**Appendix I**

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

Answer Key

**True / False Questions**

1. Even in large companies, few internal controls exist in order to establish greater control of security among limited individuals.

**FALSE**

*AACSB: Reflective Thinking
AICPA BB: Critical Thinking
AICPA FN: Research
Blooms: Remember
Difficulty: 1 Easy
Learning Objective: 1*

*Feedback True: Even in large companies there are thousands of procedures that can properly be viewed as inter­nal controls, including a range of diverse activities such as approvals, authorizations, verifications, reconciliations, reviews involving most individuals within the company.*

*Feedback False: Correct! Even in large companies there are thousands of procedures that can properly be viewed as inter­nal controls, including a range of diverse activities such as approvals, authorizations, verifications, reconciliations, reviews involving most individuals within the company.*

2. Since many internal control procedures are automated, internal software controls are not needed.

**FALSE**

*AACSB: Reflective Thinking
AICPA BB: Critical Thinking
AICPA FN: Research
Blooms: Remember
Difficulty: 1 Easy
Learning Objective: 1*

*Feedback True: Despite the fact that many internal control procedures are automated, companies need internal control safeguards to ensure that the software is working properly and doing what it is supposed to do.*

*Feedback False: Correct! Despite the fact that many internal control procedures are automated, companies need internal control safeguards to ensure that the software is working properly and doing what it is supposed to do.*

3. The Public Company Accounting Oversight Board (PCAOB) is a 7-member board operating under the auspices of the American Institute of Certified Public Accountants (AICPA).

**FALSE**

*AACSB: Reflective Thinking
AICPA BB: Critical Thinking
AICPA FN: Research
Blooms: Remember
Difficulty: 1 Easy
Learning Objective: 2*

*Feedback True: The PCAOB is a 5-member board operating under the auspices of the SEC.*

*Feedback False: Correct! The PCAOB is a 5-member board operating under the auspices of the SEC.*

4. The first decade of the SOX legislation was characterized by controversy.

**TRUE**

*AACSB: Reflective Thinking
AICPA BB: Critical Thinking
AICPA FN: Research
Blooms: Remember
Difficulty: 1 Easy
Learning Objective: 2*

*Feedback True: Correct! It is true that the first decade of SOX legislation was characterized by controversy.*

*Feedback False: It is true that the first decade of SOX legislation was characterized by controversy.*

**Multiple Choice Questions**

5. The Sarbanes-Oxley Act:
A. arose because of several accounting scandals that rocked the public's confidence in published financial statements.
B. was enacted, in part, to bring about reform in companies' financial reporting processes.
C. has distinct guidelines for reporting on an organization's internal control practices.
D. contains provisions whereby the chief executive officer (CEO) and chief financial officer (CFO) can be held criminally responsible if their firm's financial statements are found to be fraudulent in nature.
**E.** All of the answers are correct.

*AACSB: Ethics
AICPA BB: Legal
AICPA FN: Risk Analysis
Blooms: Understand
Difficulty: 1 Easy
Learning Objective: 1*

*Feedback A: While this is a true statement about SOX, there is a better answer choice listed.*

*Feedback B: While this is a true statement about SOX, there is a better answer choice listed.*

*Feedback C: While this is a true statement about SOX, there is a better answer choice listed.*

*Feedback D: While this is a true statement about SOX, there is a better answer choice listed.*

*Feedback E: Correct! All of these statements about the Sarbanes-Oxley Act are true.*

6. Internal controls focus on all of the following **except**:
A. effectiveness of operations.
B. reliability of financial reporting.
C. compliance with applicable laws and regulations.
**D.** maximization of profit and cash flows.
E. efficiency of operations.

*AACSB: Ethics
AICPA BB: Industry
AICPA FN: Risk Analysis
Blooms: Understand
Difficulty: 2 Medium
Learning Objective: 1*

*Feedback A: Internal controls focus on this factor.*

*Feedback B: Internal controls focus on this factor.*

*Feedback C: Internal controls focus on this factor.*

*Feedback D: Correct! Internal controls do not focus on maximization of profit and cash flows.*

*Feedback E: Internal controls focus on this factor.*

7. Which of the following is a typical internal control?
A. The use of password-protected computers and software.
B. The requirement that separate individuals authorize cash disbursements and sign checks.
C. The use of physical controls over inventories to prevent loss from theft.
D. A physical count of inventory at year-end to verify amounts shown on the company's accounting records.
**E.** All of the answers are correct.

*AACSB: Ethics
AICPA BB: Industry
AICPA FN: Risk Analysis
Blooms: Understand*

*Difficulty: 2 Medium*

*Learning Objective: 1
Feedback A: While this is a true statement about typical internal controls, there is a better answer choice listed.*

*Feedback B: While this is a true statement about typical internal controls, there is a better answer choice listed.*

*Feedback C: While this is a true statement about typical internal controls, there is a better answer choice listed.*

*Feedback D: While this is a true statement about typical internal controls, there is a better answer choice listed.*

*Feedback E: Correct! All of these statements about typical internal controls are true.*

8. The Sarbanes-Oxley Act established the:
A. Securities and Exchange Commission (SEC).
**B.** Public Company Accounting Oversight Board (PCAOB).
C. Financial Accounting Standards Board (FASB).
D. Institute of Management Accountants (IMA).
E. American Accounting Association (AAA).

*AACSB: Ethics
AICPA BB: Legal
AICPA FN: Research
Blooms: Understand*

*Difficulty: 2 Medium*

*Learning Objective: 2
Feedback A: This is not the correct organization.*

*Feedback B: Correct! SOX established the PCAOB.*

*Feedback C: This is not the correct organization.*

*Feedback D: This is not the correct organization.*

*Feedback E: This is not the correct organization.*

9. Which of the following bodies oversees audits and auditors, and sanctions firms and individuals for violations of laws and regulations?
A. American Institute of Certified Public Accountants (AICPA).
B. American Accounting Association (AAA).
**C.** Public Company Accounting Oversight Board (PCAOB).
D. Financial Accounting Standards Board (FASB).
E. Accounting Principles Board (APB).

*AACSB: Ethics
AICPA BB: Industry
AICPA FN: Research
Blooms: Understand*

*Difficulty: 2 Medium*

*Learning Objective: 2
Feedback A: This is not the correct organization.*

*Feedback B: This is not the correct organization.*

*Feedback C: Correct! The PCAOB oversees audits and auditors and sanctions firms and individuals for law/regulation violations.*

*Feedback D: This is not the correct organization.*

*Feedback E: This is not the correct organization.*

10. Which of the following is **not** a provision of (nor an outgrowth of) the Sarbanes-Oxley Act?
A. A public company's annual report must contain a separate disclosure that assesses the company's internal controls.
B. Management is essentially responsible for establishing and maintaining internal controls.
C. A company's Chief Executive Officer (CEO) and Chief Financial Officer (CFO) can be held criminally responsible if their firm's financial statements are fraudulent.
**D.** A company must prepare a balance sheet, an income statement, a statement of stockholders' equity, and a statement of cash flows.
E. A new body, the Public Company Accounting Oversight Board, oversees and investigates the audits and auditors of public companies.

*AACSB: Ethics
AICPA BB: Industry
AICPA FN: Research
Blooms: Understand
Difficulty: 2 Medium
Learning Objective: 2
 Feedback A: This is a provision of SOX.*

*Feedback B: This is a provision of SOX.*

*Feedback C: This is a provision of SOX.*

*Feedback D: Correct! This is not a provision of SOX.*

*Feedback E: This is a provision of SOX.*

11. Which of the following statements regarding the Sarbanes-Oxley Act is (are) true?
A. Management must establish and maintain a system of internal controls over financial reporting.
B. Management must periodically assess a company's system of internal controls over financial reporting.
C. Management must include in the company's annual report a separate report that assesses internal controls.
D. A company's auditors are required to report on management's assessment of internal controls.
**E.** All of the answers are correct.

*AACSB: Ethics
AICPA BB: Industry
AICPA FN: Research
Blooms: Understand*

*Difficulty: 2 Medium*

*Learning Objective: 2
Feedback A: While this is a true statement about SOX, there is a better answer choice listed.*

*Feedback B: While this is a true statement about SOX, there is a better answer choice listed.*

*Feedback C: While this is a true statement about SOX, there is a better answer choice listed.*

*Feedback D: While this is a true statement about SOX, there is a better answer choice listed.*

*Feedback E: Correct! All of these statements about the Sarbanes-Oxley Act are true.*

12. The provisions of sections 302 and 404 of the Sarbanes-Oxley Act (as originally enacted) have proved especially troublesome for:
**A.** Small businesses.
B. Private universities.
C. Cities and municipalities.
D. Healthcare providers.
E. Individual taxpayers.

*AACSB: Ethics
AICPA BB: Industry
AICPA FN: Research
Blooms: Understand
Difficulty: 2 Medium
Learning Objective: 2
Feedback A: Correct! These provisions of SOX have proven to be troublesome for small businesses.*

*Feedback B: This group is incorrect.*

*Feedback C: This group is incorrect.*

*Feedback D: This group is incorrect.*

*Feedback E: This group is incorrect.*

13. The provisions of section 302 of the Sarbanes-Oxley Act (as originally enacted) require the signing officers of a company to do all of the following **except**:
**A.** Audit the internal controls over financial reporting.
B. Establish the internal controls over financial reporting.
C. Maintain the internal controls over financial reporting.
D. Evaluate the internal controls over financial reporting.
E. Disclose material weaknesses in the internal controls over financial reporting.

*AACSB: Ethics
AICPA BB: Industry
AICPA FN: Research
Blooms: Understand
Difficulty: 2 Medium
Learning Objective: 2
Feedback A: Correct! Provisions of Section 302 do not require signing officers of a company to audit the internal controls over financial reporting.*

*Feedback B: This is a requirement.*

*Feedback C: This is a requirement.*

*Feedback D: This is a requirement.*

*Feedback E: This is a requirement.*

14. Section 404 of the Sarbanes-Oxley Act, *Management Assessment of Internal Controls*, includes all of the following **except**:
A. A statement of management’s responsibility for establishing the internal control structure.
**B.** A waiver of auditor responsibility for assessing management’s report on internal controls.
C. An assessment of the effectiveness of internal controls by management.
D. An assessment of the effectiveness of procedures for financial reporting by management.
E. A requirement that management include in its annual report an internal control report.

*AACSB: Ethics
AICPA BB: Industry
AICPA FN: Research
Blooms: Understand
Difficulty: 2 Medium
Learning Objective: 2
Feedback A: Section 404 includes this item.*

*Feedback B: Correct! Section 404 does not include a waiver of auditor responsibility for assessing management’s report on internal controls.*

*Feedback C: Section 404 includes this item.*

*Feedback D: Section 404 includes this item.*

*Feedback E: Section 404 includes this item.*

15. To achieve the objectives of sections 302 and 404 of the Sarbanes-Oxley Act, management and independent auditors should:
A. Disclose the minutia of the internal control structure.
B. Conduct a cost-benefit analysis prior to deciding whether or not to adopt these sections.
**C.** Emphasize those areas where the greatest risk of fraud or material misstatement is likely to occur.
D. Analyze all financial transactions that are included in the reported financial statements.
E. Work together to design the most effective internal control system.

*AACSB: Ethics
AICPA BB: Industry
AICPA FN: Research
Blooms: Understand
Difficulty: 2 Medium
Learning Objective: 2
Feedback A: This statement is incorrect.*

*Feedback B: This statement is incorrect.*

*Feedback C: Correct! To achieve Section 302 and 404 objectives, managers and independent auditors should emphasize areas where greatest fraud risk or material misstatement is likely to occur.*

*Feedback D: This statement is incorrect.*

*Feedback E: This statement is incorrect.*

16. Most of the Sarbanes-Oxley Act relates primarily to:
A. Corporate governance.
B. Financial accounting.
C. Auditing.
D. Court-invoked penalties for violating the law.
**E.** All of the answers are correct.

*AACSB: Ethics
AICPA BB: Industry
AICPA FN: Research
Blooms: Understand
Difficulty: 2 Medium
Learning Objective: 2
Feedback A: While this is a true statement about SOX, there is a better answer choice listed.*

*Feedback B: While this is a true statement about SOX, there is a better answer choice listed.*

*Feedback C: While this is a true statement about SOX, there is a better answer choice listed.*

*Feedback D: While this is a true statement about SOX, there is a better answer choice listed.*

*Feedback E: Correct! All of these statements about the Sarbanes-Oxley Act are true.*

17. Which of the following statements is **false** concerning computerized accounting systems?
A. Safeguards exist to make sure that controls are working properly.
**B.** There is no need for controls over human operators of computerized systems.
C. Computerized accounting systems are not 100% reliable.
D. Limits should be placed on who can access a computerized system.
E. Many internal control procedures are automated.

*AACSB: Ethics
AICPA BB: Industry
AICPA FN: Research
Blooms: Understand
Difficulty: 2 Medium
Learning Objective: 1*

*Feedback A: This is a true statement.*

*Feedback B: Correct! It is false that no controls are needed for computerized systems.*

*Feedback C: This is a true statement.*

*Feedback D: This is a true statement.*

*Feedback E: This is a true statement.*

18. Under section 404 of the Sarbanes-Oxley Act, auditors are required to:
**A**. Attest to and report on the effectiveness of the client's internal controls.
B. Establish and maintain internal controls for audited companies.
C. Advise management on its preparation of the Report on Internal Controls.
D. Evaluate the company’s internal control system periodically throughout the year.
E. All of the answers are correct.

*AACSB: Ethics
AICPA BB: Industry
AICPA FN: Research
Blooms: Understand
Difficulty: 2 Medium
Learning Objective: 2
Feedback A: Correct! Auditors are required under Section 404 to attest to and report on the effectiveness of the client’s internal controls.*

*Feedback B: This is not a requirement of Section 404.*

*Feedback C: This is not a requirement of Section 404.*

*Feedback D: This is not a requirement of Section 404.*

*Feedback E: This answer is wrong, because several of the answer choices are incorrect.*

**Essay Questions**

19. Smart Start Company is a hardware supplier to building contractors. At the end of each month, the employee who maintains all of the inventory records takes a physical inventory of the firm’s stock. When discrepancies occur between the recorded inventory and the physical count, the employee changes the physical count to agree with the records.

**Required:**

A.What problems could arise as a result of Smart Start Company’s inventory procedures?

B.How could the internal control system be strengthened to eliminate the potential problems?

C. What are the implications of SOX sections 302 and 404 for the company’s internal control issues?

**Solution:**

|  |  |
| --- | --- |
| A. | 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. Separation of duties is needed in this system. |
|  |  |
| B. | The internal control system could be strengthened in two ways: |
|  |  |  |
|  | (1) | 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. |
|  |  |  |
|  | (2) | Require that discrepancies between the inventory records and the physical count be investigated and resolved when possible. |
| C. 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. As mentioned in Requirement B, the internal control system could be strengthened in two ways: (1) Assign two different employees the responsibilities for the inventory records and the physical count. With this arrangement, the internal control of separation of duties would be achieved and the chance of collusion would be lessened. (2) Require that discrepancies between the inventory records and the physical count be investigated and resolved when possible. This will lead to more timely and accurate recordkeeping. |

*AACSB: Reflective Thinking*

*AICPA BB: Critical Thinking
AICPA FN: Risk Analysis*

*Blooms: Apply*

*Difficulty: 2 Medium
Learning Objective: 2*

20. What does it mean to say that the concept of risk exposure may be the key to making SOX sections 302 and 404 more effective?

**Solution:**

As some critics of SOX have suggested, it is unrealistic to expect a company to regularly report on the minutia of its internal controls over financial reporting, because of the cost and labor involved. 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.