



VOLUME 2

INTERNAL CONTROLS

— OVER —

FINANCIAL REPORTING



Volume 2:

“6x20” Control Framework for

TESTING, REPORTING, AND

OPTIMIZING CONTROLS OVER

FINANCIAL REPORTING FOR SMEs

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Executive Summary

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Introduction

As of this writing (August 2022), the COVID-19 pandemic is still with us; however, most of the heavy restrictions (masks wearing and vaccine mandates) have been lifted. Unfortunately, there is no guarantee that these restrictions will not rear their ugly head again.

Paul Volcker, former Fed Chairman, once wittily said that “about every 10 years, we have the greatest crisis in 50 years” (Financial Times, 2015). Volcker et al, believe that global financial crises occur about every decade or so.

Let's see if Volcker's theory holds true. For this, we go back to the 1970s.

- During the **1970s**, both Britain and US had their real estate credit crises. Back then, this crisis was called the 'Great Recession.'
- Progressing to the **1980s**, there was a global crisis of imploding loans to the governments of less-developed (now 'emerging') countries, as well as the failure of the remarkable total of 2,808 US financial institutions between 1982 and 1992.
- The **1990s** brought forth a series of international financial crises: Mexico, Russia, and Asia, as well as the creation of the egregious U.S. tech stock bubble, which shriveled early in 2000.
- Finally, during the **2000s**, there was the collapse of multiple national housing bubbles, a European sovereign debt crisis, and another 'Great Recession'.

So... even going back some 50 years, we do see that there is some merit to this “**decade crisis theory**.” However, there is a major difference between what's happening today with the COVID pandemic and what happened in the past crises.

- **First**, COVID was a global medical emergency caused by a virus that spread from China to the rest of the world at a phenomenal rate.
- **Second**, to control the virus, the world's governments instituted a self-inflicted economic catastrophe as a necessary (so they thought) policy to contain the virus.

Even though COVID was/is a different kind of crisis, it still shows the vulnerability businesses face daily. We know business by its very nature is risky, but to do business, you have to take on risks. When you take on risks you need to have the necessary controls in place so you can understand what's going on in your business. To understand what's going on, you need to have access to good financial information. Finally, you need to know how to report this information. Hence, you need good internal controls over financial reporting (ICFR). Without ICFR, you put your business, your career, your livelihood at risk.

To begin our ICFR journey, let's first look at what is meant by good financial information. We then progress to our “6x20” Control Framework.

Executive Summary

Good Financial Information

Good financial information has three primary characteristics. The information has to be: ¹

- **Reliable.** This means the information is believable and trustworthy.
- **Accurate.** This means the financial numbers are without significant errors or mistakes.
- **Transparent.** This means the company has disclosed everything that needs to be disclosed, such as off-balance sheet financing and related party transactions.

If the reliability, accuracy, and transparency of financial information are crucial for good decision-making then having strong ICFR is an absolute must. This is generally easier to talk about than to implement. Many of you have already studied this topic extensively but being familiar with the theory is only the first step. We wrote this paper to assist you with the implementation process. We look at the theory of ICFR and then present the method to *test* your controls over financial reporting.

Note: Because the topic of internal control is so broad, we narrowed the focus of this paper to testing ICFR for smaller and medium-sized companies (SMEs).

The *Committee of Sponsoring Organizations of the Treadway Commission* (better known as COSO) developed a complete and detailed framework on the topic of controls. COSO's framework was detailed in the book called *Internal Control-Integrated Framework*.

The COSO book, published in 1992 (updated May 2013), was the first document to clearly and precisely explain the components and objectives of internal control. The difficulty of using COSO's framework is that it does not set forth an approach that management can follow in evaluating whether its internal control systems are doing what they are supposed to do. If you were to drop the COSO framework on a manager's desk, unless the person is a highly qualified professional accountant, the manager would probably not know where to even begin. It was for this reason that this guide was written.

The purpose of this guide is **twofold**:

- 1) Provide a **framework** that can be used to **document and report** on *Internal Controls over Financial Reporting* (ICFR), and
- 2) Provide a simple **case study** that puts the "6x20" **control framework** to use. In the case study at the end, we look at controls over the revenue-collection cycle (credit sales process).

As mentioned in the title, we believe this guide is geared more **toward managers of small and medium-sized companies (SMEs)** rather than for larger listed companies. This is because larger firms tend to already have extensive *policies* and *procedures* for internal controls and systems of financial reporting that already address in greater detail than what this guide presents.

¹ Good financial information should be **ACCURATE**. This is the acronym for **accurate, complete, cost/beneficial, user-targeted, relevant, authoritative, timely, and easy to use**.

Executive Summary

Note The definition of an SME is a business that maintains revenues or a number of employees below a certain standard. Every country has its definition of what is considered a small and medium-sized enterprise. In the United States, there is no distinct way to identify SMEs; it typically depends on the industry in which the company competes. In the European Union, a small-sized enterprise is a company with fewer than 50 employees, while a medium-sized enterprise is one with fewer than 250 employees and which has an annual turnover not exceeding 50 million Euros, and/or an annual balance sheet total not exceeding 43 million Euro.

Note: The *International Accounting Standards Board (IASB)* promulgated specific financial accounting standards for SMEs. The principal factor for the IASB to develop accounting standards for SMEs was to provide a framework for SMEs to generate reliable, accurate, and transparent financial information.

The users of financial statements are likely to be different for SMEs compared to larger, multinational corporations. For SMEs, the only groups likely to receive the information are management, shareholders, and perhaps government agencies.

For more information on IFRS standards for SMEs visit the IASB website at: www.ifrs.org

The “6x20” Control Framework

The “6x20” Control Framework is a **six component-twenty principles** model which can be used to **document** and **report** on ICFR. The basis of “6x20” was built on the internal control framework published by COSO, with two additional elements. We discuss the difference between the two models in Chapter 1.

Implementation of this framework should be enough to demonstrate to the board and other outside users that financial controls are in place and operating as they should throughout the company.

Shown in the table below is a summary of the *components* and *principles* of our model.

CONTROL COMPONENTS	PRINCIPLES
I. Control Foundation Analysis	(1) Integrity and ethical values. (2) Commitment to financial reporting competence. (3) Human resource policies and procedures. (4) Assigning decision rights. (5) Management philosophy and operating style over financial reporting. (6) Board & audit committee oversight. (7) Organizational structure over financial reporting.
II. Risk Assessment Analysis and Response	(8) Determine financial reporting objectives. (9) Identify significant accounts & disclosures over the financial reporting process. (10) Identify risks within the significant accounts & disclosures. (11) Have an awareness of potential fraud when reviewing accounts & disclosures. (12) Assess and prioritize significant risks within accounts & disclosures. (13) Respond to significant risks.

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III. Design Controls	(14) Design controls to address significant risks.
IV. Information & Communication	(15) Determine information needs over financial reporting. (16) Communicate financial reporting needs.
V. Monitoring	(17) Monitor results through ongoing monitoring. (18) Periodically conduct separate evaluations. (19) Report control deficiencies over financial reporting to management.
VI. Learning	(20) Develop a learning program.

The use of this Guide

When writing this guide, we never intended it to be a **one size fits all** guide. We understand that the complexity or simplicity of any control system is dependent on the size, structure, and complexity of the organization itself. For this guide to be useful it will probably need to be modified, if necessary, to meet your organization's financial reporting needs.

The intended users of this guide will most likely include board members or owners, financial managers, and internal auditors.

- **Board Members and Owners**

Board members and owners might find the guide useful in fulfilling their monitoring and oversight responsibilities. Board members (including members of the audit committee) and owners will find this guide useful to better understand their own company's internal control systems. Based on this, they should have better discussions with financial managers about the state of their company's ICFR. All of this will lead to a healthier, more profitable company.

- **Financial Managers**

Financial managers should find this guide useful when designing and implementing an approach to document and report on the effectiveness of ICFR. The formality of the assessment design will depend on the size and complexity of the organization.

- **Internal Auditors**

Internal auditors should be able to use this guide in relation to their evaluations of ICFR it has undertaken or plans to undertake.

Conclusion

As mentioned earlier, this guide is geared more toward SMEs since these types of companies have less sophisticated financial reporting systems, and thus, are in more need of guidance. However, this does not imply that financial managers in larger firms might not find specific elements of this guide useful, for example, using the control foundation review matrix, or one of the other presented matrices might prove to be useful.

What we think makes this guide different from others is that we present an **Illustrative Case Study** of implementing the framework. The Illustrative case study shows the process of reviewing the internal control environment, the

Executive Summary

process of assessing and ranking risk, identifying financial reporting risk within a particular process, developing a risk and control matrix, and finally reporting on the effectiveness of the company's financial reporting.

Executive Summary

THE "6x20" Control Framework

Chapter 1: The “6x20” Framework

Chapter 1: The “6x20” Control Framework

You may be familiar with the saying, “**a chain is only as strong as its weakest link.**” In the discussion of internal controls this quote seems very apropos. This quote says that if any link in your control system is weaker than any other link, your entire control system is threatened, threat of theft of assets, threat of financial reporting manipulation, threat of error, and many other types of threats. These threats mean that your company is more likely not to achieve its objectives – both operational and financial.

For example: Your organization could have strong written IT policies/procedures over confidential information (e.g., customer information, credit card numbers, etc.) requiring users to login based on a unique item in their possession. This requires the user to have a login ID and password and the unique item, such as an ATM card and PIN, at the time of login. This provides a second layer of protection against unwanted intrusion. However, if the IT staff simply shrugs off the security protection and allows users to use common passwords then this is a weak link that allows for possible abuse and misuse. Therefore, no matter how effective the written policies may seem to be on the surface, without the next link carrying out the policies the whole security protection system is deficient. You need to remember that no single link in the control system is more important than the next.

In the study of internal controls, you need to remember that internal controls must be:

- 1) **Robust, numerous** and at **every level of the company**, from the top (corporate level) down to the transaction level.
- 2) **Embedded** within the **processes, culture, structure, and systems**.
- 3) **Flexible** enough to change as the business or business environment changes.
- 4) Able to only provide only **reasonable assurance**, not a guarantee, to senior management and board that business objectives will be achieved; and
- 5) Must be **cost beneficial**. If the cost of a control is greater than its benefit, then the control(s) should not be installed.

As we mentioned earlier, the intent of our “6x20” framework is to be a user-friendly guide to assist you in your assessment, evaluation, and reporting of internal controls over financial reporting (ICFR). Ultimately, completing this exercise will hopefully give you the knowledge by which you are then able to strengthen and improve financial reporting controls.

It is not uncommon to sometimes hear experts expound the idea that assessing and strengthening internal controls is not that difficult, if you just follow their model. However, after saying this, they then proceed to explain that “**no one system fits all,**” and an organization’s control system will depend on many factors, such as company **culture, operating style, regulatory requirements** and a host of other factors. Hence, contrary to what the supposed experts might say, building a strong control system is not an easy task. It takes time, energy, and a lot effort. It was because of this that we developed the “**6x20**” model.

Why the “6x20” model?

The “6x20” framework is a **six-component, twenty principles** model, hence the name 6x20. As mentioned in the *Executive Summary*, the basis of this model was built on the internal control framework published by COSO, with two additional elements included to take into account the fact that companies always have to safeguard their assets, and they always have to be in a learning mode: learning from their mistakes and learning new and better ways to improve operations.

There are **four primary control objectives** of “6x20” model, including:

- 1) The reliability of financial reporting,
- 2) The effectiveness and efficiency of operations,

Chapter 1: The “6x20” Framework

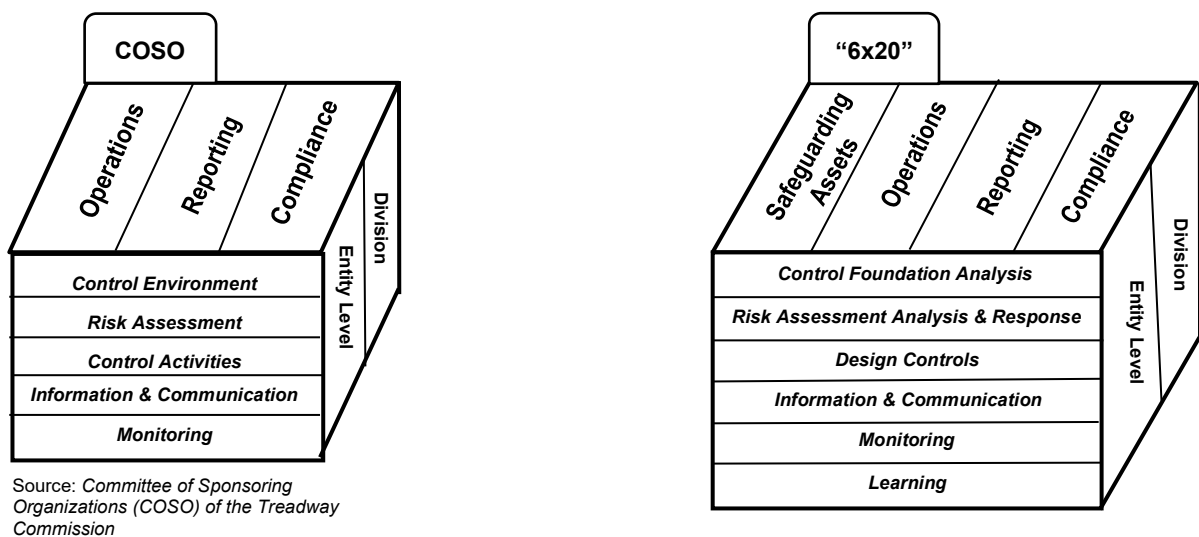
- 3) The compliance with laws and regulations (both internal/external), and
- 4) The safeguarding of assets.

Safeguarding assets, which is implied within COSO’s three control objectives is a separate objective in the “6x20” model because, as mentioned, companies always have to be doing a better job in safeguarding their assets. This is particularly true of SMEs since their resources are even scarcer than in larger companies.

Safeguarding assets include not only physical assets, like equipment, cash, and others, but also includes non-physical assets, like personal information about customers, information about its employees, its systems and processes, and so on. **So, always remember, “protect your assets.”**

A cubic form comparison of the **two models** is shown below.

COSO vs “6x20” Models



The “6x20” model contains **six control components**:

- 1) **Control Foundation Analysis**
- 2) **Risk Assessment & Response**
- 3) **Design Controls**
- 4) **Information & Communication**
- 5) **Monitoring**
- 6) **Learning**

Learning is a separate component because all businesses (whether large or small) have to develop a learning process whereby if mistakes in controls do occur the company is able to learn why the mistake occurred and learn how not to repeat the mistake. No company or individual wants to make the same mistake over again. Also, companies have to learn new and better ways to improve efficiency and effectiveness of operations.

Besides the six control components, there are twenty principles which can help you assess and improve internal controls. We elaborate further on the components and principles in the table on the next page.

Chapter 1: The “6x20” Framework

In the following table we further elaborate on the **control components** of the “6x20” model. We also detail the **principles** behind achieving the framework.

CONTROL COMPONENTS	PRINCIPLES TO ACHIEVING FRAMEWORK
<p style="text-align: center;">I.</p> <p style="text-align: center;">Control Foundation Analysis</p> <p><i>Assessing the control foundation is done through evaluating the seven primary principles of the control environment.</i></p> <p><i>Reliable, accurate and transparent financial information is only possible if there is top-down communication on what the company’s risk and control philosophy is, and what is expected of the company’s people.</i></p> <p><i>A good way to know your control environment is to review the seven principles to the right.</i></p> <p><i>A review of these principles can help you understand how internal control is addressed by the organization’s people, including its integrity and ethical values. It can also tell you whether you have the right people in the right positions, and whether you have the right organizational structure for your company.</i></p>	<p>1. Integrity and ethical values. <i>Sound integrity and ethical values, initiated by senior management, set the standard of conduct for financial reporting.</i></p> <p>2. Commitment to financial reporting competence. <i>Your company needs competent people in its financial reporting positions.</i></p> <p>3. Human resource policies and procedures. <i>Human resource policies and procedures should be designed to make sure the right people are in the right positions, particularly over financial reporting.</i></p> <p>4. Assigning decision rights. <i>Assigning decision-rights has to do with how much authorization and what type of decisions managers may or may not make.</i></p> <p>5. Management philosophy and operating style. <i>These are the values, beliefs, and attitudes of management that shape your company’s internal control process.</i></p> <p>6. Board & audit committee oversight. <i>The board, with the assistance of the audit committee, has to understand its responsibility to provide oversight of the financial reporting process.</i></p> <p>7. Organizational structure over financial reporting. <i>Your company’s organizational structure supports effective controls over financial reporting.</i></p>
<p style="text-align: center;">II.</p> <p style="text-align: center;">Risk Assessment Analysis & Response</p> <p><i>Every threat is a risk, but not all risks are threats.</i></p> <p><i>Risk assessment is about identifying risks and then analyzing them for significance. You need to concentrate your efforts on the threats, not just on risks. Every organization faces a lot of risks but only a few of them put the company at risk. However, you still have to have an awareness of all possible risks to look for trends. For example, a specific risk might not be a threat yet, but there could be a threat of the risk growing.</i></p> <p><i>A crucial aspect of risk assessment is being able to recognize warning signs that fraud could be occurring.</i></p> <p><i>When threats have been identified and analyzed you need to prioritize them, so you concentrate your efforts on where it counts - on the important risks.</i></p> <p><i>Finally, you need to understand how best to respond to the significant risks. Threats can be transferred, accepted, reduced or avoided (TARA).</i></p>	<p>8. Determine financial reporting objectives. <i>A precondition to assessing risk is the establishment of objectives for reliable financial reporting.</i></p> <p>9. Identify significant accounts & disclosures over financial reporting process. <i>Identify the significant financial reporting accounts (e.g., revenue, accounts receivables, purchases, and inventory) and disclosures (e.g., related party, depreciation method, inventory flow method) within the financial reporting process.</i></p> <p>10. Identify risks within the significant accounts & disclosures. <i>Risks within the financial reporting process (e.g., transaction cycles) are identified and categorized.</i></p> <p>11. Have an awareness of potential fraud when reviewing risks in accounts and disclosures. <i>When evaluating risks you need to identify potential material misstatements due to fraud. You need to understand where fraud could be occurring.</i></p> <p>12. Assess and prioritize significant risks within the accounts & disclosures. <i>Significant risks (threats) within the financial reporting process are assessed and prioritized.</i></p> <p>13. Respond to significant risks. <i>Once the significant risks have been assessed and prioritized you need to respond to them.</i></p>

Chapter 1: The “6x20” Framework

CONTROL COMPONENTS	PRINCIPLES TO ACHIEVING FRAMEWORK
III. Design Controls <i>In order to manage the identified threats, you need to design controls to protect yourself from potential adverse conditions.</i>	14. Design controls to address significant risks. <i>Controls need to be designed to minimize or lessen the likelihood of risks occurring.</i>
IV. Information & Communications <i>For controls to be effective you need to understand management’s information needs, and then you need to communicate management’s accountability and responsibility for controls over financial reporting. This last item allows people to carry out their financial reporting responsibilities.</i>	15. Determine information needs. <i>Management’s information needs are identified at all levels to support the financial reporting objectives.</i>
	16. Communicate financial reporting needs. <i>Senior management communicates accountability and responsibility for internal control over financial reporting.</i>
V. Monitoring <i>The monitoring process allows you to understand whether controls are working as they should, whether they need to be modified or not.</i> <i>If control deficiencies are discovered they have to be reported in a timely manner.</i>	17. Monitor results through ongoing monitoring. <i>Ongoing monitor tells you how effective internal controls over financial reporting are.</i>
	18. Periodically conduct separate evaluations. <i>Conducting separate evaluations can be used to provide feedback on the effectiveness of the ongoing monitoring program.</i>
	19. Report control deficiencies over financial reporting to management. <i>Internal control deficiencies are identified and reported in a timely manner to those who are able to take corrective action.</i>
VI. Learning <i>Improvements to the financial reporting process can only be made if companies are willing to learn from past mistakes.</i> <i>A hurdle for most people is to admit that a mistake was made. They feel that to admit such an error is to lose face. However, it is through mistakes that people learn not to make the same mistake again.</i>	20. Develop a learning program. <i>Learning from one’s past mistakes can help in making sure the same mistakes do not happen again, particularly financial reporting mistakes.</i>

Conclusion

We mentioned in the executive summary that there is no one definition of what represents a SME. A SME can range in size from a few employees to more than 250+ (depending on whose definition you are looking at). Based on this, financial reporting requirements can range from a simple cash report to the preparation of complete financial statements, including income statement, balance sheet, cash-flow, statement of owner’s equity.

Whether small, large or medium- sized, all companies have to have reliable information for good decision making. So, in conclusion, make sure you install a financial reporting system which gives you the reports you need when you need them, even if it is just a simple monthly cash flow report.

Chapter 2: Build a Solid Control Foundation

Chapter 2: Build a Solid Control Foundation

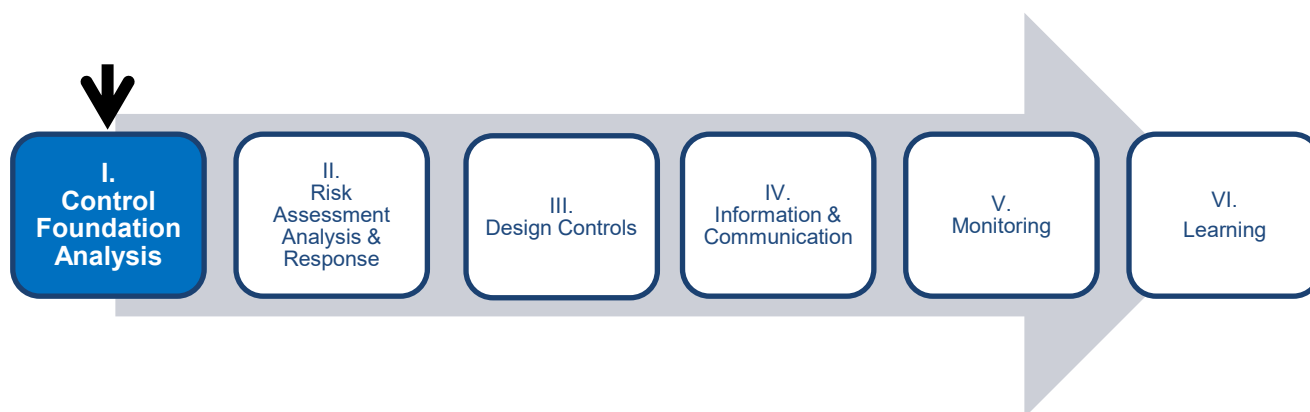
The business environment in which companies have to operate today is much more volatile than it was, say, even ten-fifteen years ago, particularly now, with COVID still a threat. This presents companies with uncertainty they never had to face before, including the risk to the stability of the European Union, risk of government debt downgrading (see US, France and other countries), risk of possible sovereign defaults (see Greece, Italy, Spain, Portugal and others), anemic economic growth, the threat of terrorism, the threat of government sponsored hacking (see Iran, China) and many other types of risks and uncertainties.

Some of the risks that companies face today were thought to be non-existent only a few years ago. This challenging environment means that management and directors have to find new and innovative ways to grow their business while still maintaining their competitive advantage and protecting themselves from the risks they face.

This is a daunting task even under the best of circumstances. Given current economic conditions, companies that survive the coming years will survive because they are better managed. Better managed companies are those that understand clearly how their companies are being **directed** and **controlled**; understand their **operations**; understand their **business philosophy**, their **culture**, and their **operating style**. Understanding these factors gives companies the chance to put in place the right kind-of control systems necessary to be successful.

The items mentioned above are connected to the company's control environment. When talking about the control environment we are talking about how the company manages its risks through the implementation of controls. You need to remember that controls are initiated at the top of the control hierarchy and then cascade down throughout the organization.

The diagram below shows our progression through the "6x20" control framework. The **darkened blue area** with the black arrow represents where we are in our progression.



I. Control Foundation Analysis

Our first component has you analyzing your company's control foundation. You analyze the foundation by reviewing its **seven core principles**. We describe these principles in the following pages. These principles are similar to the ones identified by COSO, except COSO lists five principles and we list seven.

In the paper titled, *Be Your Company's 'Air-traffic' Controller*, we discussed that there are two basic elements of every company's financial reporting structure: the **financial accounting system**, and the **control procedures**.

There is an interaction between the **accounting system** and the **control procedures**, and they both have to be working together for there to be confidence in the financial reports. However, there is an equally important third element that is also necessary for every financial reporting system. This third element is what is often referred to as the **control foundation**.

Chapter 2: Build a Solid Control Foundation

It will be the control foundation that gives **credence** to the whole financial reporting process. It is the foundation that makes sure the other two elements are doing what they should be doing. We diagram this interaction in **Exhibit 2.1** below. In essence, you can think of the control foundation as being the **pillar** that supports the entire financial reporting system. Without these pillars, the financial reporting system simply crashes and is ultimately useless. Ultimately, what you are looking for is '**balance**' between the **control procedures** and the **accounting system**.

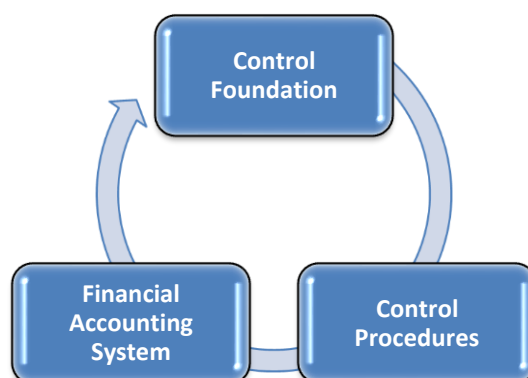
What do we mean by balance?

On the one hand, we need an **effective control system** that verifies that the controls are in place, so reliable financial reports are produced. However, on the other hand, we need an **efficient reporting system** that allows financial reports to be processed in a timely manner. If you are a financial manager, you don't want to place too much emphasis on one or on the other. In other words, you want to balance the two. It is in this respect that the control foundation plays such an important role trying to find the right balance between the **quality of the information** and the **timeliness of the information**.

If you place too much emphasis on timeliness you might be sacrificing quality and if you place too much emphasis on quality, you might be sacrificing timeliness. Ideally, you want both, and this is what you should always be striving to obtain, but there is probably always going to have to be a tradeoff between the two. This will be true whether your accounting system is semi-automated, or completely automated.

Exhibit 2.1

Control Structure over Financial Reporting



On the following pages, we discuss each element of the control foundation in more detail. We do this since it is the control foundation that really sets the tone for the achievement of your financial reporting objectives. You can achieve your objectives only if you have set the right environmental tone.

Have you worked in a company where it seems management just doesn't take controls seriously? Management bypasses them when they're not convenient or ignores them all together. If you have, then you understand the frustration in working in such an environment. In this type of situation do you believe long-term success is possible?

When reviewing the principles of the control foundation, try to think of them as the **pillars** that support and promote **risk awareness** and **control** throughout your company. They are, in essence, the **first line of defense against the risk of financial reporting errors and misstatements**. This is true because if the control foundation is weak then risk awareness and all other controls throughout the organization will be weakened. This drastically increases the possibility that the company will be victimized, either through fraud or the intentional misstatement of financial information.

In **Exhibit 2.2** below we try to show that you should always be striving to find the right '**balance**' between the risks your company's management is willing and able to take on and the controls necessary to properly manage the company.

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Exhibit 2.2

The Balancing Act



Note: Soft vs. Hard Controls

The control foundation principles are considered to be **soft controls**. Soft controls differ from **hard controls** in that soft controls are not characterized by specific activities or procedures that can be tested and observed in some finite manner. Soft controls have more to do with philosophies and attitudes (e.g., ethics and integrity, skills, competencies, knowledge, etc.).

Principle 1: Integrity and ethical values

These are two terms which have certainly received a lot of attention recently. This is particularly true with the advent of the financial meltdown back in 2008-09. When thinking of this current crisis, names like *Bernie Madoff*, or *AIG*, or *Lehman Brothers* probably come to mind.

“Striving for integrity means knowing your values in life and behaving in a way that is consistent with those values.”

Below we take a closer look at what is meant by having **“integrity”** and **“ethics.”** We do this because companies that don’t practice what they preach have less chance of being successful, and thus, they diminish their chance of having reliable, accurate and transparent financial statements.

The Need to have Integrity

There is an old adage that says integrity **“is doing the right thing, even if no one is watching.”** It is said that if you consider something wrong then it probably is wrong, and you should not do it. As far as financial reporting you must be **honest** and **straightforward** when reviewing and issuing financial reports. This means that if something just doesn’t seem right to you, you have a responsibility to report the finding to some with enough authority to deal with the issue. You need to do this until you are satisfied that the issue has been properly taken care of.

An example of someone who we believe exhibited the highest level of integrity is *Cynthia Cooper*. *Cynthia* was the Internal Auditor of WorldCom. It was *Cynthia* who exposed the fraud that occurred at WorldCom in 2002. At one time, WorldCom was the 25th largest company in the U.S. Today, this company does not even exist (it was merged with MCI).

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The story about *Cynthia* is quite amazing. At some point in our lives we all have to make a choice between giving in to pressure and doing 'what is right.' In the following case, *Cynthia* did what was right, even though she risked her career and family to do the right thing.

Case Study of Integrity: The Cynthia Cooper Story

WorldCom (headquartered in Clinton, Mississippi) started off as a mom-and-pop long-distance company in 1983. Its CEO was *Bernie Ebbers*. Though, by the 1990s, the company emerged into a powerhouse. In 1997, the company shocked the long-distance industry by taking over MCI. At the time MCI was almost 3-times the size of WorldCom. *Scott Sullivan*, WorldCom's CFO, was the brains behind the takeover. By 1998, CFO magazine named *Sullivan* one of the country's best CFOs. He was only 37 and already earning \$19.3 million a year.

It was during this time that ***Cynthia Cooper*** became VP of Internal Audit. At that time *Cynthia* was so exuberant for the company that she would sometimes talk of retiring early and starting a bead shop. Unfortunately, she has not been able to realize her dream.

The problems at WorldCom started in early 2001. By this time, the enthusiasm for the telecom market created a glut of companies like WorldCom and others, and profits started to dramatically fall. *Cynthia* knew of the drop-off in profits but was unaware of *Scott Sullivan's* creative accounting to hide the fact.

Cynthia says it was a fluke that she got wind of *Scott's* creative accounting scheme. A worried executive in the wireless division told her in March 2002 that corporate accounting had taken \$400 million out of his reserve account and used it to boost WorldCom's income. Wanting to find out more, *Cynthia* went to the company's independent auditor, Arthur Anderson, to inquire about the issue. She was told by the partner that it was not a problem and ignored her. But, for *Cynthia*, this was not enough; particularly with the problems Arthur Anderson was facing with the Enron scandal.

At this point, *Scott Sullivan* told *Cynthia* that everything was fine and to "back off." *Cynthia*, being *Cynthia*, did not back off. As a matter of fact, she said, when someone is hostile, her first instinct is to find out why. For many, having the audit company and CFO say back off would be enough, but not for *Cynthia*. She pressed on wanting to find out whether there was in fact a problem. Over the course of the next few weeks, *Cynthia* directed her team members to widen their net. She and her team worked late to keep their project a secret. They knew that they had no allies at the company. As a matter of fact, they bought a CD burner and started to copy data, concerned that the information might be destroyed before they could finish.

During the course of their work, the team found that the company had capitalized billions of dollars of ordinary servicing fees. Through the use of capitalization, the company was able to put these operating expenses on the balance sheet and then summarily expensed them out over future periods. This was done none other than to make company's profit greater than it should have been. Instead of showing what should have been a \$662 million loss in 2001, the company was able to report a \$2.4 billion profit. An amazing \$3 billion turn-around.

The beginning-of-the-end of WorldCom's world started on June 11th. *Scott Sullivan* called *Cynthia* to his office and asked her to "what was up." She told *Scott* everything about conducting an audit on the improper capitalization. *Scott* remained calm and simply asked her to delay the audit until WorldCom filed with the SEC. *Cynthia* told *Scott* that would not happen.

The next day, *Cynthia* presented her findings to the audit committee. Even though she knew there was little chance of it, "she still held out hope of there being a reasonable explanation." As a matter of fact, *Cynthia* and her staff went out of their way to try to produce logical explanations for the accounting treatments. Finally, *Cynthia* confronted *David Meyers*, WorldCom's controller, "who admitted he knew the accounting could not be justified."

At this point, she knew there was something very wrong at WorldCom and she was not the type to back down. *Cynthia* grew up in a family where money was tight, and where, at the age 14, she went out and got a job working at the local eateries, including McDonald's. She tells the story of when she worked at the Golden Corral, she struggled to make it as a waitress, but she was determined not to quit, and to do better. So, her dad bought her some weights so she could get gain some strength, and sure enough, after several weeks, she went from being the worse waitress to the best.

So, now, instead of making it as a waitress, she had to go up against WorldCom. The showdown came on June 20th, when *Cynthia* and her team went to Washington for WorldCom's audit committee meeting. *Cynthia* was there to tell her side of the story and management would present theirs. After *Cynthia* told the audit committee what she and her team had found out, *Scott* then tried to present his side of the story. Even though the audit committee gave him the weekend to get information to support his argument, he failed to do so. Finally, on June 24th the committee had no choice but to ask *Scott* and *David* for their resignations.

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David resigned, but *Scott* refused to quit, so he was fired. Considering the circumstances, WorldCom had no choice but to come clean about what had happened.

Even though there were changes made at the company, and the company implemented many of her recommendations, she paid a high price for her courage. Many in the community blame her for the collapse and naively think the company could have borrowed its way out of bankruptcy had she stayed quiet.

But, considering everything, she strongly believes there was a point to the loss. For one, Congress passed Sarbanes-Oxley, which states that all public companies to maintain an internal audit function. Because of this act, *Cynthia* believes internal auditing will be taken more seriously.

As a last word, Time magazine named *Cynthia Cooper* as one of their “Persons of the Year” in 2002. Staying humble to the end, *Cynthia* says of the honor, “I’m not a hero; I’m just doing my job.”²

Source: Amanda Ripley, “The Night Detective,” Time Magazine, December 30, 2002.

Other acts of Fraud

Further investigation of WorldCom’s accounting found other acts of fraud committed by the company. These other acts of fraud include:

- 1) When WorldCom would acquire a company, it would write-down the assets acquired in the takeover but included in the write-down estimates of future operating costs. In this way, WorldCom was able to record the future costs as costs arising from the takeover instead of having to record them in future periods.
- 2) During the acquisition of the telecommunication company MCI, it reduced MCI’s assets and increased its goodwill on the acquisition; thereby it was able to amortize the goodwill at a slower rate than it would have to charge depreciation on the tangible assets.
- 3) WorldCom also under-provided for bad debts.

Source: “Journal of Emerging Technologies in Accounting” Vol. 3, 2006, pp. 61-80.

Lessons Learned of WorldCom

- 1) Have a keen awareness of the red flags of fraud. Always think of the ways fraud could be committed in your company.
- 2) If you suspect something wrong, follow through until you are satisfied with the result. Do this even if this means going over your boss’s head, as *Cynthia* did.
- 3) Always maintain your integrity and honesty. It may be difficult at times because of the pressures of work and career, but the benefits of having and maintaining them far out weight its cost.
- 4) Finally, never be afraid to quit. If you are afraid to quit, then you may be willing to compromise your ethics.

Ethical values for SMEs

SMEs are characterized by being more informal in the way business is conducted. Relationships with customers, employees, vendors, and so on are on a more personal level than they are in large companies. The values and ethical principles of the company will usually be more implicitly implied rather than explicitly stated through policies, codes and programs which are common in large companies.

Large companies are known for their bureaucracy; SMEs are known for their lack of formality. Because of their size SMEs simply do not have the ability to devote as many resources to building an ethical work environment as larger companies. However, there are some advantages to developing a more formal ethics policy, even for SMEs.

² Amanda Ripley, “The Night Detective,” Time Magazine, December 30, 2002.

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First, it explicitly reinforces the idea that ethics is important to the organization, particularly, the way the company conducts its business. This idea of having strong values and ethical principles can then be communicated to stakeholders so they can feel more assured that they will be treated in a fair way. Second, an ethics guide provides guidance and support to employees on how they are expected to conduct themselves.

“A policy will provide a context and the vocabulary for employees to raise any concerns they have with their supervisors or the directors. It will form a framework for management and staff to decide what is the “right thing to do.””³

Guidelines to improve your Company’s Code

The following are some general guidelines when reviewing or developing a *Code of Conduct* for a SME. These guidelines include:

1) **Focus on business practices or specific issues that are important for your company.**

Every company’s *Code of Conduct* will be different, so you want to make sure to concentrate on those areas that are important for your company. General items you should consider having in your *Code* are the importance of good customer relations, conflict of interest issues, company policy towards sexual harassment, employee safety, environmental standards, and rules and regulations specific to your industry.

2) **Tailor the Code to fit your company, not someone else’s.**

Every company is different so your company’s *Code* should fit your company, not someone else’s. Your company’s *Code* should clearly identify the **values** and **mission** it wants in the company. Simply copying a *Code* from a website is not enough because it would be someone else’s *Code*.

3) **Involve the employees when developing the Code.**

This is a great way for the company employees to feel a part of the company. To some extent, it is a way to motivate them to actually follow the *Code*. This is a much better way than simply having the *Code* mandated from above.

4) **When completed, properly communicate the Code to all employees.**

Once the *Code* is completed, it then needs to be communicated to the employees. The *Code* needs to be explained so people understand why the *Code* was developed and what is expected of them. In addition, during the process of establishing the *Code* your company might want to consider appointing a compliance person whose job would be to investigate any violations of the *Code* and to review the *Code* with the employees on a regular basis.

5) **Make sure to punish violators.**

Failure to act upon a violation is the best way to destroy the purpose of the *Code*. If this happens then people will not take the *Code* seriously. When developing the *Code* there should be a process laid out that describes what happens when a violation does occur. Your company should specify a range of penalties that goes with certain violations. For example, under what circumstances is the violator fired, or put on probation, or demoted. You just need to make sure that people understand the ramifications of violating the *Code*.

6) **Live the Code.**

3 Institute of Business Ethics, “Business Ethics for SMEs,” December 2007 (updated January 2010), Issue 6.

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For the *Code* to be taken seriously everybody has to take the *Code* seriously, including the board and senior management. If they don't, then no one else will take the *Code* seriously. In essence, they must become the role models.

Illustrative Overview of a Code of Conduct

Our Values

- The best solutions come from working together with colleagues and clients.
- Effective teamwork requires Relationships, Respect and Sharing.
- Delivering what we promise and adding value beyond what is expected.
- We achieve excellence through Innovation, Learning, and Agility.
- Leading with clients, leading with people and thought leadership.
- Leadership demands Courage, Vision and Integrity.

Upholding the [firm] name

- Our clients and colleagues trust [firm name] based on our professional competence and integrity – qualities that underpin our reputation. We uphold that reputation.
- We seek to serve only those clients whom we are competent to serve, who value our service and who meet appropriate standards of legitimacy and integrity.
- When speaking in a forum in which audiences would reasonably expect that we are speaking as a representative of [firm name], we generally state only [firm name] view and not our own.
- We use all assets belonging to [firm name] and to our clients, including tangible, intellectual and electronic assets, in a manner both responsible and appropriate to the business and only for legal and authorized purposes.

Behaving Professionally

- We deliver professional services in accordance with [firm name] policies and relevant technical and professional standards.
- We offer only those services we can deliver and strive to deliver no less than our commitments.
- We compete vigorously, engaging only in practices that are legal and ethical.
- We meet our contractual obligations and report and charge honestly for our services.
- We respect the confidentiality and privacy of our clients, our people and others with whom we do business. Unless authorized, we do not use confidential information for personal use, [firm name's] benefit or to benefit a third party. We disclose confidential information or personal data only when necessary, and when appropriate approval to do so has been obtained, and/or we are compelled to do so by legal, regulatory or professional requirements.
- We aim to avoid conflicts of interest. Where potential conflicts are identified and we believe that the respective parties' interests can be properly safeguarded by the implementation of appropriate procedures, we will implement such procedures.
- We treasure our independence of mind. We protect our clients' and other stakeholders' trust by adhering to our regulatory and professional standards, which are designed to enable us to achieve the objectivity necessary in our work. In doing so, we strive to ensure our independence is not compromised or perceived to be compromised. We address circumstances that impair or could appear to impair our objectivity.
- When faced with difficult issues or issues that place [firm name] at risk, we consult appropriate [firm name] individuals before taking action. We follow our applicable technical and administrative consultation requirements.
- It is unacceptable for us to receive or pay bribes.

Respecting Others

- We treat our colleagues, clients and others with whom we do business with respect, dignity, fairness and courtesy.
- We take pride in the diversity of our workforce and view it as a competitive advantage to be nurtured and expanded.
- We are committed to maintaining a work environment that is free from discrimination or harassment.
- We try to balance work and private life and help others to do the same.
- We invest in the ongoing enhancement of our skills and abilities.
- We provide a safe working environment for our people.

Corporate Citizenship

- We express support for fundamental human rights and avoid participating in business activities that abuse human rights.
- We act in a socially responsible manner, within the laws, customs and traditions of the countries in which we operate and contribute in a responsible manner to the development of communities.
- We aspire to act in a manner that minimizes the detrimental environmental impacts of our business operations.
- We encourage the support of charitable, educational and community service activities.
- We are committed to supporting international and local efforts to eliminate corruption and financial crime.

Source: COSO, Enterprise Risk Management – Integrated Framework, Application Techniques, Sept. 2004, pg. 10–11

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Principle 2: Commitment to financial reporting competences

A common denominator of all successful companies is that they employ competent people. *“There is nothing that will destroy a company as quickly as having the wrong people in the wrong positions”* This is particularly true for SMEs. It is often said that *“it is better to be understaffed with competent people than to hire the wrong people who can very quickly destroy the company’s reputation.”* To have competent people over financial reporting is to make sure that the right people are in the right position, making sure they have the right *skills* and *knowledge* to carry out their responsibilities.

“Incompetents invariably make trouble for people other than themselves.”

Source: Larry McMurtry⁴

Guidelines to improve competences

There are **three primary guidelines** which can help improve your company’s financial reporting competences. These guidelines are:

(1) **Identify the needed competences within your company.**

Employees who are hired who will be involved in the financial reporting process have to have the knowledge, skills and abilities to properly discharge their duties. This is obvious. An important basis for recruitment is the **job description**.

Job descriptions should list all of the necessary skills and requirements for the finance and accounting position. By having proper job descriptions, it makes it easier for management to determine whether they are properly staffed.

(2) **Make sure to retain good, ethical employees.**

Once a person is hired, and if the person is a good and ethical employee, then the next step is to do your best to retain the person. This can become a huge issue for a lot of companies. The more successful companies have been shown to have lower turnover rates than less successful companies.

The most common method to retain competent employees is by providing a financial incentive, such as offering cash bonus if targets are reached or providing stock options. However, other incentives can also induce employees to stay, such as offering advanced training, or providing free medical insurance, or use of company car, etc.

(3) **Evaluate the key competences.**

The last guideline is to periodically evaluate the key personnel over financial reporting to determine whether their skills are appropriate for their current job responsibilities.

⁴ Larry McMurtry is an American novelist, and Academy Award winning screenwriter whose work is predominantly set in either the "old west" or in contemporary Texas.

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These evaluations should be seen as a method to identify weaknesses and give them the opportunity to improve their performance. The evaluation should not be based on likes or dislikes or other non-job-related factors.

Principle 3: Human resource policies & procedures

Ultimately, it is the employees who make a company successful or not; therefore, it is imperative that your human resource department has the proper tools to manage its employees.

This means making sure your company has the right human resource policies and procedures. Having the right policies and procedures will make it possible for your human resource department to provide more effective control over company operations.

“Having the right people in the right position means having a chance to succeed.”

Guidelines to managing the company’s human resources

Whether a small five-man operation or a large corporation with thousands of employees, there are **five simple guidelines** to help you better manage your company’s human resources.

(1) Conduct background checks on all new hires.

Surprisingly, a lot of companies don’t follow through with background checks. They do this for a variety of reasons. It is possible they believe a background check wouldn’t uncover anything, or maybe they just don’t have the time. But, whatever the reason, make sure your company does follow up with background checks. If your company does not, then it runs the risk of hiring someone who is not as qualified as thought during the initial interview.

(2) Establish the right human resource policies and procedures to demonstrate a commitment to integrity and ethics.

We have already discussed the importance of integrity and ethics. The human resource department should take an active part in their promotion, and if necessary, take action against violators.

(3) Provide training and employee development programs.

It is through training that employees are able to become more competent in their jobs. Because technology is continuously changing, training provides the means to keep up with the changing technology.

(4) Conduct regular performance evaluations.

An important part of a manager’s job is employee evaluation. When performed properly, the evaluation process is an instrument that promotes the growth of the employee. The evaluation documentation must be *complete*, *accurate* and *consistent*, and notice of a pending evaluation must be given so employees have the opportunity to prepare for the evaluation.

(5) Develop the right compensation and benefit programs.

We discussed this earlier, but employee compensation is a very important aspect of the decision a potential employee makes when deciding to work for a company. It is also important when the employee has to decide whether to stay with the company or not.

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Besides the base salary, employees can be compensated through cash bonuses for achieving a performance target or providing health and life insurance to the employee and his/her family, or offering stock options, or pensions or other forms of non-monetary compensation.

Principle 4: Assigning decision-rights

Properly assigning decision rights has to do with how much authorization and what type of decisions managers may or may not make.

Ultimately, it has to be senior management and the board who decide who is authorized for what types of decisions to ensure effective internal control over financial reporting.

“Assigning decision-rights is like getting your tooth pulled. It is one of those things in life where people put off until they have no choice. However, after it’s pulled, they wonder why they waited so long.”

At first glance, this may not sound all that difficult, but how a company dictates as to who is authorized for what types of decisions can have a serious impact on the company’s ability to successfully execute its strategy, and thereby, have an impact on the bottom line.

Let us take an example of a US multinational corporation that shifted the final decision on the pricing of its services provided by its foreign subsidiaries to its US headquarters. The US headquarters believed that its US based executives would be more effective in making pricing decisions because they have a broader purview of the company’s needs. However, shifting the pricing decision to headquarters reduced the time it took for the company to respond back to the customer. Aware of this change, a European competitor was able to more quickly and more competitively bid on the customer’s services, thus winning new business as a result.

Unfortunately, this type of scenario is not all that uncommon, and therein lies the problem. How effective a company is at making decisions that are in line with its mission and objectives will determine its ability to compete in the marketplace. But, trying to understand where decisions need to be made that will maximize company performance can be an extraordinarily difficult and a controversial management task.

Consider the Costs

One of the difficulties in assigning decision rights is that any time you are assigning decision rights there is a cost that needs to be considered. For example, let us say you have delegated decision rights to those who have enough information to make a decision, but suppose their goals are not aligned with the goals of the company. In this case, the decision that is going to be made might not be congruent with the overall goals of the company.

You also need to consider the cost of making sure the relevant information is accurate and up to date when being transferred to the decision maker. Again, if the information is not the best, most accurate information, then it is highly probable that the most optimal decision is not going to be made.

Guidelines to assigning decision rights

To overcome the hurdles mentioned above, *Michael Jensen*, professor emeritus at Harvard Business School, suggested **four items** that should be considered when delegating decision rights. A summary of Michael’s suggestions is discussed below.

- (1) **Periodically review and update how decision rights are delegated.**

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Because the environment in which a company operates can continually change, it is important to review and update the process of how decision rights are assigned and delegated. This should be done on some periodic basis, whether annually, semiannually, or more often if necessary. During your review you should carefully examine where in the company are the various decisions being made, and whether these decision points are still effective.

Decision point means where the decision is being made. For example, going back to our earlier example, management should review whether the decision point should be made at the US executive level, or at the subsidiary level. The question should be asked, “Who’s in the best position to make the right decision?”

(2) **Balance between centralization and decentralization of decisions rights.**

We saw in our example of what can possibly happen if management tries to have too much centralization of decision-making. In this particular example, because of the time delay in making a pricing decision, the competition was able to take advantage of the situation and win over clients. This did not seem to be the result management was looking for. As a manager, you may feel that “you can make the better call,” but then again, it goes back to making sure you have the relevant information necessary to make the call.

Here you have to make sure that the information flows up as well as flows down. Also, you need to make sure you don’t bring too many people into the decision-making process. This happens too often in companies, and sometimes it seems that the whole process can come to grinding halt. You just need to make sure to involve only those who need to be involved in making the right decision.

(3) **Assign decision rights explicitly.**

When decision rights are given, they have to be done in a manner where there is absolutely no question about who has the *authority* and *responsibility* to make a decision. It is not uncommon for managers not to properly inform those to whom they gave decision authority. This type of situation can cause confusion and can lead to conflict.

(4) **Do not confuse the end results with the assignment of decision rights.**

In our earlier example, we saw a problem that can result from having too much centralization of decision rights. But it is always good to remember that sometimes “good decisions produce bad results.” Managers sometimes are too quick to blame the decision makers when results are not as expected. You just need to remember that if the decision rights are well assigned then reassigning them could possibly make the results even worse.

In the assigning of decision rights, always keep in mind that reallocating decision rights is not an easy task and can sometimes lead to controversy. But, as controversial as this can sometimes be, it is one that companies must continually be engaged in to maintain whatever competitive advantage the company has.

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Principle 5: Management's philosophy and operating style

Every business and every manager have a different philosophy and operating style. No-one type of philosophy, and no-one type of style fits every company every time. For this principle, you simply want to have an idea as to how management feels about controls over financial reporting.

“Effective controls are only as effective as management wants them to be effective.”

Guidelines for enhancing management's control over financial reporting

If management is responsible for running the company than controls are more likely to function well if **management believes that controls are important and communicates that support to employees at all levels**. However, if management believes controls are meaningless or even an obstacle, employees will notice this attitude. Even if there are formal policies which say otherwise, employees will still view internal controls as “red tape” to be “cut through” to get the job done.

The effectiveness of any organization's control system has to be a **'top-down'** endeavor, which means management's philosophy and operating style can and does impact the effectiveness of the company's control process. Management has to emphasize the importance of control over financial reporting.

The following are suggestions for evaluating management's commitment to *high-quality* and *transparent* financial reporting process.

- (1) **Evaluate management's general philosophy and operating style** and make sure it is congruent with stated policies over financial reporting.
- (2) **Verify that management holds formal meetings with staff** (those involved with financial reporting) to discuss policies and procedures over financial reporting.
- (3) **Verify that management does review its accounting principles on a regular basis** and, in particular, reviews its accounting estimates.
- (4) Finally, **if deficiencies** are noted, **verify that action is taken a timely manner** to correct the deficiencies.

Principle 6: Board & audit committee oversight

The board with the assistance of the audit committee provides oversight of the financial reporting processes and internal controls.

“How important is having board and audit committee oversight? Think of what happened to Enron, WorldCom, or AIG and you have your answer.”

It is stipulated that public companies are required to have an active audit committee that assists the board in fulfilling its oversight responsibilities. It was through passage of the **Sarbanes-Oxley Act of 2002 (SOX)** that the role of the audit committee became much more important.

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Before passage, the audit committee was often thought of as nothing more than a '**Boy's Club**' where committee members would meet at the country club, play a round of golf and, maybe, if time permitted, talk a bit of audit committee business. In other words, the functions of the audit committee were not taken seriously. However, the implementation of SOX changed all that.

However, even if your company is not listed, it is still considered **best corporate governance practice** for companies (assuming they have multiple shareholders) to have an audit committee.

Guidelines for strengthening the Audit Committee's oversight function

Because of management's ability to override internal controls the audit committee now plays a very crucial role in ensuring the effectiveness of controls over financial reporting. Based on this, the following **four guidelines** can be used to ensure the audit committee is fulfilling its oversight responsibilities.

(1) **Verify the independence of the audit committee members.**

At **least one member needs to be a financial expert**, and committee members must be made up of **independent outside directors**. Independent outside directors haven't worked with the company for a period of time (typically for at least one year). As an example, a recently retired CFO should not become a committee member.

(2) **Make sure the audit committee meets on a regular basis.**

It is generally recommended that audit committees meet at least quarterly, or more often if warranted. To ensure adequate topic coverage, the committee should develop a schedule of topics that needs to be reviewed and discussed during the coming fiscal year. The schedule can help the board, through the audit committee provide oversight of internal control and helps management anticipate and plan for audit committee expectations.

(3) **Review the committee's responsibilities over financial reporting.**

The following are specific recommended responsibilities over financial reporting.

- Review significant accounting and reporting issues, including complex or unusual transactions and highly judgmental areas, and recent professional and regulatory pronouncements, and understand their impact on the financial statements.
- Review with management and the external auditors the results of the audit, including any difficulties encountered.
- Review the annual financial statements, and consider whether they are *complete*, *consistent* with information known to committee members, and reflect appropriate accounting principles.
- Review other sections of the annual report and related regulatory filings before release and consider the accuracy and completeness of the information.
- Review with management and the external auditors all matters required to be communicated to the committee under generally accepted auditing *Standards*.
- Understand how management develops interim financial information and the nature and extent of internal and external auditor involvement.
- Review interim financial reports with management and the external auditors before filing with regulators and consider whether they are complete and consistent with the information known to committee members.

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(4) Review the committee's responsibilities over internal control and risk management.

The following are specific recommended responsibilities over internal control and risk management.

- Consider the total effectiveness of the company's internal control system, including information system's security and control.
- Consider the effectiveness of the company's risk management process, particularly over financial reporting.
- Understand the scope of internal and external auditors' review of ICFR, and obtain reports on significant findings and recommendations, together with management's responses.

A sample schedule of audit committee functions is given below.

Sample Schedule of Audit Committee Functions

SAMPLE AUDIT COMMITTEE SCHEDULE							
	Frequency			Planned Meeting			
	A	E	AN	Quarter			
				1	2	3	4
<i>Audit Committee issues</i>							
Review audit committee's charter to make sure it is up-to-date.	√			√			
Review the organization's code of conduct	√				√		
Make sure committee members have the skills and experience to fulfill their responsibilities.			√				
Establish the number of meetings for the coming year.	√			√			
The audit committee Chairman has to establish the agenda and attendees required.		√		√	√	√	√
Make sure committee members are financially literate – up on current issues.		√		√	√	√	√
<i>Assessing Financial Information</i>							
Annual report, Security exchange reports, and Proxy Statement matters.	√			√			
Quarterly reports, Earnings review with external auditor and management.		√		√	√	√	√
Assessment of internal environment and systems of internal control.	√			√			
Status of significant accounting estimates and judgments (e.g., reserves) and special issues (e.g., major transactions, accounting changes, etc.).			√				
<i>External Auditors</i>							
Recommend appointment and review performance of the external auditor.	√			√			
Approve the external auditor's compensation fee and terms of engagement.	√			√			
Review audit plan and scope of audit work.	√			√			
Consider policy in relation to non-audit services.	√			√			
Review external audit findings.	√				√		
Discuss auditor's views on control environment including fraud risk management.			√				
Discuss with auditor in absence of executives and management.			√				
Ongoing communication (written/oral) of external auditor with audit committee.			√				
<i>Internal Auditor / Risk Management</i>							
Scope of internal auditing plan for upcoming year.	√						√

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Coordination with external auditors / outsourcing work of the internal auditor.			√				
Review whistleblowing arrangements.		√		√	√	√	√
Summary of significant audit findings and status update relative to annual plan.		√		√	√	√	√
Executive session with internal audit risk assessment.			√				
<i>Other responsibilities</i>							
Review legal and compliance developments.			√	√	√	√	√
Report to shareholders on the role and responsibilities of the committee.	√						√
Perform self-assessment of committee performance.	√			√			
Conduct special investigations and perform other activities as appropriate.			√				
A = Annually; E = Each meeting or Conference Call; AN = As necessary							

Principle 7: Organizational structure over financial reporting

Having the right organizational structure is the last of the control environment principles. However, being last is not an indication of its importance.

It is through having the right organizational structure that there can be, in fact, effective control over financial reporting.

“Having the right organizational structure simply means you can carry out your duties with some sense purpose.”

Guidelines to achieving the right organizational structure over financial reporting

There are **four guidelines** to making sure your company has the right organizational structure.

- (1) Define the key areas of **authority and responsibility** within the financial reporting process and delineate reporting lines. It is through this that management is able to plan, direct, execute, control, and monitor the effectiveness of internal controls over financial reporting.
- (2) A company’s organizational structure should be **whatever suits its needs**. It may be centralized or decentralized. It may have direct reporting relationships or reporting may be more like a matrix (reporting to more than one supervisor, e.g., consulting and audit firms). It may be organized by industry, product line, geographical location or distribution network, or it may be organized functionally.
- (3) **Delegate decision rights** to the extent necessary to achieve the organization’s objectives.
- (4) The control environment is influenced by the fact that all individuals in the organization realize that they will be held **accountable**.

However, you need to keep in mind that a company’s organizational structure is not “**set in stone**,” and so therefore, needs to be flexible enough to adjust to changing circumstances.

Illustration: Let us say you work for a medium-sized company and the overall organizational structure, including financial reporting, is fairly simple and straight forward. As a result, there are no specific external financial reporting requirements beyond reporting to board members and potential investors. Financial reports are pretty much whatever the company wants them to be. However, because the company grew rapidly and required additional external financing to increase production capabilities, the company conducted an IPO (Initial Public Offering) on the London Stock Exchange. This led to company’s financial reporting structure becoming more stringent due to the additional financial reporting requirements.

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The company is now required to report to the Financial Services Authority (UK financial reporting regulatory agency), which oversees the financial reporting of all UK publicly traded companies. Based on this, the accounting and financial reporting departments had to hire additional people to take care of the added financial reporting requirements, such as mandatory interim and annual reporting.

Besides the financial reporting requirements, the company also has to report on whether it is in accordance with UK's corporate governance code. Before going public it was common practice for the employees to spend time with the CEO (open door policy) and other senior executives, like the CFO, or COO. However, after going public, the company had to develop more formal job descriptions, so each person understood his or her responsibility within the company's financial reporting and corporate governance processes. Documentation of the major transaction cycles had to be established to highlight the key controls in the financial reporting process and each person's responsibility in the process. Therefore, the financial reporting process became much more formal and centralized. Along with this, the CEO and other senior executives' positions became much more demanding, leading to a change in the open-door policy. Thus, after this, if someone in the company needed to talk with the CEO or possibly the CFO, he/she had to make an appointment with the secretary.

When reviewing organizational structure, you need to be conscious and alert for structures that are complex and difficult to understand. Statistically speaking, fraud occurs more frequently in companies that have more complex structures. Having an unintentionally complex and difficult to understand structure certainly does not indicate wrongdoing, but it does make it easier for fraud to be committed and concealed. It is not unknown for structures to be intentionally complex to facilitate fraud. Enron is a good example of this where it used hundreds of special purpose entities to hide its corporate debt. As we read earlier, Enron's structure was so convoluted that not even the supposed experts understood it.

Organizational structure in SMEs

What aspects of the control foundation are important for a company will depend on its size and structure. There are seven stated principles of the building a solid control foundation, however, if you work in a small organization, the organization is not likely to have a board of directors or have a complex organizational structure. Therefore, these two principles might not need reviewing.

On the following pages we provide a sample **Control Foundation Questionnaire Matrix** that can help you evaluate your company's control foundation.

Sample Control Foundation Questionnaire Matrix

1. Integrity and Ethical Values			
<i>The board and management must convey the message that integrity and ethical values cannot be compromised, and employees must receive and understand that message. Management must continually demonstrate, through words and actions, a commitment to high ethical standards.</i>	Yes/No/ NA	Person(s) Responsible	Control Testing Assessments & Observations
1.1 Do the board and management provide oversight regarding integrity and ethical values?			
1.2 Does the company have a formal code of conduct?			
1.3 Is there proper communication of ethical values concerning the reliability of financial reporting?			
1.4 Is there an established whistleblowing program?			
1.5 Are violations of the Code of Conduct documented?			
1.6 Is there a compliance program for the Code of Conduct?			
1.7 Are there penalties or disciplinary actions for violation of the formal codes of conduct?			

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2. Commitment to Financial Reporting Competence	Yes/No/ NA	Person(s) Responsible	Control Testing Assessments & Observations
<i>Management must specify the level of competence for particular jobs (for example, over financial reporting) and translate the desired levels of competence into requisite knowledge and skill.</i>			
2.1 Have the employee competencies that support reliable financial report been identified?			
2.2 Are there formal job descriptions for each employee who is involved in the financial reporting process?			
2.3 Do employees have the necessary knowledge and skills to perform their jobs?			
3. Human Resource Policies and Procedures	Yes/No/ NA	Person(s) Responsible	Control Testing Assessments & Observations
<i>The company's human resource policies and procedures should have a positive influence on the company's ability to maintain effective controls over financial reporting. When considering the effect of personnel policies and procedures on financial reporting, the company should identify accounts or transaction cycles that may be specifically affected by personnel issues, such as high turnover of staff in the finance and accounting departments.</i>			
3.1 Does human resource have the policies and procedures in place to ensure key positions over financial reporting meet education and experience requirements?			
3.2 Are there regular performance evaluations for key financial reporting positions?			
3.3 Do employees have access to tools and training needed to perform their financial reporting roles?			
3.4 Is there an establish compensation program that supports the achievement of financial reporting objectives?			
4. Assigning Decision-Rights	Yes/No/ NA	Person(s) Responsible	Control Testing Assessments & Observations
<i>Decision rights should be assigned to those individuals who have the greatest chance of accomplishing management's objectives, for example, reliable, accurate and timely financial report.</i>			
4.1 Are decision rights over financial reporting properly assigned by senior management?			
4.2 Does the assignment of decision rights include appropriate limitations, such as segregation of duties to minimize the risk of financial misstatements?			
4.3 Is there regular review of decision rights over financial reporting?			
5. Management's Philosophy and Operating Style	Yes/No/ NA	Person(s) Responsible	Control Testing Assessments & Observations
<i>Management's philosophy and operating style should emphasize high-quality and transparent internal and external financial reporting. Management has to emphasize the importance of controls over financial reporting.</i>			
5.1 Is management's general philosophy and operating style congruent with stated policies over financial reporting?			
5.2 Does management hold formal meetings with staff to discuss policies and procedures over financial reporting?			
5.3 Does management follow a disciplined approach in reviewing <i>accounting principles</i> and developing <i>accounting estimates</i> ?			
5.4 Are there exceptions to financial reporting policies?			
6. Board and Audit Committee Oversight	Yes/No/ NA	Person(s) Responsible	Control Testing Assessments & Observations

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An active and effective board or audit committee provides an important oversight function, and because of management's ability to override controls, the audit committee plays a crucial role in ensuring effective control over financial reporting.

6.1	Does the board and audit committee meet frequently enough to review important oversight responsibilities?			
6.2	Does the board, through the audit committee actively evaluate and monitor risks over financial reporting?			
6.3	Does the board provide proper oversight of the effectiveness of internal controls over financial reporting?			
6.4	Does the audit committee provide proper review over the release of financial and non-financial disclosures and notes?			
6.5	Does the audit committee meet on a regular basis with the company's internal auditor?			
6.6	Is the audit committee comprised of independent non-executive directors?			
6.7	Does the audit committee have at least one member who is a financial expert?			
6.8	Does the audit committee have the authority and responsibility to hire & fire and determine the compensation the external auditor?			
6.9	Does the audit committee provide effective oversight of the work of the external auditor?			

7. Organization Structure over financial reporting

A company's organizational structure provides the overall framework for planning, directing, and controlling operations. The organizational structure should be simple enough, so individuals understand their financial reporting responsibilities but not so simple that it does adequately monitor the financial reporting activities or is so complex that it inhibits the flow of information on financial reporting activities.

		Yes/No/ NA	Person(s) Responsible	Control Testing Assessments & Observations
7.1	Is there an updated organizational chart?			
7.2	Has management established internal reporting responsibilities for each area of the company that is consistent with the objective of achieving effective internal control over financial reporting?			
7.3	Does management's line of reporting provide objective verification of the information reported to the public?			

Chapter 3: Know Your Threats

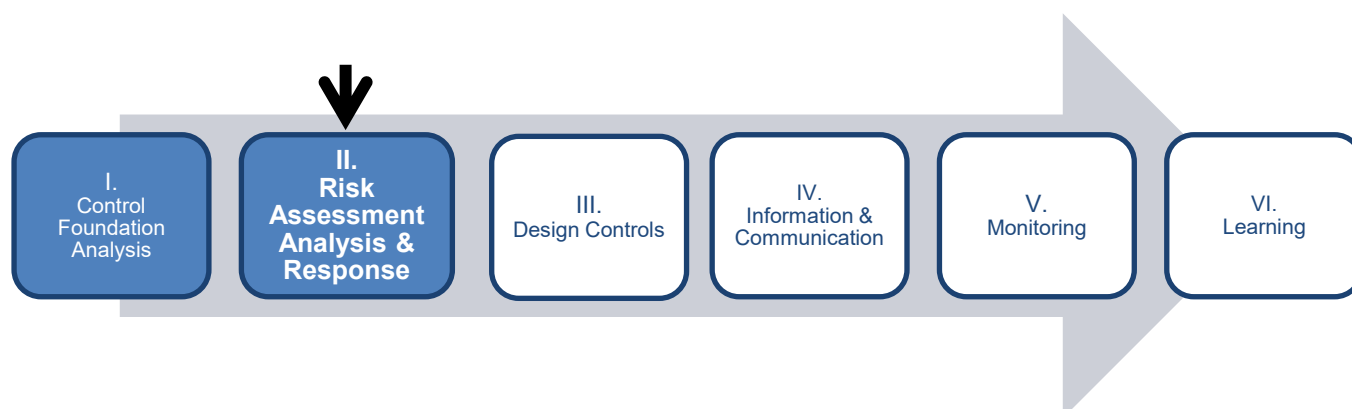
Continuing along the “6x20” pathway, we start the process of *identifying* and *analyzing* events which could possibly keep your company from achieving its financial reporting objectives.

Management is responsible to make sure financial information and reports are reliable, accurate and transparent. Based on this, it is important for management to know what threatens the company, identify its threats, risk areas, which are those areas that have a greater chance of being misstated. Identifying and analyzing risk is part of **risk assessment**. After conducting risk assessment, you then have to understand how to respond to the risks.

“You can’t mitigate your threats unless you see them coming”

II. Risk Assessment Analysis & Response

Our component on risk assessment is discussed in the next three chapters. Within these three chapters are **six principles**, of which three principles are reviewed in this chapter.



Principle 8: Determine financial reporting objectives

COSO summarizes **risk assessment** the following way:

*“Every entity faces a variety of risks from external and internal sources that must be assessed. **A precondition to risk assessment is establishment of objectives**, linked at different levels and internally consistent. Risk assessment is the identification and analysis of relevant risks to achievement of objectives, forming a basis for determining how the risks should be managed. Because economic, industry, regulatory and operating conditions will continue to change, mechanisms are needed to identify and deal with the special risks associated with change.”*

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Formality vs. Informality of the Risk Assessment Process

The formality of the risk assessment process to a great extent is going to depend on the size and complexity of the company. For the most part, smaller and less complex companies (SMEs) will have less formal risk assessment programs than larger corporations. However, this does not mean a SME's risk assessment program is any less effective. Actually, it might be quite the opposite. This is because in SMEs, senior managers, for example, the CEO, or CFO, will probably take a more active role in the assessment of risks. It is therefore possible that they will have a **"better understanding"** of the risks impacting their company. Compare this with large corporations, where the assessment of risk is most often left with lower-level managers. Senior management then has to rely on their judgment concerning risks, without maybe really understanding the risk themselves.

There are several levels at which risk assessment may occur. It may occur at the entity-level, at the process level, or at the transaction level. Financial reporting objectives, risks and controls can be analyzed at any level. When you are conducting risk assessment for financial reporting purposes you first need to consider the higher levels of objectives, risks and controls and then work down to the lower-level activities. This type of risk assessment is referred to as **Top-down Risk Assessment (TDRA)**.

Detailed guidance about performing TDRA is included in PCAOB (Public Company Accounting Oversight Board) *Auditing Standard No. 5*.

We mentioned that a *"precondition to risk assessment is the establishment of objectives"* therefore you need to establish your financial reporting objectives before you can start identifying and evaluating risks.

The Importance of knowing your financial reporting objectives

Establishing financial reporting objectives helps you set the **context** and **boundaries** by which you are able to identify the risks which could threaten the reliability of your company's financial information.

We suggest the following when **determining your financial reporting objectives**.

- 1) Make sure you are in accordance with an **accepted accounting principle**, such as US GAAP, IFRS (International Financial Reporting Standards), or some other national GAAP.
- 2) Make sure to define the **financial reporting objectives** for each activity within the accounts and disclosures.
- 3) Make sure to concentrate your efforts on those areas which are considered to be **material**. Something is considered to material if it causes you to change your opinion or decision.

We discuss each point in greater detail below.

1) Make sure you are in accordance with an accepted accounting principle (GAAP)

*"Management has the responsibility to provide stakeholders with financial statements that fairly present the company's financial position, results of operations and cash flows in accordance with a GAAP (General Accepted Accounting Principle)."*⁵

This does not mean that your financial statements have to be strictly in accordance with US GAAP. Your financial statements might be prepared in accordance with International Financial Reporting Standard (IFRS), or UK GAAP, or some other country's accounting principle. So, the critical issue is to **KNOW YOUR GAAP**.

5 Securities and Exchange Commission, 17 CFR Part 241, pg. 12.

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This can be a huge issue and costs for larger corporations because it might be possible that the corporation could have to prepare financial reports not only in IFRS, but also in US GAAP (if it is listed on the stock market in the U.S.) and, possibly, in a 3rd GAAP (home country's GAAP).

In today's world there is a push to get countries and organizations to converge to IFRS in the coming years. The push to IFRS is driven by a lot of different factors, including the issues of comparability and the benefit of having enhanced access to global capital markets.

Note: If your company is planning to, or in the process of transitioning to IFRS then we recommend referring to **IFRS Standard 1: First time Adoption of International Financial Reporting Standards**. An important issue to keep in mind when transitioning to IFRS is the verification of the accounting balances under the previous GAAP. If those balances are materially misstated then the IFRS balances going forward will be materially misstated as well.

Relevance for SMEs

If your company is a smaller private company you could try to argue that being in compliance with a GAAP is not that necessary since the only external financial reporting the company is required to do is for the tax authorities, and generally tax authorities only care about making sure the organization pays its fair share of taxes. The tax authorities in most countries do not care whether an organization uses the cash basis of accounting or accrual basis, as long as the organization pays its taxes. However, there are some countries, like the former Soviet Union countries, including Russia and the Ukraine, where registered companies are required to submit complete local GAAP-based financial statements (income statement, balance sheet and cash flow statement) to the tax authorities. Therefore, companies operating in these countries are mandated to be in compliance with their local GAAP.

2) Make sure to define the financial reporting objectives for each activity within the accounts and disclosures

Management presents financial statements to **external auditors**, so they are able to give an opinion as to whether the financial statements are fairly stated. This is the primary job of the external auditor. When management does this, they are making **claims** or **assertions** about the financial accounting balances.

Management is saying the presented financial statements are free of material misstatements, whether caused by errors or fraud. The external auditor then has to verify management's claim or assertions about the financial accounting balances.

Financial reporting assertions are generally classified into **five board categories** listed below:

1) Existence or occurrence

This means that all balance sheet items that are recorded exist and that all income statement items occurred during the period. In a sense this is the opposite of completeness. Completeness is making sure that everything that is supposed to be included is included while existence or occurrence is related to making sure that everything that is included is supposed to be included.

2) Completeness

This means that everything that is supposed to be in the financial statements is actually in the financial statements. Here, you need to make sure no transactions are missing.

3) Rights and obligations

This means that everything that is reported as an asset represents something that the company has a right to, and everything reported as a liability represents an obligation of the company.

4) Valuation or allocation

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This means that items in the financial statements are valued at the correct amount and that income statement amounts have been allocated to the proper period. For **example**, are the accounts receivables really collectable?

5) **Presentation and disclosure**

This means that the financial statements are correctly presented in accordance with a specified accounting principle (e.g., US GAAP or IFRS). This also means that relevant financial information not reported in the financial statements is disclosed in the notes.

When management assesses its ICFR, they (management) are essentially doing what the external auditors do except they will be assessing themselves. Management has to know how well its controls are working that they **designed** and **implemented**.

To accomplish its self-assessment, *“management identifies the risks to reliable financial reporting, evaluate whether controls exist to address those risks, and evaluate evidence about the operation of the controls included in the evaluation based on its assessment of risks.”*⁶

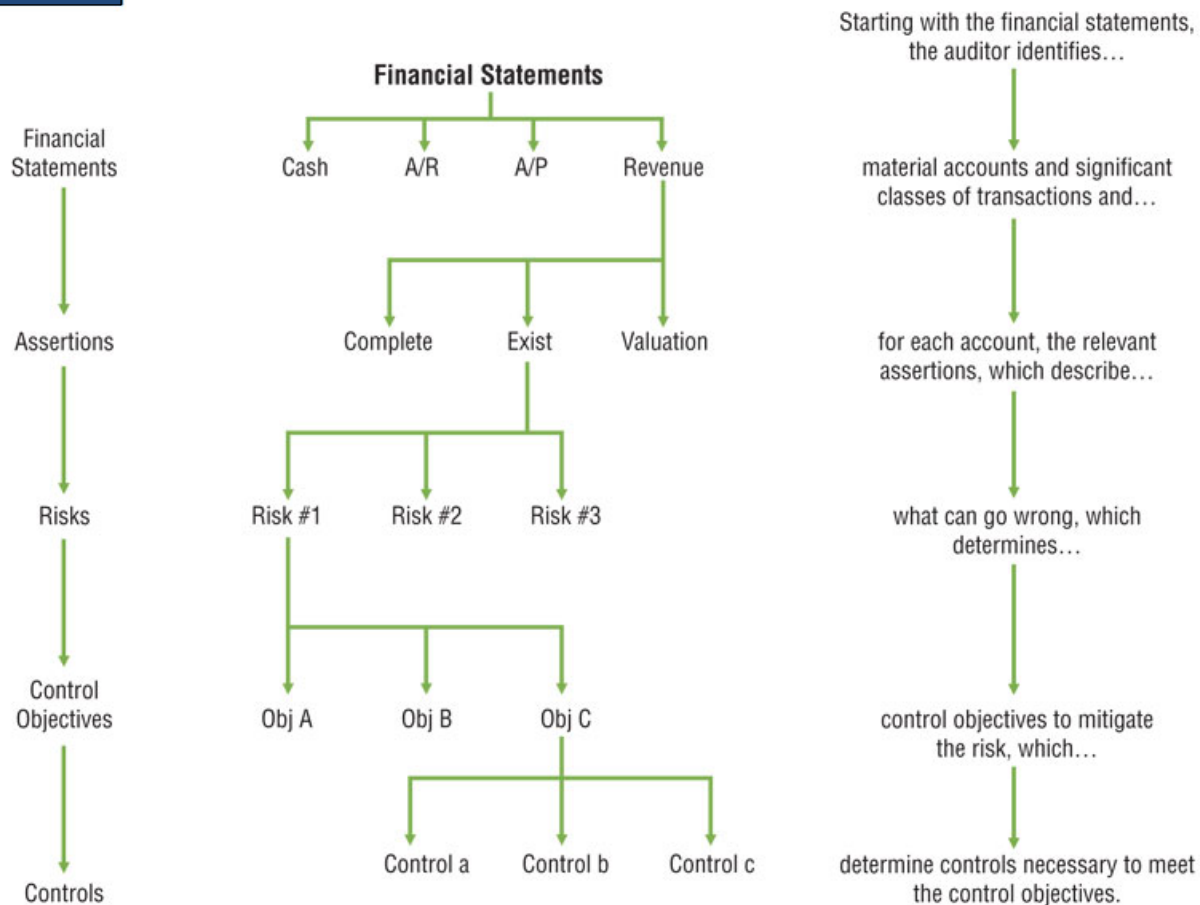
The evaluation of risks and controls will most certainly vary from company to company; however, we believe the most effective and efficient way to conduct this evaluation is through conducting a TDRA, as diagramed below in **Exhibit 3.1**.

6 Securities and Exchange Commission, 17 CFR Part 241, pg. 9.

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Exhibit 3.1

The TDRA Process



Source: Journal of Accountancy

We can see that using TDRA the ultimate aim of the process is to identify those items that potentially **threaten** the reliability of your financial reports and then design controls to mitigate the threats.

Before moving on to the TDRA process, we want to review the types of general financial reporting control objectives that are found when testing ICFR. When testing internal controls related to any part of the financial statements you need to make sure these general controls objectives have been achieved. Once you understand these general objectives you are in a better position to develop more specific objectives for each account balance under review.

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Financial Reporting Control Objectives

There are **nine general financial reporting control objectives** which management needs to assess. In the table below, as an exercise, we show how assertions relate to management's control objectives.

	Management Assertions	Financial Reporting Control Objectives
1.	Existence or Occurrence	Validity
2.	Existence or Occurrence	Authorization
3.	Valuation or Allocation	Cutoff
4.	Completeness	Completeness
5.	Valuation or Allocation	Valuation
6.	Rights and Obligations	Ownership
7.	Presentation and Disclosures	Classification
8.	Presentation and Disclosures	Disclosures
9.	Valuation or Allocation	Accuracy

Occasionally, we will refer back to these general objectives when working our way through the TDRA process. You may wish to mark this page for future reference.

(1) Validity

The objective here is to make sure that all transactions are valid. To be valid means to record only actual transactions. An example of a valid control would be to match the items on a sales order to a shipping document by a person independent of the shipping function.

A good real-life story of where there was a lack of validity controls is the story of **Barry Minkow and ZZZZ Best**. We discuss this case study on the next page.

Case Study of the lack of Validity Controls: The Barry Minkow & ZZZZ Best Story

The case study surrounding the fraud committed by *Barry Minkow* is still considered the premier case study that illustrates the lack of validity controls.

The story of *Barry* starts in the fall of 1982 when *Barry* organized ZZZZ Best as a small, door-to-door carpet cleaning operation. At the time, *Barry* was sixteen years old. *Barry*, initially operating out of his parent's garage, saw explosive growth in both revenue and profit during the first several years of business. In the period from 1984 to 1987 the company saw its net income surge from less than \$200,000 to more than \$5 million on revenues of \$50 million.

Due to the explosive growth in the company, ZZZZ Best went public in 1986. By the spring of 1987, the company's capitalization was over \$100 million. At the time, *Barry* was the youngest CEO of any public company in the nation. *Barry* seemed to have it all – an elaborate home in an exclusive suburb of Los Angeles and a Ferrari. Because of *Barry*'s charm and charisma, he became very sought-after on the television and talk show circuit. As an example, *Barry* appeared on *The Oprah Winfrey Show* in April of 1987. During the show, *Barry* "exhorted his peers with evangelistic zeal to "think big, be big" and encouraged the audience to adopt his personal motto, "The sky is the limit." Less than two years after his appearance on *The Oprah Winfrey Show*, *Barry* started to serve a 25-year prison sentence. *Barry* was tried and convicted on 57 counts of securities fraud and fined \$26 million, having bilked his closest friends and Wall Street out of millions of dollars.

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What were the causes of Barry's meteoric plunge? As Bernie Madoff had scammed investors using a Ponzi scheme, so had Barry, however, Barry did it much earlier than Madoff.

As we mentioned earlier, Barry was 16 years old and was working out of his parent's garage. Because of his age, he found the going tough, having the banks close his accounts due to California state laws barring minors from signing binding contracts and checks. He also found it difficult to cover even his most basic expenses, such as payroll and vendors. To get around this inconvenience, Barry started to obtain usurious loans from area investors (some claimed these investors had ties to the Mafia), and also resorted to check kiting, credit card forgeries, and the staging of thefts to fleece his insurance company.

However, given his young age, he was able to escape relatively unscathed from brushes with the law. The ease at which Barry could get around the system allowed him to even exploit it more on a broader scale. Early on, Barry realized the importance of developing social networking. It was through networking that Barry met Tom Padgett, an insurance claims adjuster that Barry promised \$100 per week to simply confirm to banks and other 3rd parties that Barry's company was the recipient of insurance restoration contracts. Due to his gullibility, Tom believed that the sole purpose of the confirmations was to circumvent bureaucratic red tape in the insurance industry. Barry's insurance restoration business was totally fictitious. The scheme was used to convince investors that the company was generating huge profits and revenues. After a while, the insurance restoration business, rather than carpet cleaning became the largest revenue generator for ZZZZ Best. Barry, using his charm and charisma used the company's phony financial statements to lure "wealthy" unsuspecting individuals to invest in his company.

Eventually, Barry came to realize that taking ZZZZ Best public would propel him to even greater height and give him a way to go completely legit. ZZZZ Best officially went public in January 1986. However, going public also meant that ZZZZ Best was required to have external auditors and others go over the company's financial statements. To get past the first audit, the company had to confirm the existence of the company's major insurance restoration contracts. ZZZZ Best got around this by having the auditor contact Tom Padgett, who was the principal officer of Interstate Appraisal Services, which reportedly contracted the insurance restoration jobs out to ZZZZ Best. Tom was very much involved in the fraud scheme by this time. Barry established Interstate Appraisal Services and another company, Assured Property Management, for the sole purpose of generating fake insurance restoration contracts for ZZZZ Best. Unfortunately for Barry, a scheme like this can only last for so long before someone catches on.

The downfall of ZZZZ Best

By February 1987, ZZZZ Best stock was worth \$18 per share on the NASDAQ, which put the company's capitalization at over \$280 million. Barry's stake in the company alone was over \$100 million. The company itself had 1,400 employees with offices across California, Arizona and Nevada. However, because of the fictitious insurance restoration business, the company was stilling facing severe cash shortfalls from having to pay investors for the non-existent restoration jobs. To get the needed cash infusion, Barry had heard that the KeyServ, the authorized carpet cleaner for Sears was up for sale. Even though the company was twice the size of ZZZZ Best, the two companies agreed to a \$25 million merger in which ZZZZ Best would be the surviving company. The merger would have made Barry the president and Chairman of the board, and it would fulfill Barry's dream of having the largest carpet cleaning business in the nation.

However, as quickly as ZZZZ Best rose, it fell even more quickly. The *Los Angeles Times* published an article revealing that Barry was responsible for running up \$72,000 in fake credit card charges in 1984-85. The revelation caused a broker to short the stock, causing the stock to go down. Very quickly after release of the story, the company's banks either called on their loans or threatened to do so. In addition, Drexel Burnham Lambert, the firm charged with financing the merger, postponed the closing until it could investigate the matter further.

In order to calm banks and Drexel, Barry issued a press release the next day touting the company's record profits and revenues but did so without notifying the auditing company Ernst & Whinney (now called Ernst and Young), which was responsible for auditing the company prior to the KeyServ deal. The release also indicated that Drexel had cleared Barry of any wrongdoing. Given the news, the stock quickly rebounded, but the rebound was very short-lived after it was revealed that Drexel pulled out of the KeyServ deal.

At about the same time of the news release, Ernst & Whinney had received an anonymous tip that the one of the clients of the audit firm was involved in massive fraud. The informant was asking for \$25,000 from Ernst & Whinney for the tip, but Ernst & Whinney refused to pay. The informant later recanted the story shortly thereafter, but not before the fraud at ZZZZ Best was discovered. Ernst & Whinney approached Barry and the board and questioned them about the matter, but they denied all allegations involving ZZZZ Best. It was later discovered that individual who recanted was a former associate who knew of the fraud, and it was Barry who paid him for the recant. Ernst & Whinney discovered the cancelled checks used to pay the bribe. Ernst & Whinney resigned as ZZZZ Best's auditor, but the firm did not inform the SEC of its suspicions until a month after the firm resigned.

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At this same time, investigative journalists were researching the company and found that most of the insurance restoration contracts did not exist. Another *Times* story caused the FBI to start its own investigation looking into ties with the Mafia and white separatist movements. The final straw that caused the company's collapse was when an independent law firm hired by ZZZZ Best to investigate the allegations of wrongdoing asked for the addresses to the company's restoration jobs. Barry knowing that he could not possibly produce the addresses resigned from the company, citing "health reasons." Three days after Barry's resignation, the company's new management filed suit against Barry and several colleagues for misappropriating \$23 million of company funds. Because of the embezzlement, the company was forced to file bankruptcy.

A week after the company filed for bankruptcy, the Los Angeles police raided Barry's home and ZZZZ Best offices and uncovered evidence that ZZZZ Best was being used to launder money from the sale of narcotics. The police believed that the non-existent restoration contracts were being used for money laundering in order to inflate ZZZZ Best's stock.

Epilogue

Barry Minkow and eleven others were convicted in Los Angeles court on 54 counts of racketeering, securities fraud, embezzlement, mail fraud, tax evasion and bank fraud. In addition, Barry was accused of setting up dummy companies, writing phony invoices and conducting tours of purported sites. These three counts were added to a superseding indictment. Barry was sentenced to 25 years in prison. He was also placed on 5 years of probation and ordered to repay \$26 million in restitution.

Barry served just less than 7½ years of his 25-year sentence. He got a reduction for "good behavior." During his prison time, Barry became a Christian minister. He also earned a Bachelor of Arts and Master of Arts degrees from Liberty University. Released in 1996, Barry is currently the senior pastor of a large nondenominational church in San Diego.

Besides his pastoral duties, Barry lectures across the United States on how to prevent and detect financial fraud. Barry also holds an executive position at the Fraud Discovery Institute (FDI) in San Diego, which he helped found. FDI was founded to investigate fraud.

Source: Adapted from *Contemporary Auditing: Issues & cases* – Michael Knapp

Lessons Learned – Know what red flags are.

The following are 10 red flags that the auditor's failed to see.

- 1) The amounts called for by the insurance restoration contracts were excessively large.
 - 2) The number of multimillion-dollar insurance restoration contracts reportedly obtained by ZZZZ Best exceeded the total number available nationwide during the relevant time period.
 - 3) The purported contracts failed to identify the insured, the insurance companies, or the location of the restoration jobs.
 - 4) The contracts consisted of a single page, which failed to contain details and specifications of the work to be done, such as a square yardage of carpet to be replaced, which were usual and customary in the restoration business.
-
- 5) Virtually all of the insurance restoration contracts were with the same party.
 - 6) A large portion of the insurance restoration contracts occurred immediately, and opportunistically, prior to the planned offering of stock.
 - 7) The purported contracts provided for payments to ZZZZ Best or Barry alone rather than to the insured or jointly with ZZZZ Best and the insured, contrary to the practice of the industry.
 - 8) The purported contracts provided for payments by the insurance adjustor, contrary to normal practice in the industry under which payments are customarily made by the insurance company directly to its insured or jointly to its insured and the restorer.
 - 9) ZZZZ Best's purported gross profit margins for its restoration business were greatly above the normal profit margins for the restoration industry.
 - 10) The internal controls at ZZZZ Best were grossly inadequate.

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(2) Authorization

Achieving this objective means that all transactions should be properly authorized before they are carried out. Without proper authorization, the entire financial reporting system is at risk. As an example, without proper authorization controls it would be possible for an employee to extend credit to a customer who did not meet the company's credit requirements. Based on this, there is a higher risk that the credit will not be repaid, causing bad debt for the company.

A real-life example of where there was a lack of proper authorization is the story of **Jérôme Kerviel** and the French bank, **Société Générale**. Société Générale started to rack up huge losses at the beginning of 2008. The bank's losses were caused by a rogue trader, **Jérôme Kerviel**. The bank accused **Jérôme** of making unauthorized transactions.

Case Study of a Rogue Trader: The Story of Jérôme Kerviel

The trading losses experienced by Société Générale are valued at €4.9 billion. Société Générale claims these losses were the result of a rogue trader named **Jérôme Kerviel**. Société Générale claims that **Jérôme** was working the trades alone and without authorization, although many believe that it would have impossible for **Kerviel** to have done what he did acting alone. From his statements to investigators, **Jérôme** claims that what he did was normal practice and widespread and that "getting profit makes the hierarchy turn a blind eye." Until the discovery of fraud perpetrated by **Bernard Madoff**, it was considered the largest fraud in banking history.

The Fraud allegations

The bank states that **Jérôme** was assigned to arbitrage discrepancies between equity derivatives and cash equity prices and started to create fictitious trades in late 2006 and early 2007, but his trades were relatively small. But, after that the size and frequency of the fake trading increased.

Based on the information from bank officials, **Jérôme** had been profitably trading in anticipation of falling market prices; however, bank officials have accused **Jérôme** of exceeding his authority to engage in unauthorized trades totaling as much as €49.9 billion, a figure far higher than the bank's total market capitalization. Bank officials claim that **Jérôme** tried to conceal the activity by creating losing trades intentionally so as to offset his early gains. According to the BBC, **Jérôme** generated €1.4 billion in hidden profits at the beginning of 2008.

The bank claims **Jérôme** "had taken massive fraudulent directional position in 2007 and 2008 far beyond his limited authority and that the trades involved European stock index futures. Though, the bank authorities say **Jérôme** apparently worked alone, skeptics question how authorized trading of this magnitude could go unnoticed. **Jérôme**'s unassuming background and position have heightened the skepticism that he worked alone. Some analysts suggest that unauthorized trading of this scale may have gone unnoticed initially due to the high volume in low-risk trades normally conducted by his department. Bank officials go on to say that whenever the fake trades were questioned, **Jérôme** would describe them as a mistake and then cancel the trade, after which he would replace the cancelled trades with other transactions using different instruments to avoid detection.

Jérôme's lawyers, **Elisabeth Meyer** and **Christian Charrière-Bournazel**, said that the bank managers "brought the loss on themselves" accusing the bank's management of wanting to "raise a smokescreen to divert public attention from far more substantial losses in the last few months." The lawyers claim that **Jérôme** made the bank a profit of €2 billion as of December 31, 2007.

Jérôme is not thought to have profited personally from the suspicious trades. **Jérôme** told prosecutors that his actions were also practiced by other traders in the company. **Jérôme** admitted to exceeding his credit limits but claims he was working to increase profits.

Legal repercussions

Jérôme was formally charged on January 28, 2008, with abuse of confidence and illegal access to computers. **Jérôme**'s trial began on June 8, 2010. On October 5, 2010, **Jérôme** was found guilty and sentenced to five years of prison, with two years suspended, full restitution of the \$6.7 billion which was lost, and a permanent ban from working in financial services.

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Lessons Learned of Société Générale

This is a perfect example of what can happen when authorization controls **aren't working**. Was the bank was telling *Jérôme* that he should do whatever is necessary to produce profits? It seems this way even though this might not have been the case at all. The perception on the part of the traders seems to indicate that senior management was aware of what was going on and they simply turned a blind eye to the fact.

(3) Cutoff

Cutoff means that all transactions of a period should be recorded in the proper period and not shifted to another period. Incomplete accounting and coincident cutoff errors include such things as:

- **Failure to record accruals** for expenses incurred but not yet paid, thus understating both expenses and liabilities.
- **Failure to record purchases** of materials not yet received and therefore, not included in the ending inventory, thus understating both inventory and accounts payable.
- **Failure to accrue unbilled revenue** through the fiscal year-end for customers on a cycle billing system and thus understating both revenue and accounts payable.

(4) Completeness

Completeness means that everything that is supposed to be in the financial statements is actually in the financial statements. Here, you need to make sure that no valid transactions are missing. For example, all expenses incurred during the period must be recorded and all amounts owed to vendors must be included in the accounts payable balance. Adequate controls would include the use the pre-numbered documents, to ensure that all transactions are captured by the accounting system.

Note: If evaluating **assets**, *completeness tends not to be an issue* since a company would want to include everything it can on the financial statements. However, if evaluating **liabilities**, then *completeness is an issue* since a company may not want to record all of its liabilities.

(5) Valuation

The objective here is to make sure that all items in the financial statements are valued at the correct amounts and that income statement amounts have been allocated to the proper period. Making sure that everything is properly valued is one of the bigger challenges for businesses. This is because in many cases the valuations are based on some subjective estimate, and unfortunately, estimates can be wrong.

As an **example**, if a business gives credit to customers the business should set up a reserve to take into account the possibility of bad debt. The reserve account might be based on a percentage of sales, or some other method; however, regardless of the method used, the amount is still an estimate, which could be manipulated.

A good example of a company that violated the valuation rule is *AIG*. *AIG* violated the rule through the use of what accountants' call "*mark-to-model*" valuation. We discuss this term and the term '*mark-to-market*' below.

As an **example** of *mark-to-model* valuation let us say *AIG* sold a five-year credit default swap (CDS) to a corporate client for say 2% of the face value. The size of the fee is going to be dependent on the *expected default rate* of the swap. Since the default rates on swaps are subjectively calculated, *AIG* was able to manipulate the models to reflect the lower perceived risk, thereby not setting up an adequate provision on the balance sheet to reflect the risk of the swaps. Since bonuses were paid based on profits, top managers had an incentive to report as high a profit as possible, hence, there was management bias. This type of accounting seems to be common throughout

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the financial services industry. Many consider this bias in accounting to be fraudulent since *AIG* never had the capital to back up the swaps in case of default, and profits were booked way before they were earned.

Note: *'Mark-to-market'* is simply where the value of a financial instrument is "marked" to the current "market" value of the instrument, hence the term, "mark-to-market." This "mark-to-market" is a simple exercise if the instrument is traded on an active market. For example, if an investor purchases 100 shares of stock for \$10 per share, and the price of the shares goes to \$15, the investor would book \$5 per share of gain. If the share price goes the opposite direction, then the investor would book a loss. Mark-to-market is relevant for SMEs because excessive cash generated by the SME might be invested in marketable securities.

However, if the instrument is not traded on an active market, the market price cannot be objectively determined. If this is the case, financial institutions could only *subjectively* calculate the instruments value through the use of sophisticated computer valuation models, such as Black-Sholes, binominal or other lattice models. Thus, the value of the instruments went from being "*mark-to-market*," to being "*mark-to-model*." This led to some companies manipulating the model to achieve some spurious valuations, as we saw in *AIG's* case.

The best detective control in place to make sure that assets are properly valued is through the **regular independent valuation** of assets. This can be done through the use of an actuary, or some other professional appraisal service.

(6) Ownership

Ownership has to do with whether assets are the rights of the company and whether liabilities are the obligations as of a given date.

For **example**, an account receivable balance should represent the amount that the company has a legal right to collect on. As an example, let us say that a company has entered into a finance lease for the use of a building. The amount that is capitalized in the balance sheet should represent the cost of the company's rights to the leased building and that the corresponding lease liability represents the obligation to a 3rd party.

(7) Classification

Classification makes certain that all transactions are properly recorded in the right accounts, credited to the right customer, et cetera. A good example of a company that committed fraud through misclassification is *WorldCom*.

We looked at the fraud committed by *WorldCom* under the section of Integrity and Ethics. One of the frauds committed by *WorldCom* was the capitalization of basic servicing fees. These fees should have been expensed off immediately; however, *WorldCom* capitalized them so they could be expensed off later. Capitalizing the costs improved the bottom line.

An effective detective control to catch these improper transactions would be an *independent review of all capitalized costs*.

(8) Disclosures

The disclosure objective is to make sure that all account balances and related disclosure requirements are properly presented along with the financial statements. To help you with the issue of disclosures we included more information about disclosures under the next principle. We also included a sample disclosure questionnaire to help you when reviewing disclosures. Remember, disclosures are important because they give the financial statements more *clarity* and *transparency*.

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(9) Accuracy

Accuracy has to do with making sure that the amounts and other data relating to recorded transactions and events have been recorded appropriately.

For **example**, individual accounts receivable amounts on a listing of accounts receivable should be the same as in the accounts receivable subsidiary ledger which should total the amount in the general ledger control account.

Develop Specific Reporting Objectives

We just briefly described the nine general financial reporting objectives. If you understand these nine general reporting objectives, then developing more specific reporting objectives is made easier.

The tables below show the difference between general reporting objectives and specific reporting objectives. For our examples, we use **accounts receivables** and **inventory** to highlight the differences. We use these two examples since receivables and inventory can be large amounts on a company's balance sheet.

Accounts Receivables	
General Reporting Objectives	Specific Reporting Objectives
Authorization	All credit sales are properly authorized.
Validity	All recorded trade receivables exist at the balance sheet date.
Cutoff	Substantiate the existence of recorded cash. Sales cutoff at year-end is proper.
Completeness	There are no unrecorded trade receivables.
Valuation	An allowance for doubtful debts has been provided for.
Ownership	Accounts receivables have not been sold or pledged as collateral.
Classification	All accounts on the list are expected to be collected within one-year.
Disclosures	Any agreement or condition that restricts the nature of the trade receivables is known and disclosed.
Accuracy	Accounts receivables that have become uncollectible have been written-off.

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Inventory	
General Reporting Objectives	Specific Reporting Objectives
Authorization	All inventory purchases are properly authorized.
Validity	All inventory items exist, including items in transit, in storage and out on consignment to others.
Cutoff	Purchases cutoff at year-end is proper.
Completeness	All existing inventory which is saleable has been counted and included on the balance sheet.
Valuation	All inventory items are properly valued on the financial statements, for example, stated at lower of cost or market (LCM). This means obsolete inventory has been written down or written off the balance sheet.
Ownership	The company has title to all inventories as of the cut-off date.
Classification	Inventory items are properly classified as finished goods, work-in-progress and raw material as of the cut-off date.
Disclosures	Method of inventory valuation has been disclosed (e.g., LIFO, FIFO, weighted average). Inventory items pledged or collateralized are properly disclosed.
Accuracy	Inventory items have been accurately recorded, either at historical cost or at LCM (discussed above).

3) Make sure to concentrate your efforts on areas that are considered material

What makes something material or not material? This is difficult question and one that professional accountants wrestle with every day. We mentioned one definition as the amount that would cause someone to change his or her decision. Materiality can be measured both quantitatively (an amount) and qualitatively (a characteristic) and is a matter of professional judgment.

An example of a characteristic would be a \$100 error that is the difference between a \$50 profit and a \$50 loss. Though the dollar amount itself is not material, the fact that it causes a change from a profit to loss makes this amount qualitatively material.

External auditors often use what is called the **5% rule**. The 5% rule simply says that “*reasonable investors would not be influenced in their investment decision by a fluctuation in net income of 5% or less. Nor would investors be swayed by a fluctuation of less than 5% in income statement line items, as long as the net change was less than 5%.*”

As a recommendation, when assessing financial statements make sure there is clear understanding among the accounting staff of what constitutes a material misstatement and what does not. This is particularly critical if your company has to report under Sarbanes-Oxley. However, this does not mean that if an error falls below the threshold level, it does not need to be reported or investigated. From the external auditor’s standpoint, an error below the materiality threshold would not change the auditor’s opinion on the fairness of the financial statements.

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However, from the internal auditor's standpoint, the control deficiency that led to the error still needs to be documented in order to enhance the company's control processes over financial reporting.

Because something is not material from a financial statement standpoint does not mean that it may not be an issue that requires further investigation from an operations standpoint.

Note: When considering materiality refer to **SEC Staff Accounting Bulletin (SAB) 99** and **Public Company Accounting Oversight Board (PCAOB) Auditing Standard № 2**.

Principle 9: Identify significant accounts & disclosures over the financial reporting process

Once the financial reporting objectives have been determined you start the TDRA process by identifying significant financial reporting elements within account balances and disclosures. The question now is *what constitutes a significant account?*

A **significant account** is defined as:

"An account or group of accounts that can contain errors that individually or collectively could have a material effect on the financial statements or even if they are not material could adversely affect the company's reputation or relationship with customers, shareholders or public."⁷

To determine whether an account is significant or not will be based on a series of risk factors that is related to the likelihood of financial statement error and magnitude (dollar value) of the account.

The following is a list of some possible **risk factors** which influence the significance of an account:

- **Impact of financial statements.** The financial statement account is assessed based on its relationship to total balances in the group, e.g., account balance to total revenue, or to total assets.
- **Complexity of the account.** The more complex the transactions are, the greater the chance that errors or mistakes could occur. For example, if a company has derivative transactions, then more care has to be taken to ensure the transactions are properly recorded in the financial statements.
- **Volume of transactions / activity in the account.** An account is generally considered to be higher risk the greater the volume of transactions processed through the financial statement account. With greater volume of transactions, you may have to resort to sampling, which means there is the risk that the sample might not be representative of the population.
- **Susceptibility of the account to manipulation or error.** Account balances need to be accessed based on the chance of the balance being manipulated by management or based on the chance of there being an error in the account. The difference between manipulation and error is that manipulation is done with intent, and errors are simply mistakes that are done without intent.

Example: There are many accounts which are based on estimates, such as bad debt, depreciation expense, warranty expense, and so on. Because an estimate is just that, it can be intentionally manipulated to improve the financial results. Also, there is the chance that the estimate could be wrong based on changes that were not known. In this case, there was no intent to misstate the financial results.

⁷ PCAOB Auditing Standard №5 definition.

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- **Changes to the organization affecting the account.** For **example**, if there have been changes in management structure this could be a risk factor because accounts could possibly be more easily manipulated.
- **Assessment of fraud.** When reviewing account balances, you always need to consider how fraud could be committed. We consider fraud to be such an important factor that it is presented as a separate principle.

Assess and Rank Risk Factors

We just reviewed a series of risk factors which need be considered when assessing the significance of an account balance. Added together these risk factors will determine the overall significance of an account balance, which will then be used to rank the riskiness of an account. Higher the perceived riskiness of an account, the more testing will be done on the account.

It is generally perceived that accounts with large balances are presumed to be significant, but you need to be careful about falling into this trap. This is why you need to consider all risk factors when considering the significance of an account balance, just not the monetary size of the account. You particularly want to look at **trends**. If a trend in any given account is getting worse then you need to test and investigate as to the reason behind the worsening situation.

The question then becomes how do you assess the risk factors? We mentioned a few possible risk factors above; however, the risk factors developed for your company will probably (and should) be different. The risk faced by your company will differ from the risk faced by your competitor, or some other company. You just need to remember that the risk factors you are analyzing need to be applicable to your company.

Professional accountants believe that “*at a minimum, risk rankings should be defined and documented based on the organization’s risk appetite.*”⁸ This is true only to the extent of understanding what your high and low risk areas are.

For example, let us say that an American company has some transactions that are denominated in a foreign currency, say Euros. Even though there is almost a 100% chance that there will be fluctuations in the currency causing differences between the initial recording and the final settlement amounts, the impact (currency gain or loss) on the organization’s financials will be insignificant unless there is a major currency devaluation.

On the other hand, the chance of your organization having a major fire or flood is probably very low but the impact of such a fire or some other catastrophe would probably be very significant. These are the two extreme examples, but they signify that when looking at risk you need to consider both **impact** and the **likelihood** (probability) of occurrence.

It is generally acceptable to rank risk based on whether it poses a **high, medium** or **low level** of risk to the company. How you determine the level of risk will depend on both **qualitative** and **quantitative measures**, such as the number of past deficiencies, the number of personnel involved in the transaction process, etc. The source from which you can get information in order to rank the risk of the account will probably come from several sources, including:

- Discussions with the process owners and other key personnel,
- Specific review of the account,
- Conduction of self-risk assessment by the process owners, or
- Meetings with key levels of management.

Based on this information, you should be able to rank the overall significance of the accounts (balance sheet/income statement). An easy way to accomplish this task is through completing the ‘**Significant Account Analysis Matrix**’ shown below.

8 Internal Auditor, August 2008 Edition, pg. 74.

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The sample matrix below shows the accounts based on **likelihood** and **impact**. In analyzing likelihood (probability), we included **complexity** of the account transactions, **volume**, and **susceptibility** of there being a **material mistake**. However, you may consider other risk factors which influence the likelihood of there being a material mistake.

Sample Significant Account Analysis Matrix

We first review the *balance sheet accounts* and then the *income statement accounts*.

Account Balances	Monetary value (\$)	% of total assets	Impact rating	Complexity	Volume	Susceptibility	Likelihood rating	Relevant Disclosures
				Likelihood				
BALANCE SHEET								
Current Assets								
Inventory								
Accounts Receivables								
Other current assets								
Cash and Cash Equivalentents								
Non-current Assets								
Property, Plant and Equipment								
Current Liabilities								
Short-term borrowings								
Accounts Payables								
Accrued Expenses								
Non-current Liabilities								
Long-term obligations								
Equity & Liabilities								
Share Capital and Additional Paid-in Capital								
Retained Earnings								

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Account Balances	Monetary value (\$)	% of Net Sales	Impact	Complexity	Volume	Susceptibility	Likelihood rating	Relevant Disclosures
				Likelihood				
INCOME STATEMENT								
Revenue								
Primary Sales								
Secondary Sales								
Cost of Sales								
Direct Material								
Direct Labor								
Other Direct Costs								
Overhead costs								
Selling and Marketing Expenses								
Selling expense								
Marketing expense								
General & Administrative Expenses								
Administrative salaries								
Communication expense								
Office support expenses								
Entertainment expenses								
Other Expenses								
Operating taxes								
Depreciation expense								
Interest Expenses								
Income Taxes								

Prioritize Account Balances

Once you have identified which accounts need to be assessed and tested you then need to prioritize the accounts, so you concentrate your efforts on the ones which have a higher probability of being materially misstated.

The matrices used above are a good place to start the process of prioritizing the account balances, but ultimately, it comes down to you using your best judgment about which accounts to test. The knowledge you have of the business and of its operations is a crucial factor for making the decision which accounts need testing because there may be situations in which you know a particular process so well that you decide to concentrate your efforts on other areas even though the matrix says it is a significant account. So, remember, when it comes to selecting what to test or not test, **'use your best judgment.'**

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The Adequacy of your Notes & Disclosures

Besides checking and testing the reliability of the financial accounts, you also need to make sure your **notes and disclosures** are *reliable, accurate and transparent* as well. The reliability of the notes and disclosures tends to be overlooked when assessing controls over financial reporting.

When reviewing your notes and disclosures you would want to ask yourself this question: *“Do these notes and disclosures explain everything I need to know about the company if I were the outside investor?”*

The audit company KPMG discussed the importance of disclosures in their publication *“Beyond the Numbers.”*⁹ Even though initially published in 2002, the concept and the idea of why disclosures are relevant still apply to today’s financial situation.

We highlighted the key points to the publication below.

Beyond the Numbers

Organizations are increasingly beginning asked to share their values as well as their value with their stakeholders. In this new dialogue, companies are expected to explain what they stand for, to communicate how they are responding to non-traditional business risks, and to demonstrate how their performance objectives are both linked with their financial goals and reflected in their overall performance. The leading companies are beginning to build stakeholder trust and simultaneously improve their business performance by measuring and reporting on both financial and non-financial indicators related to such issues as environmental management, worker relations, and social responsibility. In fact, they are creating a new type of competitive advantage by linking value and values, to position themselves as companies of choice among customers, employees, investors, suppliers, business partners, and local communities.

By linking “profits and principles,” leaders have recognized that, just as balances sheets may not reflect the full value of a company; financial indicators alone do not adequately communicate either their opportunities or their business risks. Indeed, leaders have found that financial indicators must be augmented by a variety of non-financial measurement techniques. By learning how to define, capture, and report on non-financial indicators as a part of performance measurement, organizations are finding new ways to safeguard their reputations, build trust among their stakeholders, and ultimately, improve their corporate performance. They are recognizing that failure in many non-financial areas can heavily damage the bottom line, perhaps irreparably. Indeed,

“...the new marketplace is proving that profits can best be maximized by embracing, rather than forswearing, social concerns. The idea that profitability and social awareness are not antagonistic but interdependent redefines the purpose of business.”

For this very reason, many companies are beginning to reconfirm or augment their current visions and redefine their management processes to link financial value with non-financial values.

Source: KPMG, “Beyond the Numbers: How leading organizations are linking values with value to gain competitive advantage.”

It is the notes and disclosures that fill in the blanks so there are **NO SURPRISES**, no unexpected lawsuits, no unexpected future obligation and so on.

As part of the review process to determine what needs to be disclosed and what does not, it is useful to set up a **disclosure checklist** so you can get full disclosure coverage. The checklist should be for both financial and non-financial notes and disclosures.

The **disclosure checklist** is used by both internal and external auditors when conducting financial statement engagements. A simple financial statement disclosure checklist for *inventories* is shown below.

9 2002 KPMG LLP: “Beyond the Numbers: How leading Organizations Link Values with Value to Gain Competitive Advantage.”

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Sample Financial and Non-financial Notes & Disclosures Matrix

Assessing Financial & Non-financial Notes & Disclosures			
The objective with this principle is to assess the adequacy of the company's financial and non-financial notes & disclosures.	Yes/No/NA	Person(s) Responsible	Control Testing Assessments & Observations
<p>1. Does the company have a disclosure committee? Or if not, who is responsible for disclosures?</p> <p>2. Are all key notes to the financial statement made known, for example accounting policies of the company, including:</p> <ul style="list-style-type: none"> • Method of accounting (in accordance with US GAAP, IFRS or local) • Inventory valuation method (FIFO, LIFO, weighted average, specific identification) • Depreciation method (straight-line, accelerated) • Related party transactions • Off-balance sheet transactions (operating leases, SPVs) • Method of accounting for bad debts (allowance method, direct write-off) • Special transactions or events • Post balance sheet events • Retirement benefits • Segment reporting and others 			

Sample Financial Disclosure Checklist for Inventories (based on IFRS)

INVENTORIES

	Disclosure Made		
	YES	NO	N/A
IAS 2 sets forth certain disclosure requirements relative to inventory accounting methods employed by the reporting entity. According to IAS 2, the following shall be disclosed:			
a. The accounting policies adopted in measuring inventories, including the costing methods (e.g., FIFO or weighted-average, or special identification) employed.	_____	_____	_____
b. The total amount of inventories and the carrying amount in classifications are appropriate to the Company.			
For example:			
• Raw Material	_____	_____	_____
• Work-in-process	_____	_____	_____
• Finished goods	_____	_____	_____
c. The carrying amount of inventories carried at FV less cost to sell.	_____	_____	_____
d. The amount of inventories recognized as an expense during the period.	_____	_____	_____
e. The amount of any write-down of inventories is recognized as an expense in the period.	_____	_____	_____
f. The amount of any reversal of any previous write-down that is recognized in profit or loss for the period.	_____	_____	_____
g. The circumstances or events that led to the reversal of a write-down of inventories to net realizable value.	_____	_____	_____
h. The carrying amount of inventories pledged as security for liabilities.	_____	_____	_____

Source: Adapted from International Financial Reporting Standards (IFRS)

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Note: Under US GAAP, **ASC 330** is the source of guidance for the measurement of inventory.

As a real example, we look at a couple of disclosures for the cell phone manufacturer, **Nokia**. The following is Nokia's financial statement disclosure for inventory (*Annual Financial Report for 2021*).

Accounting Principles - Inventories:

Inventories are stated at the lower of cost or net realizable value. Cost is determined using standard cost, which approximates actual cost, on a first-in; first-out (FIFO) basis. Net realizable value is the amount that can be realized from the sale of the inventory in the normal course of business after allowing for the costs of realization. In addition to the cost of material and direct labor, an appropriate proportion of production overhead is included in the inventory values. An allowance is recorded for excess inventory and obsolescence is based on the lower of cost or net realizable value.

Note #17: Inventories

EURm	2021	2020
Raw Materials and semi-finished goods	673	552
Finished goods	1,039	940
Contract work in progress	680	750
Total	2,392	2,242

An important non-financial disclosure is **related party transactions**. We show a disclosure list below for **related parties**, based on IFRS.

Non-Financial Disclosure Checklist for Related Party Transactions

	Disclosure Made		
	YES	NO	N/A
The objective of IAS 24 is to ensure that an entity's financial statements contain the disclosures necessary to draw attention to the possibility that its financial position and profit or loss may have been affected by the existence of related parties and transactions and outstanding balances with such parties. According to IAS 24, the following shall be disclosed:			
a. The relationship between parent and subsidiary (irrespective of whether there have been transactions between them);	_____	_____	_____
b. The name of the entity's parent;	_____	_____	_____
c. If different, the ultimate controlling party;	_____	_____	_____
d. If neither the entity's parent nor the ultimate controlling party produces consolidated financial statements available for public use, the name of the next most senior parent that does so shall be disclosed.			
An entity shall disclose key management personnel compensation in total and for each of the following categories:			
a. Short-term employee benefits;	_____	_____	_____
b. Post-employment benefits;	_____	_____	_____
c. Other long-term benefits;	_____	_____	_____
d. Termination benefits; and	_____	_____	_____
e. Share-based payments.	_____	_____	_____

There are other disclosure requirements, based on IAS24, but we highlighted the important disclosure requirements.

Source: Adapted from International Financial Reporting Standards (IFRS)

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In following we detail Nokia's *related party transactions*.

Note #33: Related Party transactions

Nokia has borrowings of EUR 40 million (EUR 43 million in 2020) from Nokia Unterstützungsgesellschaft mbH, Nokia's German pension fund, a separate legal entity. The loan bears interest at the rate of 6% per annum and its duration is pending until further notice by the loan counterparties even though they have the right to terminate the loan with a 90-day notice. In 2020, an amendment in the loan agreement was reached allowing an off set to the loan balance of contributions, interest and benefit payments paid. The loan is included in short-term interest-bearing liabilities in the consolidated statement of financial position. For more information on Nokia's pension plans, refer to Note 25, Pensions and other post-employment benefits.

Transactions with associated companies and joint ventures

EURm	2021	2020	2019
Share of results of associated companies	9	22	12
Dividend income	8	5	6
Share of shareholders' equity	243	233	165
Sales	87	115	153
Purchase f	(114)	(177)	(193)
Trade receivables	45	31	22
Trade payables	(29)	(26)	(38)

Nokia has a financing commitment of EUR 4 million (EUR 6 million in 2020) to an associated company.

You need to review all of the accounts and decide which ones need disclosing and testing for accuracy. Next, we move on to **principle 10**, which has to do with identifying risks within the accounts and disclosures.

Principle 10: Identify risks within the significant accounts & disclosures

The last principle had you identify the significant accounts to be tested. This principle identified which accounts and disclosures needed your undivided attention. Now, we move on to the next principle, which has you identify the potential risks within the significant financial accounts.

To help identify potential risks within the accounts it is useful to keep closely related types of transactions and account balances in the same segment. This type of segmenting is called the **cycle approach**.

For **example**, cash and credit sales, sales returns, and cash collection transactions and the accounts receivable balances are all part of the revenue and cash collection cycle. Similarly, expenditure transactions and accounts payable are part of the expenditure cycle.

There are **five basic transaction cycles**, consisting of:

- (1) **Financing.** The financing cycle is the starting point for every business. The financial cycle consists of how the business obtains capital for the funding of operations. Capital can come from the owners, venture capitalist, or from bank loans.
- (2) **Expenditure & disbursement.** Once the company has its required capital it then spends the funds for things needed to produce and sell its goods and services.
- (3) **Payroll & personnel.** This cycle is where the company hires personnel to carry out its day-to-day operations.
- (4) **Inventory & warehouse.** The inventory cycle is where goods are produced or purchased and then stored for future sales. This cycle will include items from both the expenditure and payroll cycles.
- (5) **Revenue & collection.** Revenues can only be generated if the inventory cycle is completed. Unfinished goods or services are not reported in the revenue cycle.

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These transaction cycles are part of the financial reporting process which begins by capturing data about transactions and ends with information output. All financial information is processed through the general ledger. At the trial balance level, *adjusting* and *closing entries* will have to be made.

Note: Transaction cycles are discussed in more detail in our paper titled '**Essential Knowledge: Internal Controls over Financial Reporting.**'

Identify Risk within Significant Financial Reporting Processes

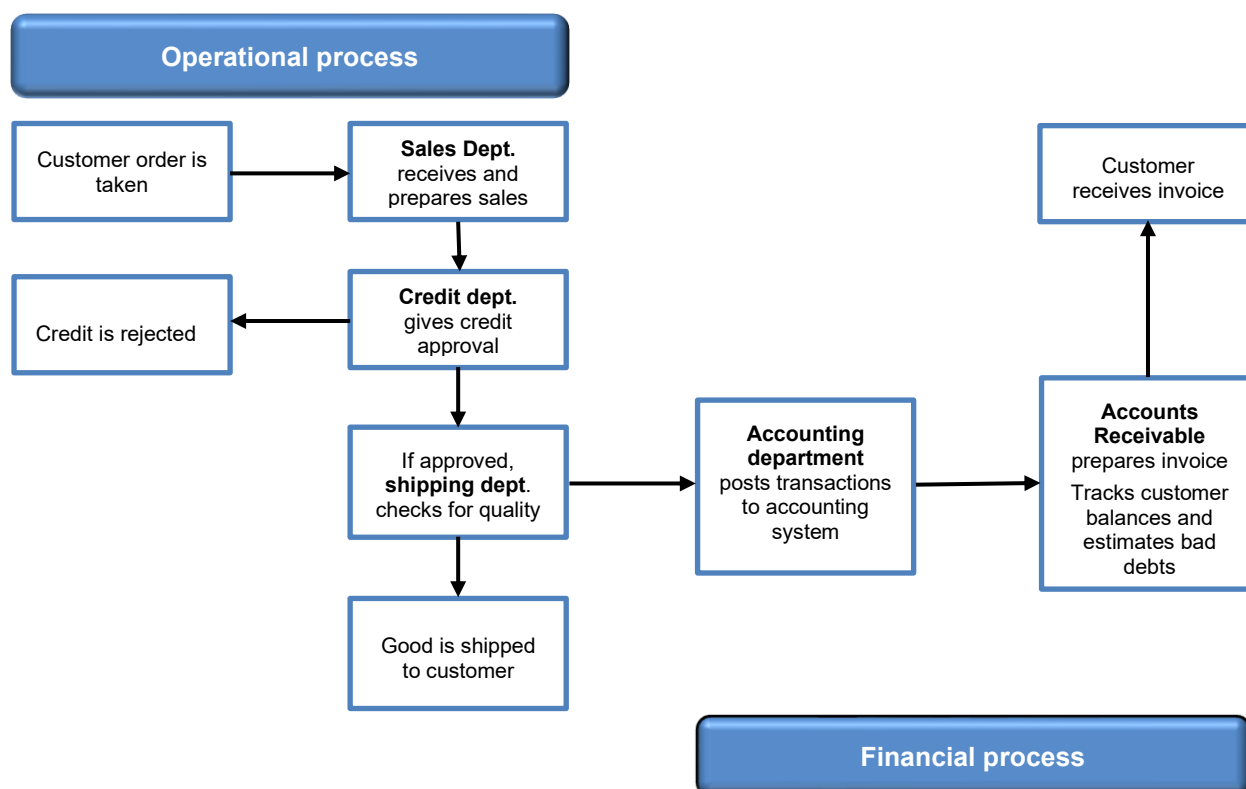
Management needs to see the '**big picture**' which is why segmenting accounts into cycles, thereby into processes, makes sense. To help you in this exercise, it is useful to use **narratives**, **questionnaires**, or **flowcharts** to get a better understanding of what is going on in the financial reporting process.

In **Exhibit 3.4**, we diagram a basic flowchart for a company's credit sales process, which is part of revenue-collection process. From the diagram you can see that the credit sales process is made up of two distinct processes: **operational** and **financial processes**.

You need to remember that if you want to improve controls over financial reporting you need to look at the whole process. Using the example of credit sales, you need to look at controls from the time the customer orders a product to the time the customer receives and is invoiced for the product. You can see that these two processes flow across multiple departments: from sales to shipping to accounting to accounts receivable.

Some risk management experts have suggested that looking at risks specifically within the financial reporting process yields better results, but we believe that you should also consider operational risks as well since these risks can also impact the reliability and accuracy of the financial information.

Exhibit 3.4 Flowchart for Credit Sales Process



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Continuing with the example of credit sales, the **business objectives** for the process are to: (1) make sure only qualified customers are able to obtain credit; (2) the goods they receive meet their expectations (at the right time and at the right price); and (3) recorded sales are *promptly* and *accurately* recorded.

Specific financial reporting objectives for credit sales would be:

- (1) All credit sales are properly authorized (**authorization**),
- (2) All authorized transactions are valid (**validity**),
- (3) All valid credit sales transactions are recorded in the correct period (**existence/cutoff**),
- (4) All credit sales transactions have been recorded accurately (**completeness**),
- (5) All credit sales transactions have been recorded to the correct customer (**accuracy**),
- (6) Shipped produce is safeguarded from spoilage (**valuation**),
- (7) Accounts receivables have not been pledged to a 3rd party (**ownership**),
- (8) Accounts receivables have been properly classified (**classification**), and
- (9) All relevant information regarding trade receivables has been disclosed (**disclosure**).

Inherent Risk Concept

The **inherent risk concept** is simply the process of identifying any and every risk which could keep the company from achieving its reporting objectives without regard for the effectiveness of the controls in place. It seems too often that managers really do not understand the risks they face. Common sense dictates that if you do not understand the risks, it is unlikely you can put in the right controls to manage and control the risks.

This process of identifying risks is made easier if you can understand the activities that are being performed within any given process. Having an understanding of these activities lets you understand the specific tasks that are occurring in each process. From this, you can set the specific financial reporting objectives and then identify the inherent risks of the process.

Control effectiveness is going to be determined when testing the controls in place. This is done in the twelfth principle. This does not mean that you should ignore the lower risk areas; simply that you want to do more extensive testing in the higher-risk areas.

Sample Inherent Risk Identification Matrix

Process Activities	Financial Reporting Objective(s)	Inherent Risks

Step 1: Identify activities with process. Identify the activities within the process under review.

Step 2: Identify financial reporting objectives. Map process activities to financial reporting objectives.

Step 3: Identify risks to reporting objectives. Identify any and all risks which could keep the organization from achieving its financial reporting objectives.

Continuing with our example of the credit sales process, we identified **three activities** within the process. These activities are:

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- 1) Process the customer order.
- 2) Ship goods to the customer.
- 3) Invoice the customer for shipped goods.

The steps in processing the customer order are: (1) take the customer order, (2) check the customer's credit status, (3) check inventory for availability of product, and then (4) respond to customer inquiries.

From this, you are able to map process activities to the financial reporting objectives; mapped to the inherent risk. We show this mapping process in the matrix below.

Credit Sales Activities	Financial Reporting Objectives	Inherent Risks
<p>1) Process customer order:</p> <ul style="list-style-type: none"> ▪ Take customer order. ▪ Check customer's credit status. ▪ Check produce inventory for availability of product. ▪ Respond to customer inquiries (accept or/reject credit request) 	<ul style="list-style-type: none"> ▪ Customer order is promptly taken and properly authorized (Authorization). ▪ Customer order is properly priced, and amount of sales is correct (Valuation). ▪ Only valid orders are fulfilled (Validity). ▪ All valid orders are processed and recorded (Completeness). ▪ All relevant information is properly classified and/or disclosed (Classification / Disclosures). 	<ol style="list-style-type: none"> 1) Customer order is not properly authorized. 2) Price quoted to customer is inaccurate or set below production cost. Company loses money on sale. 3) Customer order is not received and processed in timely manner. 4) Invalid or fictitious order is taken. 5) Incomplete or inaccurate customer order causing inefficiencies and customer dissatisfaction. 6) Duplicate order is processed leading to misleading financial results. 7) Sales are made to customers with poor credit. 8) Orders are not legitimate. 9) Relevant information about customer discounts and incentives is not disclosed. 10) Good customers are rejected credit of out-of-date information.
<p>2) Ship product to customers:</p> <ul style="list-style-type: none"> ▪ Package & prepare customer order for shipping. ▪ Ship product to customer. 	<ul style="list-style-type: none"> ▪ Only valid orders are prepared for shipment (Validity). ▪ Shipped produce is recorded in proper period (Cutoff). ▪ Only quality produce is authorized for shipment (Authorization). ▪ Correct order is shipped to customer and are properly recorded (Completeness). ▪ Posting made to cost of sales and /or inventory in general ledger is correct (Valuation). 	<ol style="list-style-type: none"> 11) Shipping errors (wrong company name, wrong address, etc.) causes delay in customers receiving product. This causes dissatisfaction and loss of future sales. 12) Shipping documents are not forwarded to accounting office in a timely manner. 13) Shipping documents are not processed in the proper period. 14) Incorrect goods or spoiled goods are sent to customer. 15) There is human error when entering transactions.
<p>3) Invoice customers for shipped goods:</p> <ul style="list-style-type: none"> ▪ Invoice customer. ▪ Update customer accounts receivable balance. 	<ul style="list-style-type: none"> ▪ Customers are invoiced for all sales (Completeness). ▪ Invoices have right information (Valuation). ▪ Customer accounts are properly maintained (Ownership). 	<ol style="list-style-type: none"> 16) Failure to invoice customers in a timely manner. 17) Invoices are not properly priced. 18) Errors in invoicing causing loss of assets or customer dissatisfaction. 19) Policy of charging off account may not be followed.

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		<p>20) Accounts may be written off without proper authorization.</p> <p>21) Uncollectible accounts may not be written off in a timely manner.</p> <p>22) Errors in maintaining customer accounts cause customer dissatisfaction and loss of sales and may indicate theft of cash.</p>
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Inherent risk has to do with the susceptibility of there being a mistake. It is often said that the driving force behind every control is risk. Based on this, the function of the matrix above is to get you to '**know your risks**.' At this point you have not yet prioritized the risks based on significance; you simply understand what risks are present in the process.

One of the problems with this concept is that it does not take into account that some of the mistakes or errors could be intentional. If intentional, this is **fraud**. When identifying and assessing risks always have an awareness of where fraud could be occurring within the process. Fraud is such an important topic that we devote the next principle to understanding what it is, and what are the different types of fraud.

Chapter 3: Know Your Threats

Chapter 4: Be Aware of Fraud

When conducting an assessment of controls *fraud* is one of those things that always need to be considered. This does not mean you have to be an expert on fraud issues, but you should have an awareness of when fraud could be present.

This principle below should help you increase your awareness of situations where fraud could be present.

Principle 11: Have an awareness of potential fraud when reviewing accounts and disclosures

Fraud is such a serious issue for companies we decided that the topic needed to be discussed separately, which is why it became our eleventh principle. The opportunity for fraud to occur in your company is something you should always have an awareness of. Assessing for fraud **needs to be an integral part of your risk assessment program.**

“To find fraud, one has to know what it looks like. To stop fraud, one has to know what causes it.”

Source: *Internal Auditor*, December 2007, pg. 63.

If you refer back to the inherent risk identification matrix, you will notice that there are several areas where potential fraud could occur. For **example**, when reviewing the credit sales process there is the chance that a related party could be extended credit for purchase of product and then the amount written off at a later date.

As an exercise, it might be useful to go through the fraud assessment questionnaire at the end of this section. In the following pages, we discuss the topic of fraud so you can have a better understanding of what fraud is, and what are the indicators (red flags) of fraud.

Understanding Fraud

In criminal law, **fraud** is *“a crime that entails deliberately deceiving another in order to damage them.”* There are almost as many types of fraud as there are types of people who commit fraud. The most important thing to remember about fraud is that every company is at risk of being defrauded. Because of this, it is imperative for companies to understand the risks of fraud and how to assess for it.

Because of the many different types of fraud, we want to focus our attention on fraud that is perpetrated against companies. This type of fraud is more commonly referred to as **occupational fraud**.

By definition, *Occupational Fraud* is *“the use of one’s occupation for personal enrichment through the deliberate misuse or misapplication of employing organization’s resources or assets.”* As you can see, occupational fraud encompasses every employee within the company, from top executives’ right down the reporting line. Occupational fraud can vary from very sophisticated investment schemes, like the one committed by *Bernard (Bernie) Madoff* or it might simply be the theft of petty cash. However, whatever the fraud and no matter how small it may seem, the act is wrong, and it is fraud.

The fraud committed by *Bernie Madoff* is discussed in the case study below.

Chapter 4: Be Aware of Fraud

Case Study of Fraud: The Ponzi Scheme of Bernie Madoff

One person who stands out as being the epitome of corruption and unethical behavior is *Bernie Madoff*. As of this writing, *Bernie* is charged with perpetrating the largest investor fraud ever committed by a single person (up to \$50 billion). Seems pretty incredible, doesn't it? What's even more incredible is the fact that red flags were raised regarding *Bernie's* scheme going back to 1999. Financial analyst *Harry Markopolos* complained to the SEC Boston office in May 1999, telling the SEC staff they should investigate *Madoff* because it was impossible to legally make the profits *Madoff* claimed to have made using the investment strategies he was using. In fact, Markopolos sent the SEC a detailed 17-page memo specifying the 29 red flags. The paper concluded that Madoff was running the world's largest unregistered hedge fund.

The scheme that *Bernie* is accused of running is something called the **Ponzi scheme**. A Ponzi scheme is simply a pyramid scheme that pays returns to investors out of the money paid by subsequent investors rather than from profit.

What's even more amazing is how the scheme came unraveled. On December 10, 2008, Madoff suggested to his sons, *Mark* and *Andrew* that the firm pay out several million dollars in bonuses two months ahead of schedule. These bonuses were to be paid from the \$200 million in assets the company still had. Unaware of the pending insolvency, the sons confronted their father about the payout, and why they were paying bonuses to employees if it could not pay investors. It was then that *Madoff* admitted that the asset management arm of the firm was in fact a Ponzi scheme. It was then that sons passed this information to authorities. *Madoff* was then promptly arrested the following day by the FBI.

According to the SEC, Madoff confessed to an FBI agent that there was "no innocent explanation" for his behavior, and that he "paid investors with money that wasn't there."

The criminal complaint alleges that investors lost up to \$50 billion through the scheme, though The Wall Street Journal claims "that the figure includes the alleged false profits that *Madoff's* firm reported to its customers for decades. Therefore, it is unclear exactly how much investors deposited into the firm."

The conviction:

"On March 12, 2009, Madoff pleaded guilty to 11 federal offenses, including securities fraud, wire fraud, mail fraud, money laundering, perjury and making false filings with the SEC." On June 29, 2009, *Judge Chin* sentenced *Madoff* to the maximum sentence of 150 years in prison. Because parole has been abolished in the federal prison system since 1984, it was equivalent to a life sentence.

Lessons Learned of the Bernie Madoff Embezzlement

The fact that *Harry Markopolos* saw what was going on all the way back in 1999 and even tried to bring it to the attention of the authorities does say something about the SEC as a regulatory agency. It was *Madoff's* sons that told the authorities about what was going on. However, this still doesn't excuse the investors' responsibility for having investing in something that should have seemed shaky at best. For example:

- 1) Investors should have been alerted when *Madoff's* returns were inconsistent with his general overall strategy of buying puts and selling covered call options on stocks in the portfolio. This type of strategy should produce losses during bear markets, though less than that of the overall market. But Madoff consistently reported profits that shouldn't have happened. There is an old saying about something "being too good to be true is probably too good to be true," and
- 2) There was a lack of audited financial reports. This lack of transparency should have also alerted the investors, but the exclusive nature of *Madoff's* "club" created the aura that seemed to attract investors to the scam. Some commented that they wanted to be part of the "in crowd" and investing with Madoff seemed to be part of the "in crowd."

Chapter 4: Be Aware of Fraud

Types of Occupational Fraud

There are **three main types** of occupational fraud. They are:

- 1) **Fraudulent Financial Statements.** Fraudulent financial statements are financial statements that are intentionally misstated in order to mislead users. The general users of financials include management, financial analyst, shareholders, suppliers and others.
- 2) **Asset Misappropriation.** Another word for asset misappropriation is “stealing.” Asset misappropriation includes theft of any assets, or any other action that causes the company to expend cash or other assets for things that will not benefit the company.
- 3) **Corruption.** Corruption includes illegal gratuities, bribes and kickbacks, conflict of interest, and economic extortion (e.g., blackmail).

These three branches of fraud are highlighted at the end of this section. Our **fraud tree chart** gives a detail breakdown of the type of activities related to each branch.

Why Do People Commit Fraud?

It has been generally recognized that in order for fraud to be committed, three conditions need to be present:

- (1) The person has to be **motivated** to commit the fraud,
- (2) The person has to have the **opportunity**, and finally,
- (3) The person has to have the ability to **rationalize** his or her behavior.

On the following pages, we discuss each type of fraud individually.

Motivation

Motivation is the reason behind the fraud – the reason that the individual chose to commit fraud. There is no single reason why a person commits fraud, but some of the more common factors include:

- (1) **Internal pressure from senior management to meet other’s expectations** (e.g., market or revenue expectations, etc.). Not meeting their expectations could lead to job loss or demotion.
- (2) **External pressure from financiers that threatens the organization’s financial stability.** For example, not meeting various requirements in a debt agreement, etc.
- (3) **Pressure to pay for a personal lifestyle, and or vices** (i.e., gambling, drugs, etc.).
- (4) **Pressure to maximize bonuses or compensation when it is performance based** (e.g., the company has a contingent compensation structure, etc.).

Opportunity

Simply having the desire to commit fraud will not allow a person to commit fraud if the person does not have the opportunity to do it. Without opportunity, fraud could not or would not be committed.

Some of the factors and conditions that enable an individual to have the opportunity include:

- (1) **Knowledge of weaknesses** of the company’s internal control system,
- (2) **Access to accounting records or assets,**
- (3) **Lack of supervision,**
- (4) **Unethical “tone at the top,”** and
- (5) **Belief** that the person will not get caught.

Chapter 4: Be Aware of Fraud

It is up to management to understand the opportunity factors that could lead to fraud being committed in a company and then to minimize the risk of fraud by reducing the opportunities that exist for fraud to be committed, for example, making sure the company has the right tone at the top that punishes violators, etc.

Ability to Rationalize Behavior

The last factor that has to be present in order for fraud to be committed is the ability of the person to rationalize his or her behavior. Unless you can rationalize your behavior, you will not commit fraud – even if you have the motive and opportunity. Quite simply what you are doing here is convincing yourself that there is a perfectly acceptable reason for what you are doing. The sense of ethics, morality, and the idea of right and wrong is what prevents some individuals from rationalizing this behavior.

Some examples of *rationalization* are:

- (1) An individual believes that they have not been properly compensated for their work. They believe the company owes them something for work that they have done in the past, and therefore, stealing money is not stealing, but just getting what is rightfully theirs.
- (2) Not getting the recognition an individual feel that they should be getting.
- (3) Needing more money in order to support their personal life, or
- (4) Perhaps the individual is able to justify the theft because they plan on returning the money in the future (so no one will notice).

Again, without some form of rationalization, together with motivation and opportunity, fraud would not be committed. In the following fraud awareness questionnaire, we provide some examples of questions that could be asked when assessing for fraud. You simply need to always be looking for fraud when testing controls. When testing controls, always ask yourself – “Where could fraud be taking place?”

Sample Fraud Awareness Questionnaire Matrix

Description <i>The following are some examples of questions that might be asked when thinking about fraud.</i>	Yes/No/ N/A	Person(s) Responsible	Control testing assessments & observations
1. Is fraud assessment an integral part of the risk identification and evaluation process?			
2. Does the company's assessment of fraud risk consider incentives and pressures, attitudes, and rationalizations, as well as opportunity to commit fraud?			
3. Does the company consider risk factors relevant to its industry and to the geographic region where it does business?			
4. Does the company consider the potential for fraud in high-risk areas, including: <ul style="list-style-type: none"> ▪ Revenue recognition, ▪ Management override of controls, ▪ Manipulation of accounting estimates, ▪ Significant unusual accounts, ▪ Nonstandard journal entries, ▪ Significant intercompany accounts, and ▪ Vulnerabilities related to misappropriation of assets. 			
5. Does the audit committee understand and exercise oversight of management's fraud risk assessment processes?			

Chapter 4: Be Aware of Fraud

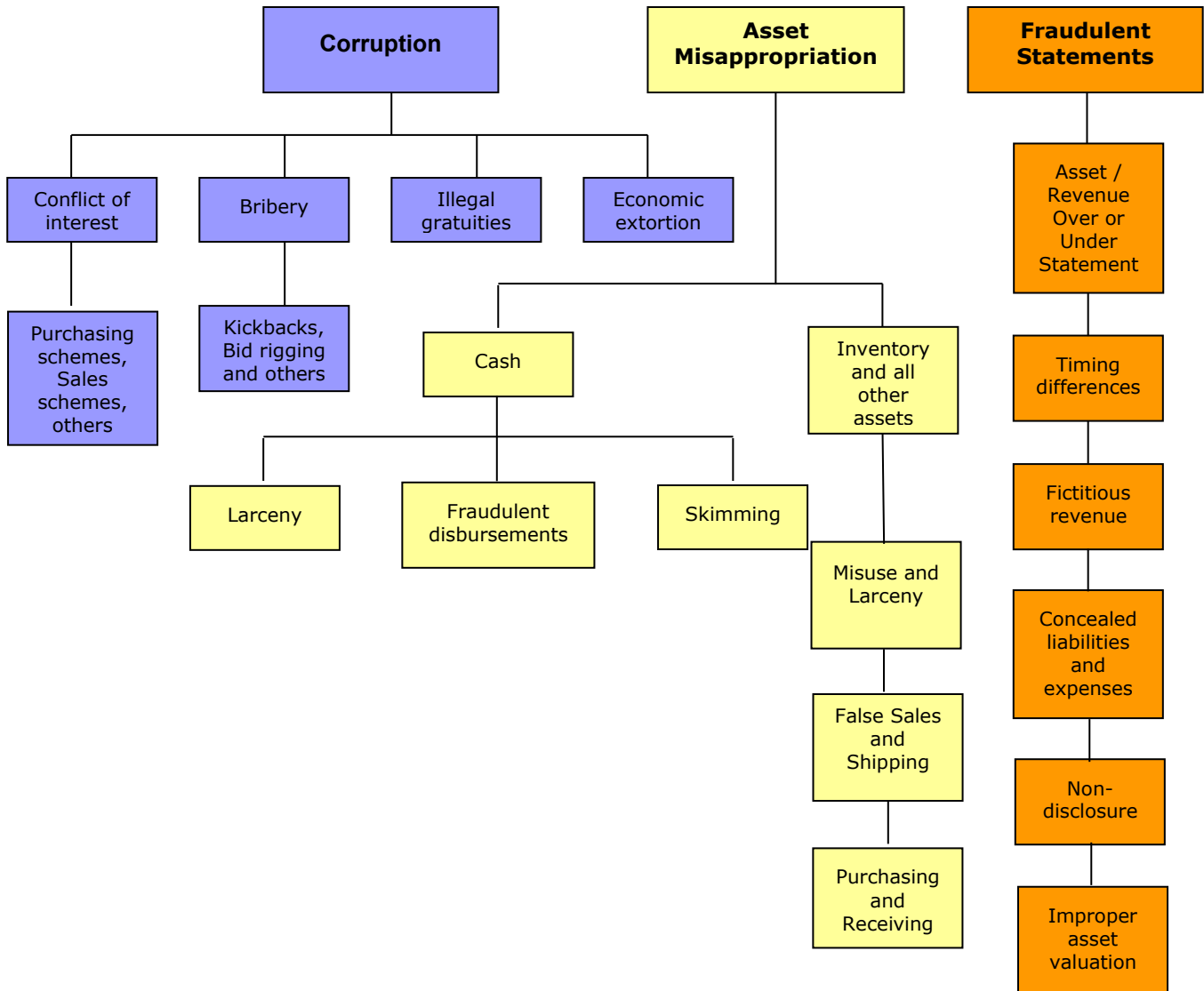
6. Does the board of directors actively evaluate and monitor risk factors affecting the reliability of financial reporting, including the risk of management override?			
7. Is training provided to accounting staff to improve their understanding of what constitutes fraud and how to minimize fraud?			

Note: Appendix D highlights 40 common forms of fraud and 20 danger signs of embezzlement. These lists were taken from *Sawyer's Internal Auditing 5th Edition*.

The Fraud Tree

The Fraud Tree

The **three main branches** of fraud have been identified as **corruption**, **asset misappropriation**, and **fraudulent financial statements**. The chart below shows examples of fraudulent activities for each branch.



Chapter 5: Prioritize Your Threats

Chapter 5: Prioritize and Respond to Threats

We have come to the **last part of the second component**, Risk Assessment Analysis & Response. To help you prioritize threats *Pareto's 80-20 theory* described below could be of use.

The 80-20 observation was developed by *Vilfredo Pareto* who was a nineteenth-century Italian economist. The 80-20 proposition can work both ways, but it always seems to hold true, even if we talk about a subject, such as risk (20% of risks cause 80% of the material misstatements).

“80%” of the tasks can be completed in “20%” of the time; or “20%” of the tasks will take 80% of the time”.

Source: Vilfredo Pareto

Principle 12: Assess and prioritize significant risks within accounts & disclosures

Pareto's observation tells you that, of the twenty-two risks previously identified, more or less, only 20% of them would need closer review. However, this is not taking into consideration the probably of there being fraud.

Note: Anytime you believe that there is a high probability that fraud is taking place then you need to request a fraud investigation.

In order to assess and prioritize the risks which were identified previously you need to understand whether the company's controls sufficiently address the assessed risk of misstatement to each relevant reporting objective. When looking at the sufficiency of a control you want to look at the *design effectiveness* of the control (Is the control properly designed?) as well as its *operational effectiveness* (Is the control operating as it should?). You assess control adequacy and effectiveness by constructing a **risk evaluation matrix**.

The matrix shown below is a useful tool to help you form an overall opinion as to which of the risks identified earlier need closer review. Once you understand which ones are more significant (pose a threat to the company) you can then decide how the risks need to be responded to. Once you understand this, controls can be designed to manage the risks.

Sample Risk Evaluation Matrix

Process Activities	Objective(s)	Risks	Controls	Findings	Overall Assessment

Step 1: Identify activities with process. Identify the activities within the process under review.

Step 2: Identify financial reporting objectives. Map process activities to financial reporting objectives.

Step 3: Identify risks to reporting objectives. Identify any and all risks which could keep the organization from achieving its financial reporting objectives.

Step 4: Identify controls to test. Test controls which are important to the conclusion about whether controls sufficiently address the assessed risk of misstatement to a particular relevant reporting objective.

Step 5: Report findings. When reporting your findings, you want to report on the **design** and **operational effectiveness** of the controls in place. You want to make sure that controls are well designed and are in fact operating as intended.

Step 6: Give overall assessment on the adequacy and effectiveness of controls. Final assessment is drawn on your findings. For example, a control may be flawed because of a lack of segregation of duties, leading to an opinion of inadequacy.

Chapter 5: Prioritize Your Threats

The use of this matrix puts into clear focus the design and operational effectiveness of the controls in place. This matrix can be used to determine which controls need to be tightened up, if gaps exist.

For example, if there is a lack of segregation of duties you can decide whether action needs to be taken to mitigate the control deficiencies.

We discuss control design and operational effectiveness in more detail below.

Control Design and Operational Effectiveness

When considering **design** and **operational effectiveness** you should consider the following:

- *What is really difficult to get right?* Here you want to consider *complexity* and *volume* of transactions.
For example, if your company is highly involved in the derivatives market, then getting the valuation of the derivatives might be problematic.
- *What accounting problems have you had in the past?* In this case, by looking at the retained earnings account (R/E) you can see what adjustments had to have been made to past financial reports.
For example, supposed you had numerous error corrections to unadjusted beginning retained earnings. This would indicate an input control problem.
- *What has changed?* In this case, you would look at the major events that have changed in the past six months, or year.

For example, has the organizational structure of the company changed?

- *Who might be capable or motivated to commit fraud?* The risk that management could override important financial controls to manipulate financial reporting should also be a key area of focus. There is a fine line between acceptable accounting practice and management's deliberate misrepresentation of the financial statements. Management's consideration of the likelihood that a control might fail to operate effectively includes, among other things:
 - **Window dressing.** As an example, a supplier enters into a transaction close to year's end and reverses the transaction just after the first of the year. The goods are sold on the understanding that they will be returned immediately after the first of the year. This is being done to spruce up the supplier's earnings. This is often called **channel stuffing**, which is illegal.
 - **Off-balance sheet financing.** In these cases, transactions are deliberately arranged so to enable an entity to keep significant assets or liabilities out of the financial statements. This method could be used to improve leverage and returns on capital employed.
 - **Profit smoothing.** This is where reported profit is manipulated by recognizing artificial assets or liabilities and releasing them to the income statement as required.
 - **Aggressive earnings management.** This is where management artificially improves earnings and profits by recognizing sales revenue before it has been earned.
For **example**, a company recognizes the income from a prepayment for office rent. It should have been first recognized as a deferred income and then written off over the period of the lease.
 - **Capitalizing expenses.** We mentioned this method of massaging the financials earlier when we discussed the bankrupted company 'WorldCom.' This is very often misused means to improve financial performance.

Chapter 5: Prioritize Your Threats

Evidential Matter to Support Assessment

In order to support your assessment on the effectiveness of controls, you need to obtain sufficient evidential matter so you can feel confident that your assessment is correct. Because management is testing and reporting on its own controls you have significant flexibility as to nature and extent of evidence needed to make your assessment.

However, because management is doing a self-assessment you need to make sure that the person responsible for the control is not able to assess its effectiveness. You need to remember that whoever does the testing of controls needs to be **objective, impartial, unbiased** and **without conflict of interest**.

When testing controls, you need to consider the following factors in the context of financial reporting:

- **Sample size:** As the perceived financial reporting risk increases, sample size increases proportionally.
- **Nature of evidence:** Inquiry, observations, inspection and re-performance are four evidential types, listed in order of sufficiency (weakest to strongest). Evidence beyond inquiry, such as inspection of documents, is required to test the operating effectiveness of controls. Re-performance evidence would be expected for the highest risk controls, such as in the period-end reporting process.
- **Nature of controls (manual vs. automated):** Manual systems have a higher probability of being misstated; therefore, manual systems tend to need more testing. If IT general controls are effective, and have been fully tested in the past, the amount of testing can be lessened.

Some persuasive factors that can also affect evidence considerations are:

- **Overall strength of entity-level controls, particularly the control foundation:** Strong entity-level controls can act as a '**counterweight**' to risk across the board, reducing the sufficiency of evidence required in lower-risk areas.
- **Cumulative knowledge from prior assessments regarding particular controls.** If particular processes and controls have a history of working effectively then the extent of evidence required in lower-risk areas can be reduced.

Note: SOX requires external auditors to test management's assessment of its ICFR. Based on this, the auditor's reliance will be proportional to the competence and objectivity of the management personnel that completed the assessment and also the perceived level of risk. For the higher risk areas, such as the control foundation and period-end reporting processes, internal auditors or compliance teams are likely to be the best choices to perform this testing if a significant degree of reliance is expected from the external auditor.

Once you have arrived at an overall assessment on the *adequacy* and *effectiveness* of the controls in place, you can then decide how to **best to protect your company** against the possibility of misstated financial reports. Protecting your company is putting in place controls which mitigate or minimize the more significant threats.

The next principle looks at how threats can be responded to.

Chapter 5: Prioritize Your Threats

Principle 13: Respond to significant risks

There are **four primary** ways you can respond to risks. You can **transfer** the risk, or you can **accept** the risk, or you can **reduce** the risk, or you can **avoid** the risk. Once you know how to respond to risks, the next step is to design controls to deal with the risks.

“Risks are like time bombs; if you don’t defuse them, they can blow up in your face.”

In life there are always choices. Sometimes you might not like any of the choices, but nonetheless there are still choices available. This concept applies when talking about responding to risks. For example, let us say you identified a risk, and the risk is caused by a lack of segregation of duties. You have identified the risk and the control to minimize the risk is to segregate the functions. The obvious choice is to segregate the function; however, if the cost to segregate is more than the potential loss/misstatement, you might think twice about segregating the function. When there is an identified control deficiency you always have to consider whether there is a positive **cost-benefit relationship** because sometimes the cost is just not worth it. Based on this, you may end up not treating the risk, and thus, accepting the risk as is.

There are **four ways** in which you can respond to risks. It is common to refer to these four responses through the mnemonic **TARA**. You can:

1) **Transfer the risk**

Let someone else take on the risk. Best example is the purchase of insurance, or by hedging. Transferring risk would probably be used more to cover operational risks instead of financial reporting risks.

2) **Accept the risk**

This means tolerating or accepting the risk. For example, accepting the risk of forged authorization in the credit department because of its low likelihood or low impact.

3) **Reduce the risk**

Reducing or treating the risk by taking specific action. For example, segregating the functions of billing and the accounts receivable department so no billings could be made to a fictitious customer. Experience has shown that the vast majority of risks can be reduced.

4) **Avoid the risk**

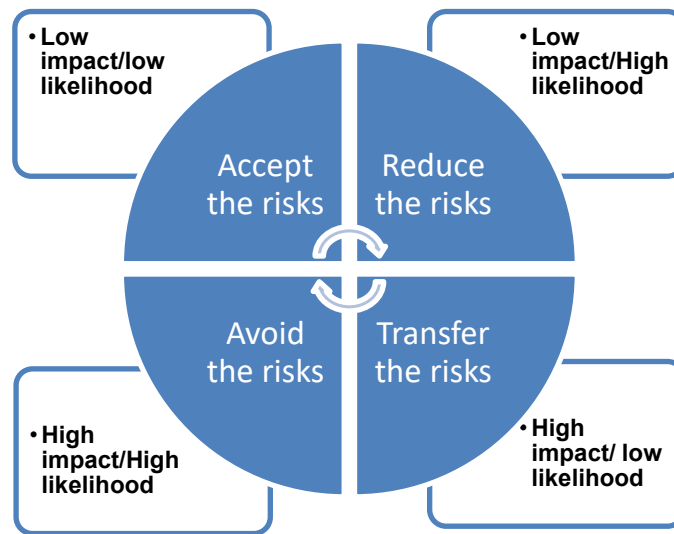
This is to eliminate the risk if it is too great for the business to bear or find ways to significantly reduce it if eliminating the risk is too impractical or too expensive. For example, a company has a division that produces a product that is highly controversial. A way to eliminate the controversy (and risk) would be to sell the division. As another example, let us say your company entered into some highly risky derivatives. In this case you could eliminate the risk by simply getting out of the market.

Note: You may see others use the mnemonic **4-Ts** instead which translate to **transfer, tolerate, treat or terminate**.

Keep in mind that for every identified risk you have to make a choice as to what to do; what you do with the risk will ultimately depend on your analysis of the risk (i.e., cost-benefit analysis). In **Exhibit 5.1** below, we diagrammed the possible ways that you could respond to the identified financial reporting risks for the credit sales process. Keep in mind that when deciding how best to respond, you first need to identify the control that is needed to strengthen or minimize the risk. You can then decide what action to take.

Chapter 5: Prioritize Your Threats

Exhibit 5.1 Responding to Risks: TARA



Referring back to the identified *twenty-two risks* of the credit sales process, we can use *Pareto's 80-20* observation and hypothesize that only a few of the identified risks would be considered **significant**.

Let's say that after further review and analysis, you determine that only *five of the twenty-two* are significant. The five significant risks might include:

- (1) **Lack of proper authorization/inadequate segregation of duties.** Sales personnel extended credit without proper authorization. A significant amount of credit was extended to customers with questionable credit history. This might explain why a high percentage of credit is past due.
- (2) **Lack of proper authorization.** The sales personnel often gave discounts without proper authorization. This resulted in the company not meeting its gross margin objective.
- (3) **Lack of proper recordkeeping.** There was an unacceptable number of duplicate orders being processed which led to mistakes in the financial information and wasted personnel's time correcting the mistakes.
- (4) **Lack of checking the quality of produce before shipping (safeguarding assets).** This resulted in spoiled or damaged goods being sent to customers, which could lead to customer ill-will.
- (5) **Lack of proper maintenance of account receivables (safeguarding assets).** Accounts receivable balance significantly increased causing an increase in bad debt write-offs.

Note: From an auditing standpoint, external auditors concentrate on risks which could impact the achievement of financial reporting objectives without regarding existing controls. For example, in considering the objective of making sure that all *customer invoices are correctly priced*, an auditor might incorrectly identify the risk as being the customer invoice not being correctly priced, which is simply the opposite of the objective. In fact, the company probably already has the controls in place to make sure that the invoice price is valid and accurate. Given this, you want to try to avoid spending time identifying risks which, in fact, probably are not risks at all. As a financial manager/internal auditor you want to spend your time on the significant risks: those risks that could materially impact the financial statements.

Once the risks (the ones mentioned above) have been identified you are then able to develop a line of defense against the unforeseen dangers. This leads us to the third component of the "6x20" model – **Designing Controls**.

Chapter 5: Prioritize Your Threats

Chapter 6: Design Your Controls

Chapter 6: Design Your Controls

For the most part, all companies have the same general business objectives. They want:

- (1) Reliable financial information,
- (2) Effective and efficient operations,
- (3) Be in compliance with laws and regulations (both internal/external), and
- (4) Safeguard their assets.

Depending on the size of the company, it is not uncommon for a company to place more focus on one or two objectives than they do the others. For **example**, SMEs generally place more focus on safeguarding assets, particularly protecting cash, and also complying with laws and regulations. If a business is not in compliance, then it could find itself out of business very quickly. Financial reporting in SMEs is generally straight forward and not very complex. The financial reports may be produced by nothing more than *QuickBooks Online* or *Xero*, or some other off-the-shelf accounting program.

However, as a company grows, financial transactions tend to become more complex and voluminous, so the reliability of its financial reports takes on more importance. Also, as the company grows and expands operations, it becomes more concerned about maintaining its competitive advantage through increased effectiveness and efficiency of operations.

To improve the reliability of financial reporting and increase efficiency and effectiveness of operations it is common for larger firms to install more sophisticated software packages, such as Enterprise Resource Planning (ERP) which integrates the planning, management and use of all resources in the entire organization. The two most commonly used ERP systems are *SAP R/3* and *Peoplesoft (Oracle)*. However, companies that go to an ERP system have to do some amount of business re-engineering, which means the design of their control system will be **remolded** and **reshaped** to integrate the new system. In other words, the company's control system is organized around the ERP system, not the other way around.

When designing controls, you need to remember that the **designed controls** have to meet the specific needs and requirements of your company. How you design your company's control system depends on such things as:

- **Management's financial reporting requirements.** What reports does management need and want? If your company is a start-up company then the only financial report management may want is a *free cash flow report*, which shows how much cash is available for further investments. As they say, '**cash is king**' and this is particularly true for SMEs.

Free cash flow is commonly used in management accounting. Free cash flow is the cash flow derived from the operations of a company after subtracting working capital, investment and taxes and represents the funds available after distribution to capital contributors (i.e., shareholders and debt holders). The idea of free cash flow is to provide a measure of the amount of cash generated by the company that management is able to decide how to use. It is calculated as follows:

$$\begin{aligned} & \text{EBIT (1 - tax rate)} \\ + & \text{ Depreciation} \\ - & \text{ Capital Expenditures} \\ +/ - & \text{ Change in non-cash working capital} \\ = & \text{ Free cash Flow} \end{aligned}$$

- **Requirements of shareholders.** As companies grow and diversify their operations, their financial reporting requirements become more cumbersome and complex, particularly when the companies become listed. If a company is listed, its shareholders, particularly institutional investors, want detailed financial reports on such

Chapter 6: Design Your Controls

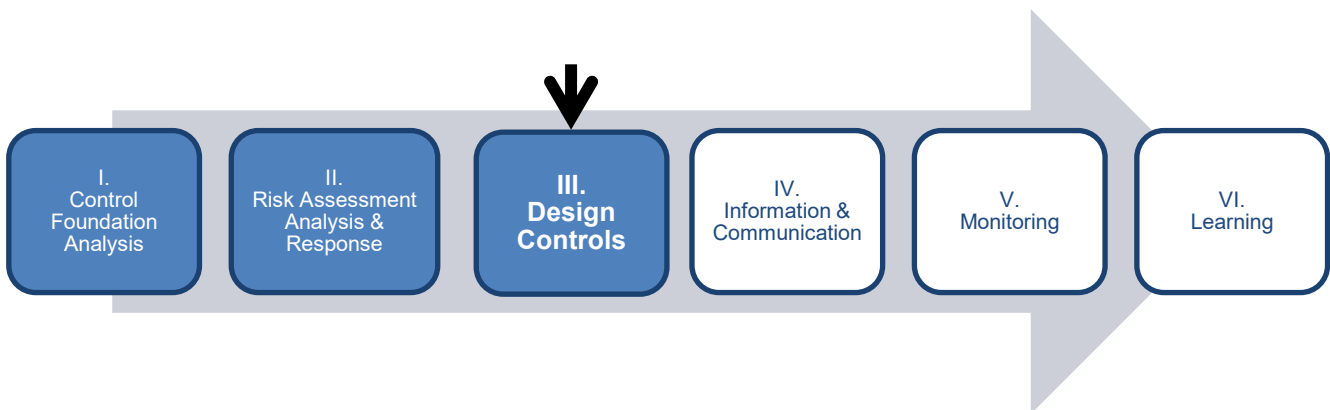
things as profitability, uses of resources, rights and obligations, segmented information and so on. Listed companies are required to present detailed quarterly and annual financial & non-financial information to its shareholders as well as to regulators.

- **Requirements of regulators.** Regulators have the responsibility to protect the public from unscrupulous businesses and individuals. To protect the public, regulators put in regulations that make it seem that there is a ‘*verification process on top of a verification process on top of verification process.*’ *Is it no wonder that management sometimes feels like controls are bloated and not effective?*

III. Design Controls

Continuing along the **pathway**, your job now is to plug in the holes and build a defense to protect your company.

“Protecting your present is protecting your future”



Principle 14: Design controls to address significant risks

Our fourteenth principle has to do with determining whether your company has the controls in place to adequately address the identified financial reporting risks. “Determining whether the control(s) are adequate involves judgment about whether the controls, if operating properly, can effectively prevent or detect misstatements that could result in material misstatements in the financial reports. The risks may have occurred simply because of not being properly executed, or maybe because, in fact, there are missing control(s). In either case, the risk(s) do exist and therefore action may need to be taken.”¹⁰

There are several methods of *reviewing* and *designing controls*. You can design controls through *narratives*, *flowcharts* and/or *matrices*. For reporting purposes, you may decide to use more than one method.

Once the significant risks have been identified, you need to determine why the risks exist: “Is it because controls are not being properly executed, or is because there is, in fact, missing controls? In this case, we need to determine why there is a problem.

Using the example of significant risks within credit sales, the first risk had to do with **sales personnel extending credit without proper authorization**. Further review led to you to discover that bad debt expense increased,

10 SEC, 17 CFR Part 241, pg. 15.

Chapter 6: Design Your Controls

therefore, negatively impacting profitability. Based on this, you drew the conclusion that the control was not being properly executed. If controls are not being properly executed, you have to understand the reasons for the problem.

Documenting Controls

As we mentioned already, there are a number of methods to document controls. Continuing with our example of credit sales, a common method to document controls is through the use of a **Control Matrix**. Flowcharting is also a common method. The control matrix matches the control with the identified risk or vulnerability, and the flowchart shows where in the process the control needs to be implemented.

We give an example of using a **control matrix** for the risks we identified earlier.

Sample Control Matrix for Credit Sales Process

Financial Reporting Objectives	Risks	Consequence / Impact on Financial Statements	Risk Response/Control Procedures	Preventive / Detective	System: Manual / Automated
Process customer order					
Authorization Customer orders have to be promptly taken and, if credit sales, the orders need to be properly authorized.	Lack of proper authorization/Inadequate segregation of duties. Sales personnel have on numerous occasions extended credit without authorization.	To make a sale, sales personnel have extended credit to customers with poor credit history. A significant amount of credit was extended to customers with questionable history. Sales personnel are not disciplined so the practice continues.	Risk response: Reduce the risk. Control procedures (General authorization/segregation of duties): There has to be strict segregation of duties were sales personnel are not able to grant credit. Someone other than the salesperson should extend the credit.	Preventive	Manual
Valuation / Authorization Customer orders are properly priced, and amount of sales is correct.	Lack of proper authorization. Sales personnel are able to give discounts without proper authorization.	Gross margin was below targeted.	Risk response: Reduce the risk. The company has to take immediate action to eliminate this risk. Control procedures (General authorization): Prices are verified from computerized price list. Price discounts have to be authorized by the sales manager.	Preventive	Manual / Automated
Validity Only valid orders are processed.	Lack of proper recordkeeping. Duplicate orders can be processed.	There were occasions that customers were double billed for delivered goods. Caused personnel to waste their time correcting mistakes. Caused aggravation on the part of the customers. This caused some customer ill-will.	Risk response: Reduce the risk. Control procedure (Adequate documents and recordkeeping): Computerize the invoicing of customers. Sales invoices are compared with shipping documents and approved customer orders before invoices are mailed out.	Preventive	Manual
Ship goods to customer					
Authorization Correct and unspoiled produce is sent to customer.	Lack of checking quality of produce before shipment. Unacceptable (spoiled) goods were sent to customers.	Occasions whereby the customer refused shipment. This caused customer ill-will and higher than expected adjustments to accounts receivable and inventory.	Risk response: Reduce the risk Control procedures (General authorization/Safeguarding assets): Shipping dept. has to verify quality before shipping to customer. Should be a quality control procedure to verify quality.	Preventive	Manual

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Invoice customer for shipped goods					
<p>Ownership Customer accounts are properly maintained. Past due credit is properly handed.</p>	<p>Lack of proper maintenance of accounts receivables. The person extending the credit sales could write off the a/r balance. Customers feel that they can delay payment.</p>	<p>Days receivables increased which caused cash flows to be less than expected.</p>	<p>Risk response: Reduce the risk. Control procedures (Segregation of duties/Safeguarding assets): There has to be segregation of duties between the person extending the credit and writing off the a/r balance. Overdue credit (past 60 days) is properly acted on.</p>	<p>Detective</p>	<p>Manual / Automated</p>

Chapter 7: Inform and Communicate

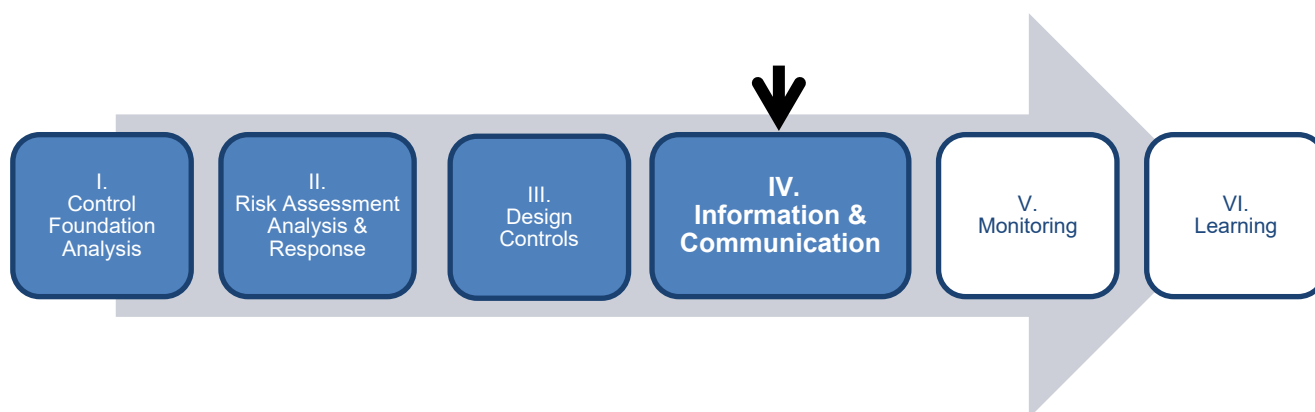
Once controls have been designed, they then need to be communicated to all those who will be affected by the newly designed controls.

Our fourth component has to do with making sure the company understands its *information needs* and then *communicate its needs*.

IV. Information & Communication

This component has to do with making sure those in the organization who have responsibility over financial reporting have the information they need so reliable, accurate and transparent financial statements can be produced. This means that if control deficiencies are found, the right people are held accountable, and action is taken to mitigate the risks.

To achieve this component there are *two primary principles* which need reviewing.



Principle 15: Determine information needs over financial reporting

A critical aspect of shaping your company's control system over financial reporting is to make sure your company is meeting its information needs. Once you know what information management needs you then need to make sure their needs are properly communicated within the organization.

For **example**, if a company's treasurer needs a detailed weekly cash report, then those who produce the report clearly understand what information needs to be included in the report and when the report needs to be submitted to the treasurer.

For there to be proper communication there needs to be free and unhindered financial information **flowing up and down** and **across the company's communication channel**. This sounds easy, but is often more difficult than it seems, or should be.

There can be a variety of reasons why information does not flow as freely as it should. This hindrance might be the result of:

- **Having a supervisor who does not respond well to criticism.** The supervisor may become defensive when criticized about his/her internal control supervision. Because of this defensiveness, information either stops flowing or is never started in the process.
- **Poor listening skills.** It is possible that the needed control issues are being discussed, but one of the people in the process just isn't listening. Because they do not 'hear' the discussion going on around them, the flow of information may stop or become misdirected.

Chapter 7: Inform & Communicate

Having proper listening skills goes a long way to improving communications. At the end of this section, we outline the **10 keys to effective listening**. Just remember, better listeners make better managers, and better managers make for successful companies.

- **Not being able to focus on current issues, such as control deficiencies.** Sometimes the issue of control is not the most interesting, so people just tune out and prefer to spend their time on something that is more interesting, but not necessarily more important.
- **Not wanting to admit that there are deficiencies where deficiencies have been found.** Sometimes it is difficult for managers to simply admit that there might be a problem which needs fixing.
- **Not willing to ask for help when help is needed.** Sometimes you know you have a problem but are unwilling to ask for help in solving the control problem. Because they do not ask for help, information stops flowing through the system.

There are many more reasons why information flow problems can and do occur within organizations. This list should give you an idea of the variety of problems that can exist and the impact that these problems can have on the flow of information.

We just mentioned what could impede the information flow. Now we want to talk about what is needed to achieve your communication needs.

Principle 16: Communicate financial reporting needs

Achieving your communication needs means:

- (1) **Senior management communicates to all personnel the importance of controls over financial reporting.** It does this by communicating that controls are critical for the company success and must be taken seriously. This communication takes place both *explicitly* (by what they say and write) and *implicitly* (by the way they behave).
- (2) **Stakeholders (i.e., audit committee, risk committee, accounting department) receive information on control deficiencies in a timely manner so corrections are able to be implemented.**
- (3) **Lower-level employees are able to report financial reporting control deficiencies to supervisors and senior management freely and without recourse.** This might be accomplished by having an established whistleblowing process for both internal and external parties.
- (4) **Communication exists between senior management and the board so both have relevant information to fulfill their governance and financial reporting objectives.**
- (5) **Communication exists with outside parties on matters of financial reporting.** This could include:
 - Making sure there are open communication channels with customers, suppliers, and other stakeholders, such as financial analyst and others.

As an **example**, it is not uncommon for companies to have a place on their website where people are able to ask questions, voice complaints, or give comments. This type of information can also be useful for the internal control process.
 - Having an independent assessment of financial reports by external auditors, or possibly a relevant regulatory agency.

It is important to remember that the type of communication process that exists in your organization over financial reporting is going to depend on the size and complexity of the company. Generally, smaller and medium-sized companies will tend to have a communication process that is *less formal than larger, more complex companies*. In smaller companies it is not uncommon for lower-level employees to have easy access to senior management, such as the CFO and CEO.

Chapter 7: Inform & Communicate

Staying on top of the Job

How a manager stays on top of the job, of course, depends on the job itself. Some jobs require close onsite supervision, while other jobs may not need the close supervision. Electronic communications have had a big influence on the way individuals, managers, and businesses receive, process and send information. These advancements have meant that it is possible for managers to stay on top of their jobs even without having to be on onsite. Below is the story of how one CEO was able to stay on top while doing what he loves doing -- skiing.

In between downhill runs [at Park City ski resort in Utah], Mr. Summe pulled out his tiny cellular phone and his 1.4-ounce Franklin Rex electronic organizer with its 12,000-name contact list and rang up his bankers at Goldman, Sachs & Co. about a planned purchase of an instruments business by his company, a maker of airport X-rays and laboratory instruments based in Wellesley, Massachusetts. With his cell phone and organizer, he can work anywhere and contact anyone. "I'm dangerous," he jokes. The 42-year-old Mr. Summe exemplifies how the executive's role is changing in the information age. "There is an exception for CEOs to be much more in touch with customers, employees, and investors than in the past," he says. "A big part of the reason may be technology." Being in touch, of course, also means being bombarded with more information -- more reports, more memos, more data.

Source: Kreitner R. & Kinicki A., Organizational Behavior, 5th edition, pg. 504

We understand that not every CEO is able to manage Mr. Summe's way. The key is to understand what your specific information needs are. This would include how often and what kind-of information you need to get the job done. Advances in technology has certainly changed (and will continue to change) the way managers manage, regarding how they receive information, how they storage and process the information and et cetera. However, you need to be careful about relying too much on automated information systems. It is always good to have a degree of skepticism when collecting information. Regarding information, there is a saying that goes, "*garbage in, garbage out.*" In other words, if your input is wrong, you have no chance for the output to be right.

Below we discuss some simple ways to achieve your information needs.

Guidelines to achieving your information needs

Regarding information, your goal is for "*relevant, reliable and accurate information to be identified, captured and communicated to the right people at the right time.*"

We have identified **three primary guidelines** to help you achieve your information needs over financial reporting. These guidelines include:

(1) **Validate key assumptions used in the production of financial reports.**

Financial managers, possibly including the CFO and CEO, should periodically review and validate the estimates used in the production of the financial reports. We discussed earlier that a vast majority of accounting problems/issues have to do with the manipulation of these accounting estimates. During your meeting with top financial managers, you should be asking yourselves whether the company's accounting estimates are reasonable, and within accounting practices.

(2) **Review exception reports in a timely manner.**

Exception reports or variance analysis are a useful financial management tool because they can point out material deviation between actual and expected results. Based on this, material deviations can then be investigated. If undesirable performance is identified, corrective action can then be taken. In addition, if a variance is favorable, the reasons for being favorable could also be analyzed so the situation becomes even more favorable.

Example: A variance between actual cost and standard cost for labor in a standard cost accounting system. In the area of data processing, an exception report may reflect those transactions not meeting the standards or requirements for the program being run.

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(3) Identify key performance/risk/control indicators.

It has been shown that there is a positive relationship/correlation between improved business performance and the improvement of internal controls. Management needs to determine its key performance/risk/control indicators that need to be continuously monitored. For any industry, there are certain general requirements for success.

As an example, in the insurance industry the requirement is for a positive investment performance. In this respect, the **key indicators** would be:

- Number of claims settled in a given period of time,
- Number of claims outstanding against major insurance policy,
- The number of policies processed in a given period of time, and
- Growth rate in insurance business with respect to each policy.

Sample Communications & Information Questionnaire Matrix

Communicating Findings to Management <i>All management, particularly those in positions over financial reporting need to receive a clear and concise message that internal controls over financial reporting is to be taken seriously.</i>	Yes	No	N/A	Person(s) Responsible	Control Testing Assessments & Observations
1. Does senior management communicate to all relevant personnel the importance of controls over financial reporting?					
2. Do stakeholders receive information on control deficiencies in a timely manner, so correction is able to occur?					
3. Do lower-level employees are able to freely and without recourse report control deficiencies to supervisors and senior management?					
4. Are there established internal & external communications channels?					
5. Do stakeholders receive information on control deficiencies in a timely manner so corrections can occur?					

Keys to Effective Listening

The following are recommendations to become a more effective listener by avoiding the 10 habits of bad listeners while cultivating the 10 good listening habits. **Always try to become a better listener**; your success might depend on it. If you are actually listening to the people who have to carry out the controls you will be in a better position to implement effective controls. The one common characteristic of all successful people is that they all have developed good listening skills.

Chapter 7: Inform & Communicate

Keys to Effective Listening	The Bad Listener	The Good Listener
1. Capitalize on thought speed	The bad listener tends to daydream	The good listener will stay with the speaker, mentally summarizing the speaker, weighing evidence, and listening between the lines
2. Listen for ideas	Listens for facts	Listens for central or overall ideas
3. Find an area of interest	Tunes out dry speakers or subjects	Listens for any useful information
4. Judge content, not delivery	Tunes out dry or monotone speakers	Assesses content by listening to entire message before making judgments
5. Hold your fire	Gets too emotional or worked up by something said by the speaker and enters into an argument	Withholds judgment until comprehension is complete
6. Work at listening	Does not expend energy on listening	Gives the speaker full attention
7. Resist distractions	Is easily distracted	Fights distractions and concentrates on the speaker
8. Hear what is said	Shuts out or denies unfavorable information	Listens to both favorable and unfavorable information
9. Challenge yourself	Resists listening to presentations of difficult subject matter	Treats complex presentations as exercise for the mind
10. Use handouts, overheads, or other visual aids	Does not take notes or pay attention to visual aids	Takes notes as required and uses visual aids to enhance understanding of the presentation

Source: Adapted from Kreitner R. & Kinicki A., Organizational Behavior, 5th edition, pg. 494

Chapter 7: Inform & Communicate

Chapter 8: Monitor & Learn

We have now reached the **last two components** of the “6x20” model – **Monitoring** and **Learning**. We first discuss the importance of monitoring and then discuss the importance of learning from mistakes.

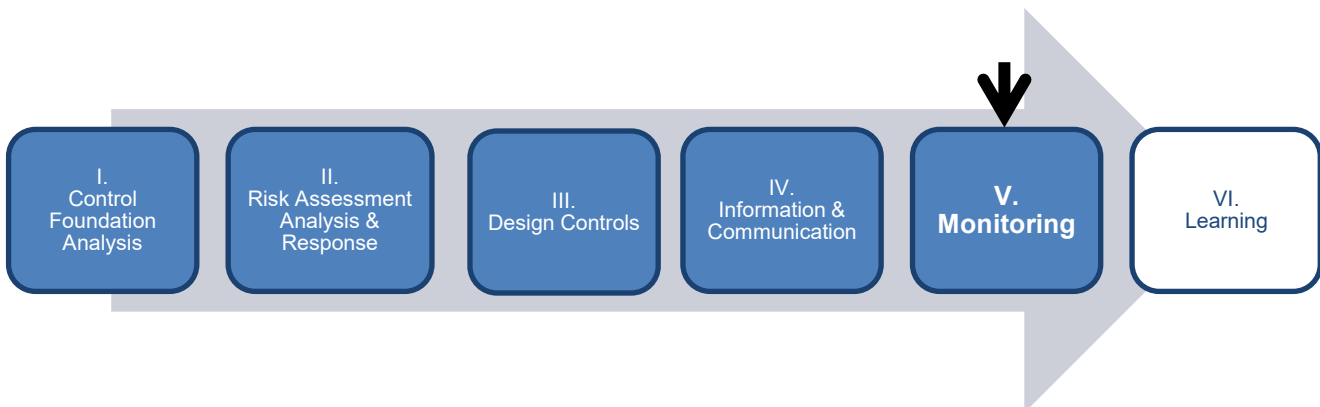
V. Monitoring

The previous component had you properly *inform* and *communicate* to those who will be directly impacted by the controls. However, when controls are put in place you have to then make sure the controls are operating as they should. This entails having a **monitoring** system which is able to let you know if control deviations are occurring, particularly over financial reporting.

**“If you can’t See, you can’t Do
and if can’t Do, You Fail”**

If deviations are occurring then you have to know why. Once you know the answer to the why question, you can then put in the controls to lessen the significance of the deviation.

The last component of the “6x20” model has to do with **learning**. In this case you have to make sure that if mistakes do happen, they do not happen again.



Monitoring - Why is it Important?

Over the past decade, companies have invested quite heavily into improving the quality of their internal control systems. Earlier in this paper we mentioned some reasons why this was done. First, good internal controls make good business sense since they can help a company meet its operating, financial and compliance objectives. Second, many companies were forced to do so because of regulatory requirements (i.e., SOX, SEC, and many other requirements).

If you want to know whether monitoring is important, simply ask yourself whether you would still have the same confidence level in your financial reports if you knew the company did not have a monitoring program? Probably not... Also, would you have confidence that identified control problems would be corrected in a timely manner? Also, probably not... Based on this, we can conclude that monitoring is, in fact, important and it is something that needs management's full and undivided attention.

Chapter 8: Monitor & Learn

COSO defines monitoring as “a system that is implemented to help ensure that internal control continues to operate effectively.”¹¹ COSO identified the following benefits of having a properly *designed* and *implemented* monitoring program:

- Control problems should be identified and corrected on a timelier basis,
- Financial statements should be more accurate and timelier,
- The company should be able to produce more *accurate* and *reliable information* for decision-making, and
- The company should be in a position to meet its certification requirements (i.e., SOX, ISO 9000 and other possible legislative requirements). This last point is particularly poignant if your company has to be in compliance with SOX 404 (For more information about SOX 404, refer to **Appendix B**).

Over time companies that establish an effective monitoring program should experience greater efficiencies, leading to lower costs associated with financial reporting on internal control because problems are identified and addressed in a more **proactive**, rather than a **reactive**, manner.¹²

How to establish an effective monitoring program

An effective monitoring program includes three activities. These activities are:

- (1) Perform **ongoing monitoring**,
- (2) Perform **separate evaluations**, and
- (3) **Report deficiencies**. When control deficiencies have been identified they need to be communicated in a timely manner to those who are able to take action.

Having these three activities as part of your overall monitoring program should give you greater confidence that you have the necessary control system in place and operating as it should. This should help you when having to document the effectiveness of ICFR.

On the following pages we discuss the above-mentioned monitoring activities in more detail.

Principle 17: Monitor results through ongoing monitoring

Ongoing monitoring is what your company's management is doing on a day-to-day basis. For example, a financial treasurer receives daily cash reports and based on these reports he/she will have an idea as to whether the company is going to have enough cash to cover its immediate cash needs. If there is an indication that the company will have excess cash, this excess cash could be invested in some marketable security, giving the company even more profit. On the other hand, if there is an indication that a cash shortage is imminent then the treasurer has the opportunity to see to it that the shortage can be taken care of. One responsibility of the treasurer is to keep the business liquid so basic obligations, such as wages and payments to vendors and creditors can be made. Having a liquidity problem could have negative repercussions for the company. As an example, if a vendor isn't paid on time, the next time the company needs materials or supplies the vendor could request a prepayment or have stricter credit terms. Either way this could result in higher finance charges for the company.

The idea of an effective ongoing monitoring program is to alert management that a potential problem might be in the forecast. Thus, if management is alerted, they will be in a position to possibly take care of the problem or at least

11 The Committee of Sponsoring Organizations of the Treadway Commission (COSO), Internal Control – Integrated Framework, pg. 69.

12 COSO's Guidance on Monitoring Internal Control Systems, January 2009, pg. 2.

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minimize it. Taking the example of the treasurer, if the treasurer receives cash report where the cash balance was below an acceptable amount the treasurer would be in position to make arrangements with the bank to cover any shortfall. A good way of alerting management of a problem, or potential problem, is through the use of indicators. We talk about the usefulness of indicators below.

The Use of Indicators in the Monitoring Process

Indicators are used to help companies define what they hope to achieve. The use of **indicators** as a management tool has been around for a while. In fact, **Henry Ford** used indicators when he was producing the model-T automobile back in 1903. Even though indicators have been around for a while they are still an excellent tool so the company can understand whether it is on track or not.

There are many different types of indicators but the three which are important for financial reporting are: **Key Performance Indicators (KPIs)**, **Key Risk Indicators (KRIs)**, and **Key Control Indicators (KCIs)**.

In the table below, we match the **organizational level** with the **indicator** that is most prevalently used at the level.

Organizational level	Indicator
Corporate-level	Key Performance Indicators (KPIs) – These indicators are used by senior management to understand how they are doing against their target.
Operational-level	Key Risk Indicators (KRIs) – These indicators are used by management to indicate the riskiness of an activity.
Transactional-level	Key Control Indicators (KCIs) – These indicators are used to understand if controls are in place relative to desired risk tolerances.

We further discuss the different types of indicators below.

Corporate-level indicators

We mentioned that **key performance indicators (KPIs)** are used at the corporate level to tell senior management whether they are on track or not. At this level, senior managers are asking the question: “**Are we achieving our desired level of performance?**” If not, then management needs to understand why not.

KPIs can be financial or operational. In the table below, we give some examples of the more common *financial* and *operational KPIs*.

Financial	Operational
<ul style="list-style-type: none"> ▪ Production cost per unit. ▪ Gross margin percentage. ▪ Operating profit and profit margin percentages. ▪ Asset turnover ratio. ▪ Return on Capital Employed (ROCE)/ Return on Assets (ROA). ▪ Employee expenses/headcount. ▪ Write-offs as a percentage of revenue, or as a percentage of ending receivable balance. ▪ Provisions as a percentage of assets. ▪ Reserves as a percent of A/R over 90 days past due. ▪ Variance analysis (flexible budget vs. actual). ▪ Market value to contract value of financial instrument. 	<ul style="list-style-type: none"> ▪ Number of defects produced in a production run. ▪ Throughput contribution (sales minus cost of material). ▪ Throughput as a percentage of capacity. ▪ Number of orders past due. ▪ On time delivery percentage. ▪ Number of complaints. ▪ Returns as a percentage of sales. ▪ Days of inventory. ▪ Inventory turnover ratio. ▪ Days of receivables. ▪ Receivables turnover ratio. ▪ Market share.

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- | | |
|--|--|
| <ul style="list-style-type: none">▪ Accounts receivable aging.▪ Accounts payable aging.▪ Financing costs as a percent of revenue.▪ Working capital.▪ Time-interest earned coverage.▪ General & administrative expenses as a percentage of revenue.▪ Earnings per share (both basic and diluted).▪ Trends of debt-to-equity. | |
|--|--|

Operational-level indicators

At the management level, **Key Risk Indicators (KRIs)** are used to help management identify the riskiness of an activity. In this case, KRIs is used to answer the question: “**How are our risks changing and are they within our risk tolerance levels?**”

Whereas KPIs can tell you whether you are achieving your targets, KRIs can serve as an early warning to identify potential risks which could keep your company from achieving its objectives. Based on this, KRIs becomes the foundation of a company’s risk analysis, and thus, can help identify financial reporting risks.

For **example**, if you are noticing that your company’s gross profits have been eroding without any clear reason, then you need to decide if the trend is getting worse, or whether was a one-time event. If the trend is getting worse than this could be telling you that something else is going on, such as incorrect inventory values due to miscounting or actual stealing of inventory by employees. KRIs might not specifically tell you what the problem is, but they can tell you the trend is getting worse, and an investigation is needed.

Transactional-level Indicators

Finally, we come to the transaction level indicators. It is at this level that controls are instituted so risks can be managed to an acceptable level. KCIs are used to answer the question: “**Are our company’s internal controls effective? Are we ‘in control’?**”

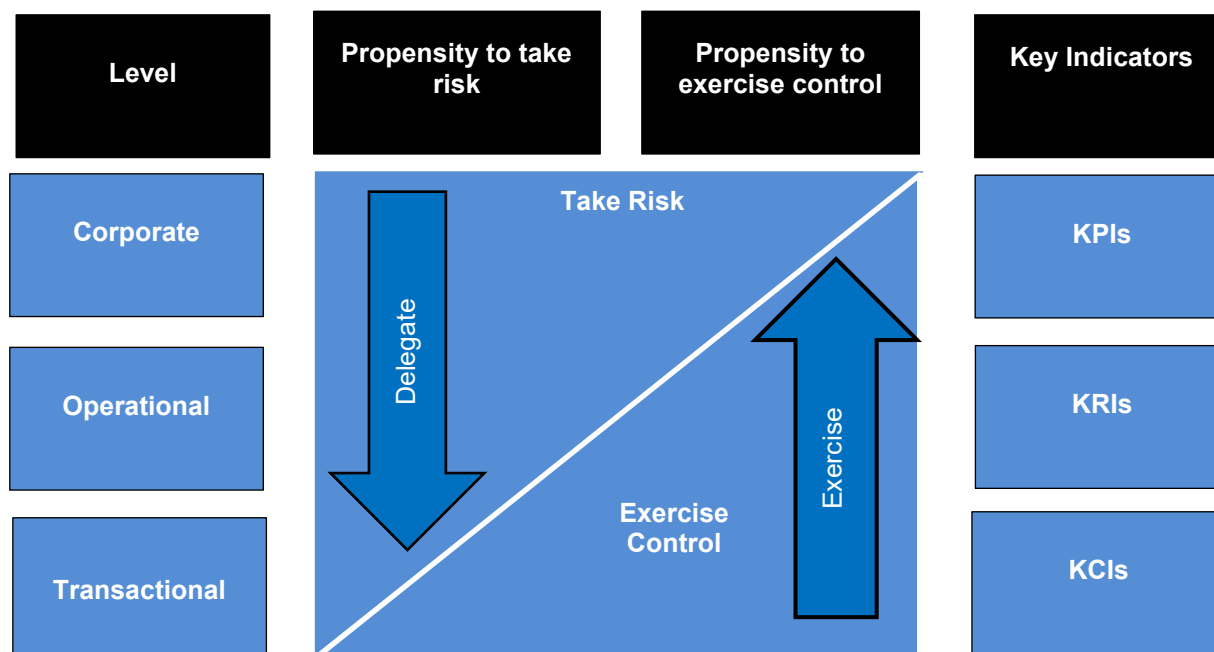
As you can surmise: KPIs and KRIs set the boundaries for the company’s risk tolerances and KCIs make sure the company has an effective control and monitoring system so risks can be dealt with. Continuing with the example given above, if gross margins are less than they should be, the KRI brought the potential risk to management’s attention. The KCIs role in this case is to ensure that management adequately responds to the risk situation (eroding gross margins). Based on this, operational people would need to verify that controls over inventory are effective. This means making sure inventory is not being stolen and it is valued at the right amount.

In this example, maybe the reason of the eroding margins was because the company had to take a higher-than-normal write-down due to obsolescence. If this is the case, controls would have to balance between stock outs (not having enough inventory in stock) and the risk of having too much inventory in stock and not being able to sell it, thus leading to the write down and higher than expected cost of goods sold.

In **Exhibit 8.1**, we show the link between KPIs, KRIs and KCIs. Remember, risk is taken at the corporate level. It is then delegated down through the organization. It is at the transactional level that controls are actually exercised, and risk is managed.

Exhibit 8.1

Organizational Levels Linked to Key Indicators



Source: Adapted from Institute of Risk Management

Final Word about Using Indicators

We just defined and explained the use of KPIs, KRIs, and KCIs. The difficult part now is to put these indicators to work.

As a final word, you simply need to remember that these indicators are useful because they can help you:

- (1) **Identify and communicate exceptions** (the use of KPIs).
- (2) **Identify trends, thus risks** (the use of KRIs).
- (3) **Understand what actions (implementation of controls) need to be taken if outside the tolerable range** (the use of KCIs).

The Role of the External, Internal and Governmental Auditors in the Control Process

Besides management, there are other parties who have a keen interest in making sure controls are in place and working as intended. These parties are **external auditors**, **internal auditors**, and possibly **governmental auditors**.

1) External Auditors

The external auditors' purpose is to give an opinion on the fairness of the financial statements. However, in order to judge whether the financial statements are fairly stated, the auditor first needs to review and assess the company's control systems.

Based on AU 316 (*"Fraud Consideration in an Audit of Internal Control over Financial Reporting"*), *"the auditor should evaluate all controls specifically intended to address the risk of fraud that have at least a reasonably*

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possible likelihood of having a material effect on the company's financial statements. Controls related to the prevention and detection of fraud has a pervasive effect on the risk of fraud. Such controls include, but are not limited to, the:

- Controls restraining misappropriation of company assets that could result in a material misstatement of the financial statements.
- Company's risk assessment processes.
- Code of ethics/conduct provisions, especially those related to conflicts of interest, related party transactions, illegal acts, and the monitoring of the code by management and the audit committee or board.
- Adequacy of the internal audit activity and whether the internal audit function reports directly to the audit committee, as well as the extent of the audit committee's involvement and interaction with internal audit; and
- Adequacy of the company's procedures for handling complaints and for accepting confidential submissions of concerns about questionable accounting or auditing matters."

This is a huge responsibility for external auditors, but the failure to properly review, evaluate and assess internal controls can have a very negative impact on the external audit firm (*Arthur Anderson* is a good example). The importance of making sure controls are as they should be has led external auditors to form a sort of partnership with the internal auditor.

2) Internal Auditors

Internal auditor's work has become more and more crucial to the success of companies, especially large companies. According to the Institute of Internal Auditors (IIA), the U.S. professional organization of internal auditors, internal auditing is defined as:

"An independent, objective assurance and consulting activity designed to add value and improve an organization's operations. It helps an organization accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control and governance processes."

Over time, the role of internal audit has expanded to be more than just "bean counters." In many cases, internal auditors provide consulting services as well (i.e., advisors, trainers, facilitators, counsel, et cetera). A reason for the expansionary role of the profession was because of economics, but also because of the increased professionalism of the profession itself. Today, the goal of internal audit is to assist management carry out their monitoring responsibility effectively and efficiently. Based on this, internal auditors can assist management in carrying out their day-to-day functions in an effective and efficient manner.

Regarding internal controls, internal auditors' have the responsibility to promote effective control at a reasonable cost. Internal auditor can do this by:

- Testing individuals' compliance with controls to determine whether policies and procedures established by management are being followed, i.e., the quality of performance in carrying out assigned responsibilities.
- Evaluating the adequacy and effectiveness of the control system in a systematic and thorough manner.
- Examining and evaluating the reliability and integrity of financial and operating information and the means used to identify, measure, classify and report the information.
- Reviewing systems that impact operations and reports to determine whether the organization is in compliance with policies, plans, procedures, and regulations.
- Examining and evaluating the effective and efficient use of an entity's resources.

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- Reviewing the means used to safeguard assets and verifying the existence of those assets as appropriate.
- Furnishing analyses, appraisals, recommendations, counsel and information concerning activities reviewed to the management of the organization in order to assist them in the effective discharge of their responsibilities.

3) Governmental Auditors

Governmental auditors work for either the country's tax authority (for example, in the U.S. it is the Internal Revenue Service (IRS)), or for a regulatory agency that oversees companies that use the public's money, such as banks or insurance companies. These agencies have a strong interest in making sure the organization's books are in order and meet government regulations, such as required deposits, etc. The government's interest is to protect the public's money and banks and insurance companies both hold a lot of money for the public. Because of the governmental regulations, banks and insurance companies in most countries are required by law to have strong internal controls.

Each one of the above-mentioned auditors is looking for those items or risks that could keep the financial statements from being reasonably accurate or correct.

Principle 18: Periodically conduct separate evaluations

The second aspect of monitoring is the need for individual or separate evaluations. These evaluations are used *"to provide feedback on the effectiveness of the ongoing monitoring program."*¹³ These types of evaluations need to be done by someone who understands the components being evaluated and how they relate to the activities supporting the reliability of financial reporting. You need to be careful that the person doing the evaluation can maintain his or her objectivity and independence. In other words, the person needs to be totally unbiased when doing the review. The person could be the internal auditor or someone else in the company.

It might also not be a bad idea to use an independent party to perform the separate evaluation. The findings could then be used to show compliance with Sarbanes-Oxley as in accordance with **Section 302**.

The **scope** and **frequency** of the separate evaluations will depend on the:

- Significance of the risks, and
- Importance of the controls necessary to minimize the risks.

Below we discuss the involvement of the internal audit function in this review process.

Involvement of the Internal Audit Function

It is likely that the internal audit function will be involved in providing separate evaluations of business processes. Internal auditors have a keen interest to make sure management's monitoring programs are effective. If internal audit is conducting a separate evaluation, then the scope and frequency needs to be agreed to by the Chief Audit Executive (CAE), senior management and the board/audit committee.

13 Internal Control-Integrated Framework, "Guidance for Smaller Public Companies Reporting on Internal Control over Financial Reporting, pg. 112.

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The scope of the evaluation will depend primarily on the significance of the risks being controlled and the importance of the controls in reducing risks to an acceptable level. Prior to the start of the review, the CAE needs to make the audit staff operate in an unbiased manner and have the skills and knowledge on the control system being reviewed.

Upon completion of the evaluation, the CAE will distribute the evaluation report to appropriate members of the staff, including the staff under review, senior management and the board.

The contents of the report would include:

- The objective and scope of the work performed,
- Comparing what should be with what is, and
- Documenting control deficiencies and management's response and proposed remediation.

As part of the evaluation process, it is suggested that senior management sign off on the report, thereby providing evidence that the control deficiencies are understood, and appropriate corrective action will be done. If management decides to assume the risk of not correcting the reported condition because of costs or other considerations, then this provides evidence that the internal auditor fulfilled its responsibility to the company, even if there is strong disagreement.

Principle 19: Report control deficiencies over financial reporting to management

Any time a **control deficiency over financial reporting** is found you need to make sure the deficiency is **properly communicated and is reported in a timely manner**.

- **Properly communicating results.**

If a control deficiency over financial reporting is found, you must communicate it to the appropriate level of management. It is usual protocol to report the control deficiency to the person who is able to make correction and one level above that person. This would ensure that the problem gets handled correctly.

In some cases, if the control deficiency is thought to be serious enough a report should be given to the board, so they are able to fulfill their oversight responsibly. This is particularly true if the company is publicly traded and has to report to the SEC and be in compliance with Sections 302 and 404 of Sarbanes-Oxley.

While not reporting control deficiencies can be disastrous for a company, reporting unnecessarily can also leave the door open to other problems, such as stock market backlash, etc. The goal should be to report what needs to be reported to ensure the problem is taken care of and also minimize negative backlash.

- **Reporting in a timely manner.**

A critical aspect of communications is for communications to be timely. This is particularly crucial when discussing control issues over financial reporting.

For **example**, if there was a material year-end cutoff issue, reporting this issue after the presentation of the financial statements would not be considered timely.

If a control deficiency does exist, it might be because of a **design deficiency** (e.g., there is a lack of segregation of duties) or because of an **operational deficiency** (e.g., not getting proper authorization for a credit sales). The definition of control deficiency is defined by PCAOB below.

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Note: PCAOB, Auditing Standard №5 says “a **deficiency in internal control over financial reporting** exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect misstatements on a timely basis.

- A deficiency in **design** exists when (a) a control necessary to meet the control objective is missing or (b) an existing control is not properly designed so that, even if the control operates as designed, the control objective would not be met.
- A deficiency in **operation** exists when a properly designed control does not operate as designed, or when the person performing the control does not possess the necessary authority or competence to perform the control effectively.”

Monitoring Questionnaire Matrix

You can use the following questionnaire to help you assess whether management has established an effective monitoring program to minimize the risk of misstated financial reports.

Ongoing monitoring program	Yes	No	N/A	Person(s) Responsible	Control Testing Assessment & Observations
<i>Ongoing monitoring enables management to determine whether internal controls over financial reporting are present and functioning as intended.</i>					
1. Does management periodically review the accounting processes to ensure expectations are met?					
2. Does management regularly monitor its key performance indicators (KPIs), key risk indicators (KRIs), and key control indicators (KCIIs)?					
3. Are variances from expected performance indicators investigated and resolved?					
4. How often are deviations from expected performance discussed with the board?					
5. Are financial reports submitted to management with analysis of performance?					

Separate evaluations	Yes	No	N/A	Person(s) Responsible	Control Testing Assessment & Observations
<i>Separate evaluations are used to gain more insight to controls over financial reporting.</i>					
1. Does the company conduct separate evaluations?					
2. Is the person conducting the evaluation considered to be independent?					
3. How often are separate evaluations conducted?					
4. Is the evaluator someone who understands the company's control system and the means by which reliable financial reports are produced?					
5. Does management vary the scope and frequency of separate evaluations depending on the significance of risks being controlled and importance of the controls in mitigating those risks?					

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Reporting deficiencies <i>Control deficiencies are properly communicated and communicated in a timely manner to allow for corrective action.</i>	Yes	No	N/A	Person(s) Responsible	Control Testing Assessment & Observations
1. Are control deficiencies first communicated with the process owners? Are they in a position to take corrective action?					
2. Are control deficiencies regularly, or as necessary, communicated with senior management and the board?					
3. If corrective action is not taken, do senior management and the board assume responsibility for not taking corrective action?					

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VI. Learning

We have now come to the end of our **pathway**.

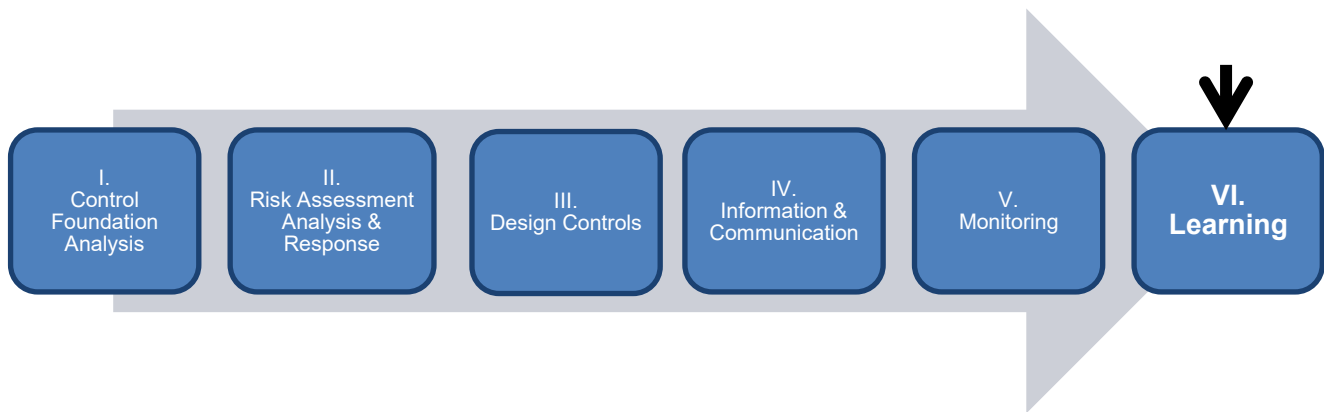
This final stage has to do with why learning is so important for businesses. Ultimately, learning is crucial if you hope to **maintain strong internal controls**.

“Tell me, I forget. Teach me and I remember. Involve me and I learn”

Source: Benjamin Franklin

It has also been said that *“those who don’t learn from the past are doomed to repeat it.”* The last thing companies’ need is to keep making the same mistake over and over again. Unfortunately, this is what happens too often.

Our last principle has to do with developing a learning program.



Principle 20: Develop a learning program

This last principle is one that does not get a lot of attention; however, we consider it to be an important principle because most managers want to avoid making mistakes. Mistakes means errors, and errors lead to misallocation of resources and inaccurate financial reports.

It is through the establishment of a learning process that people within the organization are able to learn from past mistakes, so the same mistakes are not repeated. Most people would think that developing a learning program is something that does not even need to be discussed since it seems obvious that one should learn from one’s past mistakes. However, lessons of the past tell us differently. In the early part of this century we had the accounting scandals of *Enron*, *WorldCom*, and others. We then had the 2008-09 financial meltdown. Unfortunately, many of the reasons that both situations were able to occur had to do with senior management not fully understanding the risks they faced and not properly accounting of those risks.

From the ruins of *Enron* came the **Sarbanes-Oxley Act**. It seems obvious that more regulation and more governmental oversight over company affairs will follow. However, as we mentioned earlier, experience tells us that these acts are rarely successful. Business by its very nature is risky and there is no way to completely eliminate risk from the business community. It then becomes management’s responsibly to understand what risk it does face and to act in a **responsible manner**.

Acting in a responsible manner is having the foresight to know that mistakes are going to happen and also having the fortitude to admit that when mistakes do happen we should try to learn from the mistakes, so they do not happen again. If a mistake does happen, real progress occurs when the information on the mistake is shared with others so

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they can avoid the same mistakes. When this information is shared with others, either internally or externally, it is referred to as **share learning**, which is discussed on the next page.

The idea of shared learning

For most people, learning is more than just taking a class or getting a degree. It is the desire and the want to learn from past experiences. From past experiences, you can understand what works and what doesn't work. From a company perspective, it wants to make sure that the individuals that work for it are able to learn from their experiences and then share these lessons with colleagues. We call this **shared learning**. The idea behind shared learning is to make groups collectively smarter than they otherwise would have been.

It is for this reason that organizations need to encourage shared learning. With a shared learning program, you are attempting to rise to higher level of achievement, and to continuously make improvements. For shared learning to be successful, it needs to be practiced throughout the company and the employees must be committed to it. Shared learning encourages employees to take chances, but more importantly, it allows them to learn from their successes and also learn from their mistakes or failures. You have probably heard the saying, "*you can't learn unless you fail.*"

A major hurdle to overcome with shared learning is the idea that if you admit to a mistake, you will lose face. Some people are willing to admit their mistakes in private but not in public. Others simply try to hide them, and in most cases, this makes the problem even worse. In order to enhance the idea of shared learning, employees should be encouraged to acknowledge and discuss mistakes. This would then give colleagues the opportunity to learn from another's mistake. However, for this to happen, management must have the fortitude to endure good faith errors, the ability to evaluate the efforts honestly, and the patience to intervene only if absolutely necessary.

Guidelines to help you establish a shared learning program

There are **three primary guidelines** behind any shared learning program. These are to:

- 1) **Encourage people to be candid about sharing their successes and acknowledging mistakes.**

Without candor a shared learning program is not likely to be developed.

- 2) **Establish a non-threatening atmosphere, such as in a group or team, where people can feel comfortable with sharing their experiences.**

Management should try to discourage the perception that admitting to mistakes is equivalent to losing face. In order to avoid repeating mistakes there needs to be a process to let others know what the mistake was. Keeping mistakes to *yourself* does not do any good.

- 3) **Make sure the business has an established forum whereby people are able to be honest, so if mistakes do happen, people within the business are able to discuss what went wrong and learn from the mistake.**

Besides learning from mistakes, you can also learn from successes as well. If you can learn why something went right, maybe you can repeat the same success. This is how companies have become even more successful than they were.

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Sample Learning Questionnaire Matrix

You can use the following questionnaire to help you assess whether management has established an effective monitoring program to minimize the risk of misstated financial reports. In addition, this section also looks at the company's learning process.

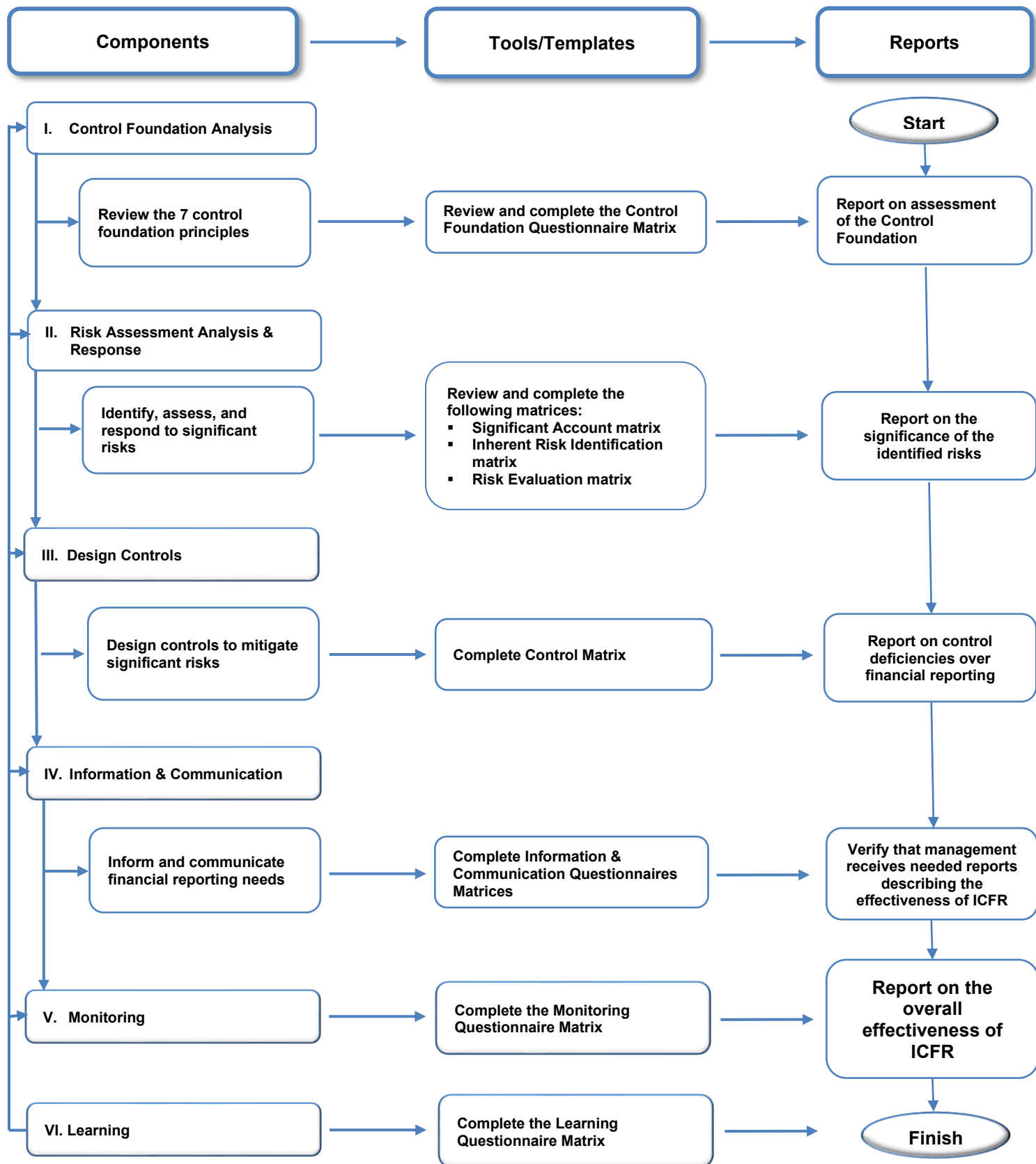
Shared Learning	Yes	No	N/A	Person(s) Responsible	Control Testing Assessment & Observations
1. Does management encourage the discussion of mistakes?					
2. Is there a non-threatening atmosphere in the company where employees can candidly discuss mistakes that have happened?					
3. Is there a forum within the business that when mistakes do occur people within the business are able to discuss and learn from the mistake?					

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Chapter 9: Internal Control Documentation & Reporting

Documentation and Reporting Template

We have just gone through the “6x20” model whose purpose is to help you **identify, assess, respond, report** and **improve** ICFR. In the diagram below we summarize the process.



Chapter 9: Documenting & Reporting on ICFR

Report on the Effectiveness of ICFR

To be useful for management, you need to produce your findings about the effectiveness of ICFR. If you are a publicly listed US company, then you need to report your findings on the effectiveness of ICFR to the Securities Exchange Commission (SEC). The SEC requires all listed companies to report on their assessment of ICFR in their annual reports. A report on ICFR would include:

- A statement of management's responsibility for establishing and maintaining adequate internal control over financial reporting for the company.
- A statement identifying the framework used by management to conduct the required evaluation of the effectiveness of the company's internal control over financial reporting.
- Management's assessment of the effectiveness of the company's internal control over financial reporting as of the end of the company's most recent fiscal year, including a statement as to whether or not the company's internal control over financial reporting is effective. The assessment must include disclosure of any "material weaknesses" in the company's internal control over financial reporting identified by management. Management is not permitted to conclude that the company's internal control over financial reporting is effective if there are one or more material weaknesses in the company's internal control over financial reporting; and
- A statement that the registered public accounting firm that audited the financial statements included in the annual report has issued an attestation report on management's assessment of the registrant's internal control over financial reporting.

A sample of management's report is included in **Appendix B, Section 404 Certification** for Nokia Corp.

The report made to the SEC is a very standardized report and really does not contain any useful information about specific control deficiencies, if there were any. The main function of the statement is to get management to take responsibility for the company's internal controls over financial reporting. The SEC believes that if management has to sign-off on the financial reports and also has to report on the effectiveness of its ICFR then there will be a greater likelihood that control deficiencies will be identified and corrected in a timely manner.

Present your Findings to Management

The fourth component of the "6x20" model has to do with meeting management's **communication** and **information needs**. This means that when presenting your findings to management you have to present reports (any report) which are understandable and useful for management. Reports you present need to be **accurate, objective, clear, concise, complete** and **timely**.

- **Accurate** – free from errors and distortions and is faithful to the underlying facts.
- **Objective** – factual, unbiased and free of opinion.
- **Clear:**
 - Everything that is required is explained,
 - The writing is concise (not wordy) and does not use technical terminology and abbreviations that are not widely understood and
 - Necessary background information is provided.
- **Concise** – it is short, to the point and does not include unnecessary detail. Summaries should be used for long reports.
- **Complete** – it lacks nothing. It includes all significant and relevant information that support the recommendations and conclusions.

Chapter 9: Documenting & Reporting on ICFR

- **Timely** – the report needs to be issued on time so that management will be able to act upon the recommendations of the report.

Also, reports that you present to management have to be **formatted** the way management wants. If the CEO or CFO have a specific format structure they want then you need to carry out their wish. As an **example**, I worked many years for a CEO who wanted a brief **executive summary**, explaining what needed to be done. The executive summary should not be more than five pages. Since CEOs and other Cs are busy, tell them what needs to be done first, and then give the details supporting your recommendations. Additionally, it may be useful for you to also present an **action plan** that lays out how the recommendations need to be implemented. Management may disagree with your plan, but it gives them a basis from which to decide the best way to implement your recommendations.

The following is a common format structure that I used when preparing reports. You may find this structure useful; however, you need to prepare whatever format structure your management wants.

Date:	March 1, 20X2
Report Title:	Report on the effectiveness of control over financial reporting
Submitted by:	Senior Internal Auditor
1. Executive Summary: The executive summary should briefly state the findings and recommendations. The executive summary should generally not be over 4 to 5 pages.	
1.1. Background and Audit Objective	
1.2. Overall Conclusion and Recommendations	
2. Background Information: This introduces why the audit was conducted and other information considered relevant to the review.	
3. Audit Objective and Scope: This lays out the specific objectives of the audit and scope of the audit. The scope describes what is to be done during the audit.	
4. Approach and Methodology: This describes the approach and methodology you took to complete the audit (review). For example, did you use <i>International Auditing Standards</i> , or <i>International Standards for the Professional Practice of Internal Auditing</i> , or some other standards when doing the audit.	
5. Findings and Recommendations: These are the specific findings and recommendations found. The findings have to support your recommendations.	
6. Other Related Observations and Recommendations: Report other issues that need to be brought to management's attention.	
7. Appendices: You can include appendices to clarify points or provide more detailed information.	

Chapter 9: Documenting & Reporting on ICFR

ILLUSTRATIVE CASE STUDY

Case Study

Illustrative Case Study: Astra Foods, LLC

For this illustrative case study, we will be looking at developing an audit report on the effectiveness of controls over credit sales. In this document we used credit sales as our example of how risks can be identified (refer to **Inherent risk evaluation matrix**), how they can be evaluated for their significance (refer to **Risk evaluation matrix**) and how they can be dealt with (refer to **Control matrix**). It is the Control matrix that links controls with the identified deficiencies.

The exercise now is to take what information has been gathered and develop a report for management. We again want to stress the necessity of being able to present information in a way that is clear and concise for management – information that they are able to use. If you are unable to properly present and communicate your findings and recommendations then there is a high probability that you wasted your time and management's time.

In the last chapter we presented a sample report structure for reporting on controls. However, remember, make sure you report in a manner that is acceptable to your company's management. For **example**, if a manager finds pie charts more useful for getting ideas across, then use pie charts in your reports. If another manager finds histograms more useful, then use histograms.

General Background Information for Case Study

This case study revolves around a company referred to as **Astra Foods**. The company sells its fresh produce to a large metropolitan market.

General information about the credit sales program is given below:

- The financial reporting period is the calendar year (January 1 – December 31, 20X1).
- For 20X1, total produce sales revenue was \$3.846 million, of which \$3.269 million was credit sales.
- Normal credit terms are for 30 days. Average account receivable balance for the year was \$350.4 thousand.
- The average days of receivables are 39 days, which is 30% higher than targeted.
- There is no cash discount for early payment.
- Price and volume discounts can be negotiated, but only with sales manager's authority.

Other general information about the company includes:

- The company, Astra Foods, is part of a holding company structure. The Holding company is made up of six subsidiaries.
- The holding company has just established an audit committee, made up of 3 members. The Chairman is the former CFO of the holding company. The other two members are independent NEDs (Non-executive Directors).
- The holding company has an internal audit function (staff of 3) which is responsible for the reviewing controls over financial reporting for all invested companies. The chief audit executive (CAE) reports to the CFO and audit committee.
- Astra Foods has never had an external audit. The audit committee has discussed having the company audited for the year 20X1.
- Financial statements are to be in accordance with **US GAAP**.

One of the first tasks of the audit committee was to review the most recent financial statements of the six subsidiaries, including the financial statements of Astra Foods. The following information was discovered when reviewing the

Case Study

financial reports and notes. The discovered information caused the audit committee to be concerned that there were not the adequate controls over credit sales. The information causing concern includes:

- **Gross margin** for produce sales was below targeted.
- A review of the company's **aging of accounts receivables** showed a high level of credit sales past due.
- There was an unacceptable **high level of returned produce**.
- The accounting department complained that there was an unacceptably **high number of duplicate orders** being processed.

Based on the audit committee's concerns, they asked the internal audit function to conduct a review of controls over credit sales.

The following is the report presented by the CAE to the audit committee, sales manager, warehouse manager, chief accountant and chief financial officer (CFO).

Report on the Effectiveness of Controls over Credit Sales

Using the format structure outlined in Chapter 9, we present a sample audit report over credit sales.

Astra Foods, LLC.

Date of Report: March 15, 20X2
Report: Audit of Internal Controls over Credit Sales
For: Chairman of Audit Committee
Chief Financial Officer
Warehouse manager
Chief Accountant
Submitted by: Senior Internal Auditor

1. Executive Summary:

1.1. Background and Audit Objective:

The audit of internal controls over credit sales was conducted from February 1 - 15, 20X2. The objective of the audit was to review the effectiveness of internal controls over the credit sale process. The audit was a special request made by the holding company's audit committee.

The audit committee, following its review of Astra Foods financial statements, became concerned that there were major deficiencies in the controls over credit sales. Their concerns stemmed from the fact that the last financial statements (issued December 31, 20X1) showed:

- **Gross margin** was below targeted (20% expected vs. 16.6% actual).
- **Aging of accounts receivables** shows that more than 26% of total a/r balance is listed as 60 days past due.
- There was **higher level of returned produce than expected**.
- The accounting department complained that there were an **unacceptably high number of duplicate orders** being processed.

Case Study

1.2. Overall Conclusion and Findings:

The audit found several major deficiencies in the design and operational effectiveness of internal controls. These deficiencies are considered to be significant enough, so immediate action is necessary. Additionally, we also found other areas that need attention.

The identified major deficiencies are:

1) **Lack of proper authorization/inadequate segregation of duties.**

The sales personnel have on numerous occasions extended credit to customers without proper authorization. A significant amount of credit (\$75,000) was extended to customers with questionable credit history. It is believed that this explains why a high percentage of credit is past due (more than 26% of accounts receivables is 60 days past due).

2) **Lack of proper authorization.**

The sales personnel often gave discounts without proper authorization. It was shown that sales were often made at a loss. This resulted in the company not meeting its gross margin objective (20% expected vs. 16.6% actual).

3) **Lack of proper recordkeeping.**

There was an unacceptable amount of duplicate orders being processed which led to mistakes in the financial information and wasted personnel's time correcting the mistakes (cost to company estimated to be no more than \$5,000).

4) **Lack of checking the quality of produce before shipping.**

This resulted in spoiled or damaged goods being sent to customers. More than \$150 thousand worth of goods came back.

5) **Lack of proper maintenance of account receivables.** Accounts receivable balance increased from \$195.4 thousand to \$506.4 thousand. This increase caused days of receivables to go from just over 30 days to 39 days.

Other observations and findings which we believe need discussion/attention are:

1) The company currently uses the direct write-off method for bad debts. This means that bad debts are only written off when management determines that there is no possibility of repayment. US GAAP prefers the use of the **allowances for doubtful debts method**.

2) The holding company and Astra Foods do not have a written **code of conduct**.

3) The company **does not offer a cash discount** for early payment.

The following are the **identified control deficiencies** with **recommended control procedures**.

Identified Control Deficiencies	Control Procedure/Recommendation
1. Lack of proper authorization/inadequate segregation of duties.	General authorization/Segregation of duties. Salespeople should not be able to extend credit without proper authorization. Proper authorization means that someone other than the person making the sale should be able to give credit to the customer.
2. Lack of proper authorization.	General authorization. Prices are verified from computerized price list which is updated on a daily basis. Price discounts have to be authorized by the sale manager.
3. Lack of proper recordkeeping.	Adequate documents and recordkeeping. Computerize the invoicing of customers. Sales invoices are compared with shipping documents and approved customer orders before invoices are mailed out.
4. Lack of checking the quality of goods before shipping.	General authorization/Safeguarding assets. The shipping department has to verify the quality of goods before shipment. Should be a quality control procedure to verify quality.
5. Lack of proper maintenance of account receivables.	Segregation of duties/Safeguarding assets. Make sure there is proper segregation of duties so the individual making the sale cannot write off the a/r. Need to make sure that invoices are sent out in a timely manner and, if accounts become overdue, then proper steps are taken to inform customer of overdue account and action is taken to recover on debt.

Case Study

The following are the **other findings** with **recommendations**:

Other findings	Recommendation
1) Improper accounting of doubtful debts.	The company currently writes off bad debts only when all means to recover debt have been exhausted. Based on US GAAP, given the high level of doubtful debts, the company should set up an allowance for doubtful debts.
2) No Code of Conduct.	Having a Code of Conduct is seen as the first line of defense against unethical behavior. The Holding Company should develop a Code of Conduct which is approved by management and reviewed by all employees. There should be training courses to verify that employees understand the Code and understand the repercussions if violations are found.
3) Cash discounts for early payment.	The company should consider offering cash discounts for early payments. For example, it may offer 1% discount if payment is made within 10 days of the invoicing date. It is believed that this could lower the days of receivables from its current 39 days.

2. Background information:

The audit committee requested the internal audit function of Astra Foods to review the adequacy of controls over the credit sales process. The audit committee became concerned that controls over the process were **not adequate**. Their assessment was based on the following:

- 1) **Gross margin** for produce sales was 16.6% (\$637.5 thousand). Targeted gross profit was 20%.
- 2) A review of the company's **aging of accounts receivables** report showed that more than 26% of total a/r balance is listed as more than 60 past-due (\$135,400).
Of this amount, it is anticipated that the company will have to write-off 30-40% (\$40,000 - \$55,000). The company uses the direct write-off method.
- 3) More than 5% of the delivered produce was **returned as unacceptable** (\$192.4 thousand worth of returns).
- 4) The accounting department complained at there was an **unacceptably high number of duplicate orders** being processed.
- 5) The accounting department complained that the salespeople were **not properly invoicing customers** leading to delay (up to 30 days or more) of customers being invoiced for delivered produce.

An audit over credit sales was initially scheduled to be conducted during the second quarter of 20X2; however, because the audit committee raised some concerns about the effectiveness of controls over credit sales, the CAE decided to move the audit up, so it was conducted before the publication of the 20X1 financial statements.

3. Audit Objectives and Scope:

The **overall objective** of the audit was to verify that controls over credit sales exist and, if deficiencies are found, recommendations for mitigation are provided.

The **scope** of the audit consisted of testing the existence and operational effectiveness of internal controls over credit sales. The activities within the credit sales process are to:

- 1) Process the customer order,
- 2) Ship product to the customer, and
- 3) Invoice the customer for product shipped and accepted.

4. Approach and Methodology:

The internal audit over credit sales was conducted in accordance to the *International Standards for the Professional Practice of Internal Auditing* as defined by the **Institute of Internal Auditors (The IIA)**.

Case Study

The standards require that the audit be conducted in such a way as to obtain reasonable assurance that the audit objective is achieved. The audit was conducted in accordance with detailed audit program that tested each of the internal financial reporting objectives over credit sales.

The internal financial reporting objectives over credit sales are:

- 1) Customer order is promptly taken and properly authorized (**Authorization**).
- 2) Customer order is properly priced, and amount of sales is correct (**Valuation**).
- 3) Only valid orders are fulfilled (**Validity**).
- 4) All valid orders are processed and recorded (**Completeness**).
- 5) All relevant information is properly classified and/or disclosed (**Classification / Disclosures**).
- 6) Only valid orders are prepared for shipment (**Validity**).
- 7) Shipped produce is recorded in proper period (**Cutoff**).
- 8) Only quality produce is authorized for shipment (**Authorization**).
- 9) Correct order is shipped to customer and are properly recorded (**Completeness**).
- 10) Posting made to cost of sales and /or inventory in general ledger is correct (**Valuation**).
- 11) Customers are invoiced for all sales (**Completeness**).
- 12) Invoices have right information (**Valuation**).
- 13) Customer accounts are properly maintained (**Ownership**).

In the table below controls are tested for each identified objective.

Risk Evaluation Matrix – Credit Sales process

Objectives	Controls to test	Findings
Process the customer order		
<p>Authorization To find out whether credit sales are properly processed.</p>	<ul style="list-style-type: none"> ▪ Review the company's written procedures for granting and approving credit to customers. ▪ Verify that there is proper segregation of duties between sales personnel and the extension of credit. ▪ Examine sales orders for evidence of credit approval. 	<ul style="list-style-type: none"> ▪ Lack of proper authorization/inadequate segregation of duties. Sales personnel have the ability to extend credit without authorization. ▪ Sales can be made to customers who are not creditworthy. This could lead to higher than expected amount of past due accounts receivables.
<p>Valuation/Authorization To find out whether customer orders are properly priced and whether the amount of sales volume is correct.</p>	<ul style="list-style-type: none"> ▪ Compare prices/terms on sales invoices to authorized price list and terms of trade. ▪ Examine the sales invoices for evidence that sales personnel were using the master price list when quoting prices. 	<ul style="list-style-type: none"> ▪ Price list was not always used when quoting prices. ▪ Lack of proper authorization. Sales personnel often gave price and volume discounts without proper authorization. ▪ The price discounts caused gross margin objective not to be met.
<p>Validity To find out whether there were some fictitious or duplicate sales.</p>	<ul style="list-style-type: none"> ▪ Review and test control procedures for accounting for numerical sequence of sales invoices. 	<ul style="list-style-type: none"> ▪ Lack of proper recordkeeping. An unacceptably high number of sales invoices were duplicates. This meant that sales had to be written down. This led to dissatisfied customers, possibly leading to lost sales.
<p>Completeness</p>	<ul style="list-style-type: none"> ▪ Review and test procedures for accounting for numerical sequence 	<ul style="list-style-type: none"> ▪ This test was done above, so need to perform the test for shipping documents.

Case Study

<p>To find out whether there are any incidences where goods are shipped but revenue is not recorded</p>	<p>of shipping documents and sales invoices.</p> <ul style="list-style-type: none"> ▪ Test a sample of daily reconciliations between sales invoices to daily sales report. ▪ Trace a sample of shipping documents (e.g., bill of lading) to their respective sales invoices and to the sales journal. ▪ Examine the open-order file for unfilled orders older than 30 days. 	<ul style="list-style-type: none"> ▪ No exceptions noted.
<p>Classification/Disclosures To verify that all relevant information concerning the process is disclosed.</p>	<ul style="list-style-type: none"> ▪ Review disclosure list for key notes & disclosures over credit sales. 	<ul style="list-style-type: none"> ▪ No exceptions noted.
Test of controls: Ship product to the customer		
<p>Validity To check that only valid orders are prepared for shipment.</p>	<ul style="list-style-type: none"> ▪ Test sales invoices and looked for the relevant authorized sales order & shipping document. 	<ul style="list-style-type: none"> ▪ No exceptions noted.
<p>Cutoff To verify that shipped produce was recorded in the proper period and is valued at the right amount.</p>	<ul style="list-style-type: none"> ▪ Compare the dates on a sample of sales invoices with the shipment dates and with the dates they are recorded in the sales journal. 	<ul style="list-style-type: none"> ▪ No exceptions noted.
<p>Authorization To check to make sure that there is inspection of produce before shipment.</p>	<ul style="list-style-type: none"> ▪ Review shipping procedures for authorizing shipments to customers. ▪ Observe procedures to verify quality of produce. 	<ul style="list-style-type: none"> ▪ Lack of checking the quality of produce before shipment. More than 5% of produce is rejected by customers. ▪ This caused customer ill-will and higher than expected adjustments to accounts receivable and inventory.
<p>Completeness To find out whether authorized orders are shipped to customers and are properly recorded.</p>	<ul style="list-style-type: none"> ▪ Same as above (cutoff). 	<ul style="list-style-type: none"> ▪ This test has already been performed above.
<p>Valuation To verify that postings to costs of sales and/or inventory is correct</p>	<ul style="list-style-type: none"> ▪ Review a sample of invoices to verify that they were properly posted to accounts. 	<ul style="list-style-type: none"> ▪ No exceptions noted.
Test controls: Invoice the customer for product shipped & accepted		
<p>Completeness To verify that customers are invoiced for all valid sales.</p>	<ul style="list-style-type: none"> ▪ Same as above. 	<ul style="list-style-type: none"> ▪ No exceptions noted.
<p>Valuation. To check to make sure that customer invoices have the right information (customer name, customer address, order number, price, quantity, etc.).</p>	<ul style="list-style-type: none"> ▪ Test a sample of invoices for accuracy of information. 	<ul style="list-style-type: none"> ▪ No exceptions noted.

Case Study

<p>Ownership. To know whether customer accounts are properly maintained.</p>	<ul style="list-style-type: none"> ▪ Check for segregation of duties to make sure that the person who has responsibility to maintain the accounts cannot write off the account. 	<ul style="list-style-type: none"> ▪ Lack of proper maintenance of accounts receivables. Bad debts are only written off when all possible means to recover debt have been exercised. ▪ The chief accountant has responsibly to write off the bad debts. ▪ The accounts receivable balance went from \$195.4 thousand to \$50.4 thousand. ▪ The increase caused days of receivables to go from 30 days to over 39 days.
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5. Findings and Recommendations:

Extensive review of the credit sales process revealed that there were five control deficiencies that exist in the credit sales process. Immediate action should be taken to correct the deficiencies. Corrective action is considered to be a **high priority**.

The following findings and recommendations were noted.

5.1. Lack of proper authorization/Inadequate Segregation of duties over credit sales

Segregation of duties. Segregation of duties is designed to reduce the risk that may arise if employees perform incompatible tasks. In this case, it was found that sales personnel could extend credit to customers without proper authorization. This lack of segregation caused a significant amount of credit to be extended to customers with questionable credit history. A high percentage of accounts receivable (26%) is past due (more than 60 days past due).

Recommendation #1:

It is recommended that all credit applications have to be authorized by someone outside of sales. It is also recommended to establish a credit department whose function is to review and authorize credit sales. ***(High priority)***

5.2. Lack of proper authorization over price discounting

It had been found that sales personnel could discount prices without proper authorization. This led to the gross margin target of 20% not to be achieved.

Recommendation #2:

Prices are to be verified from the computerized price list which is updated on a daily basis. All price discounts, even based on volume, have to be properly authorized by the sales manager. ***(High priority)***

5.3. Lack of proper recordkeeping

The accounting office complained that there had been an unacceptable number of duplicate sales. This led to mistakes in the financial information and wasted the accounting personnel's time making corrections.

Recommendation #3:

There needs to be verification that duplicate invoices are not processed and sent to customers. Sales invoices need to be compared with shipping documents and approved customer orders before invoices are sent to customers. ***(High priority)***

5.4. Spoiled goods sent to customers

A high amount of spoiled goods was sent to customers. The spoiled goods had to be discarded when returned to the warehouse. The estimated loss to the company was approximately \$50,000.

Case Study

Recommendation #4:

All produce before shipment has to be checked for quality. It is suggested to hire a quality control specialist who is charged with making sure quality meets company standards. **(High priority)**

5.5. Not properly maintaining the accounts receivable accounts

The accounts receivable balance went from \$195.4 thousand up to \$506.4 thousand (256% increase vs. increase in sales of 64%). This caused days of receivables to go from 30 days to 39 days.

Recommendation #5:

There has to be proper segregation of duties between the individual extending the credit and writing off the a/r balance.

The person in charge of sending out invoices to customers' needs to make sure invoices is sent out in a timely manner. Additionally, if accounts become overdue, then proper steps are taken to inform customer of overdue account and action is taken to recover on debt. **(High priority)**

6. Other Related Observations and Recommendations:

6.1. The accounting for credit losses

Currently, credit losses are written off using the direct write off method. No bad debts were written off in 20X1.

Recommendation #6:

Based on US GAAP, the company should set up an allowance for credit losses to account for some bad debts. The amount of a/r to write down should be based on a percentage of debts over 60 days. At this time, the amount over 60 days is \$135.4 thousand. It is estimated that 30 to 40% of this amount will probably have to be written off. **(High priority)**

6.2. Code of conduct

It is recommended that every company have a code of conduct. The code should spell out how the company and its employees, particularly sales personnel, are to treat customers and to act in an ethical manner.

Recommendation #7:

It is recommended that the holding company develop a Code of Conduct for each of its subsidiary holdings. Training courses should be held to explain the purpose of the Code. **(High priority)**

6.3. Cash discounts

The accounts receivable balance increased substantially during the year. In order to speed up the collection of accounts receivables, cash discounts are often used by companies. However, companies need to balance between the cash lost from giving the discount to the additional time customers take to make payment.

Recommendation #8:

It is recommended that management and board approve the use of cash discounts to get customers to pay quicker on their accounts. It is suggested that a 0.5% to no more than 1% discount be given if customers pay within 10 days on issuance of invoice. **(High priority)**

Case Study

Recommendations, Management Response and Action Plan

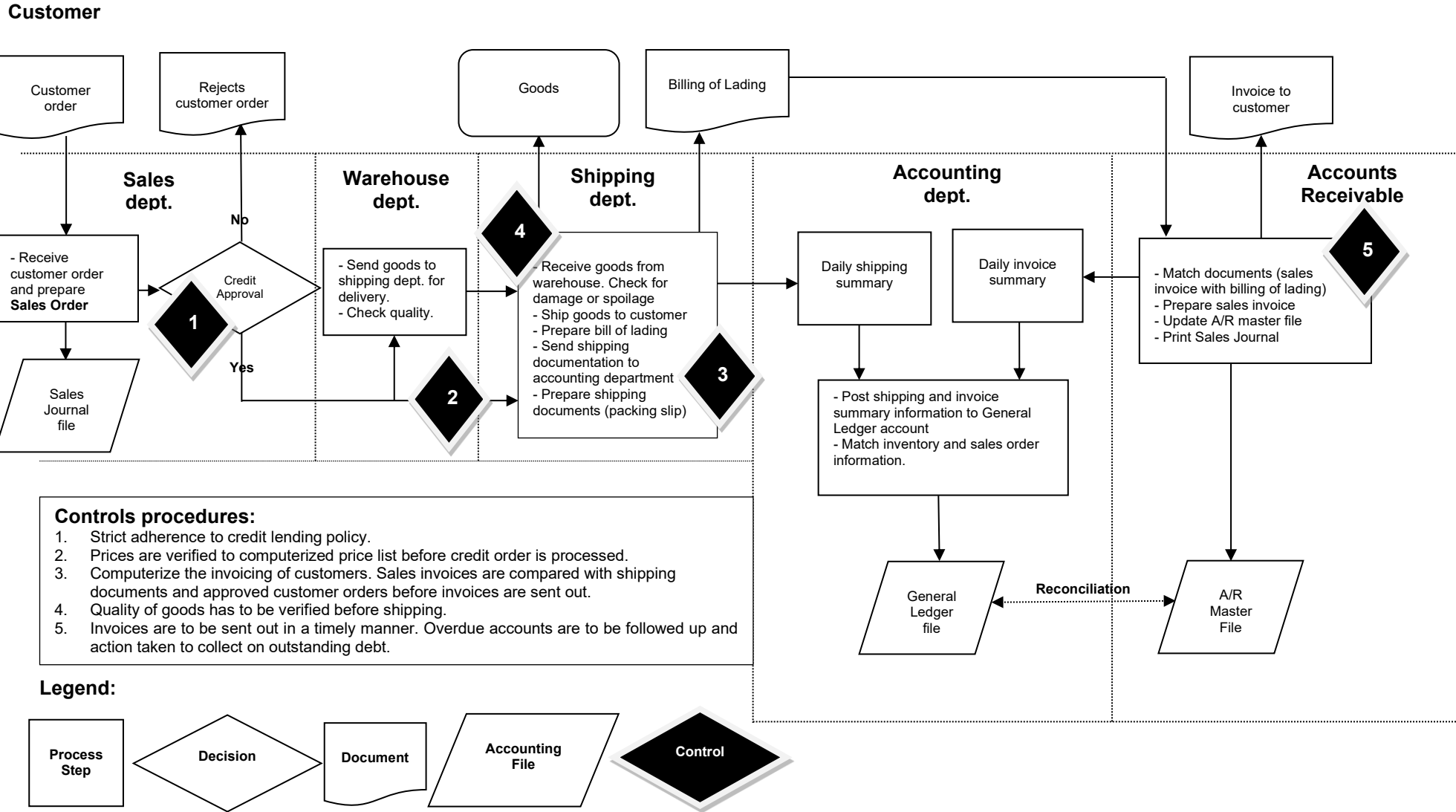
Priority level	Recommendation	Management response (Accept / Reject)	Responsible managers	Planned implementation dates
5.1. Inadequate Segregation of Duties over Credit Sales				
1) <i>High priority</i>	The internal audit function recommends that there be better segregation of duties over the extension of credit to customers. Someone outside of sales should extend credit, not the sales manager since there might be a temptation to extend credit to a customer who might not be credit worthy. It is recommended to set up a separate credit department who would be given the responsibility for credit sales.	Not accepted. Management feels that the company is still too small to have a separate credit department.		
5.2. Lack of proper authorization over price discounts.				
2) <i>High priority</i>	Produce prices should be verified from the computerized price list which is updated on a daily basis. All price discounts (i.e., volume discounts) are to be properly authorized by the sales manager – no exceptions.	Accepted.		
5.3. Lack of proper recordkeeping				
3) <i>High priority</i>	The accounting office needs verify that duplicate invoices are not processed and sent to customers. Sale invoices need to be compared with shipping documents and approved customer orders before invoices are sent to customers.	Accepted		
5.4. Spoiled goods sent to customers				
4) <i>High priority</i>	All produce has to be inspected and approved before shipment is made to customer. It is recommended that a quality control specialist who is charged with making sure quality meets company standards.	Rejected. Management feels that the shipping department need to pay closer attention to quality		

Case Study

		of produce being shipped to the customers.		
5.5. Not properly maintaining accounts receivable accounts				
5) <i>High priority</i>	The accounting department charged with sending invoices to customers has to make sure invoices are sent out in a timely manner. When credit becomes overdue, then proper steps have to be taken to inform the customer of the overdue debt. If debt becomes more than 90 days, then legal action needs to be started against the customer.	Accepted		
6.1. The accounting for bad debts				
6) <i>High priority</i>	If credit is extended to customers and if the level of bad debts can be reasonably estimated, then an allowance for doubtful debts needs to be set up. To date, RUSPRODUCE believes 30 to 40% of the debt past 60 days needs to be written off.	Accepted		
6.2. Code of Conduct				
7) <i>High priority</i>	The holding company should develop a Code of Conduct for each of its subsidiaries.	Accepted		
6.3. Cash discounts				
8) <i>High priority</i>	In order to get customers to pay quicker on their debt it is recommended to institute a cash discount program, whereby a small discount would be offered to customers who make early payment.	Accepted.		

Case Study

Credit Sales Process Flow Chart



Case Study

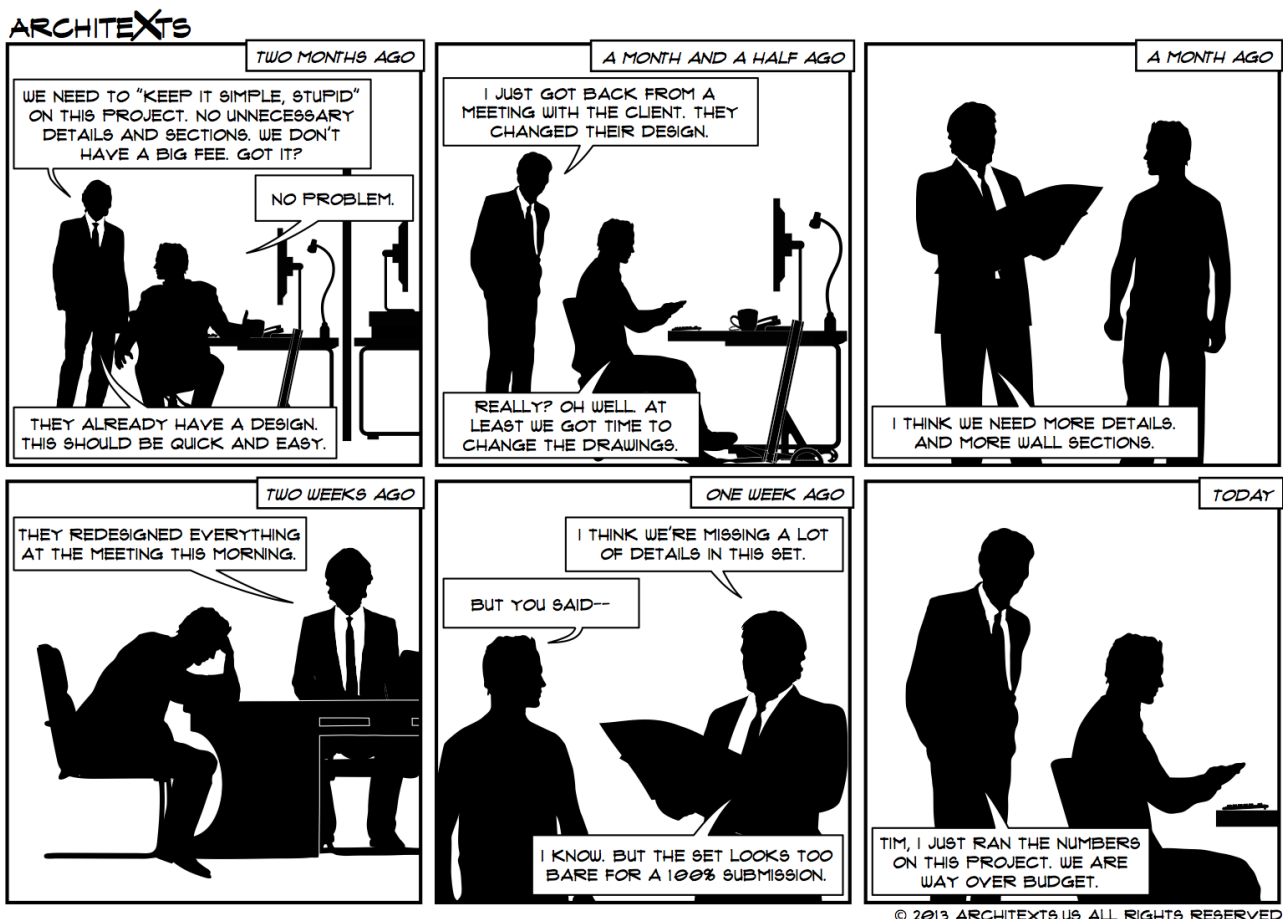
Final Word

Final Word

The purpose of this guide was to present a framework for testing controls over financial reporting. We also went through a case study of putting the framework to work. If this guide assisted you in any way in your testing and reporting of controls then we achieved our mission.

As a final, final word, we are sure you have heard the phrase “**keep it simple, stupid**” (KISS). When talking about control systems (any control system) this phrase seems very apropos. Too often people try to be clever when doing transactions; however, cleverness can, and often does, make things even more confusing and less understandable. To some extent, maybe that's the idea – keep people off-balance and confused so you can take advantage of them. Is this not what con-artists do when stealing people's money?

So, as a **last word**, when setting up your control system, try as best you can to keep it ‘**simple, stupid.**’ If you do this, you will always be better off because you will always understand why controls are in place, and whether they are working as they should work.



The cartoon above shows what happens too often with KISS – it gets complicated. Usually, when it gets complicated, it gets confusing. When it gets confusing, it gets to be useless. So...try your best to keep it simple, stupid. You will always be better off.

If you have any comments about this paper, I would appreciate your feedback. You can contact me at admin@burchbusinessservices.com or carl.burch@burchbusinessservices.com

Final Word

APPENDIXES

Appendix A: COSO Internal Control Model

As we mentioned at the beginning of this paper, COSO was the first organization to define what internal control is and what its components are. The concept of internal control was detailed in the book called *Internal Control–Integrated Framework*.

Introduction: The COSO Internal Control Model

The COSO model was last updated in 2013. The COSO model is the most commonly used internal control model, but it certainly is not the only one in use. An important aspect of COSO's internal control model is how it changed the concept of internal controls from narrow, technical terms of financial reporting to include all aspects of business operations and compliance and established a standard against which all organizations could measure their internal control systems.

For the most part every internal control model has the same goal of providing management with better understanding of their control system so you can make a judgment about their effectiveness. Before the advent of COSO's internal control model there had been no agreement on what internal control was or what it consisted of. Organizations had no standard guidance to consult to determine whether their own internal control systems were effective. This lack of guidance contributed to a good deal of confusion surrounding the topic of internal control.

Objectives of Internal Control

According to COSO, controls provide **reasonable assurance** regarding the achievement of objectives in the following areas:

- **Effectiveness and efficiency of operations**

This category addresses an organization's basic business objectives, including performance and profitability goals and safeguarding assets.

- **Reliability of financial reporting**

This second category relates to the preparation of reliable published financial statements, including interim and consolidated financial statements and selected financial data derived from such statements, as earnings releases, reported publicly.

- **Compliance with applicable laws and regulations**

The final category has to do with the organization complying with all laws and regulations to which it is subject.

Components of COSO's Internal Control Model

COSO defined internal control as having **five interrelated components** and **seventeen principles**. These components and principles are summarized in the table below:

Appendix A: The COSO Model

Components	Principles
Control Environment	<ol style="list-style-type: none"> 1) The organization demonstrates a commitment to integrity and ethical values. 2) The board of directors demonstrates independence from management and exercise oversight of the development and performance of internal control. 3) Management establishes, with board oversight, structures, reporting lines, and appropriate authorities and responsibilities in the pursuit of objectives. 4) The organization demonstrates a commitment to attract, develop and retain competent individuals in alignment with objectives. 5) The organization holds individuals accountable for their internal control responsibilities in the pursuit of objectives.
Risk Assessment	<ol style="list-style-type: none"> 6) The organization specifies with sufficient clarity to enable the identification and assessment of risk relating to objectives. 7) The organization identifies risks to the achievement of its objectives across the entity and analyzes risks as a basis for determining how the risks should be managed. 8) The organization considers the potential for fraud in assessing risks to the achievement of objectives. 9) The organization identifies and assesses changes that could significantly impact the system of internal control.
Control Activities	<ol style="list-style-type: none"> 10) The organization selects and develops control activities that contribute to the mitigation of risks to the achievement of objectives to acceptable levels. 11) The organization selects and develops general control activities over technology to support the achievement of objectives. 12) The organization deploys control activities through policies that establish what is expected and procedures that put policies into action.
Information & Communication	<ol style="list-style-type: none"> 13) The organization obtains or generates and uses relevant quality information to support the functioning of other components of internal control. 14) The organization communicates with external parties regarding matters affecting the functioning of other components of internal control. 15) The organization communicates with external parties regarding matters affecting the functioning of other components of internal control.
Monitoring	<ol style="list-style-type: none"> 16) The organization selects, develops and performs ongoing and/or separate evaluations to ascertain whether the components of internal control are present and functioning. 17) The organization evaluates and communicates internal control deficiencies in a timely manner to those parties responsible for taking corrective action, including senior management and the board of directors, as appropriate.

Appendix A: The COSO Model

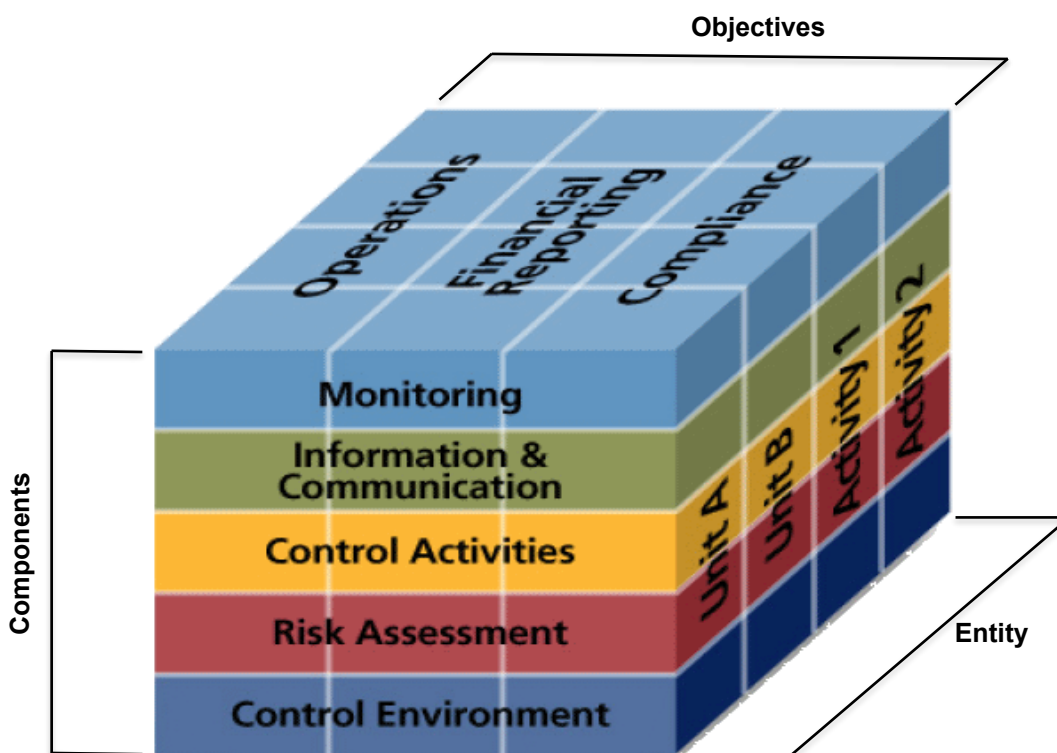
Source: Internal Control–Integrated Framework, COSO

Note: These elements may be remembered by the mnemonic **CRIME** (as identified by the underlined letters in the list above, though not necessarily in the correct order). It is important that you know not only what these components are, but also what each term means and includes.

The COSO internal control cube was initially shown in Chapter 1 when we compared the COSO model with our “6x20” model.

The **rows** show the five components of internal control, the **slices** are the three objectives of control, and the **columns** are the activities or units of the entity.

COSO Internal Control Framework



Source: Committee of Sponsoring Organizations (COSO) of the Treadway Commission

Appendix A: The COSO Model

Appendix B: Requirements of Sarbanes-Oxley Act Sections 302 & 404

The following Statutory requirements are from Sections 302 & 404 of the Sarbanes-Oxley Act of 2002.

Section 302 outlines the corporate responsibilities for financial reports and the SEC has issued guidance to implement the act.

As adopted, each company filing periodic reports under section 13(a) or 15(d) of the Securities Exchange Act of 1934, require the issuer's principal executive officer or officers and the principal financial officer or officers, or persons performing similar functions, to certify in each quarterly and annual report that:

- 1) The signing officer has reviewed the report.
- 2) Based on the officer's knowledge, the report does not contain any untrue statements of a material fact or omit to state a material fact necessary in order to make a statement made, in light of the circumstances under which such statements are made, not misleading; and
- 3) Based on such officer's knowledge, the financial statements, and other financial information, and other financial information included in the report, fairly present in all material respects the financial condition and results of the issuer as of, and for, the periods presented in the report.
- 4) The signing officers:
 - Are responsible for establishing and maintaining internal controls.
 - Have designed such internal controls to ensure that material information relating to the issuer and its consolidated subsidiaries is made known to such officers by others within those entities, particularly during the period in which the periodic reports are being prepared.
 - Have evaluated the effectiveness of the issuer's internal controls as of a date within 90 days prior to the filing date of the report; and
 - Have presented in the report their conclusions about the effectiveness of the internal controls based on their evaluation as of that date.
- 5) The signing officers have disclosed to the issuer's auditors and to the audit committee of the board of directors (or persons fulfilling the equivalent function):
 - All significant deficiencies in the design or operation of internal controls which could adversely affect the issuer's ability to record, process, summarize and report financial data and have identified for the issuer's auditors any material weaknesses in internal controls; and
 - Any fraud, whether or not material, which involves management or other employees who have a significant role in the issuer's internal controls.
- 6) The signing officers have indicated in the report whether or not there were significant changes in internal controls or other factors that could significantly affect internal controls subsequent to the date of their evaluation, including any corrective actions with regard to significant deficiencies and material weaknesses.

Appendix B: Sections 302 & 404 of SOX

Section 404 requires **management assessment of internal controls**.

- (a) As adopted, each company filing an annual report is required to include an internal control report, which shall:
- 1) State the responsibility of management for establishing and maintaining an adequate internal control system and procedures for financial reporting; and
 - 2) Contain an assessment, as of the end of the most recent fiscal year of the issuer, of the effectiveness of the internal control system and procedures of the issuer for financial reporting.
- (b) **Internal control evaluations and reporting:** With respect to the internal control assessment required by subsection (a), each registered public accounting firm that prepares or issues the audit report for the issuer shall attest to, and report on, the assessment made by the management of the issuer. An attestation made under this subsection shall be made in accordance with standards for attestation engagements issued or adopted by the Board. Any such assessment shall not be the subject of a separate engagement.

Appendix B: Sections 302 & 404 of SOX

Sample Outline of Section 302 Certification

SOX Section 302 requires chief executive officers and financial officers to certify as to the accuracy of the company's financial statements in filings and periodic reports with the SEC. A misleading or inaccurate Section 302 certification may result in civil penalties.

A sample certification form is presented below.

I, [identify the certifying individual], certify that:

1. I have reviewed this [specify report] of [identify registrant].
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report.
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of , and for, the periods presented in this report.
4. The registrant's other certifying officer(s) and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13-a-15(e) and 15d-15(e)) **and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f))** for the registrant and have:
 - (a) Designed such disclosure controls and procedures or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared.
 - (b) Designed such internal control over financial reporting or caused such internal control over financial reporting to be designed under over supervision, 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.
 - (c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation.
 - (d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer(s) and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):
 - (a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summaries, and report financial information; and
 - (b) Any fraud, whether or not material, which involves management or other employees who have significant role in the registrant's internal control over financial controlling.

Date: _____

Signature: _____

Title: _____

Appendix B: Sections 302 & 404 of SOX

Appendix C: Awareness of Fraud

Appendix C: Awareness of Fraud

40 Common Forms of Fraud

The following list was taken from *Sawyer's Internal Auditing 5th Edition*, pages 1181-1182.

- 1) Pilfering stamps.
- 2) Stealing merchandise, tools, supplies, and other terms of equipment.
- 3) Removing small amounts from cash funds and registers.
- 4) Failing to record sales of merchandise and pocketing the cash.
- 5) Creating overages in cash funds and register by under-recording.
- 6) Overloading expense accounts or diverting advances to personal use.
- 7) Lapping collections on customers' accounts.
- 8) Pocketing payments on customers' accounts, issuing receipts on scraps of paper or in self-designed receipt books.
- 9) Collecting an account, pocketing the money, and charging it off; collecting charged-off accounts and not reporting.
- 10) Charging customers' accounts with cash stolen.
- 11) Issuing credit for false customer claims and returns.
- 12) Failing to make bank deposits daily or depositing only part of the money.
- 13) Altering dates on deposit slips to cover stealing.
- 14) Making round sum deposits – attempting to catch up by end of month.
- 15) Carrying fictitious extra help on payrolls or increasing rates or hours.
- 16) Carrying employees on payroll beyond actual severance dates.
- 17) Falsifying additions on payrolls; withholding unclaimed wages.
- 18) Destroying, altering, or voiding cash sales tickets and pocketing the cash.
- 19) Withholding cash sales receipts by using false charge accounts.
- 20) Recording unwarranted cash discounts.
- 21) Increasing amounts of petty cash vouchers and/or totals in accounting for disbursements.
- 22) Using personal expenditure receipts to support false paid-out items.
- 23) Using copies of previously used original vouchers or using a properly approved voucher of the prior year by changing the date.
- 24) Paying false invoices, either self-prepared or obtained through collusion with suppliers.
- 25) Increasing amounts of suppliers' invoices through collusion.
- 26) Charging personal purchases to organization through misuse of purchase orders.
- 27) Billing stolen merchandise to fictitious accounts.
- 28) Shipping stolen merchandise to an employee or relative's home.
- 29) Falsifying inventories to cover thefts or delinquencies.
- 30) Seizing checks payable to the organization or to suppliers.
- 31) Raising canceled bank checks to agree with fictitious entities.
- 32) Inserting fictitious ledger sheets.

Appendix C: Awareness of Fraud

- 33) Causing erroneous footings of cash receipts and disbursement books.
- 34) Deliberately confusing postings to control and detail accounts.
- 35) Selling waste and scrap materials and pocketing proceeds.
- 36) "Selling" door keys or the combinations to safes or vaults.
- 37) Creating credit balances on ledgers and converting them to cash.
- 38) Falsifying bills of lading and splitting with carrier.
- 39) Obtaining blank checks and forging the signature.
- 40) Permitting special prices or privileges to customers, or gaining business to favored suppliers, for "kickbacks."

20 Danger Signs of Embezzlement

The following list was taken from Sawyer's Internal Auditing 5th Edition, page 1183.

- 1) Borrowing small amounts from fellow employees.
- 2) Placing personal checks in change funds – undated, postdated – or requesting others to "hold" checks.
- 3) Personal checks were cashed and returned for irregular reasons.
- 4) Collectors or creditors appearing at the place of business, and excessive use of telephone to "stall off" creditors.
- 5) Placing unauthorized I.O.U.s (short for "I Owe You") in change funds or prevailing on others in authority to accept I.O.U.s for small, short-term loans.
- 6) Inclination toward covering up inefficiencies by "plugging" figures.
- 7) Pronounced criticism of others so as to divert suspicion.
- 8) Replying to questions with unreasonable explanations.
- 9) Gambling in any form beyond ability to stand the loss.
- 10) Excessive drinking and nightclubbing or associating with questionable characters.
- 11) Buying or otherwise acquiring through "business" channels expensive automobiles.
- 12) Explaining a higher standard of living as money left from an estate.
- 13) Getting annoyed at reasonable questioning.
- 14) Refusing to leave custody of records during the day, working overtime regularly.
- 15) Refusing to take vacations and shunning promotions for fear of detection.
- 16) Constant association with, and entertainment by, a member of a supplier's staff.
- 17) Carrying an unusually large bank balance, or heavy buying of securities.
- 18) Extended illness of self or family, usually without a plan of debt liquidation.
- 19) Bragging about exploits, and/or carrying unusual amounts of money.
- 20) Rewriting records under the guise of neatness in presentation.