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IN PRACTICE

CORPORATE LAW

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The New Detectives

Protecting against accounting fraud and financial mistakes in the post-Sarbanes-Oxley age

Detecting accounting fraud and uncovering financial mistakes in the post Sarbanes-Oxley Act of 2002 era is critical for every organization. The establishment of financial reporting internal control systems is required for public companies, and considered best practices for all organizations to assist in detecting fraud and uncovering financial mistakes. Deficiencies in an organization's internal control system may result in criminal and/or civil liability for the company, its officers, directors, executives, principals and employees. To minimize a company's exposure to such risks and liabilities, care and planning is necessary to draft, implement and evaluate an organization's internal control systems.

Sarbanes-Oxley Section 404(a) requires each public company to file annually with the United States Securities and Exchange Commission an internal control report (404 Report). This 404 Report must state that management is responsible for establishing and maintaining an adequate internal control structure, procedures for financial reporting and an annual fiscal year assessment of the issuer's financial reporting. 15 U.S.C. § 7262. Additionally, Section 404(b) requires all public accounting firms that prepare the issuer's financial audit report "attest to, and report on, the assessment made by the management of the issuer."

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Internal and external auditors evaluate the financial reporting internal control systems by searching for material weaknesses. A material weakness is a significant deficiency (or combination of significant deficiencies), resulting in a reasonably possible or probable material misstatement of the annual or interim financial statements not prevented or detected. See Public Company Accounting Oversight Board Auditing Standard No. 2: "An Audit of Internal Control over Financial Reporting Performed in Conjunction with an Audit of Financial Statements," Para. 10 and Section 9 (March 9, 2004). A "significant deficiency" is a control deficiency, or combination of control deficiencies. The significant deficiency must adversely affect the company's ability to initiate, authorize, record, process or report external financial data reliably in accordance with generally accepted accounting principles (GAAP). The adverse affect of a significant deficiency must be such that there is a reasonably possible or probable material misstatement of the company's annual or interim financial statements not prevented or detected.

Material weaknesses in an organization's financial reporting internal control system may result in financial misstatements. Auditors must, therefore, be vigilant in determining if there are obvious or subtle flaws in the organization's financial reporting internal control systems. In doing so, the auditors (and management) must ask critical questions to evaluate internal control systems. Deficient answers may mean that the internal control systems are either not operating or functioning below optimum level, requiring immediate correction. Ineffective internal control systems may result in undetected fraud or wrongdoing, subjecting the organization to investor lawsuits, federal and state investigations, criminal and/or civil liability.

The SEC is the primary government regulator responsible for enforcing Sarbanes-Oxley. The SEC recommends that auditors and management review the work of the Committee of Sponsoring Organizations of the Treadway Commission (COSO). The SEC suggests that COSO guide management in their assessment and documentation of their financial reporting internal control systems. COSO Report, Internal Control-Integrated Framework. See also "SEC Office of the Chief Accountant Division of Corporation Finance: Management's Report on Internal Control Over Financial Reporting and Disclosure in Exchange Act Periodic Reports Frequently Asked Questions, Question 18." COSO has devised a five-component system for evaluating internal control systems, reviewing: (a) control environment, (b) risk assessment, (c) control activities, (d) information and communication, and (e) monitoring. Each of these components

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requires management and auditors to ask certain types of questions.

Establishing and maintaining an effective control environment requires a framework and ethical standards expected from the organization's managers and employees, thus, setting the tone for an organization. There are essentially seven areas necessary for any adequate control environment that an entity or its auditors must address, including: (1) integrity and ethical values; (2) commitment to competence; (3) board of directors and/or audit committee; (4) management's philosophy and operating style; (5) organizational structure; (6) assignment of authority and responsibility; and (7) human resources' policies and practices.

Management and auditors must assess an organization's integrity and ethical values. In doing so, they often will ask: does the organization maintain written policies addressing acceptable business practices and standards of ethical and moral behavior, that is then distributed to all employees, who must acknowledge reading and complying with the policies?

Further, management and auditors must review the results when a company's policies are violated and consider whether there is an adequate mechanism in place to address the violation. In essence, having an unenforced policy is as bad as not having one at all.

Every company must be committed to having competent and well-qualified individuals evaluating its internal control systems. A company should consider the following in assessing its commitment to competence:

Has the level of competence, knowledge and skills been defined for each job in the accounting and internal audit organizations?

Does management make an effort to determine whether the accounting and internal audit organizations have adequate knowledge and skills to do their jobs?

Affirmations of these types of considerations will often provide the company with the assurance that their personnel are knowledgeable and competent in managing internal controls.

Organizations must have adequate Boards of Directors and/or Audit Committees to ensure that management fulfills their duties concerning the company's financial affairs. The Board of Directors monitors management's activities and the Audit Committee provides independent oversight. Evaluating a company's Board of Directors and/or Audit Committee raises these types of inquiries:

Are a sufficient number of meetings held with adequate time to cover the agenda and to provide a healthy discussion of issues?

Do audit committee members have the knowledge, industry experience and financial expertise to serve effectively in their role?

These steps serve as an important check and balance system over management. Without such a system, the results may be catastrophic.

A company must critically assess the effect management's philosophy and operating style has on the company as a whole. Treating everyone within the organization with a level of respect, while maintaining a certain level of expectation, is a difficult balance, but necessary to the company's survival. In determining the effectiveness of management's approach to running the company, consider the following:

Is the accounting or auditing function viewed as a team of competent professionals bringing information, order and control to decision-making?

Are valuable assets, including intellectual assets, protected from unauthorized access and use?

A sound management philosophy may ultimately protect the company's valuable assets from misuse.

A company's organizational structure allows the organization to carry out its control obligations. Although the best accounting practices and most educated and trained auditors are helpful, a company cannot capitalize on these skills if the organization is understaffed. Accordingly, when determining whether the organization structure is sufficient, one should ask:

Do sufficient numbers of employees exist, particularly at the management levels in the accounting and internal audit functions, to allow those individuals to effectively carry out their responsibilities?

Management and auditors must, thus, communicate to determine staffing needs.

Is the authority delegated appropriate to the responsibilities assigned?

Management must provide auditors with clear access to conduct appropriate inquiries for each responsibility delegated, and clearly state that all employees must assist in the audit or face delineated sanctions or repercussions for failing to cooperate. Critically assessing an auditor's role will instill clarity and avoid redundancy as the auditors perform their duties.

Human resources' policies and practices must be implemented to evaluate all procedures for hiring, training and compensating employees. Internal auditors must be adequately trained and must feel such work is important to the company. Promotions, compensation and incentives commensurate with their achievements foster an atmosphere of diligence in carrying out their functions. To assess whether the company has adequate human resources policies and procedures, the following question should be considered:

Are policies and procedures in place for hiring, training, promoting, and compensating employees in the accounting and internal audit functions?

Such policies are essential to avoid questions about the integrity of the audit process.

Assessing risk is necessary to identify and analyze various business situations for an organization, and assists in meeting its objectives. One must ask: Are external risks assessed, such as creditor demands, economic conditions, regulation and labor relations?

In identifying and analyzing these risks, both internal and external risks must be assessed. An action plan should be formed to handle these risks so that they do not prevent the organization from meeting its objectives.

Control activities help ensure that management directives are performed, and include activities such as approvals, authorizations, verifications, reconciliations, reviews of operating performance, security of assets and segregations of duties. These activities occur throughout the organization, and must be assessed as part of any audit. For example, one should ask: once a review is completed, how are the results communicated and is there timely follow-up action with expectations?

Essentially, the organization must critically assess whether its internal controls are working.

An organization must identify, capture and communicate information to the appropriate people, enabling them to perform their responsibilities. Internal information, as well as external events, activities and conditions, must be communicated to management, allowing informed busi-

ness decisions and proper external reporting. There should be a process in place to collect information from external sources that may impact the business and/or financial reporting. Then information must then be relayed to the correct people on a timely basis to ensure efficient use of the information.

There must be a process in place to document errors and complaints and to analyze them to prevent future occurrence. Also, employees must be able to report wrongdoing without fear of retaliation.

Protection from corrupt information is a critical aspect of any organization's internal control system.

Monitoring is associated with the internal audit function in the company, and includes management supervisory activities. Serious deficiencies in internal controls must be reported upstream to senior management and the Board of Directors.

This article is certainly not a compendium of every answer or question that may need a response because each organization is different with individual structures, personnel and goals. Nonetheless, an organization must make critical decisions to disassociate it from ineffective internal control systems, ranging from evaluating an organization's internal controls before material weaknesses occur to correcting material weaknesses once detected. If unchecked, material weaknesses may lead to criminal and civil liability for the organization. Accordingly, devising, reviewing and/or correcting an organization's internal control systems before problems arise is essential. ■