Reliable Financial Reporting

Evaluating Deficiencies in Internal Control Over Financial Reporting

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BYU

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Internal Controls and Reliable Financial Reporting

- Importance of internal control over financial reporting (ICFR) for reliable financial reporting
  - Management assessment and performance
  - Internal and External Auditor assessment and performance

Management Performance around ICFR

In 2004, 15.7% of accelerated filers disclosed ineffective ICFR. Dropped to 3.4% in 2010. In 2015 the percentage was 5.3%. *(Source: Audit Analytics)*

Handout 1: Examples of Public Company Material Weaknesses

- Control Environment—Tone at the top, insufficient number of personnel
- Journal Entry and Account Reconciliation—Access and segregation
- Accounting for Contingencies—Management Review Controls
- Methodology to Estimate Credit Loss Allowance—Error in methodology
- Goodwill Impairment Testing—Reviews of impairment indicators

Auditor Performance around ICFR

PCAOB Inspection Results, Helen Munter, Director of Inspections

“Over the last few years, the audit of internal control has topped the list of deficiencies in the audit work we have reviewed.” (Sept 2015)

“The most frequent audit deficiencies continue to be in the key areas related to auditing ICFR.” (April 2017)

Auditor Performance around ICFR

PCAOB Inspection Results

Of the inspection 61 deficiencies reported by the PCAOB for Big 4 related to audit work for the 2015, 88% of findings related to ICFR. *(Source: PCAOB inspection reports)*

Categories of typical deficiencies

- Failure to sufficiently test the design and/or operating effectiveness of control
- Failure to identify and test any controls that addressed the risks related to a particular account or assertion
- Failure to perform sufficient testing of the information technology general controls ("ITGCs") over the IT systems that initiated, processed, and recorded revenue transactions
- Failure to sufficiently test user-access controls for certain of these IT systems

Auditor Performance around MRC

PCAOB Inspection Results, Munter Dec 2016 (Continued)

"Inspections staff continued to identify deficiencies related to testing the effectiveness of controls that **include a review element**.

Specifically, some auditors did not sufficiently evaluate the procedures performed by management, including the criteria management used to identify matters for investigation and the steps involved in investigating and resolving such matters.

…a root cause of these deficiencies may be auditors not understanding the extent of procedures and evidence that needs to be obtained when they test controls with a review element."

Reaching Consensus on MRC—Fogarty, Feb 2016

Management review controls (MRCs) are the reviews conducted by management of estimates and other kinds of financial information for reasonableness. They require significant judgment, knowledge, and experience. These reviews typically involve comparing recorded amounts with expectations of the reviewers based on their knowledge and experience.

MRCs have a higher-level focus than transaction controls, as they examine aggregated results rather than individual transactions. Also, MRCs are inherently subjective. Unlike transaction controls, which are “yes/no,” MRCs typically involve some level of subjectivity and uncertainty (i.e., shades of grey, not black and white).

Typical Management Review Control Description

The CFO reviews the impairment analysis for appropriateness. Monthly, the controller prepares an undiscounted cash flow analysis, which is then reviewed and approved by the CFO. The CFO reviews the various schedules and signs off on the control package.

Reaching Consensus on MRC—Fogarty, Feb 2016

Because of their highly qualitative nature, there is a great deal of controversy over what MRCs should look like. Some businesses are concerned about the level of supporting detail that auditors and the PCAOB inspectors now require when evaluating MRCs. There are widely varying opinions about the appropriate level of detail a review must be conducted at — and about the need for testing the accuracy and completeness of data used in the reviews.

CFO.com, Feb. 2016 “Reaching a Consensus on Management Review Controls” by John Fogarty

Problems with a Typical MRC Description

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Improved MRC—Fogarty, Feb 2016

- Inputs: Undiscounted Cash Flow Analysis (UCFA), including supporting schedules.
- Specific monthly review activities: CFO (1) discusses the current and forecasted business environment with the CEO, the COO, and the vice president of operations; (2) reviews each of the assumptions and support within the UCFA with a particular focus on the weighting assigned to each outcome; (3) challenges any assumptions or weights that may have a significant impact on the conclusion.
- Outputs: Any questions are sent to the controller to be addressed and resolved to the satisfaction of the CFO, at which point the CFO signs off on the UCFA.

Reaching Consensus on MRC—Fogarty, Feb 2016

“There appear to be differing views between all of the various MRC stakeholders — companies, auditors, and regulators — about what constitutes “enough” with respect to MRCs.

By establishing a constructive dialogue between companies, auditors, and regulators to clarify and define “how much is enough” — with a focus on creating illustrative examples that bring the definitions to life — we believe it is entirely possible to reach a reasonable and practical consensus that works for everyone.”

Evaluation of MRC Design Factors

Design Factors
Appropriateness of the Purpose of the Control and Its Correlation to the Risk/Assertion
Competence and Authority of the Person(s) Performing the Control
Level of Aggregation and Predictability
Frequency and Consistency with Which the Control Is Performed
Criteria for Investigation and Process for Follow-Up

Management and Auditor Effort to Design, Document and Test MRC and Transaction Level Controls

Handout 2: MRC Control Design Template

Illustrate Transaction Level Testing Template

CONTROL TESTING TEMPLATE

Control Summary	
Control ID	C_R_3
Control Activity Summary Description	C_R_3: The Orders Shipped Log and the Daily Open Invoice Report are reviewed by the Warehouse Director on a daily basis to confirm that all orders shipped are invoiced.
Control Description — Detailed Description of How the Control Is Expected to Be Performed	Inputs: The Orders Shipped Log is a non-system generated Excel workbook that is compiled by taking carbon copies of the bill of lading documents and manually logging them in a spreadsheet that is maintained by the shipping clerks. The Daily Open Invoice Report is a system generated report that comprises all of the daily invoices. Control Procedures (Review Activities): The Warehouse Director performs the following steps: (1) The Warehouse Director verifies that all bills of lading for

Issues with General IT Control's

From a reported Material Weakness:

Deficiencies in GITC logical access, including controls intended to ensure that access rights are compatible with job duties (segregation of duties) exist.

The following business process controls were adversely affected: controls over revenues and insurance costs; payroll tax and costs... business process controls that are dependent on affected IT systems or resulting electronic data were also deemed to be deficient and have material weaknesses.

Basic Definition Deficiency

A3 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 …

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.

Basic Definitions of Deficiency, SD, MW

.62 The auditor must evaluate the severity of each control **deficiency** that comes to his or her attention to determine whether the deficiencies, individually or in combination, are material weaknesses...

.66 Factors that affect the magnitude of the misstatement that might result from a deficiency…-

- The financial statement amounts or total of transactions exposed to the deficiency; and
- The volume of activity in the account balance or class of transactions exposed to the deficiency that has occurred in the current period or that is expected in future periods.

SEC Staff Public Comments

Where are the Material Weaknesses?

"I continue to question whether all material weaknesses are being properly identified. It is surprisingly rare to see management identify a material weakness in the absence of a material misstatement. This could be either because the deficiencies are not being identified in the first instance or otherwise because the severity of deficiencies is not being evaluated appropriately. …it may be useful for management to dust off the SEC's 2007 interpretive guidance and compare management's ICFR evaluation process to the SEC guidance to see if improvements are in order."

- *Brian Croteau*, *Deputy Chief Accountant, Office of the Chief Accountant,* 2013.

“The other area of internal controls that we wonder about is: when we see a material weakness, it's usually around the time a restatement is announced, but why aren't there more material weaknesses when there's not a restatement announced? You would expect there to be more material weaknesses prior to a restatement, but a controls error always seems to be found at just about the same time."

- *Paul A. Beswick, Former SEC Chief Accountant,* May 1, 2014.

AS5 now AS 2201 Provides Indicators of MW

Indicators of material weaknesses-

- Identification of fraud…
- Restatement …
- Identification by the auditor of a material misstatement of financial statements in the current period…that…would not have been detected by the company's internal control over financial reporting; and
- Ineffective oversight…by the company's audit committee.

Management Evaluation Tool—Handout 3

1. Gather the facts → 2. Consider the Potential Misstatement → 3. Compensating Controls → 4. Conclude

The Key Steps in Evaluating Deficiencies

Evaluate Deficiencies

The external auditor identified deficiencies related to the operating effectiveness of the Company’s controls to ensure the existence, valuation, accuracy, and completeness of inventory on hand. Specifically, we found that physical inventory procedures were not performed with sufficient consistency to ensure the underlying quantities were accurate. Specifically, cycle counts did not cover the complete population of inventory during the year.

Evaluate Deficiencies

Handout 4: Case 1

K. Maeser, Inc: Deficiency in the design and operating effectiveness of controls over the assessment of uncertain tax positions an deferred tax asset valuation allowance

Evaluate Deficiencies

Handout 4: Case 2

ABC, Inc., Revenue recognition cut-off errors at the Mexican division…not in compliance with US GAAP.

Questions

Conclusion—The Role of ICFR in Reliable Reporting

- Importance of ICFR for reliable financial reporting
  - Management assessment and performance
  - Auditor assessment and performance
- Management Review Controls
  - Lack of consensus
- ITGC's
- Evaluation and documentation of controls
- Significant Deficiencies
  - Do not require a misstatement or error
  - The appropriate response from management and audit committee
- Material Weaknesses
  - Do not require a misstatement or error