PREVENTION AND DETECTION OF FRAUDULENT FINANCIAL REPORTING IN THE CONTEXT OF THE FINANCIAL CRISIS

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Prevention and earlier detection of fraudulent financial reporting must start with the entity that prepares financial reports. Thus the first focus of the Sarbannes-Oxley Act's recommendations is the public company. These recommendations, taken together, will improve a company's overall financial reporting process and increase the likelihood of preventing fraudulent financial reporting and detecting it earlier when it occurs. For some companies, implementing these recommendations will require little or even no change from current practices; for other companies, it will mean adding or improving a recommended practice. Whether it means adding or improving a practice, the benefits justify the costs. The Sarbanes-Oxley Act is a direct response to the recent scandals in the US corporate world. Governance, compliance, risks and internal controls are mounting concerns for almost all organizations. As the numbers of rules, regulations and contractual obligations steadily rise, management is growing more and more concerned about their exposure on day-to-day operational decisions!

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Haw can defined the internal control?

The Committee of Sponsoring Organizations of the Treadway Commission (COSO), is a U.S. private-sector initiative, formed in 1985. Its major objective is to identify the factors that cause fraudulent financial reporting and to make recommendations to reduce its incidence. COSO has established a common definition of internal controls, standards, and criteria against which companies and organizations can assess their control systems. COSO is sponsored and funded by 5 main professional accounting associations and institutes; American Institute of Certified Public Accountants (AICPA), American Accounting Association (AAA), Financial Executives Institute (FEI), The Institute of Internal Auditors (IIA) and The Institute of Management Accountants (IMA).

Internal controls are put in place to keep the company on course toward profitability goals and achievement of its mission, and to minimize surprises along the way. They enable management to deal with rapidly changing economic and competitive environments, shifting customer demands and priorities, and restructuring for future growth. Internal controls promote efficiency, reduce risk of asset loss, and help ensure the reliability of financial statements and compliance with laws and regulations.

Internal control means different things to different people. This causes confusion among businesspeople, legislators, regulators and others. Resulting miscommunication and different expectations cause problems within an enterprise. Problems are compounded when the term, if not clearly defined, is written into law, regulation or rule. This report deals with the needs and expectations of management and others. It defines and describes internal control to:

The COSO framework involves several key concepts. Internal control is a *process*. It is a means to an end, not an end in itself. Internal control is affected by *people*. It's not merely policy manuals and forms, but people at every level of an organization. Internal control can be expected to provide only *reasonable assurance*, not absolute assurance, to an entity's management and board. Internal control is geared to the achievement of *objectives* in one or more separate but overlapping categories.

Establish a common definition serving the needs of different parties. Provide a standard against which business and other entities large or small, in the public or private sector, for profit or not can assess their control systems and determine how to improve them. *Internal control is broadly defined as a process, effected by an entity's board of directors, management and other personnel, designed to provide reasonable assurance regarding the achievement of objectives in the following categories*: *effectiveness and efficiency of operations, reliability of financial reporting, compliance with applicable laws and regulations.*

The first category addresses an entity's basic business objectives, including performance and profitability goals and safeguarding of resources. The second relates to the preparation of reliable published financial statements, including interim and condensed financial statements and selected financial data derived from such statements, such as earnings releases, reported publicly. The third deals with complying with those laws and regulations to which the entity is subject. These distinct but overlapping categories address different needs and allow a directed focus to meet the separate needs.

Internal control systems operate at different levels of effectiveness. Internal control can be judged effective in each of the three categories, respectively, if the board of directors and management have reasonable assurance that they understand the extent to which the entity's operations objectives are being achieved, published financial statements are being prepared reliably, applicable laws and regulations are being complied with.

While internal control is a process, its effectiveness is a state or condition of the process at one or more points in time. Internal control consists of five interrelated components. These are derived from the way management runs a business, and are integrated with the management process. Although the components apply to all entities, small and mid-size companies may implement them differently than large ones. Its controls may be less formal and less structured, yet a small company can still have effective internal control.

The components of the internal control

The components are: *Control Environment, Risk Assessment, Control Activities, Information and Communication and Monitoring.*

The control environment sets the tone of an organization, influencing the control consciousness of its people. It is the foundation for all other components of internal control, providing discipline and structure. Control environment factors include the integrity, ethical values and competence of the entity's people; management's philosophy and operating style; the way management assigns authority and responsibility, and organizes and develops its people; and the attention and direction provided by the board of directors.

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 the 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.

Control activities are the policies and procedures that help ensure management directives are carried out. They help ensure that necessary actions are taken to address risks to achievement of the entity's objectives. Control activities occur throughout the organization, at all levels and in all

functions. They include a range of activities as diverse as approvals, authorizations, verifications, reconciliations, reviews of operating performance, security of assets and segregation of duties.
Pertinent information must be identified, captured *and communicated* in a form and timeframe that enable people to carry out their responsibilities. Information systems produce reports, containing operational, financial and compliance-related information, that make it possible to run and control the business. They deal not only with internally generated data, but also information about external events, activities and conditions necessary to informed business decision-making and external reporting. Effective communication also must occur in a broader sense, flowing down, across and up the organization. All personnel must receive a clear message from top management that control responsibilities must be taken seriously. They must understand their own role in the internal control system, as well as how individual activities relate to the work of others. They must have a means of communicating significant information upstream. There also needs to be effective communication with external parties, such as customers, suppliers, regulators and shareholders.
Internal control systems need *to be monitored* a process that assesses the quality of the system's performance over time. This is accomplished through ongoing monitoring activities, separate evaluations or a combination of the two. Ongoing monitoring occurs in the course of operations. It includes regular management and supervisory activities, and other actions personnel take in performing their duties. The scope and frequency of separate evaluations will depend primarily on an assessment of risks and the effectiveness of ongoing monitoring procedures. Internal control deficiencies should be reported upstream, with serious matters reported to top management and the board.
The internal control system is intertwined with the entity's operating activities and exists for fundamental business reasons. Internal control is most effective when controls are built into the entity's infrastructure and are a part of the essence of the enterprise. "Built in" controls support quality and empowerment initiatives, avoid unnecessary costs and enable quick response to changing conditions.
There is a direct relationship between the three categories of objectives, which are what an entity strives to achieve, and components, which represent what is needed to achieve the objectives. All components are relevant to each objectives category. When looking at any one category the effectiveness and efficiency of operations, for instance all five components must be present and functioning effectively to conclude that internal control over operations is effective.
Internal control can help an entity achieve its performance and profitability targets, and prevent loss of resources. It can help ensure reliable financial reporting. And it can help ensure that the enterprise complies with laws and regulations, avoiding damage to its reputation and other consequences. In sum, it can help an entity get to where it wants to go, and avoid pitfalls and surprises along the way.
An internal control system, no matter how well conceived and operated, can provide only reasonable not absolute assurance to management and the board regarding achievement of an entity's objectives. The likelihood of achievement is affected by limitations inherent in all internal control systems. These include the realities that judgments in decision-making can be faulty, and that breakdowns can occur because of simple error or mistake. Additionally, controls can be circumvented by the collusion of two or more people, and management has the ability to override the system. Another limiting factor is that the design of an internal control system must reflect the fact that there are resource constraints, and the benefits of controls must be considered relative to their costs.

Who has responsibility for internal control ?
Everyone in an organization has responsibility for internal control. The chief executive officer is ultimately responsible and should assume "ownership" of the system. More than any other individual, the chief executive sets the "tone at the top" that affects integrity and ethics and other

factors of a positive control environment. In a large company, the chief executive fulfills this duty by providing leadership and direction to senior managers and reviewing the way they're controlling the business. Senior managers, in turn, assign responsibility for establishment of more specific internal control policies and procedures to personnel responsible for the unit's functions. In a smaller entity, the influence of the chief executive, often an owner-manager, is usually more direct. In any event, in a cascading responsibility, a manager is effectively a chief executive of his or her sphere of responsibility. Of particular significance are financial officers and their staffs, whose control activities cut across, as well as up and down, the operating and other units of an enterprise.

Management is accountable to the board of directors, which provides governance, guidance and oversight. Effective board members are objective, capable and inquisitive. They also have a knowledge of the entity's activities and environment, and commit the time necessary to fulfill their board responsibilities. Management may be in a position to override controls and ignore or stifle communications from subordinates, enabling a dishonest management which intentionally misrepresents results to cover its tracks. A strong, active board, particularly when coupled with effective upward communications channels and capable financial, legal and internal audit functions, is often best able to identify and correct such a problem.

Internal auditors play an important role in evaluating the effectiveness of control systems, and contribute to ongoing effectiveness. Because of organizational position and authority in an entity, an internal audit function often plays a significant monitoring role.

Internal control is, to some degree, the responsibility of everyone in an organization and therefore should be an explicit or implicit part of everyone's job description. Virtually all employees produce information used in the internal control system or take other actions needed to effect control. Also, all personnel should be responsible for communicating upward problems in operations, noncompliance with the code of conduct, or other policy violations or illegal actions.

A number of external parties often contribute to achievement of an entity's objectives. External auditors, bringing an independent and objective view, contribute directly through the financial statement audit and indirectly by providing information useful to management and the board in carrying out their responsibilities. Others providing information to the entity useful in effecting internal control are legislators and regulators, customers and others transacting business with the enterprise, financial analysts, bond raters and the news media. External parties, however, are not responsible for, nor are they a part of, the entity's internal control system.

Actions that might be taken as a result of this report depend on the position and role of the parties involved: Senior Management, Board Members, Other Personnel, Legislators and Regulators

Most senior executives who contributed to this study believe they are basically "in control" of their organizations. Many said, however, that there are areas of their company a division, a department or a control component that cuts across activities where controls are in early stages of development or otherwise need to be strengthened. They do not like surprises. This study suggests that the chief executive initiate a self-assessment of the control system. Using this framework, a CEO, together with key operating and financial executives, can focus attention where needed.

Under one approach, the chief executive could proceed by bringing together business unit heads and key functional staff to discuss an initial assessment of control. Directives would be provided for those individuals to discuss this report's concepts with their lead personnel, provide oversight of the initial assessment process in their areas of responsibility and report back findings. Another approach might involve an initial review of corporate and business unit policies and internal audit programs. Whatever its form, an initial self-assessment should determine whether there is a need for, and how to proceed with, a broader, more in-depth evaluation. It should also ensure that ongoing monitoring processes are in place. Time spent in evaluating internal control represents an investment, but one with a high return.

Members of the board of directors should discuss with senior management the state of the entity's internal control system and provide oversight as needed. They should seek input from the internal and external auditors.
Managers and other personnel should consider how their control responsibilities are being conducted in light of this framework, and discuss with more senior personnel ideas for strengthening control. Internal auditors should consider the breadth of their focus on the internal control system, and may wish to compare their evaluation materials to the evaluation tools.

Government officials who write or enforce laws recognize that there can be misconceptions and different expectations about virtually any issue. Expectations for internal control vary widely in two respects. First, they differ regarding what control systems can accomplish. As noted, some observers believe internal control systems will, or should, prevent economic loss, or at least prevent companies from going out of business. Second, even when there is agreement about what internal control systems can and can't do, and about the validity of the "reasonable assurance" concept, there can be disparate views of what that concept means and how it will be applied.
Corporate executives have expressed concern regarding how regulators might construe public reports asserting "reasonable assurance" in hindsight after an alleged control failure has occurred. Before legislation or regulation dealing with management reporting on internal control is acted upon, there should be agreement on a common internal control framework, including limitations of internal control. This framework should be helpful in reaching such agreement.
Rule-making and other professional organizations providing guidance on financial management, auditing and related topics should consider their standards and guidance in light of this framework. To the extent diversity in concept and terminology is eliminated, all parties will benefit.

Conclusions

This framework should be the subject of academic research and analysis, to see where future enhancements can be made. With the presumption that this report becomes accepted as a common ground for understanding, its concepts and terms should find their way into university curricula. We believe this report offers a number of benefits. With this foundation for mutual understanding, all parties will be able to speak a common language and communicate more effectively. Business executives will be positioned to assess control systems against a standard, and strengthen the systems and move their enterprises toward established goals. Future research can be leveraged off an established base. Legislators and regulators will be able to gain an increased understanding of internal control, its benefits and limitations.
Internal auditors play an important role in evaluating the effectiveness of control systems. As an independent function reporting to the top management, internal audit is able to assess the internal control systems implemented by the organization and contribute to ongoing effectiveness. As such internal audit often plays a significant *monitoring* role. In order to preserve its independence of judgment Internal Audit should not take any direct responsibility in designing, establishing, or maintaining the controls it is supposed to evaluate. It may only advise on potential improvement to be made COSO publications are available through the American Institute of Certified Public Accountants.

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