject to proper scrutiny and check.
6. To prevent and avoid the misappropriation or embezzlement of cash and falsification of accounts.

Effectiveness of Internal control system depends on following consideration

1. Clarity of responsibility
2. Division of work
3. Standardization
4. Appraisal

Flow chart technique for Evaluation of internal control

This technique can be resorted to for evaluation of the internal control system. It is a graphic presentation of internal controls in the organization and is normally drawn up to show the controls in each section or sub-section.

As distinct from a narrative form, it provides the most concise and comprehensive way for reviewing the internal controls and the evaluator's findings. In a flow chart narratives are reduced to the minimum and by that process, it can successfully bring the whole control structure, specially the essential parts thereof, in a condensed but wholly meaningful manner. Every detail from the control point of view and the details about how an operation is performed can be included in flow-chart.

Essentially, a flow chart is a diagram full lines and symbols and if judicious use of them can be made, it is probably an effective way of presenting the state of internal controls in the client's organization. More specifically it can show

- i. At what point a document is raised internally or received from external source
- ii. The number of copies in which a document is raised or received;
- iii. The intermediated stages set sequentially which the document and the activity pass;
- iv. Distribution of the documents to various sections, departments or operations;
- v. Checking authorization and matching relevant stages;
- vi. Filing of the document; and
- vii. Final disposal by sending or destruction.

Purpose of Internal control over financial reporting

1. Procedures to be included in the internal control over Financial reporting
2. Extent of management's duty to assess and report on the company's internal control over financial reporting.
3. Procedures to be followed by management in preparing the report of effectiveness of internal control over financial reporting.
4. Location of the Annual report of the management's report on the effectiveness of internal control over financial reporting.
5. Framework to be adopted by management in evaluating the internal control over financial reporting.
6. What must the outside accountant's attestation on management's internal control report include and what accounting standards will be used for such attestation.
7. Can management delegate the evaluation of the internal control over financial reporting to the company's outsider accountants?

Sarbanes Oxley Act, 2002

The Sarbanes Oxley act, 2002 established corporate accountability and civil and criminal penalties for white-collar crimes. The act also known as the Public Company Accounting Reform and Investor Protection Act 2002 and commonly called SOX or Sarbox; is a united states federal law passed in response to a number of major corporate and accounting scandals including those affecting Enron, Tyro International, and WorldCom. These scandals resulted in a decline of Public trust in accounting and reporting practices.

This act provides regulatory bodies and courts to take various actions-civil and criminal proceedings in connection of misstatement amounting to accounting scandals and fraudulent financial reports, other frauds on serious matters, obstruction of justice relating against corporate whistleblowers. This act mainly contains eleven titles.

Title I : Public Company Accounting Oversight Board established in an independent private board to regulate the accounting profession, to be dominated by executives and experts from outside the accounting profession

Title II: Auditor Independence:

- Regulator Authorities – Securities exchange Board (SEC) was entrusted to issue rules
- To comply with PCAOB rules and regulation
- To enhance the rights, duties and responsibilities of the audit committee.

Title III – Corporate Responsibility

- The audit committee to be more independent through enactment of their oversight responsibilities and one of the audit committee member to be “Financial expert”
- Requires CEO and CFO to issue certification of quarterly annual report to SEC.
- Provides rules conduct form companies management and their officers regarding pension matters.

- To comply with the SEC rules requiring attorneys to report violations of securities laws to the company's CEO or Chief legal Counsel and Audit Committee if no action is taken.

Title IV – Enhanced financial Disclosure

- Obligatory for the companies to provide objective and transparency in disclosure of financial results.
- Disclosure the corporate mission statement and corporate ethics and their implementations.
- Disclosure by CEO, directors, Management of the company and principal stockholders involving company securities.

Title V – Analyst Conflict of Interest

- Declaration by SEC of rules to address conflicts of interest arising when securities analyst recommend equity securities buying and selling in their research report and announcement to public.

Title VI – Commission Resources and authority

- To provide additional funding to SEC.
- Power to SEC and federal courts to censure and impose prohibition on persons and corporate entities.

Title VII – Studies and reports

- Federal regulatory bodies to conduct studies regarding accounting firms, credit rating agencies, violation of laws, rules and regulations by various agencies concerning corporate affairs and action involving securities laws.

Title VIII – Corporate and Criminal fraud accountability

- To enforce tougher civil and criminal penalties for fraud and accounting scandals, securities fraud and certain other forms of obstruction of justice.
- In case of violation of securities laws there may be debts non-dischargeable.
- Protect employer against corporate whistle blowers.

Title IX – White-Collar Crime Penalty Enhancements

- Tougher practice for CEO's guilty of wrong doing and other fraud such as mail and wire fraud and ERISA violation.
- CEO and CFO issue certification of quarterly financial reports to SEC.

Title X – Corporate Tax returns

- CEO should sign company's federal tax returns.

Title XI – Corporate fraud and Accountability

- Provide regulatory bodies and courts to take various actions-civil and criminals proceedings in connection of misstatement amounting to accounting scandals and fraudulent financial reports, other frauds on securities matters, obstruction of justice and retailing against corporate whistleblowers.

The major provisions of Sarbanes Oxley act are as follows

1. Creation of the public company Accounting Oversight Board (PCAOB)
2. A requirement that companies evaluate and disclose the effectiveness of their internal controls as they relate to financial reporting, and that independent auditor for such companies agree to such disclosure;
3. Certification of financial reports by CEO and CFO.
4. Auditor independence, including oversight bans on certain types of work for audit clients and pre-certification by the Audit Committee of all other non-audit work.
5. Ban on most personal loans to any executive officer or director;
6. Accelerated reporting of insider trading;
7. Prohibition on insider trades during pension fund blackout periods;
8. Enhanced criminal and civil penalties for violation of securities law;
9. A requirement that companies listed on stock exchanges have fully independent audit committees that oversee the relationship between the company and its auditor;
10. Additional disclosure;
11. Significantly longer maximum jail sentences and larger fines for corporate executives who knowingly and willfully misstate financial statements, although maximum sentences are largely irrelevant because judges generally follow the Federal Sentences Guidelines in setting actual sentences;
12. Employee protections allowing those corporate fraud whistleblowers who file complaints with OSHA within 90 days to win reinstatement, back pay and benefits, compensatory damages, and congressional page abatement orders, and reasonable attorney fees and costs.