

Best Practices under Audit Standard 5

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With the introduction of the Sarbanes-Oxley Act (SOX) in 2002, companies have had to dramatically ramp up regulatory compliance efforts. Based on the guidance they received, companies began factoring a compliance check list into almost every process. Controls were designed to cover every possible source of financial reporting fraud. As these controls became more cumbersome, companies found it an increasing strain to comply with SOX regulations—and still, they failed to prevent the fraud these requirements were supposed to address, as evidenced by recent headlines regarding financial misstatements and deceit on the part of some very high-profile corporations.

New Expectations under Audit Standard 5

There are several changes to the guidance in Audit Standard 5 (AS 5) that help make compliance more effective. AS 5 adopts a more risk-based approach that allows companies to evaluate where to place their control emphasis. Instead of trying to cover every potential fraud scenario, they can devote their resources to preventing fraud where it is most likely to occur. In this way, they still achieve the goal of preventing fraud without wasting time and money chasing down every remote possibility of fraud, irrespective of likelihood or potential impact. Rather than devoting resources to document the security around back up tape procedures, an organization can devote resources to continuously monitoring journal activities to identify management override of controls. The largest losses to investors have come from management “cooking the books” not from someone restoring data from manipulated back up tapes. By identifying areas of highest risk, and focusing on those, they will be able to prevent fraud that might otherwise have slipped through unnoticed.

For example, AS 5 stresses reliance on the work of others. Currently, auditors can look at reporting data collected by a company, and while it shows them everything they need to know, they still need to go through the process of pulling together the same report for their own use. Under the new guidance, external auditors can rely on well-documented results to know where to focus their time and attention, thus reducing costs and duplication of work. For example, companies that have a continuous monitoring system in place can show the data already collected and addressed by the solution, eliminating the need for third-party testing.

What Constitutes Risk?

With these changes, auditors are directed to focus efforts in the highest-risk areas as determined by a risk analysis. In most companies, the highest risk for fraud involves the general ledger (GL) and revenue recognition. In order for a company to effectively use the GL, there are always adjustments that need to be approved, and privileged users who can revise account balances without causing comment. There are, however, a number of examples of abuse that can arise through otherwise valid adjustments, including:

- Management override of journal entry policy – Management can either use its own override capabilities to circumvent journal entry controls or ask/pressure subordinates to make entries contrary to policy.
- Journal entry split to override manual entry policy – Authorized users can circumvent corporate policy and/or journal entry controls by splitting single manual entries into multiple manual entries, each of which individually falls within policy restrictions.
- Management override of revenue recognition policy – management efforts to circumvent revenue recognition policy through either direct entry or by asking/pressuring subordinates.

Considerations When Developing a Risk-Based Approach

Shifting to AS 5 should be a smooth transition because companies have already spent years developing checklists of controls. Previous guidance was more bottom-up, cover-all-the-bases, and focused on making sure a company has a plan in place. Under AS 5, companies won't have to spend a great deal of time proving they are attending to all the minuscule details, instead emphasizing their fraud risk assessment. For example, the Association for Certified Fraud Examiners found that 73 percent of fraud is committed by trusted employees in executive management, accounting, sales, finance or procurement positions. With this higher potential for management fraud, a company will be able to focus more effort in this area.

In adjusting to AS 5 guidelines, companies need to monitor all GL transactions for specific categories of fraud risk with a process already in place for addressing any problems. Today, company policy might require all manual journal entries greater than a specific dollar amount to be reviewed and approved by the controller. However, with AS 5, auditors will be evaluating all entries in areas of greatest risk, including automated entries. Consequently, companies need to ask themselves, "Is our current policy adequate to address fraud risk?"

Developing this kind of a risk-based approach will also help companies to highlight the measures they have taken to decrease risk when they are audited. With AS 5, auditors can base their

judgments on the systems the company has in place to minimize the potential for material misstatement due to fraud and management override.

How to Reduce Fraud and Lessen Compliance Costs

To combat fraud and lower compliance costs effectively, companies need to consider the fraud diamond, including the following elements: Capability, Opportunity, Pressure and Rationalization.

CAPABILITY: As employees learn the intricacies of a company's financial system, those who will potentially commit fraud gain confidence in their ability to subvert the controls. Under AS 5, companies can focus their attention on the areas where these behaviors are most likely to occur. Still, companies need to understand that auditing only a sample of transactions in these areas leaves them vulnerable to fraud, as employees learn what steps to take in order to remain hidden. Fraud consists of singular events that can be impossible to find through a sample.

OPPORTUNITY: Companies need to evaluate whether controls are sufficient to address the risks of fraud, especially regarding management override. One of the most effective ways to do this is to implement a continuous monitoring solution. Continuous monitoring is a control that monitors the effectiveness of other controls by testing every transaction. If a company's continuous monitoring program includes the processes for dealing with errors and other problems, continuous monitoring allows the company to detect and prevent misstatements on a timely basis. Under AS 5, if other control activities do not help to prevent the material misstatement of financial information, or if they only remove an extremely remote opportunity, companies may consider removing them from being key controls.

PRESSURE: Reducing fraud risk can also be applied to general company policies. One of the precursors to fraud involves tying compensation closely to financial performance. In the 2007 Oversight Systems Report on Corporate Fraud, 81 percent of survey respondents said fraud occurs because of the pressure to do whatever it takes to meet goals. If this business structure is necessary, companies need to have independent controls over management overrides to reduce this risk.

RATIONALIZATION: Those involved in fraudulent behavior are capable of committing illegal actions they do not perceive as being in conflict with their personal ethical standards. In many cases the individuals only started out "stretching" company policy by a small degree. Over time their activity stretched further and further from appropriate behavior. Effective fraud prevention must assist the individual's ability to recognize the rift between the appropriate values and their actions. This "conflict consciousness" can be raised by the application of continuous monitoring

that clearly flags as potentially fraudulent actions that are exceptions to accepted policy and controls. In this way, even “shades of gray” are highlighted as being out of compliance, making it harder for an individual to begin the slide into outright fraud.

There are definite tactics companies can employ to combat the various elements of the fraud diamond. Employing continuous monitoring and honing their controls to address risk will impair the capability and directly reduce the opportunities employees have to take advantage of the system. Adjusting company policies to eliminate unreasonable performance pressures may reduce fraud risks associated with management override of controls, and continuous monitoring not only aids in detection and prevention of financial misstatements, it also minimizes the personal rationalizations that lead otherwise trustworthy employees to perform fraudulent actions.

With AS 5, compliance efforts can be focused where they will do the most good in preventing errors and fraud. For example, under AS 2, if a company had nine different locations with the same configuration, it was necessary to check all nine, significantly expanding internal testing requirements. AS 5 eliminates the need to test all nine, by empowering the company to test only those that represent the greatest risk, thus reducing costs and allowing these resources to be reallocated where they will best reduce risks.

