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AN INTRODUCTION

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BUT HOW DOES ALL THAT RELATE TO ME?

There has been so much press lately about the required public company reporting of internal controls that some people believe that internal controls pertain only to public companies. That is a misperception, since this issue has been and will continue to be relevant for all enterprises. Writings in the auditing literature that predate the birth of all the potential readers of this work address issues of internal control. And, after all, how would Scrooge and Marley in Charles Dickens's *A Christmas Carol* have prevailed in taking ownership of the business had there not been a "discrepancy in the accounts"? The issues here transcend time and cultures. The myth has also developed that internal controls have to be expensive and complicated. That argument is perhaps more a consequence of the semichaotic 2004 public company implementations of internal control reporting requirements than the true costs of implementing effective internal controls themselves. This topic is discussed more at the end of this chapter.

Of course, designing and implementing an iron-clad system of controls might be a very expensive proposition. Ian Fleming's (James Bond) Goldfinger dreamed of penetrating Fort Knox, but most businesses are not likely to yield such a large reward worthy of such a complicated effort. And in a business where the doors are wide open to all who choose to enter and create mischief, such extremes are not necessary. Many who choose to take advantage do so because it is easy and because we business owners and managers make it so easy for them to do so.

Let's speak facts. A 2006 published survey on fraud, published by the Association of Certified Fraud Examiners (ACFE), noted some statistics about

reported frauds.[1] A couple may be surprising. The median (median means middle, with half the reported amounts above this number and half below) reported fraud for entities of less than 100 employees was $190,000. For private companies, the number was pegged at $210,000. I also find it surprising that the number for public companies is $200,000, given the size of these entities and the fact that these companies make public reports. The fact that the numbers are so large for the smaller, private entities may be a reflection on the weaker control environments that often exist there. How many small businesses can sustain frauds of $190,000?

How many businesses have failed because of undetected frauds that have robbed them of the working capital to continue in business? In one family business I am familiar with, a nephew was taken into the business and put in charge of the books since the owner-uncle did not have computer literacy and the business had grown to need better records. The nephew perpetrated a skimming scam, redirecting certain deposit streams of cash to his personal accounts and not deposited with the business. Soon, when customers demanded their deposits back, the business was short of cash. The ultimate result was bankruptcy. The situation was almost inexplicable to the aged businessman, whose health and ability to cope failed almost in tandem to the business. True, there was no auditor or third party watching over the process, but the lack of any observable accounting and cash controls or interest in such mundane matters from within the business made the nephew's malfeasance possible. Once it was clear that such control matters were not important to management, the door was wide open. There was no happy ending here, except for the nephew, who has moved on to more profitable opportunities. He may now work for you.

Not-for-profits have been shaken by widely publicized cases of misdirected funds, such as at the American Red Cross and the United Way of National Capital Area. Most recently the allegations of fraud and waste regarding monies paid on claims of damage due to Hurricane Katrina in the Gulf region have lessened sympathies for the victims of this tragedy. Such an environment sours voluntary contributors. No specific estimate is available of the contributions lost, and that continue to be lost annually, when individuals and corporations place their contribution dollars elsewhere. Not-for-profit boards are seeking more information about internal controls and strengthening their processes in order to protect themselves from personal risk and their

1. Association of Certified Fraud Examiners, 2006 ACFE Report to the Nation on Occupational Fraud and Abuse (ACFE, 2006).

organizations from risks. It is becoming increasingly harder to recruit and retain qualified directors to such positions, particularly when controls are found to be lax.

Issues relating to government waste and corruption are legendary, but the ACFE survey does not report the government as being the most vulnerable group. The survey notes that the median reported fraud for government entities was $100,000. This does not mean that this issue is less important for these entities, but the many audit programs and instituted controls in some government environments and agencies have lessened the number of programs that today are open to abuse. Or perhaps many of the sources of abuse have just not been detected or reported. Nevertheless, government entities pushed hard with the Auditing Standards Board to enact more specific standards requiring auditors to assess controls design and implementation and report to management and governance boards on significant deficiencies and material weaknesses on every audit.[2]

WE ARE ALL IN THIS TOGETHER

Try to think of an entity that has no relationship to anyone or anything else. Were you successful? Probably not. As long as an entity (of whatever form or description) touches third parties that rely on its financial viability, then the distinction of "nonpublic" entity is really not a valid one. Private companies have suppliers and creditors and customers who rely on them. Employees also are dependent on the financial viability of the entities. Entities that do not manage or control their affairs might be successful, but there are few examples to share. In a competitive environment, forces usually favor the businesses that understand and manage their risks, have a culture of integrity and honesty, and place financial controls over the receipt and disbursement of funds. Companies, auditors, government entities, and not-for-profits are all subject to the risks of poor controls: significant losses can cause small businesses to close, donors to drop charities, and taxpayers to revolt because their monies are being squandered.

Starting in 2007, a required step in the audit of companies that seek independent opinions regarding their financial statements is for the independent

2. The Auditing Standards Board is a committee of the American Institute of Certified Public Accountants charged with the development of auditing standards for audits of non-public companies. Prior to 2003, the AICPA issued auditing standards that applied to both public and private companies. In 2003, the Public Company Accounting Standards Board announced it would adopt the existing AICPA standards as interim standards but would issue its own standards for public companies in the future.

auditor to assess the adequacy of the companies' controls design and implementation.[3] If company controls are found lacking, management and those charged with governance will receive a communication outlining the significant deficiencies and material weaknesses identified. I will discuss this in more depth later. Here it is important to note that auditors will need to communicate a lack of company documentation of controls and procedures.[4]

The rationale in clarifying this requirement is that so many business-threatening issues are able to be foreseen, but just do not seem to get management's attention, it is a good practice to put in writing issues or conditions that management needs to be aware of that could threaten the business. Also, memories also are short. Regardless of the oral communications and nodding acceptance of management to heed the advice of its advisors, there is no substitute for a written communication focusing on issues.

SO WHAT IS ALL THIS FUSS ABOUT COSTS?

Let's discuss this very public debate on costs a bit more.

The protestations of smaller public entities that the regulations and auditing rules under the Sarbanes-Oxley Act of 2002 (SOX) are prohibitively expensive have caused officials to reconsider those requirements and ease their punitive nature. The rules and regulations set down for companies by the Securities and Exchange Commission (SEC) and for auditors by the Public Company Accounting Oversight Board (PCAOB) do not change the basic principles of effective internal controls, only the mechanisms to test and report on such conditions. Whether a control or business process is tested 50 times, 20 times, or once every several years (when controls do not change) does not mean a control is more or less effective, but such testing requirements define the amount of evidence necessary to meet professional standards for reporting on such matters and affect the costs of such an exercise. Many of the costs that these companies are now concerned about are tied up in a number of regulatory and reporting matters that do not apply outside of the public company arena, and should not be extrapolated to the non-public company marketplace. The implementation of internal control reporting in 2004 was marked by very distinct issues that do not necessarily apply to businesses that are seeking a more effective controls environment. For example, specific to the 2004 time frame:

3. SAS No. 109, *Understanding the Entity and its Environment and Assessing the Risks of Material Misstatement.* AICPA (1995)
4. SAS No. 112, *Communicating Internal Control Matters Identified in an Audit.* AICPA (1995)

- The SEC provided broad, sketchy requirements for companies to follow in documenting and assessing internal controls.
- Because the independence of auditors would be questioned if they became too involved in the company's controls assessment process, many companies and auditors took different paths to comply with SOX. The result: more time in reconciling the two approaches later.
- The PCAOB established a high standard for auditor performance when reporting on internal controls and removed many cost-effective alternatives from the auditor's procedures tool kit. These new auditing standards were not implemented and effective until July 2004, creating a training crunch for auditors.
- More detailed rules for implementing these requirements were successively revealed during 2004, with various "questions and answers" being released by the SEC and PCAOB in the latter part of the year.
- The uptick in the stock market in mid-2004 swept many smaller companies into the SEC's "accelerated filer" category. These companies and their auditors had only six months to complete their assessments of internal controls.
- Auditor training was in "real time" as information that affected auditor engagement performance and assessments became known or understood throughout the 2004 period.
- No common software solution for documenting and assessing internal controls existed, leading auditors and companies to devise their own formats and approaches. Thus, both parties had to take time to reconcile their different solutions to the same issues of controls documentation and assessment.

All these ingredients created a good recipe for raising costs in a business environment. More telling is the second-year experience of many companies: They experienced 20 to 40% overall cost reduction, even in the absence of any relaxation of the regulatory rules.

AUDITOR GUIDANCE

In 2007, the PCAOB anticipates finalizing Auditing Standard No. 5, a replacement to Auditing Standard No. 2. The Auditing Standards Board anticipates finalizing the exposure draft to its internal controls reporting guidance, AT 501, in 2007 as well. Both of these standards may significantly affect the procedures and reporting requirements associated with reporting to third parties on internal controls. Auditors should be alert to these developments.

IT CAN BE MANAGED

Documenting and assessing internal controls do not have to cost a fortune. The most significant step to take to control those costs is to be willing to put in some front-end time to learn about the process and become familiar with the terms and objectives of the exercise before plunging in with both feet. This book is part of that process and will assist you in the learning process if it is taken to heart and not put on the trophy case bookshelf.

Remember the old adages: "Look before you leap" and "How do you have the time to fix the problem when you did not have the time to do it the right way in the first place?" Believe them, they are true.

In 2003, a major public company foresaw the inevitable requirement to document its controls and plunged headlong into the exercise, using flowcharts, narratives, copying documents and manuals, and so on. The company built up a mountain of documentation of just about anything and everything. Crates of documents were stored in a warehouse-like room. When the auditors inquired how things were going, the company proudly announced that the documentation was "done."

Their auditors were horrified. The documentation was:

- Not well organized or assembled
- Inconsistent in quality from process to process
- Limited to control activity processes (e.g., sales, inventory, purchases)
- Voluminous—beyond what any reasonable documentation standard would require, with many details that were irrelevant to the task
- Not in a format that could be easily updated for changes from year to year and included many written notes and documents
- Not related at all to the Committee of Sponsoring Organizations (COSO) Framework (1992) for documenting and assessing controls
- Difficult to relate to the auditors' controls assessment tool, which *was* based on COSO

What followed was a costly and frustrating (for management) exercise of recasting the documentation into a usable form.

Some success stories are also worth telling, but they are far less interesting. In general, the formula for cost-effective projects is just the reverse of the bad example:

- Obtain an understanding of what needs to be done.
- Plan for the work to be done over a reasonable period of time.
- Put the resources in place to do the tasks in the time frames outlined.

- Coordinate with your "independent auditor" as the project progresses so that you will both be on the same page at the completion of the task.

The rest of this book will assist you in accomplishing the task of controls documentation efficiently. If you do not first understand what needs to be done, your project too will become an unguided missile that is likely to miss the mark.