Teaching Notes

Undergraduate and Graduate Courses in
Introduction to Financial Accounting

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Appendix A
Management and Auditor Reports in Target Corporation's 2013 Form 10-K

Management is responsible for maintaining reasonably effective systems of internal control.

No system of internal controls is perfect. Cost-benefit tradeoffs are typically framed in economic terms, but what about the moral and human costs associated with ineffective controls?

Item 8. Financial Statements and Supplementary Data

Report of Management on the Consolidated Financial Statements

Management is responsible for the consistency, integrity and presentation of the information in the Annual Report. The consolidated financial statements and other information presented in this Annual Report have been prepared in accordance with accounting principles generally accepted in the United States and include necessary judgments and estimates by management.

To fulfill our responsibility, we maintain comprehensive systems of internal control designed to provide reasonable assurance that assets are safeguarded and transactions are executed in accordance with established procedures. The concept of reasonable assurance is based upon recognition that the cost of the controls should not exceed the benefit derived. We believe our systems of internal control provide this reasonable assurance.

The Board of Directors exercised its oversight role with respect to the Corporation's systems of internal control primarily through its Audit Committee, which is comprised of independent directors. The Committee oversees the Corporation's systems of internal control, accounting practices, financial reporting and audits to assess whether their quality, integrity and objectivity are sufficient to protect shareholders' investments.

In addition, our consolidated financial statements have been audited by Ernst & Young LLP, independent registered public accounting firm, whose report also appears on this page.

Gregg W. Steinhafel
Chief Executive Officer and President
March 20, 2013

John J. Mulligan
Executive Vice President and
Chief Financial Officer

Report of Independent Registered Public Accounting Firm on Consolidated Financial Statements

The Board of Directors and Shareholders
Target Corporation

We have audited the accompanying consolidated statements of financial position of Target Corporation and subsidiaries (the Corporation) as of February 2, 2013 and January 28, 2012, and the related consolidated statements of operations, comprehensive income, cash flows, and shareholders' investment for each of the three years in the period ended February 2, 2013. Our audits also included the financial statement schedule listed in Item 15(a). These financial statements and schedule are the responsibility of the Corporation's management. Our responsibility is to express an opinion on these financial statements and schedule based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the consolidated financial position of Target Corporation and subsidiaries at February 2, 2013 and January 28, 2012, and the consolidated results of their operations and their cash flows for each of the three years in the period ended February 2, 2013, in conformity with U.S. generally accepted accounting principles. Also, in our opinion, the related financial statement schedule, when considered in relation to the basic financial statements taken as a whole, presents fairly in all material respects the information set forth therein.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the Corporation's internal control over financial reporting as of February 2, 2013, based on criteria established in *Internal Control—Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission and our report dated March 20, 2013, expressed an unqualified opinion thereon.

Ernst + Young LLP

See the independent accountant's report on internal control, below.

Minneapolis, Minnesota

March 20, 2013

Management's responsibilities include establishing and maintaining adequate internal controls and assessing their effectiveness.

Report of Management on Internal Control over Financial Reporting

Our management is responsible for establishing and maintaining adequate internal control over financial reporting, as such term is defined in Exchange Act Rules 13a-15(f). Under the supervision and with the participation of our management, including our chief executive officer and chief financial officer, we assessed the effectiveness of our internal control over financial reporting as of February 2, 2013, based on the framework in *Internal Control—Integrated Framework*, issued by the Committee of Sponsoring Organizations of the Treadway Commission. Based on our assessment, we conclude that the Corporation's internal control over financial reporting is effective based on those criteria.

Our internal control over financial reporting as of February 2, 2013, has been audited by Ernst & Young LLP, the independent registered public accounting firm who has also audited our consolidated financial statements, as stated in their report which appears on this page.

Gregg W. Steinhafel
Chief Executive Officer and President
March 20, 2013

John J. Mulligan
Executive Vice President and
Chief Financial Officer

The independent auditor's report also describes management's responsibilities to establish and maintain adequate internal controls and assessing their effectiveness.

Report of Independent Registered Public Accounting Firm on Internal Control over Financial Reporting

The Board of Directors and Shareholders, Target Corporation

We have audited Target Corporation and subsidiaries' (the Corporation) internal control over financial reporting as of February 2, 2013, based on criteria established in *Internal Control—Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (the COSO criteria). The Corporation's management is responsible for maintaining effective internal control over financial reporting, and for its assessment of the effectiveness of internal control over financial reporting included in the accompanying Report of Management on Internal Control over Financial Reporting. Our responsibility is to express an opinion on the Corporation's internal control over financial reporting based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, testing and evaluating the design and operating effectiveness of internal control based on the assessed risk, and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company, (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company, and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use or disposition of the company's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions or that the degree of compliance with the policies or procedures may deteriorate.

In our opinion, the Corporation maintained, in all material respects, effective internal control over financial reporting as of February 2, 2013, based on the COSO criteria.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated statements of financial position of Target Corporation and subsidiaries as of February 2, 2013 and January 28, 2012, and the related consolidated statements of operations, comprehensive income, cash flows and shareholders' investment for each of the three years in the period ended February 2, 2013, and our report dated March 20, 2013, expressed an unqualified opinion thereon.

Ernst & Young LLP

Minneapolis, Minnesota
March 20, 2013

Appendix B: Basic Elements of Internal Control

Learning Objective 1: Identify the Five Elements of Internal Control and Give Examples of Each

The Committee of Sponsoring Organizations (COSO) set forth five broad elements of internal control:

1. Control environment
2. Management's risk assessment
3. Accounting information and communication systems
4. Control activities
5. Monitoring (e.g., Internal Audit)

The five components of internal control are interdependent and all are important. A primary emphasis on control activities is appropriate for an introductory core course in financial accounting because they involve the practical implementation of specific preventive and detective controls over key activities and processes.

Each element is discussed in more detail below.

1. **Control environment:** This represents the "tone at the top" – management's attitude and philosophy about the importance of internal control. It includes the following components:

    a. **Management's characteristics:** integrity, commitment to competence, and philosophy and operating style

    b. **Organizational structure:** lines of responsibility and authority, board of directors and audit committee, human resource policies and practices (e.g., hiring and retention

2. **Management's risk assessment:** Management must assess the risks that (a) assets may not be properly safeguarded, (b) financial statement items may not be fairly stated, or (c) other objectives may not be achieved. Management must then implement relevant controls to reasonably address those risks.

3. **Accounting information and communication system:** An accounting information system identifies, assembles, classifies, analyzes, records, reports the entity's transactions, and maintains accountability for the related assets. An effective accounting information system produces reliable financial statements and related disclosures.

4. **Control activities:** These are policies and procedures that management establishes to meet its asset stewardship and financial reporting objectives.

    a. Adequate segregation of duties

        - Segregation of custody of assets from accounting for those assets
        - Segregation of authorization of transactions from the custody of related assets
        - Segregation of operational responsibility from record-keeping responsibility

- Segregation of information technology (IT) duties inside and outside the IT functions

b. Proper authorization of transactions and activities (e.g., proper authorization of sales, purchases, write-offs of bad debts, and payments of vendor invoices).

- This requires some reliable documentation to substantiate the authorization.
- Authorization should be performed by someone who has the necessary knowledge, skill, and assigned responsibility.
- As noted earlier, authorization also should be separated from asset custody, operational responsibility, and recordkeeping

c. Adequate documents and records. These provide support for authorization and the amounts reported in the various accounts and financial statements. Examples:

- Documents should be pre-numbered and accounted for periodically, prepared on a timely basis, and user friendly to minimize errors and fraud.
- Chart of accounts: A good chart of accounts properly classifies transactions into individual income statement and balance sheet accounts

d. Physical control over assets and records (this prevents theft of assets and destruction or manipulation of the accounting records)

- Examples include locked drawers, locked gates, and supervision of trash removal from a retail store at the end of a shift

e. Independent checks on performance to detect and correct misstatements

- For example, a car sales manager might review a sales transaction before it is completed to ensure accuracy and compliance with the auto dealer's policies

5. **Monitoring:** Monitoring activities involve ongoing or periodic assessment of the effectiveness of the design and operation of an ICS by management to determine that it is operating as intended and that it is modified as appropriate for changes in conditions.

- Monitoring is necessary because internal control systems tend to drift over time and conditions change, making it necessary to design new approaches to internal control
- Internal auditors perform this valuable monitoring role in many organizations.

Learning Objective 2: Distinguish between Preventive and Detective Controls, and Give Examples of Each

Preventive controls prevent misstatements or fraud before they occur. The following **preventive controls** prevent theft and financial statement misstatements:

- physical safeguards (e.g., locks, fences, and routine inspections)
- segregation of incompatible duties
- proper authorization and approval
- adequate documents and records
- independent checks on performance (when conducted before transactions occur or before they are recorded)

Detective controls are designed to detect misstatements and fraud after they occurred. The following **detective controls** detect theft and financial statement misstatements *after* they occurred:

- Independent periodic reviews, after transactions have occurred or after items have been recorded (e.g., payroll records can be reviewed to detect fictitious employees or nonexistent hours worked)
- Reconciliations (these compare two or more things; e.g., the inventory accounting records are compared against actual inventory on hand to detect inventory shrinkage)
    - Note: reconciliations require a comparison between two or more pieces of information. A review or examination of the inventory accounting records by itself is not a reconciliation, and counting physical inventory on hand by itself is not a reconciliation. A reconciliation would require both to be performed and the results compared.
- Reperformance of procedures that might or should be performed as preventive procedures (e.g., reperformance of procedures to establish proper authorization, but here the procedures are performed after rather than before the transactions occurred).

Learning Objective 3: Identify Controls over Cash Disbursements and Receipts

Because cash is easily susceptible to theft, an organization needs to implement effective controls over cash receipts and payments. Some control examples are listed below.

- **Preventive controls over cash disbursements:**

  1. Proper authorization: An approved vendor list, purchase order, inventory receiving report, and vendor invoice is required before writing checks. Voucher systems involve documents and procedures to ensure properly authorized cash payments.

  2. Segregation of duties: The person who approves of the cash payment is independent of the person who signs the check, and both persons are independent of the person who enters the payment in the accounting records.

  - **Detective controls over cash disbursements**

  1. Periodic reviews of cash payments to identify unusual trends, amounts, or vendors

  2. Periodic reconciliations of cancelled checks (or other evidence of payment) with supporting evidence (e.g., details on the purchase orders, inventory receiving reports, invoices, and a pre-approved vendor list)

  3. Reperformance of procedures that should be performed to establish proper authorization

- **Examples of controls over cash receipts:**

  1. Cash register tape (or electronic recordkeeping) and receipts ensure that cash are completely and accurately recorded.

  2. Daily reconciliation of cash register records and cash on hand to identify overages and shortages.

  3. When cash is received in the mail (e.g., when customers pay on account), they should submit checks rather than cash along with the **remittance advice** (the portion of the bill they send in with their payment).

     - The person who receives the cash or checks has asset custody. This person should restrictively endorse the check, prepare a **prelisting** of the customer name, ID, amount, etc., preparer a **bank deposit slip**, and **make the actual bank deposit**.

     - The prelisting is given to a different person who has recordkeeping responsibility. The record keeper records the receipt in the accounting records (e.g., by debiting cash and crediting accounts receivable) but does not have access to the cash or checks.

Electronic funds transfers (with appropriate technology-based controls) are an excellent way to ensure that cash receipts are recorded accurately, completely, and on a timely basis.

Appendix C:

Examples of Embezzlement Enabled by Inadequate Preventive and Detective Controls over Cash Disbursements

(Note: Instructors can substitute their own examples from their local business media.)

Questions for class discussion:

1. Which preventive and detective controls were missing in these embezzlement scenarios?
2. Which costs and benefits do you believe may have been overlooked by the managers who were responsible for designing, maintaining, and assessing their organization's internal controls? Which parties besides investors or creditors may have been harmed by the embezzlements?
3. Would the harm to all of the affected stakeholders be adequately compensated if the embezzlers were eventually able to make full financial restitution? Explain.
4. Even in cases where the embezzlers are able to make full financial restitution, and even when that restitution reduces the embezzled organizations' economic loss to zero, the human cost to the embezzler still remains. When the perpetrators of fraud are caught, they face shame, embarrassment, and potential imprisonment.
    a. How would you factor these human costs of ineffective internal control, or alternatively the human benefits of more effective internal control, in a cost-benefit analysis of internal control investment?
    b. What principles from the Catholic intellectual and social tradition, or from other spiritual or humanizing traditions, would you use to justify a larger investment in internal control beyond what is found in a strictly economic cost-benefit analysis?

July 29, 2011, Star Tribune, "Western Minn. Bookkeeper pleads guilty to stealing $275,000 from schools", by Paul NcEnroe.

- Liane Claasen gave herself regular pay raises for her work as the business manager of a struggling school district in Stevens County.
- She stole almost $300K from 1999 to 2010.
- She approved her own pay raises; did the bookkeeping for payroll, enabling her to electronically move and hide money taken from different accounts, and then deposited the money electronically into her personal bank account and retirement funds; and set up the internal audits (monitoring and review procedures).

February 15, 2012, Star Tribune, "Prison for east metro bookkeeper who skimmed $348K from employer", by Paul Walsh.

- An auto body shop bookkeeper, Caren Lynn Schmidt, 52, of Shoreview, was sentenced to 16 months for mail fraud and tax evasion and was ordered to pay $348K in restitution.
- She made false accounting entries and failed to report the stolen money as income on her income tax returns.

September 25, 2013, Chicago Tribune, "Dixon to get $40 million in settlement of embezzlement case," by Melissa Jenco.

Former Dixon, IL Treasurer Rita Crundwell embezzled nearly $54 million over 22 years. At Crundwell's sentencing in February, several Dixon city officials testified how Crundwell's theft crippled the small northwestern Illinois community, delaying projects like repaving streets and replacing police radios, and leading to fears of layoffs. Crundwell, 60, who used the money to fund a lavish lifestyle and a horse-breeding operation, is serving a sentence of nearly 20 years in prison after pleading guilty to a single count of wire fraud and admitting to money laundering. She is appealing the sentence.