*APPENDIX I*

The Sarbanes-Oxley Act, Internal Controls, and Management Accounting

# Answers to Review Questions

I-1 The Sarbanes-Oxley Act of 2002 was enacted by the U.S. Congress to bring about reform in companies’ financial reporting processes, as well as the internal and external auditing of the financial reporting process.

**I-2** **Internal controls over financial reporting refers to the broad set of policies, processes, and procedures that enable both the organization’s management and interested outside parties to have confidence in the organization’s financial reports. Internal controls over financial reporting include a diverse range of activities such as physical control over inventories, maintenance of cost records, authorizations for purchases, and separation of duties for signing checks.**

**I-3 The Public Company Accounting Oversight Board (PCAOB) is an agency established by the Sarbanes-Oxley Act to oversee and investigate the audits and auditors of public companies, and sanction both firms and individuals for violations of laws, rules, and regulations.**

**I-4 SOX 302 is a section of the Sarbanes-Oxley Act, which requires the signing officers of a company’s financial reports to establish, maintain, and periodically evaluate the effectiveness of the company’s internal controls over financial reporting.**

**I-5 SOX 404 is a section of the Sarbanes-Oxley Act, which requires a company to include in its annual report a report on the company’s internal controls over financial reporting.**

I-6 SOX sections 302 and 404 are controversial because they place a great burden on businesses to document and report on their internal controls over financial reporting. This burden is particularly costly for small businesses, which often do not have the resources to fully comply with SOX 302 and 404. Some in Congress have called for the repeal of SOX or its modification. Other lawmakers have urged that its requirements be waived for small businesses. Many, however, defend SOX as a necessary reform in the wake of various scandals in accounting and corporate governance.

# Solutions to exercises

EXERCISE I-7 (15 MINUTES)

Answers will vary depending on each students work experience and the college the student attends. As for internal controls in a typical college, in many respects they are the same as those in a business. Among such internal controls would be the following: safeguarding assets, requiring two signers on checks, and controlling who has access to the college’s computer software systems and data.

EXERCISE I-8 (15 to 30 MINUTES)

Students typically have varying opinions about the extent to which a CEO can really know what is going on at all levels in the organization the CEO leads.

EXERCISE I-9 (30 MINUTES)

Many relatively short SOX articles can be found on the Internet. Since the story is evolving, the content of these stories will vary over time.

EXERCISE I-10 (30 to 45 MINUTES)

Students’ opinions about SOX will vary widely. An in-class debate can be an interesting exercise.

EXERCISE I-11 (15 MINUTES)

Some observers have suggested that it is unrealistic to expect a company to regularly report on the minutia of its internal controls over financial reporting. It’s just too costly and burdensome to do so. If, instead, a company concentrates on those internal control areas where lapses in internal control have the greatest potential to result in material misstatement of the company’s financial reports, then the goals of SOX could perhaps be achieved at a much more tolerable level of cost and effort.

EXERCISE I-12 (15 MINUTES)

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| The company’s internal control system is flawed. The same employee is responsible for keeping the inventory records *and* taking the physical inventory count. In addition, when the records and the count do not agree, the employee changes the count, rather than investigating the reasons for the discrepancy. This leaves open the possibility that the employee would steal inventory and conceal the theft by altering both the records and the count. Even without any dishonesty by the employee, this system is not designed to control inventory since it does not encourage resolution of discrepancies between the records and the count.  SOX sections 302 and 404 require the company’s management to establish, maintain, and regularly report on the firm’s internal controls. In the process, any flawed internal control procedures would presumably be identified and strengthened. The internal control system could be strengthened in two ways: (a) Assign two different employees the responsibilities for the inventory records and the physical count. With this arrangement, collusion would be required for theft to be concealed. (b) Require that discrepancies between the inventory records and the physical count be investigated and resolved when possible. |

EXERCISE I-13 (20 MINUTES)

*The accounting adjustments contemplated by John Winslow are unethical* because they will result in intentionally overstating income by understating the cost of goods sold.

SOX sections 302 and 404 require the company’s management to establish, maintain, and regularly report on the firm’s internal controls over financial reporting. Proper internal control procedures would be likely to identify such an inappropriate accounting treatment, thereby allowing corrective action to be taken.

*[Final version – Appendix I]*