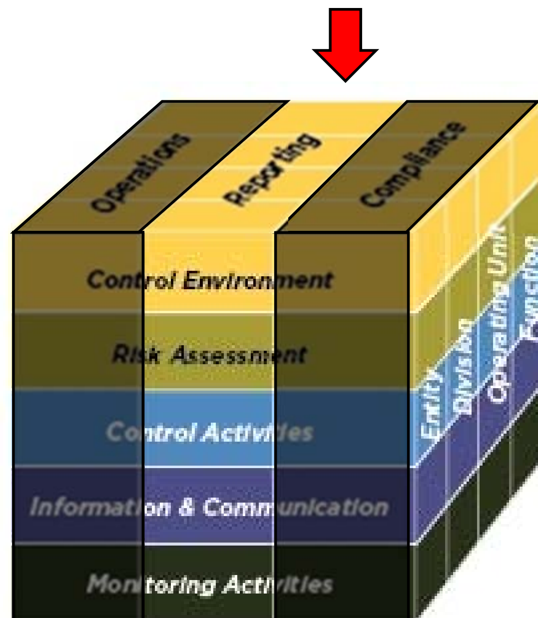
Introduction

Welcome to *Take Control of your Financial Reporting* – a seminar presented by Berry Talbot Royer. This seminar is designed to provide a simulation of how an organization should methodically think about their system of internal control with respect to external financial reporting. It will walk seminar participants through the different components of a system of internal control (control environment, risk assessment, etc.) and engineer those components to help the organization achieve its external financial reporting objectives.

As seminar participants, you are going to pretend that you are associated with The Fake Company. You could be a shareholder, a board member, a member of senior management, an operational manager, an employee, or some other stakeholder. You will be required to imagine yourself in these different roles in order to help the company develop and implement an effective system of internal control over external financial reporting.

Remember, the five components of a system of internal control cut across the three major categories of objectives – operational objectives, reporting objectives, and compliance objectives. So, your job right now is to focus on **external financial reporting objectives** so that you can apply the five components to help control risks in achieving those objectives.



Before an organization can design a system of internal control, it must first establish objectives to control for. Entity-wide objectives are normally established by the board of directors and senior management. However, two categories of objectives, external financial reporting objectives and compliance objectives, are essentially established by external organizations. So, luckily for us, we already know what our financial reporting objectives are (see Appendices).

Additionally, the board and senior management would need to develop and overall strategy for achieving those financial reporting objectives. Before we get into the specifics of a system of internal control, and as a way to warm up our collaborative engines, let's answer this first question.

1. What is going to be our overall strategy for achieving the defined external financial reporting objectives?

The Fake Company

The Fake Company is a privately-held corporation that produces fake pieces of artwork and sculptures. The goal of the organization is to produce high-quality fakes for customers who want the trappings of wealth at a reasonable price.

The company's stated mission on its website and its investor relations material is:

> *"To be the world leader in producing fake artwork and sculptures of such high quality that they are, to all but the experts, indistinguishable from genuine articles in all aspects but price."*

The basic structure of the organization is similar to most organizations. Its shareholders elect a Board of Directors to guide and oversee the management of the company. The Board of Directors hires the Chief Executive Officer who is responsible for implementing the Board's policies and managing the company to achieve the Board's goals. The CEO is responsible for hiring his senior management team who are, in turn, responsible for hiring their operational managers and other employees.

A family of three brothers and sisters, the founders of the company, control 51% of the outstanding common stock. The remaining 49% is owned by about 500 other investors of all types. Additionally, the founding family also holds preferred shares. These are non-voting shares, but have a preference on dividends.

The company's headquarters are in Lewiston, Maine where there is an abundance of reasonably priced mill space to produce goods, property taxes are not particularly high, the infrastructure for shipping and receiving goods is suitably built up, a local community college is ready and available to develop courses to train potential employees in specific skills the company requires, and labor costs are generally lower than in other parts of Maine and New England with similar attributes. All production, warehousing, and administrative functions occur in Lewiston.

The company's major productions are mass-produced objects that it sells at specialty retail stores – particularly home goods retailers. The company also has the capability, through its website, to generate customer-specific items that is not part of its mass-produced list of items.

The company's major transaction classes are as follows:

- Purchases from material suppliers
- Payroll
- Sales to retail stores
- Sales to customers through the website
- Payments to third-party shippers

The company's major assets and liabilities are as follows:

- Cash – the company maintains an operating checking account
- Investments – the company invests excess cash in a diversified portfolio of stocks, bonds, money market funds, and CDs.
- Raw Materials Inventory – due to the vast mill space that the company was able to purchase at such a bargain price, the company is able to take advantage of supplier deals and buy in large quantities that they will eventually use. The company is constantly looking for suppliers offering deals.
- Finished Goods Inventory – the company tries to keep its finished goods inventory to a minimum by only producing products under specific contracts, but retailers often don't have warehousing space themselves, so any excesses not able to be showcased need to be warehoused at the Company until they can be shipped. Average finished goods inventory age is usually around 6 days or so.
- Land and Building – the Mill, a former shoe factory on the Androscoggin River, is aging well
- Equipment – some costly pieces of high-tech production equipment, including 3D printers and some painter robots, and also various office equipment
- Line of credit – the company maintains a line of credit with the bank, but has yet to use it. The balance on the line is secured with raw materials and finished goods inventories.
- Business Loan – the company took out a large loan to buy the high-tech equipment. The loan is secured by the equipment and also has a number of debt covenants that require the company to maintain minimum working capital levels and debt to assets ratios.
- Mortgage – the company financed the purchase and refurbishment of the mill space with a mortgage. The company was able to secure the loan, in part, because it City had agreed to a Tax Increment Financing district plan.

Control Environment

Before any organization can get down to the nitty-gritty of control activities, it must first establish a solid Control Environment. The principles of an effective Control Environment are:

- The organization demonstrates a commitment to integrity and ethical values.
- The board of directors demonstrates independence from management and exercises oversight for the development and performance of internal control.
- Management establishes, with board oversight, structures, reporting lines, and appropriate authorities and responsibilities in pursuit of objectives.
- The organization demonstrates a commitment to attract, develop, and retain competent individuals in alignment with the objectives.
- The organization holds individuals accountable for their internal control responsibilities in the pursuit of objectives.

The responsibility to establish the Control Environment falls to senior management and board members. Imagine you're a board member or perhaps the CEO or CFO of The Fake Company and work through the following discussion questions.

1. What approaches can we take to demonstrate our commitment to integrity and ethical values?

2. How can we demonstrate independence from management and exercise oversight properly?

3. What structures, reporting lines, and appropriate authorities and responsibilities should we establish?

4. How can we demonstrate a commitment to attract, develop, and retain competent individuals?

5. What will we do to hold individuals accountable for their internal control responsibilities?

Risk Assessment

The next step is to perform risk assessments. Remember, risk is the variability and uncertainty of outcomes, and it can arise from both internal and external sources. Risk, as it relates to external financial reporting objectives, therefore, is the variability and uncertainty, for either internal or external reasons, in providing decision-useful information to external users.

First, the organization must specify objectives with sufficient clarity to enable the identification and assessment of risks relating to objectives. Remember that overall objectives (or, entity-wide objectives) will always cascade down from the entity level to subunits and become more and more specific.

1. How can we define our external financial reporting objectives more clearly?

Next, we imagine that we are senior managers, operational managers, or area specialists working at The Fake Company. We must ask ourselves "What can go wrong?" This is called risk identification and it needs to be done across the entity (all subunits and activities that play a role in achieving our financial reporting objectives). Also, don't forget that information technology systems play a large and ever-increasing role in companies' operations and, therefore, we should be considering risks to IT systems as they might pertain to the objectives.

2. Review the major assets and liabilities and major transaction classes of the The Fake Company as well as the specific objectives and ask "What Can Go Wrong?"

While doing the above brainstorming to identify risks, the company also needs to consider the potential for fraud. Fraud is intentional misstatements or misappropriation of assets (essentially, lying and stealing). Ask yourself:

3. Where could fraud be perpetrated that would risk our achievement of our financial reporting objectives?

Note: For a more in-depth discussion of fraud, attend our seminar, *Fraud in Your Organization.*

While still performing the brainstorming session, the company also needs to consider changes that could present risks or impact the system of internal control.

4. What changes could occur that need to be considered during our risk assessment phase?

Once the brainstorming session is complete and a list of identified risks has been developed, the final step in risk assessment is to actually assess them. Risks are analyzed to determine two different aspects:

- What is the risk's likelihood of occurrence?
- What would be the impact on the achievement of objectives if the risk occurred?

Approaches can vary, but essentially a weight is given to each question and the *combined* weights result in the overall assessment of that risk.

5. What do we think the likelihood and potential impact would be on the financial statements for each of the identified risks?

Control Activities

With our risks to external financial reporting objectives identified and assessed, we are now ready to select and develop control activities to respond to those risks.

1. What approaches can we use to select and develop controls in response to identified risks?

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Also, don't forget that IT systems are integral to operations and that we need to select and develop both general controls and activity controls over IT systems.

2. What types of general IT controls can we put in place?
3. What specific finance-related application controls can we develop?

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Let's take a moment and think about the risks we've identified for The Fake Company and what controls we could put in place to mitigate them.

We need to go through them once more and determine which are the **key controls**. These are the control activities that will provide the most bang for the buck. Generally, they will effectively control for more than one risk and, thus, create efficiencies. It's important to always be considering the costs in implementing controls and comparing them to the expected benefits. Review the controls developed and figure out which set of these controls will provide the most coverage of risks with the least cost to company resources.

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Information and Communication

Relevant, quality information and effective communication of that information are necessary for any organization to carry out its internal control responsibilities. Information can be obtained or generated from both internal and external sources, and it should flow up, down, and across the organization so that clear messages can be relayed to and received by necessary parties.

1. What are some of the ways that we can go about obtaining, generating, and using relevant, quality information to support the functioning of internal control over external financial reporting?
2. What approaches can we take to internally communicate information, including objectives and internal control responsibilities as they related to external financial reporting?
3. What can we do to communicate with external parties regarding matters affecting internal control over external financial reporting?

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Monitoring Activities

We now have one final component of internal control to design and implement – Monitoring Activities. If an organization designs and implements controls, but then never monitors them to determine if they have been designed appropriately or are operating effectively, the whole system is at risk of failure.

The company needs to perform ongoing and/or separate evaluations of the system of internal control to ensure that all seventeen principles are *present and functioning*. The point of monitoring activities is to determine whether control activities possess *design effectiveness* and are *operating effectively*. A breakdown in either case is considered a *control deficiency*. A *major deficiency* is a control deficiency that severely reduces the likelihood of achieving objectives. If a major deficiency exists, the entire system of internal control cannot be considered effective.

1. What monitoring activities can we establish?
2. How can we evaluate and communicate deficiencies in a timely manner so that corrective action can be taken?

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What Are Financial Reporting Objectives?

Chapter 1 of FASB Concepts Statement No. 8, *Conceptual Framework for Financial Reporting* explains what the objectives are for general purpose financial reporting.

> "The objective of general purpose financial reporting is to provide financial information about the reporting entity that is useful to existing and potential investors, lenders, and other creditors in making decisions about providing resources to the entity."

It's called *decision usefulness*. In order for financial information to be useful to decision-makers, however, we need to know what decisions are being made.

Investors – They make decisions about buying, selling, or holding equity securities in the company. They base those decisions on expected returns on investments which come from dividends on equity investments, and market price changes of investments.

Lenders, Bondholders, and Other Creditors – They make decisions about providing or settling loans and other forms of credit. Their decisions are based on expected payment of interest and return of principal or other returns.

Both sets of decision-makers establish their expectations, and thus make their decisions, based on their assessment of the amount, timing, and uncertainty of future net cash inflows to the entity. Therefore, the information needs to help them make assessments about *future net cash inflows*.

Information that helps them make those assessments includes:

- Information about the entity's resources and claims on those resources
    - Information about the entity's assets, liabilities, and equity

- Information about changes in those resources and claims on resources
    - Information about the entity's net income, comprehensive income, and their components
    - Information about the entity's cash flows
    - Information about the entity's changes in equity

- Information on how efficiently and effectively management and the governing board have discharged their responsibilities to use the entity's resources (stewardship).
    - Information about the custody and safeguarding of resources
    - Information about efficient and profitable use of resources
    - Information about how management is protecting against unfavorable economic impacts, technological developments, and social changes
    - Information about compliance with applicable laws, regulations, and contractual provisions

The following types of information help users assess amounts, timing, and uncertainty of net future cash inflows:

- Return on investment
  - Provides a measure of overall performance
  - Results from dividends, interest, and appreciation in market value of securities (future net cash inflows)

- Risk
  - Variability and uncertainty of future outcomes (in the case of investors and creditors, this means variability and uncertainty of future net cash inflows) – more variability and uncertainty means more risk
  - The greater the risk of an investment, the higher the expected return on the investment

- Financial flexibility
  - Ability of a company to use its financial resources to adapt to change, respond to unexpected needs, and take advantage of opportunities as they arise
  - The greater the financial flexibility, the lower the risk

- Liquidity
  - How quickly a company can convert its assets into cash to meet current obligations and cover operating costs
  - The greater the liquidity, the higher the financial flexibility and, the lower the risk. However, the greater the liquidity, the lower the expected return on investment.

- Operating Capability
  - The ability to efficiently produce goods and services – how much goods and services can be produced given the productive capacity of assets and the efficiency of productive processes
  - The greater the operating capability, the higher the return on investment

Chapter 3 of FASB Concepts Statement No. 8, *Conceptual Framework for Financial Reporting* explains the qualitative characteristics of decision-useful information.

In order for information to be useful to decision-makers, it must have two fundamental qualitative characteristics: it must be relevant and it must be a faithful representation of reality.

- **Relevance** means that the information has a role in how a user is making a decision. Relevant information can make a difference in the conclusions reached and decisions made. Irrelevant information is not useful to a decision-maker. To be relevant, information…

  - Must have **predictive** value – information that helps users form expectations about the future
  - Must have **confirmatory** value – information that provides feedback regarding prior decisions to either confirm the predictions they have made or to correct those predictions so that updated/refined expectations can be made about the future
  - Should be **material** - information that is of a nature and magnitude to affect the decisions of a user. Materiality is a *combination* of qualitative (nature) and quantitative (magnitude) aspects of information – not either/or. That is, something may be of a very small magnitude, but because of its nature it would affect the decisions of a user and, therefore, be considered material. Likewise, the nature of information may be relevant to decisions, but if its magnitude is so small, it may not be considered material.

- **Faithful Representation** means that the economic substance of underlying transactions, events, accounts, and arrangements are accurately depicted in the financial information. To be a faithful representation, information…
    - Must be a **complete** representation – the information is a full disclosure of all necessary facts, descriptions, and explanations in order to understand the information
    - Must be a **neutral** representation – the information is not biased, emphasized, or otherwise manipulated to influence a user's decisions *in a particular direction*.
    - Must be an **error-free** representation – information is measured and described as accurately as possible using the best available inputs.

Additionally, there are four enhancing qualitative characteristics. These characteristics, by themselves or in combination with each other, cannot make irrelevant or un-representational information useful to decision-makers. However, when relevant and faithfully represented information is provided, these characteristics enhance the decision-usefulness of that information.

- **Comparability** – information that enables users to identify and explain similarities and differences between the reporting entity other entities (intercompany comparison) and between the entity's prior information and current information (intracompany comparison). Implicit in comparability is the quality of *consistency*. Consistency means that methods and procedures are applied in the same manner from period to period, or transaction to transaction, or even from one type of transaction to another type of transaction (i.e., the methodology of how to approach the transactions is consistent).

- **Verifiability** – information that allows different observers to reach a consensus that a particular representation is faithful and that the measurement results can be independently duplicated

- **Timeliness** – information that is available to decision-makers in time to influence their decisions

- **Understandability** – information that is comprehensible to users who have a reasonable knowledge of business and economic activities and are willing to study the information carefully

All of these aspects of financial reporting information is constrained by costs. Costs include use of resources to collect, record, compile, organize, and communicate information for and to decision-makers. The marginal costs of doing all of that for a particular piece of information should be less than the marginal benefit to decision-makers. Keep in mind, too, that for publicly held corporations, cost constraints can also include disclosing too much information and losing a competitive advantage.

Financial Reporting Standards

The Financial Accounting Standards Board (FASB) develops a comprehensive set of standards to ensure that the qualitative characteristics of financial reporting are met. They have developed a single body of authoritative literature, the *FASB Accounting Standards Codification*, which provides guidelines, procedures, and practices for all reporting companies to use. This is referred to as U.S. generally accepted accounting principles (U.S. GAAP).

U.S. GAAP is developed based on certain assumptions:

- Economic entity / reporting entity assumption – the financial accounting and reporting is separate for each economically distinct entity

- Going concern assumption – the entity will continue to operate into the foreseeable future

- Period of time assumption – financial reporting of the entity covers a specific period of time and balance sheet items are measured as of the last day of the reporting period. Transactions before or after the reporting period are not included in the accounting information.

- Monetary unit assumption – all measurements are performed using a single monetary unit (e.g., dollar, euro, etc.) and the monetary unit is assumed to be stable over time

- Mixed attribute measurement assumption – different aspects of financial reporting will be measured using the most relevant and representationally faithful measurement attribute (e.g., historical cost, fair values, present values of future cash flows, net realizable value, etc.)

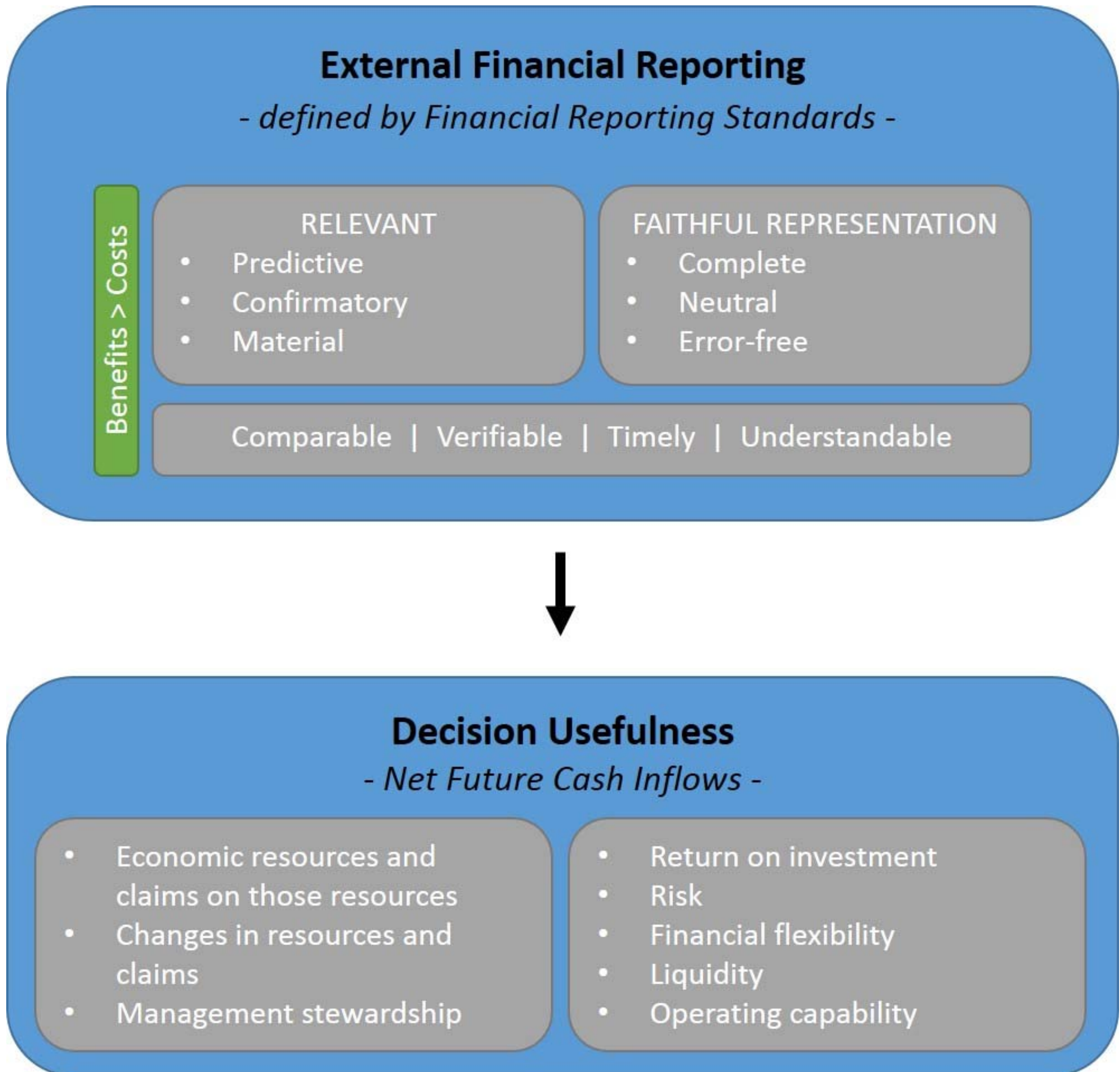
- Recognition assumption – for an item to be recognized in the financial records, it must be (a) an accounting element (asset, liability, equity, revenue, expense, etc.), (b) measurable, (c) relevant, and (d) representationally faithful.

- Accrual accounting assumption – the accounting records measure and report all items that affect economic resources, claims to those resources, and changes in those resources in the current period. Revenue is recognized in the period it is earned and is measurable. Expenses are recognized in the period they are incurred and are measurable. And, expenses are matched to the period in which they generate revenues.

- Conservatism assumption – accounting records will avoid overstating net assets and/or net income when the amounts composing them are uncertain and alternative accounting valuations are equally possible

Financial reporting standards also promulgate what financial statements must be prepared in order to achieve the financial reporting objectives:

- Balance sheet
- Income statement
- Statement of Cash Flows
- Statement of Changes in Owner's Equity


External Financial Reporting
- defined by Financial Reporting Standards -
Benefits > Costs
RELEVANT
Predictive
Confirmatory
Material
FAITHFUL REPRESENTATION
Complete
Neutral
Error-free
Comparable | Verifiable | Timely | Understandable
Decision Usefulness
- Net Future Cash Inflows -
Economic resources and claims on those resources
Changes in resources and claims
Management stewardship
Return on investment
Risk
Financial flexibility
Liquidity
Operating capability

How Do Financial Reporting Objectives Differ for Governments?

Because of the differences between the operational goals of businesses and governments, governmental financial statement users are different and have different informational needs in order to make decisions with respect to the government.

The primary users of governmental financial reporting fall into three categories:

- The citizenry
- Legislative and oversight bodies
- Investors and creditors

These groups use governmental financial reporting primarily to…

- Compare actual financial results with legally adopted budgets
- Assess the financial condition and results of operations of the government
- Assist in determining compliance with finance-related laws, rules, and regulations
- Assist in evaluating efficiency and effectiveness

Additionally, governments can have complicated structures and carry on multiple activities that will require it to disaggregate its overall financial reporting into smaller sub-units in order for it to be useful to decision-makers. Hence, government-wide financial statements are broken out into two general categories: governmental activities and business-type activities. Furthermore, fund financial statements narrow in on major activities that have been tracked using fund accounting methods. These are broken out into three broad fund categories – governmental funds, proprietary funds, and fiduciary funds.

GASB has identified, in its Concepts Statement No 1 *Objectives of Financial Reporting*, the following financial reporting objectives (these apply to both governmental activities and business-type activities):

- Financial reporting should assist in fulfilling government's duty to be publicly accountable and should enable users to assess that accountability by:
    - Providing information to determine whether current-year revenues were sufficient to pay for current-year services (called *interperiod equity*)
    - Demonstrating whether resources were obtained and used in accordance with the entity's legally adopted budget, and demonstrating compliance with other finance-related legal or contractual requirements
    - Providing information to assist users in assessing the service efforts, costs, and accomplishments of the governmental entity

- Financial reporting should assist users in evaluating the operating results of the governmental entity for the year by:
    - Providing information about sources and uses of financial resources
    - Providing information about how it financed its activities and met its cash requirements
    - Providing information necessary to determine whether its financial position improved or deteriorated as a result of the year's operations

- Financial reporting should assist users in assessing the level of services that can be provided by the governmental entity and its ability to meet its obligations as they become due by:
    - Providing information about its financial position and condition
    - Providing information about its physical and other nonfinancial resources having useful lives that extend beyond the current year, including information that can be used to assess the service potential of those resources
    - Disclosing legal or contractual restrictions on resources and the risk of potential loss of resources.

The objectives are different from non-governmental entities, but it's important to realize that the qualitative characteristics of financial information are generally the same. GASB identifies the following characteristics as essential in governmental financial reports:

- Understandability
    - To be publicly accountable, a government should issue financial reports that can be understood by those who may not have a detailed knowledge of accounting principles. Note that this is a different level of understandability required by FASB.

- Reliability
    - The characteristic of reliability encompasses the characteristics of *verifiability*, *neutrality*, *faithful representation*.

- Relevance
    - Again, to be relevant, the information must be capable of making a difference in a user's decisions.

- Timeliness
    - As time passes, the usefulness of financial information diminishes.

- Consistency
    - Once an accounting principle or reporting method is adopted, it will be used for all similar transactions and events.

- Comparability
    - Differences between financial reports should be due to substantive differences in the underlying transactions or the governmental structure rather than due to selection of different alternatives in accounting procedures or practices. Intergovernmental comparability and intragovernmental comparability is important.

Governmental Financial Reporting Standards

The Governmental Accounting Standards Board (GASB) develops a comprehensive set of standards to ensure that the qualitative characteristics of financial reporting are met. They have developed a single body of authoritative literature, the *GASB Accounting Standards Codification*, which provides guidelines, procedures, and practices for all reporting state and local governments to use. This is referred to as U.S. generally accepted accounting principles (U.S. GAAP) for state and local governments.

There are many differences between FASB's Codification and GASB's Codification. This is because of the divergence between financial reporting objectives. A few major differences include:

- The use of fund accounting
- The requirement for both government-wide financial statements and fund financial statements
- The measurement focus and basis of accounting for governmental funds
- The required supplementary information to be presented along with the basic financial statements

Financial Statement Assertions

Financial statements are really a just a collection of assertions that *management* is making with regard to the entity. Assertions can be categorized as:

- Assertions about the **transactions and events** that occurred during the period
- Assertions about the **account balances** at the end of the period
- Assertions about the **presentation and disclosure** of financial information

The specific assertions for each of these categories are as follows:

Transactions and Events

- Occurrence – the underlying transactions and events reflected in the accounting records actually took place and pertain to the entity
- Completeness – all transactions and events that should have been recorded have been recorded
- Accuracy –transactions and events have been recorded at appropriate amounts
- Classification – transactions and events have been recorded in the proper accounts
- Cutoff – transactions and events have been recorded in the proper accounting period

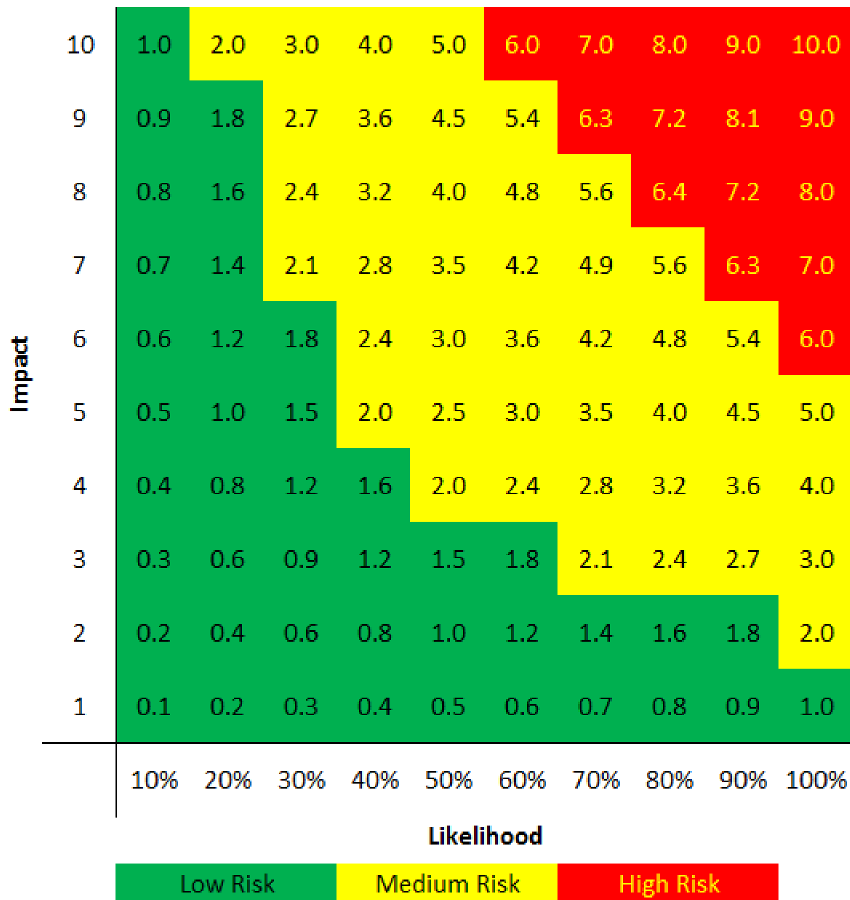
Account Balances

- Existence – assets, liabilities, and equity interests reported actually exist (and are not overstated)
- Completeness – all assets, liabilities, and equity interests that pertain to the entity have been reported (and are not understated)
- Valuation and Allocation – assets, liabilities, and equity interests are included in the financial statements at appropriate amounts and any resulting valuation or allocation adjustments are recorded appropriately
- Rights and Obligations – the entity holds or controls rights to the assets reported and the liabilities reflect the entity's legitimate obligations

Presentation and Disclosure

- Occurrence – transactions and events disclosed have occurred and pertain to the entity
- Completeness – all disclosures required to be made have been made
- Accuracy and Valuation – financial and other information is disclosed fairly and at appropriate amounts
- Classification and Understandability – financial information is appropriately presented and described information in disclosures is expressed clearly

Approaches to Assessing Risks



Impact										
10	1.0	2.0	3.0	4.0	5.0	6.0	7.0	8.0	9.0	10.0
9	0.9	1.8	2.7	3.6	4.5	5.4	6.3	7.2	8.1	9.0
8	0.8	1.6	2.4	3.2	4.0	4.8	5.6	6.4	7.2	8.0
7	0.7	1.4	2.1	2.8	3.5	4.2	4.9	5.6	6.3	7.0
6	0.6	1.2	1.8	2.4	3.0	3.6	4.2	4.8	5.4	6.0
5	0.5	1.0	1.5	2.0	2.5	3.0	3.5	4.0	4.5	5.0
4	0.4	0.8	1.2	1.6	2.0	2.4	2.8	3.2	3.6	4.0
3	0.3	0.6	0.9	1.2	1.5	1.8	2.1	2.4	2.7	3.0
2	0.2	0.4	0.6	0.8	1.0	1.2	1.4	1.6	1.8	2.0
1	0.1	0.2	0.3	0.4	0.5	0.6	0.7	0.8	0.9	1.0
	10%	20%	30%	40%	50%	60%	70%	80%	90%	100%

Likelihood

Low Risk | Medium Risk | High Risk

Likelihood	Impact	Overall Risk
Almost Certain	Material	High
Almost Certain	Moderate	High
Almost Certain	Minimal	Medium
Probable	Material	High
Probable	Moderate	Medium
Probable	Minimal	Medium
Even Chance	Material	Medium
Even Chance	Moderate	Medium
Even Chance	Minimal	Low
Unlikely	Material	Medium
Unlikely	Moderate	Low
Unlikely	Minimal	Low
Remote	Material	Low
Remote	Moderate	Low
Remote	Minimal	Low

How to Think About Transaction Classes

Transactions are what gets the company from one financial condition (its starting balance sheet) to another financial condition (its ending balance sheet). Thus, it's important to be able to think about the fundamentals of each transaction class so that control activities can be designed to combat where risks in the processes arise.

All transactions will can be broken down into different *process activities*:

- Initiation
  - What events trigger the start of a transaction?

- Processing
  - How does the transaction get processed from initiation through recording and reporting stages?

- Recording
  - How is the transaction recorded in the accounting records?

- Reporting
  - How is the transaction compiled with other data and formatted appropriately for reporting?

Note that transactions always start with initiation and end with reporting. But, processing and recording can come in any order in between and may occur more than once before the transaction is complete.

Once those are understood, *control activities* can be incorporated as part of the overall transaction:

- Authorization
  - The basis by which authority to complete the various stages of the transaction is delegated. In an authorization, a *role* is being granted a *privilege* to perform a specific *action*.
  - The authority should be documented. For standing authority, it should be documented in permanent files. For temporary authority it should be documented with the use of such things as a stamp, initials, emails, etc.
  - Individuals should have first-hand knowledge of the transactions being approved.
  - Authorization should be timely. Time lags create opportunities for altered documents.

- Documentation
  - Paper or electronic communication that supports the completion of the lifecycle of a transaction. Basically, anything that provides evidence for the transaction, who performed each action pertaining to the transaction, and the authorities to perform the transaction.
  - Standard forms, templates, stamps, etc., should be developed and used whenever possible.
  - Documentation should also include changes made subsequent to authorization/approval.
  - Establish retention policies so that documents no longer relevant to the entity can be discarded.

- Review and Reconciliation
  - The process of comparing transactions and activities to supporting documentation and resolving any discrepancies.
  - Ensures that unauthorized changes have not occurred
  - Primary function is to control for accuracy and validity (occurrence) of transactions. Errors and discrepancies should be investigated and resolved in a timely fashion.
  - Establish review and reconciliation procedures that are consistent and thorough.

- Security
    - Safeguarding of assets and records is technically an operational objective, but security controls implemented often help to control for financial reporting objectives.
    - Security can be broken down into three types: Administrative, Physical, and Technical
        - Administrative Security – focuses on processes put in place to protect assets and records, and includes authorization, documentation, and review and reconciliation control activities.
        - Physical Security – protects the physical assets and records from theft, damage, or unauthorized access and disclosure.
        - Technical Security – protects electronic records from theft, damage, or unauthorized access and disclosure.
    - As the value of assets and sensitivity of records increases, the number of individuals with access to them should decrease.
    - Always consider access left open to terminated employees and closing those access points down in a timely fashion.
    - Establish policies for access including IT policies that prohibit the shared use of logins and passwords.

- Segregation of Duties
    - Separates incompatible duties so that no one person has sole control over the lifespan of transactions.
    - Assures that misstatements, intentional or unintentional, cannot be made without another individual discovering it.
    - Even small organizations can find ways to segregate duties effectively enough to reduce risk. In these cases, however, it won't be the only control activity covering the transaction.
    - Establish written responsibilities for employees and ensure that they understand the reason why duties are being segregated.
    - Segregation of duties should be able to be demonstrated to outside parties.

For every major transaction class, the company should prepare a step-by-step list of the transaction processes, identify which type of process it is (initiation, processing, etc.), and which roles perform which parts. Diagrams can also be useful. Once the processes are identified, the company can more easily determine which control activities should be implemented and at what points in the transaction stream.

It's also helpful to identify whether the control activity is a **preventive** control or a **detective** control. Preventive controls are designed to identify misstatements before they can occur. They aim to deter fraud or error. Detective controls are designed to identify misstatements after they occur, but in a *timely fashion*. Detective controls that are not timely lose their usefulness. For example, reconciling all bank statements at the end of the year is not a particularly useful detective control.

One Last Thing about Transaction Classes

Even though most organizations don't realize it, the *Financial Close and Reporting Process* is always considered to be a major transaction class. This process is what happens at the end of the accounting cycle; it also includes the General Journal Entry process.

Please attend our seminar on the Financial Close and Reporting Process to learn more.

Risk Inventory

External Financial Reporting Objectives

Risk ID	Description of Risk	At Risk Balances / Transactions / Disclosures	At Risk Assertions	Assessed Likelihood	Assessed Impact	Assessed Overall Risk
R01						
R02						
R03						
R04						
R05						

Risk Inventory

External Financial Reporting Objectives

Risk ID	Description of Risk	At Risk Balances / Transactions / Disclosures	At Risk Assertions	Assessed Likelihood	Assessed Impact	Assessed Overall Risk
R06						
R07						
R08						
R09						
R10						

Control Inventory

External Financial Reporting Objectives

Control ID	Description of Control	Risk IDs Controlled For	Control Level	Frequency	Performed By (Manual / Automated)	Preventive / Detective
C01						
C02						
C03						
C04						
C05						

Control Inventory

External Financial Reporting Objectives

Control ID	Description of Control	Risk IDs Controlled For	Control Level	Frequency	Performed By (Manual / Automated)	Preventive / Detective
C06						
C07						
C08						
C09						
C10						

How to Assess Controls during Monitoring Activities

The whole point of control activities is to help reduce risk in achieving objectives. Therefore, if a control is not designed properly and/or is not operating effectively, the control is of no help and the risk is not reduced.

Design Effectiveness

First, the monitor should determine if the control's design will effectively address the identified risk. To do so, the monitor reviews the risk the control is supposed to control for and determines whether or not the control would effectively reduce the risk.

For example, suppose a retail store identifies the risk that shoplifters can shoplift items. They decide that they will mitigate this risk by installing cameras in the ceiling and have them record activity in the store aisles. Then, at the end of the day, the store manager will review the recordings from camera. Is this an effectively designed control? No. The risk is that shoplifters will steal merchandise. Reviewing the recordings at the end of the day does not help to reduce this risk. An effectively designed control would be to have someone watching all camera feeds throughout the day and have communication with security personnel near the doors.

An ineffectively designed control may be deemed to be operating effectively, but it is nevertheless an ineffectively designed control and should be considered a control deficiency.

Operating Effectiveness

Operating effectiveness is the next consideration of the monitor. Operating effectiveness concerns itself with three questions:

- Is the control activity being performed *consistently*?
- Is the person performing the control the one who is *authorized*/*assigned* to perform the control?
- Is the authorized person performing the control *competently* (i.e., do they follow the stated control procedures, do they understand what the procedure is controlling for, do they know what to look for, etc.)

Using the example above, suppose the monitor notes that the person who is assigned to watch the camera feeds is the only employee authorized to perform this role, has been trained on how to perform the control, and demonstrates a thorough understanding of what to do and why. However, upon further monitoring, it's noted that the employee takes frequent breaks and often mills about the store chatting with other employees. Can this control be considered to be operating effectively? No. It's true that the person authorized to perform the control is the one who does it and he seems competent in the control activity. However, he doesn't perform the control consistently enough to seriously reduce any risks.