CHAPTER 2

THEORETICAL FRAMEWORK

2.1 Internal Control

In running profit or non-profit formal organizations, performed internal control has significant functions. This process further would help board of management and enterprise initiator in determining the company strategy and future policy. According to ***SPAP (2007:319)***, definition of internal is a process initiated by board of commissioner, management, and other personnels, designed to bring proper confidence about three kinds of objectives as the following:

a. Financial Report Reliability

   Management is responsible in providing financial report for investors. Not only that, it has obligation to guarantee the existing information that has fulfilled standard basis of report.

b. Operations Effectivity and Efficiency

   The initiation of internal control within an organization to make efficiency and effectivity. In other words, saving resources could be happened to get the optimal result and reaching company's objective in certain stated period.

c. Obedience of Applied Law and Rules

In running its operation, a company must follow the law and regulation that is related to the applied accounting.

Another source mentioned internal control as a process initiated by board of commissioner, management, and other personnels that is designed to bring proper confidence in approaching company's objectives **(Company)**. In *The committee of Sponsoring Organization* (COSO), defined internal control **(Moscove)** as "*A process, effected by an entity's board of directors, management, and other personnel, designed to provide reasonable assurance regarding the achievement of objectives in the following categories* :

a. Effectiveness and efficiency of operations

b. Reliability of financial reporting

c. Compliance with applicable laws and regulations"

While according to *Romney and Steinbart (2003) "Internal Control is the plan of organizations and the method of business use to safeguard assets, provide accurate and reliable information, promote and improve operational efficiency, and encourage adherence to prescribe managerial policies"***(Romney)**. Another source refers to *Boynton, William C., Raymon N. Johnson* dan *Walker G. Kell (2003)* in his book of *Modern Auditing*, translated by *Rajoe, P.A., Gania, G., & Budi, I.S,* mentions internal control as "*A process performed by board of directors, management and other personnels in an entity that is designed to provide proper confidence related to approaching the objectives in the following categories; reliability financial report, applied law and rules obedience, operations efficiency and effectivity* **(Boyton)**." And according to *Mardiasmo (2004)* in his book entitled '*Akuntansi Sektor Publik'*, Internal Control involves certain activities, such as:

1. Planning
2. Interstructural organization coordination
3. Communication of Information
4. Decision Making
5. Motivates every persons included in organization to act correlated to organization's objectives and company's goals
6. Work Assessment

Thus, in general comprehension, internal control system could be defined as a mechanism designated to keep (preventive), detect (detective), and provide correction mechanism (corrective) against the potential of mistakes, misdeeds, or errors (error) and abusive acts (fraud).

Internal Control Objective

Referring to its intention, the initiation of internal control in certain company aims to share future achievements of the company itself, whereas according to *Bodnar* and

William (2000) in their book "*Accounting Information System, 9th edition*" translated by *Saputra* and *Setiawati*, the objective of control on income cycle would be:

1. Customers have to be authorized accordingly to management's stated criteria
2. Price and period of products and services that are sold should be authorized accordingly to management's stated criteria
3. All delivery products and services should be followed with bills to customer
4. Bills and customers should be accurate, and fastly classified, summarized and, be reported (2006 : 129)

In addition, according to *James A. Hall* (2007:181) in his book "*Accounting Information System, 4th edition*" translated by *Dewi Fitriasari* and *Deny Arnos*, implementation of internal control is to achieve four main achievements, they are:

1. To maintain company assets
2. To ensure accuracy and the reliability of notes an accounting information
3. To promote company operations efficiency
4. To measure the accordance of policy and procedures stated by management

The concept of internal concept itself, following *COSO*, would be expected to provide proper confidence but not absolute. The latter was intended for management and board of director of certain entity. This is because of the existence of limitation, which could be tagged along in all internal control system and the necessity of considering cost and relative advantages of control. Internal control aims to approach the objective in redundant category of financial report, obedience, and operations.

Components of Internal Control

According to *William C. Boynton* dan *Raymond N. Johnson* (*2006:392*) the COSO reports (and *AU 319.07*) identifies five interrelated components of internal control :

1. Control environment sets the tone of an organization, influencing the control consciousness of its people. It is the foundation for all other components of internal control, providing discipline and structure.

   Factors that form control environment in certain entity are:

   a. Integrity and ethical values
   b. Commitment to competence
   c. Board of directors and audit committee
   d. Management's philosophy and operating style
   e. Organizational structure
   f. Assignment of authority and responsibility

g. Human Resource policies and practices

2. Risk assessment is the entity's identification and analysis of relevant risk to achievement of its objectives, forming a basis for determining how the risks should be managed.

   There are some occurrence needed to be concerned in its initiation, they are:

   - Risk relation and the match over detail reports and accounting activities, managerial and reports
   - Changes that could be happened in scope of internal or external
   - Consideration that might be urged based on the mentioned changes

3. Control activities are the policies and procedures that help ensure that management directives are carried out.

   Its performance is involved :

   - How standard operation and working standard are implemented
   - How data and information are managed
   - How is the flow of provided resources distribution
   - And how the separation of assignment could be said as proportional

4. Information and communication are the identification, capture and exchange of information in a form and time frame that enable people to carry out their responsibilities.

5. Monitoring is a process that assesses the quality of internal control performance over time.

A similar assertion also stated by *Institut Akuntan Publik Indonesia (2001)* in Public Accountant Professional Standard, internal control consists of five correlated components:

1. Environment of Control

   Environment of control could stated the pattern of certain organization and affects the control awareness of its people. As what has been claimed by *Boynton William C Raymon N. Johnson* and *Walker G. Kell (2003)* in their book entitled *Modern Auditing* translated by *Rajoe, P.A., Gania, G., & Budi, I.S.*, "Control Environement develops *the atmosphere of an organization which influences the awareness of control from its people. Control Environment could be a base of every internal control components that provides discipline and structure."*

   Environment control itself is the basis for whole components of other internal control to provide discipline and structure. Institut Akuntan Publik Indonesia stated the scope of control environment involves the following aspects:

   a. Value and Ethics Integrity
   b. Commitment on Competention
   c. Commissioner Board or Audit Committee Participation
   d. Philosophy and Management Operational Flows
   e. Structural Organization

f. Authorization and Responsibility Distribution

g. Policy and Human Resource Practice

2. Risks Assessment

According to A.A., Elder, R.J., and Beasley, M.S. (2006) in their book entitled Auditing and Assurance Service and Integrated Approach, in respect of risk assessment, *"Risk Assessment for financial reporting is managements identifications, and analysis of risk relevant to the preparation of financial statements in conformity with GAAP."*

Risk assessment for financial report is an identification, analysis, and management towards risks relevantly to organizing proper financial report which is referred to the generally applied accounting principles. Risks themselves could be urged or changed in these conditions:

a. Changes in operation environment

b. New personnel.

c. New or repaired information systems

d. New technology

e. New product, segments or activities

f. Cross nation operation

g. New accounting standard

3. Control Activities

   Control activities are regulation based policy to support the direction of management control. According to Marshall B. Romney and Paul John Steinbart in the book "*Accounting Information Systems, 9th edition*" translated by Deny Arnos Kwary, M.Hum and Dewi Fitriasari,M.Si, " policy and control procedure should be made and applied to identify every single activity held by management to prevent the risk of organizational objectives and run it effectively". This control activity made for many purposes and can be classified as policy and procedure related with :

   - Program review
   - Information processing
   - Physically control
   - Job segregation

4. Information and Communication

   Information and communication in this context aims to verify financial report process on the applied accounting system, which involves recording method, preparation, provision of report for every transaction to maintain the balance of accounting accountability variable. This would be used further as a material of consideration in organizing future company policy, which would work with internal or external changes of condition.

5. Monitoring

   Monitoring is an assessment of control performance quality process. It is also involved in determining timely control operation design and correctional action initiation.

Internal Control Characteristics

Amin Widjaja Tunggal (2010) explained that characteristics of strong internal control are:

1. Competent and honest employees; have knowledge of accounting standard, taxation, and capital market regulations.
2. Transactions are authorized under the allowance of rightful officer (valid transaction).
3. Transactions are recorded accurately (total, estimation and accounted)
4. Assignment segregation that has tendency of stimulating transactions, records and be stored
5. Access on assets and company records are correspondingly to function and assignment of the employee
6. Periodically comparison between the recorded balance and its fiscal numbers.

Characterizations above supposed to comply three criteria of effective control, they are:

1. *Preventive Control Tendency*

   Control for prevention is reducing the urgency of problems before they could be appeared. Employing qualified accounting personnel, appropriate job segregation, and effectively controlling the fiscal access of assets, facilities and information. They are all good preventive control tendency.

2. *Detective Control Tendency*

   Not all problems could be prevented. Therefore, examining for problems would be necessary to be used, at that time the problems are urged. Examples for the latter are; examining copy on calculation, bank reconciliation preparation and monthly balance check.

3. *Corrective Control Tendency*

   Corrective control could solve problems discovered by control examination for problems. This control includes conducted procedure to identify the cause of problems, reconditioning problems or complications that they have caused, and change the system in expecting to minimize problems or eradication.

Initiation of Internal Control

Agoes. S (2004:79) in book of "*Auditing : Pemeriksaan Akuntan oleo Akuntan Publik*", there are three manners that could be granted for auditor in initiating internal control:

1. *Internal Control Questionnaries* (ICQ)

   KAP mostly has used this manner, because it is more straight and practical. Usually, KAP already has a set of ICQ standard that is usable to comprehend and evaluate internal control implementation in any enterprises. Questions in ICQ would demand yes/no answer or, irrelevant. If the question has been finely organized, therefore the answer of 'yes' would show good internal control characterization. On the other hand, 'no' would make a depiction of weak internal control characterization and, 'irrelevant' would mean that the question is not suitable for the involved company.

2. *Flowchart*

   Flowchart depicts the flow of document in system and procedure of an enterprise. For well-trained auditor, the use of flowchart is more preferred because the auditor could be faster in seeing the weaknesses and strength of particular systems or procedures. After the flowchart has been organized, auditor should commence *walk through*, which means taking two or three documents to examine whether the running procedure would be matched to flowchart's depiction.

3. *Narrative*

   In this part, auditor would narrate in the form of memo, system, and accounting procedure implemented in particular company. This manner is usually used for casual accountancy client.

Examination on Internal Control

Examination on internal control is a procedure to reveal control effectivity which supports reduction of control risks assessment. According to *Arens and Loebbecke*, translated by *Amir Abdi Jusuf (2003:284-286)*, there are four types of procedure that would be usable in supporting internal control, they are:

a. Question and Answer with reliable employee of certain company

   In spite of the proof sufficiency of question and answer, it still could not be the strongest source of fact in initiating effective internal control.

b. Document, record, and report inspection

   Examiner would conduct document inspection and ensure that the document is complete and has required marks of authority. This refers to the correlation of activity and procedure toward control and documentary proofs possession.

c. Observation on Control-Related Activities

For control that doesn’t have documentation proofs, examiner would perform observation on control implementation in any activities counted within a year.

Limitation of Internal Control

Internal control could not be the perfect controlling instrument. Because there is limit in its part. Following *Mulyadi (2002: 173)*, limits of internal control are:

1. Mistakes in making consideration

   Management and other personnel often be misunderstood in considering business decision that has taken or, in condition of performing routine assignment. This is caused by the lack of information, limitation of time, or any other pressures.

2. Distraction

   Distractions in set control could be happened because personnel are mistaken in understanding instruction, or any other reason of errors.

3. Collusion

   The act of individual group for criminal tendency could be claimed as collusion. It could bring the developed internal control for reserving entity treasures to be collapsed. Moreover, it would cover the irregularities or will not be able to detect frauds in

4. Disregarding Management

   Management could disregard policy or appointed procedure for illegal interests such as private manager's advantages, provision financial condition exaggeratedly or ingenuinuity submission. For an example, a manager who reports fraud numbers of profit that is higher than the actual amount to receive private bonus.

5. Cost Against Benefits

   Required cost against benefits for internal control operational could not surpass the expected benefits of the control itself. Because accurate measurement of whether cost or benefits would be impossible to perform. This would be a stimulation to management in making estimation and concerning this matter, in quantitative and qualitative method for evaluating cost and benefits of particular internal control structure.

Sampling Attributes of Examining Internal Control

Attributes sampling is used to examine effectivity internal control performance. According to *Mulyadi (2002:253)*, there are three models of attribute sampling:

1. *Fixed-sample-size a ttribute sampling*

Sample collection in this method aims to estimate the percentage of particular quality within certain population. This model is mainly used if auditor initiates control examination in respect of internal control, and the auditor would be estimated to have mismatches as his/her findings.

2. *Stop or go sampling*

   These models are often called as *decision attribute sampling*. It could prevent auditor from redundancy of samples, by holding the examination earliest possible. This model is used if auditor has confidence in the occurrence of errors, that is predicted to be happened in the smallest amount of population.

3. *Discovery sampling*

   This model is suitable to be utilized if predicted level of errors in population could be stated as very low. In this model, auditor want particular probabilities to find one error, for the least, if the finding shows that error level is higher than expected. *Discovery sampling* is used by auditor to reveal fraud, heavy violation in context of internal control, and any other misdeeds.

Party of Interest

Referring to *Drs. Sanyoto Gondodiyoto (2007:254)*, there are some groups that have interest internal control. They are:

1. Company Management

   Management party of organization/company does have interest on internal control system, because internal control structure in certain company is basically would be a responsibility for top management (*top management*, on *two board system* which is applied in Indonesia consisting of board of direction and company board of commissioner)
2. Board of Commisionner, Internal Auditor
3. Employees in certain company do have interest because of internal control system function itself, they are:
    a. Represent regulations applied and be followed in the company
    b. Performance guideline
4. *Regulatory Body*
5. Independent external auditor which has benefits for internal control:
    a. To simplify the initiation of study towards client's information system
    b. To state risks as an auditor
    c. As indicators in determining argument on audited system reliability

2.2 Revenue Cycle

Cash Definition

Cash refers to current assets. It consists of currency or anything that is suitable to currency and be accessible directly. Otherwise, cash also could be seen as payment reserve. *Weygandt, Kieso, and Kimmel (2005:326)* argued that, ”*Cash is the only asset that is readily convertible into any other type of asset. It is easily concealed and transported and it is highly desired. Because of these characteristics, cash is the asset most susceptible to improper diversion and use. Cash consists of coins, currency (paper money), checks, money orders, and money on hand or on deposit in a bank or similar depository*.” *Gill dan Chatton (2008:9)* explained more simplified way that cash is usable printed money. .

In the book of *Intermediate Accounting* written by *Kieso (2002:342)* translated by *Salim, E.,* cash is explained as the most liquid assets. It is a standard medium of transaction and basic measurement, also accounting for all remaining posts. It is generally classified as assets. To be reported as cash, a post could be used faster to pay assets obligation and should not be dependent from every contractual restriction that limits its use in neutralizing debts. Cash consists of metal coin money, printed and provided budget in bang deposit. Negotiable instrument such as, saving account authorized bill, cashier bill, and private check are called as cash.

Definition of Revenue

According to *Imam Ghazali (2007:294)*, revenue could be taken as company product. It means that something that is provided by cost that is in company possession. It could be measured by the amount of new assets of currency, that is received by other faction. The new assets could be an exchange assets that is received by company over the sold products/services.

According to *BusinessDictionary.com (2009) revenue is the amount generated from sale of goods or services, or any other use of capital or assets, associated with the main operations of firm before any costs or expenses are deducted.* It is a total number that received from sold product.services, or anything that are in context of funds or assets and to main operation of company, before calculating the cost of expenses.

Revenue Cycle Definition

Romney dan Steinbart (2006:354) argued that, "*the revenue cycle is a recurring set of business activities and related information processing operations associated with providing goods and services to customers and collecting cash in payment for those sales.*"

In other words, revenue cycle is a process run by the company and consists of products provision transactions to other factions, in gaining payment from bought products conducted by the faction.

Functions related to Recenue Cycle

According to *Romney dan Steinbart (2006:356-373), revenue cycle* in any organizations generally consisted of 5 business elementary activities, they are sales order entry, shipping, billing and collecting payment of cash.

1. *Sales Order Entry*

   There are three phases in this entry:

   - Picking Consumers Order

     Consumers' ordered product could be received in various way, like direct selling in store, mails, phone calls, etc..

   - Customers Credit Arrangement

     Credit selling should reach to agreement before its procession. Maximum credit is needed by consumers based on its latest record and payment capability.

   - Stock Checking

     This tends to figure the date of shipment for consumers. If the stock would not be sufficient, back order should be commenced.

2. *Shipping*

   There are two phases in this process:

   - Picking

     Picking card is printed with selling notes, this would quicken picking and packing process

   - Shipment

     Shipment department would compare calculation of physical numbers in picking card and copy of selling order. This process would change the amount numbers in stock database, and would provide packing slip.

3. *Billing and Accounts Receivable*

   Phases in billing and receivable accounts are:

   - Billing

     This activity needs information from shipping department which identifies goods and numbers of delivered order. Price information and other terms from sales department also stated on this.

   - Stored receivable accounts data

     The function of receivable accounts is using all information in the sales invoices to debit consumers’ account, and make credit on that account at the time of receiving payments.

4. *Cash Collections*

   Cashier is the responsible party in receiving cash. Received Cash or check should be stored well in case of avoiding problems. The function of credits could not have physical access to cash or check. Its function should be able to conduct identification on received money source. Furthermore, sales invoice should be taken of credited. Presently, the most popular payment mediums are *Electronic Funds Transfer* (EFT) and *Financial Electronic Data Interchange* (FEDI).

5. *General Control Issues*

   This process is related records of goods data and performance evaluation.

Documents of Revenue Cycle

Romney (2006:356-371) exclaimed that usable documents for *revenue cycle* are; *Sales order, Credit limit, Picking ticket, Packing slip, Bill of lading, Sales invoice, Remittance advice, Remittance list, Credit memo.*

2.3 Internal Control on Revenue Cycle

Internal Control on *revenue cycle* could be defined as a process initiated by board of commissioner or other personnel, designed to make proper confidence about reliability financial report accomplishment, effectivity and efficiency of operation and, submissions to law and applied rules—which all are related to an arrangement of business and activities in conducting information process related and continuously with product provision to consumers and demanding cash as payment of sold products.

According to *Romney (2006:376-382), in the revenue cycle, a well designed AIS should provide adequate controls to ensure that the following objectives are met*. In revenue cycle, good accounting information system is supposed to be providing an appropriate control system to guarantee the following objectives would be achieved:

1. All authorized transactions
2. All recorded transactions are correct and factual.
3. All corrected and authorized are recorded.
4. All records are accurate.
5. *Safe Assets* from thievery and loss.
6. Business activities performed with efficiency and effectivity.

All these objectives are summarized in every revenue cycle activities, they are:

a) ***Sales Order Entry***

Ensure the company would receive payment for all credits and all transactions are legal. This is also reducing the loss of revenue achieved caused by the lack of stocks management.

b) ***Shipping***

The main objective of shipment is to accomplish customers' order efficiently and accurately, and to ensure stocks availability.

c) ***Billing and Accounts Receivable***

To ensure that customers are received bills for every performed sales, and thus the account could be managed with accuracy.

d) ***Cash Collections***

To ensure the accomplishment of payments, that is initiated by consumers.

e) ***General Control Issues***

Two main points in every activities of revenue cycle are the availablity of accurate data and to ensure that all activities are performed in effective and efficient way.

In every process of *revenue cycle,* there are threats as *Romney and Steinhart (2003)* defines in the following table with its control method ***(Table II.1)*** :

Process	**Threat**	**Control Procedures**
Sales Order Entry	1. Incomplete / inaccurate customer orders 2. Credit Sales to poor credit customers 3. Legitimacy of orders 4. Stock out, carrying costs, and markdowns	1. Data entry checks 2. Credit approval by manager, not by sales function 3. Signature on paper document 4. Inventory control systems
Shipping	1. Shipping Error: Wrong merchandise, wrong quantities, wrong address 2. Theft of inventory	1. Reconciliation of sales order with packing slip 2. Restrict physical access to inventory
Billing & A/R	1. Failure to bill customers 2. Billing errors	1. Separation of shipping and billing functions 2. Data entry edit

	3. Posting errors in A/R	controls; price list 3. Reconciliation of subsidiary A/R ledger with general ledger
Cash Collections	1. Theft of cash	1. Segregation of duties, minimization of cash handling
General Control Issues	1. Loss of data 2. Poor performance	1. Back up and access control 2. Preparation and review of performance report

More than that, *Clark (2008)* argued about the increasing *revenue cycle*, "*the entire revenue cycle must function at peak performance, otherwise the revenue cycle can leak revenue at various stages of the process". Jonathan Clark* (2008) mentioned that there are four steps in strengthening revenue cycle, they are:

1. *Establish and track the right key performance indicators for each department.*

2. *Implement the proper organizational structure for the overall revenue cycle*
3. *Hire outstanding and high performing leaders*
4. *Implement efficient processes throughout each department*