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**CHAPTER 11**


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**ACCOUNTING AND DISCLOSURES**


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This chapter discusses the accounting for changes in principle, estimate, and reporting entity. Corrections of errors are also delved into. The accounting requirements for development stage companies are mentioned. In a troubled debt situation, the debtor wants relief from the creditor. Noninterest-bearing notes and futures contracts are presented. Disclosure about financial instruments with off-balance-sheet risk are discussed.

## HIERARCHY OF GAAP

FASB Statement No. 162, *The Hierarchy of Generally Accepted Accounting Principles*, identifies the sources of accounting principles and the framework to select them in preparing financial statements in conformity with GAAP. The GAAP hierarchy should be directed to the company.

The hierarchy of GAAP applies to the following levels:

- *Level 1 (highest level)*—FASB statements and interpretations, APB opinions, and AICPA accounting research bulletins.
- *Level 2*—FASB technical bulletins, AICPA industry audit and accounting guides and statements of position.
- *Level 3*—AICPA accounting standards executive committee practice bulletins, and consensus positions of the FASB emerging issues task force.
- *Level 4 (lowest level)*—Implementation guides (questions and answers) published by the FASB staff, and practices widely recognized and prevalent either generally or in the industry.

An accounting entity should follow the accounting treatment specified by the accounting principle from the source in the highest category available. A company should not follow the accounting treatment specified in accounting principles for similar transactions or events in cases where those accounting principles either prohibit the application of the accounting treatment to the particular transaction or event or indicate that the accounting treatment should not be applied by analogy.

## ACCOUNTING CHANGES

The types of accounting changes provided for in ASC 250, *Accounting Changes and Error Corrections*, are principle, estimate, and reporting entity. Proper disclosure of accounting changes is necessary.

### *Change in Accounting Principle*

Once adopted, it is presumed that an accounting principle should not be changed for events or transactions of a similar nature. A method used for a transaction that is being terminated or was a single, nonrecurring event in the past should not be changed. Only where necessary should a change in principle be made.

Footnote disclosure should be made of the nature and justification of a change in principle and should include an explanation of why the new principle is preferred. Proper justification may take the form of a new FASB pronouncement, new tax law, new AICPA recommended practice, a change in circumstances, and a change to conform more readily to industry practice.

If an accounting change in principle is deemed immaterial in the current year but is expected to be material in later years, disclosure is necessary.

*Not considered changes in accounting principle are:*

- A principle adopted for the first time on new or previously immaterial events or transactions.

- A principle adopted or changed owing to events or transactions that are clearly different in substance.

ASC 250 mandates retrospective application of changes in accounting principle to previous years' financial statements, unless either the cumulative effect of the change or the period-specific effect cannot be determined. Retrospective application is the application of a different accounting method to prior years as if that new principle had always been used. If it is not practical to ascertain the period-specific impact of a change in accounting principle on previous periods, the newly adopted accounting method must be applied to the beginning balances of assets or liabilities of the earliest period for practical retrospective application. Additionally, a corresponding adjustment must be made to the beginning balance of retained earnings (or other appropriate equity components or net assets) for that period; it is not to be reported in the income statement. In the event that the cumulative dollar impact of applying an accounting principle change to previous periods is impractical, the new accounting method must be applied as if it were adopted prospectively from the earliest practical date.

It is deemed impractical to apply the effect of a change in principle retrospectively only when any of the following three conditions exists:

1. After a good faith effort, the entity is unable to apply the pronouncement's requirement.
2. The entity is unable to verify management's presumptive intent in a prior year.
3. Management is unable to objectively estimate amounts required that:
  - a. Would have been available in the previous year, and
  - b. Provides proof of circumstances that existed on the date(s) when the amount's would be recognized, measured, or disclosed under retrospective application.

**Note:** If any of the three conditions exists, it is not practical to use the retrospective approach. Rather, the new accounting method is applied prospectively as of the earliest date that it is practical to do so.

An example of an impractical situation is the change to the LIFO method. In this event, the base-year inventory for all later LIFO computations is the beginning inventory in the year the method is adopted. It is impractical to restate prior years' income. A LIFO restatement has assumptions—which usually result in computing a number of different earnings figures—as to the different years the layers occurred. The only adjustment needed may be to restate the beginning inventory to a cost basis from a lower of cost or market value approach. Therefore, disclosure is limited to showing the effect of the change on the operating results in the year of change.

ASC 250 requires that retrospective application to a change in accounting principle be limited to the direct effects of the change (e.g., net of tax). An example of a change in accounting principle is switching from the average cost inventory method to the FIFO method. Indirect effects of a change in principle are recognized

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**CHAPTER 28**


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**THE INTERNAL AUDIT FUNCTION AND  
INTERNAL CONTROL**


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Internal auditing serves as an independent appraisal activity within an entity for the review of accounting, financial, and other operations as a basis of service to management.

Internal auditing can help improve the efficiency and profitability of the business. Proper review and appraisal of policies is essential. Audit procedures should be periodically performed on a cycle basis so that all individuals will know that the activity may be subject to audit. Where necessary, management may also request special audit reviews.

The purposes of internal auditing are to:

- Understand the nature and scope of the activity/function.
- Check on the administrative efficiency in terms of current policies and procedures while determining the extent of actual compliance with those policies and procedures.
- Appraise policies and procedures in terms of possible improvement.
- Increase efficiency (i.e., corporate welfare) by identifying any other means by which the activity/function can be made more effective.
- Ascertain the extent to which company assets are accounted for and safeguarded from losses of all kinds.
- Determine the reliability of management data developed within the organization.

Also relevant is the efficiency with which the various units of the organization are conducting their assigned tasks. Specific audit tasks should be properly communicated to staff by means of formal written documents.

Problem areas have to be uncovered, especially vulnerable ones. For example, the internal auditor's examination of sales, receivables, and credit activities may point to poor credit policies having a negative affect on profitability.

A vital aspect of internal auditing is the appraisal of internal control. Emphasis should be placed on the prevention rather than on the detection of fraud. The internal auditor should preferably be a planner, eliminating the conditions under which fraudulent activity may cultivate. If there is strong internal control, fraud has a higher probability of being detected.

This chapter considers the internal control of the company, internal audit techniques and approaches, audit programs, and internal audit reports.

A company's internal control structure consists of management's policies and procedures that are designed to provide reasonable, but not absolute, assurance that specific entity objectives will be achieved.

## INTERNAL AUDITING ASPECTS

Internal auditing deals with those procedures and techniques emphasizing adherence to management policies, existence of internal controls, uncovering fraud, existence of proper record keeping, and effective operations of the business. The major elements of the internal auditor's task are to determine the reliability and accuracy of accounting information, determine whether corporate data have been determined in accordance with corporate policies and rules (e.g., manuals), and ascertain the adequacy of the internal control function. Internal auditing is the "eyes and ears of management." It deals not only with financial auditing but also operational auditing. Internal auditing should be carried out in conformity with the *Standards for the Professional Practice of Internal Auditing* and with the *Code of Ethics of The Institute of Internal Auditors*.

Besides looking at the safeguarding and existence of assets, the internal auditor must be assured that resources are used economically and efficiently. Are actual results in conformity with objectives?

The internal auditor plans the audit scope, conducts the operation, communicates results to the audit manager and auditor to ensure that deficiencies have been recognized and steps taken to

The purpose of internal auditing is to ensure that there is proper responsibilities. The internal auditor provides analyses, appraisals, recommendations, and relevant comments regarding the activities.

Internal auditing involves many activities including:

- Reviewing and evaluating the reasonableness, adequacy, and application of accounting, financial, and other operating information and controls. Effective controls should be implemented at reasonable cost. For example, the telephone system should give a reading of numbers called and should block out exchange calls (i.e., 900 calls).
- Determining the degree of compliance with policies.
- Ascertaining the degree to which corporate assets are accounted for and safeguarded.
- Evaluating the quality of performance in conducting responsibilities.
- Determining the reliability of management data.
- Recommending improvements in performance.
- Assisting in ways to improve profit performance.
- Conducting special audits such as developing new procedures as well as the acquisition of subsidiaries and divisions.

In the audit process:

- Determine the audit scope during preaudit through the review of management reports and risk analysis. For example, the audit objective might be to determine if purchase orders are authorized and processed in accordance with policy.
- Identify applicable criteria for evaluation to determine acceptance or nonacceptance. An appropriate standard will have to be developed, such as anything over 10% is considered excessive (depends on materiality and exposure).
- Collect and evaluate information. An example is computing the actual turnover rate.
- Compare information against evaluative criteria. An example is comparing the actual turnover rate of 25% to a standard turnover rate of 10%.
- Form a conclusion, such as the turnover rate is excessive.
- Formulate and provide recommendations to solve the problem at hand.

An audit tool is a means by which the internal auditor achieves his or her objective. It may be either manual or automated. An example of an audit tool is the use of questionnaires in assessing internal control. Common tools in internal auditing include internal control questionnaires, narratives, flowcharts, and audit software. These tools serve to develop an understanding of the area being audited.

The amount of audit evidence required depends on the conclusions to be reached from the preliminary survey and the sufficiency of internal control. The audit evidence typically relates to random pieces of information that apply to particular events or transactions. Flowcharting is helpful in presenting a pictorial format.

The work papers should detail the transactions or accounts examined, the degree of testing, exceptions, and conclusions. The scope of the tests performed should be described along with the details of any errors or deficiencies. A record of internal audit operations is especially important when the company does not have standardized procedures.

In a new assignment, the internal auditor will initially examine the organization chart to determine the "key" people involved. For example, in examining procurement, those responsible for purchasing, accounts payable, and treasury functions will be identified. Interviews with these individuals will be held to develop an understanding of the system.

The purpose of testing data for a specific application is to evaluate the appropriateness of current controls, determine compliance with present policies and procedures regarding data reliability, and substantiate processed transactions.

The extent of audit testing necessary depends upon the quality of internal control, the areas tested, and the particular circumstances. If controls seem appropriate, the internal auditor will substantiate whether those controls are indeed operating effectively. If no reliance on the controls exists, the usual substantive testing must be carried out.

In poor internal control situations, detailed verification is required. Here, a large sample is needed. Less field work is necessary when the company has significant self-checking devices to highlight defects and alert management to control breakdowns. Of course, the self-checking devices will still have to be scrutinized by the internal auditor.

In audit testing, the actual results of examining selected transactions or processes are compared to prescribed standards. In so doing, the internal auditor will be able to form an audit opinion. Some or all of the transactions, functions, activities, records, and statements are examined.

The following steps are usually involved in audit testing: (1) determining standards, (2) defining the population, (3) selecting a sample, and (4) examining the sampled items.

Standards may be explicit or implicit. Explicit standards are clearly stated in job instructions, directives, laws, and specifications. An example of an explicit standard is that competitive bids must be received on contracts in excess of \$500,000. However, competitive bids may be "rigged" by specification requirements so that only certain suppliers can compete. Implicit standards exist when management formulates objectives and goals but does not establish in particular how they are to be accomplished. In this case, the internal auditor, upon completing a review of the objectives considering the controls in place, will consult with management regarding what is satisfactory performance.

In travel, the policy of upgrading from coach class should be spelled out. Is there a separate travel department? Are employees abusing the frequent flier privilege? There should be a written policy of who may be entertained and how much cost may be incurred. What is the policy regarding company vehicles? The personal use of office supplies, copiers, and fax machines must also be controlled.

In proportional analysis, the auditor evaluates certain revenue and expense items by relating them to other revenue and expenses. For instance, the cost of shipping cartons should have a proportional relationship to the number of units sold and shipped.

The population to be tested takes into account audit objectives. If the purpose is to derive an opinion on transactions occurring after last year, all transactions constitute the population. If the objective is to formulate an opinion regarding current controls, the population becomes more restricted. Management wants to know if the system is working properly. If not, ways to improve it must be formulated.

In deriving the population to be tested, a determination must be made of the total transactions (e.g., purchase orders, invoices, billings). These should be serially numbered. If documents are missing, the reasons must be uncovered. The character and location of the inventory must be determined. Are transactions stratified by value or other characteristic?

Whether verifications and analyses are carried out in detail or on a test check basis depends on the importance of the item and the likelihood of material misstatement. In test-checking, a statistical sample is selected.

The sample should be selected according to the audit objective, whether it is judgmental or statistical. Reliable selection is from lists that are separate from the records themselves. This assures that items that may have been removed from the physical units have not been overlooked.

Statistical sampling used in the internal auditing process includes random, discovery, and multistage. Sampling techniques are used to verify such things as recorded amounts in the financial statements and product quality control.

The internal auditor should be assured that there is proper communication within the organization. Needed information should be available when a decision must be made and it must go to the appropriate party. The information must be clearly understood.

To develop an understanding of internal control, the internal auditor must become familiar with the operating unit or area being audited. The stages in this process are as follows:

- *Preaudit.* Information is gathered and the internal auditor becomes thoroughly familiar with the factual content. Departments or operational sections should be separated in the work papers and cross-referenced where there are overlapping data.
- *Scope.* The internal auditor meets with the unit or department manager to start the operational review in his or her area. The scope and objectives