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EVER SINCE the Arthur Andersen/Enron scandal broke in 2001, the headlines have been dominated by alleged financial frauds at companies such as WorldCom, Xerox, Adelphia, Merrill Lynch, and Tyco. Congress reacted by passing the Sarbanes-Oxley Act of 2002 with its sweeping implications for the way publicly traded companies perform accounting and report results.

As we all know by now, under Sarbanes-Oxley, signing officers (CEOs and CFOs) must certify the effectiveness of their internal controls. But one lesson from Enron was that the most serious internal control problems weren't a result of neglecting to get the proper signatures or booking bogus journal entries. The most serious problems, besides wholesale fraud, were acts of *omission*, such as Enron's nondisclosure of special-purpose entities (SPEs).

Is What-You-See Really What-You-Got?

In order to match *all* the "stuff" to *all* the "money," you need a comprehensive internal control methodology that works with Sarbanes-Oxley.

This means that accountants have been hit with a new set of problems. Instead of verifying that certain acts were conducted properly (acts of *commission*), accountants now find themselves trying to ascertain information that has been (as at Enron) intentionally *omitted* (acts of *omission*). Instead of just looking for the proper authorizations for journal entries in a ledger, we now have to look for things that aren't presented to us at all.

Thus the internal control problem has expanded to a much broader scope—for management as well as internal and external auditors. The industry has to address the question: "How do the CEO and CFO, who are now required to attest to the completeness of their internal controls, actually know that there are no improprieties at some distant operation?"

This raises another question: How can an issuer assure the investing community that it has an adequate system of internal control, and how can this be proved beyond any reasonable doubt?

EXTERNAL AUDITORS

Let's examine the current "standard" external audit function. External auditors require management to sign a representation letter—the "rep letter"—which states that management made no material misrepresentations to the auditors. This is a technique external auditors use to protect themselves (or so they think) from litigation. The representation letter draws a nice, neat parameter around the subject matter that the external auditors need to concern themselves with. Everything else, even inappropriate items, can be conveniently ignored.

Why do external auditors knowingly ignore inappropriate activities? The common belief is that they would jeopardize their lucrative consulting contracts with the client. I have personally witnessed this at more than one publicly traded company, as have many other people (which is how it came to be common knowledge). Now the sale of consulting services by external auditors is supposed to be prohibited by Sarbanes-Oxley. Ironically, this provision was diluted somewhat in early 2003.

Sarbanes-Oxley seeks to hold management accountable for *all* of an organization's financial results, not just those favorable to management or convenient to the external auditors. While the Act takes steps to eliminate conflicts of interest, it doesn't go far enough.

Even though the external audit firms are restructuring, the conflict-of-interest problem remains unchanged. That is, no external audit firm can realistically be expected to say anything materially bad about its client. While audit firms vehemently deny this conflict of interest exists, I contend that, at least to some extent, it does and always will as long as they have this type of relationship. I would further contend that the audit firms won't change their current state of industry oversight until the litigation costs become too high.

So what we have now is an environment where the external audit firm still has an inherent conflict of interest: It has to vouch for the client's audit while still relying on that same client to pay its invoice.

But both the auditor and client carry a much larger risk: They are effectively responsible for *all* of the activities of the client firm now. The representation letter does nothing to limit the liability of the auditor, and nothing limits the liability of the firm's senior management to civil litigation.

OMISSION AND COMMISSION

So how does a company's management ensure that its internal controls are so comprehensive that they protect against errors, not just of *commission* but of *omission* as well? Comprehensive internal controls should be able to identify illegal activities such as the manipulation of the California energy market, which in June 2003 prompted the Federal Energy Regulatory Commission to strip Enron of some of its rights to trade electricity and natural gas.

The existing internal control systems and internal audit functions are really only designed to check the material presented to the auditor. Therefore, the internal control solution required for the future should go well beyond the traditional methodologies.

Internal Control Methodology

Most internal control systems consist of the standard basic:

- Authorization processes for capital expenditures.
- Graduated approval levels granted to operational managers for hiring personnel and for approving various levels of expense, such as procurement and travel.
- Accounting controls regarding approvals for journal entries.
- Basic approval forms that are supposed to be signed and retained.
- An internal audit department that conducts periodic inspections to see if all of the above procedures were being followed.

Typically, unless egregious violations are discovered, remediation includes the standard measures like increasing the focus on the completion of the requisite forms and restricting various types of access to systems. For serious violations, management usually fires the employee for cause and replaces him/her.

HOW THEY SHOULD WORK

Here's how a proper internal control system should work.

Business Processes:

- Should cascade from the highest levels to the lowest levels.
- Should be supported at each level by management control systems.
- Should be linked via data flow documentation to the financial results of the organization.
- Should include some level of contingency planning, if done correctly.
- Should complement and intersect with the ISO certification process documentation in some instances. At the high levels, processes will be separate. At the lower levels, processes will be much more comprehensive than ISO documentation.
- At the lowest levels, processes should be to the lowest material level of detail.

Understanding Systems:

- The linkage between the business activities as documented in the processes and the flow of data to the ledger systems should be well understood and documented.
- Disconnected reporting systems need to be audited more thoroughly.
- All the traditional issues of data integrity should be adhered to.

Reported Results:

- Identify all transactional activity in summaries.
- Correlate all of the transactional activity to the ledger.
- Correlate the changes in the ledger to business processes.

This correlation is the key. The cause-and-effect relationships must be understood completely.

IMPLEMENTING THE COMPREHENSIVE AUDIT CONTROL SYSTEM

1. Clean up the existing internal controls. Write the missing policies, processes, and procedures. This means documenting so that the flow of money, data, and resources can be understood.
2. Develop the linkage and correlation between the business processes, transactional activities, and the ledger.
3. Organize the materials so that they can be properly correlated, understood, reviewed, and presented.

The problem is the inherent limitations of the existing methodologies, such as their limited scope, silo approach, and transactional orientation. Other limitations include the failure to correlate flows of funding and resources on a comprehensive basis across different areas of a large firm.

Plus, fraud exists at all levels. I have often seen fraud at lower levels that, when augmented by the fraud at senior levels, becomes greatly exacerbated. To be effective, a system of internal controls must prevent fraud at *all* levels within the organization.

THE SOLUTION

The solution is to match *all* of the "stuff" to *all* of the "money." Stated differently, we must correlate all of the flows of assets and services to their corresponding financial results.

As all of you know, business processes are the activities conducted in the course of a company's business that are expected to add value to the materials consumed and people the business employs. Financial results are the reported outcomes of the business processes conducted by the employees that consume or add value to the materials.

Yes, this is basic, but it establishes the basis for some new thinking on the subject. There's a new method of auditing called the Comprehensive Audit Methodology™ (CAM™). It's the oversight function of a new set of internal controls, the Comprehensive Internal Control Methodology™ (CICM™), which establishes a comprehensive framework for internal controls that has the ability to correlate all activities of an organization to a set of reported transactions. When we look at the situation *comprehensively*, we should be able to see an offsetting effect for everything that happens.

Auditors typically look at transactions one at a time, but the Comprehensive Audit Methodology™ looks at transactions in related groups, so the materials prepared for this audit must be presented comprehensively. This is known as the Comprehensive Internal Control System™ (CICS™), which is based on the Comprehensive Internal Control Methodology™. For each change in one area of a financial statement, we are looking for the offset in another section.

The more experienced management accountant or financial manager might think of it like the discontinued "Sources and Uses" financial statement that used to be common, expanded beyond just cash, with references to business processes. While the CAM™, CICS™, and CICM™ are considerably more complex than this, the analogy is useful.

For example, it was widely reported that Enron had undisclosed special-purpose entities that produced profit for the primary corporation. The CAM™ would have quickly uncovered this using a simple checklist that correlated the profits to their corresponding source business process. In this example, we would have seen profit on a financial statement with no corresponding source business process. In its basic form, the CAM™ correlates business processes to transactional flows and then matches them with financial statements. Then we simply check these for completeness in both directions.

In comparison, it was widely reported that WorldCom had numerous costs that weren't reported. The story came out that they had put costs into work orders but never closed those work orders to either expense or balance sheet accounts. CAM™ would have easily uncovered this setup. This would show up as the opposite of what we saw in the example above. We would see business processes, payrolls, and expenses with no corresponding effect on a financial statement. Using our systematic checklist, we would try to follow these expenses and would have found that they "disappeared" and never made it to a financial statement.

Corporate management must understand that this is really the *only* way to prove beyond a reasonable doubt that their internal controls are effective. Errors of commission are easy enough to detect. It's the errors of omission that pose the greatest risk. Existing control and audit methodologies aren't capable of detecting errors of omission. And management can't rely on the external auditors to protect the company. This is an exercise that every company should undertake if their executives want to be able to sleep at night.

Corruption exists at all levels within large organizations. The time-tested methods of manipulating financial results are by no means limited to senior management. Only a Comprehensive Audit Methodology™ is capable of addressing fraud at all levels within an organization. ■

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