PKF PERSPECTIVES

AUDIT RISK UPDATE

Financial Reporting Process and Safeguarding Company Assets

GUIDANCE FROM RECENT AUDITING STANDARDS NOW REQUIRES AUDITORS TO MAKE CERTAIN INQUIRIES OF MANAGEMENT AND TO DOCUMENT THE CONTROL PROCESS WITH RESPECT TO THE COMPANY'S POLICIES AND ITS PROCEDURES TO ACCUMULATE AND PRESENT FINANCIAL RESULTS AND TO SAFEGUARD CORPORATE ASSETS.

As either a business owner, board member or financial management professional, you are rightfully concerned with your organization's bottom line. Whether your business is for-profit or not-for-profit, privately-owned or publicly-traded, you need to be vigilant in ensuring that your corporate assets are safeguarded and your financial results are fairly presented. In this post-Enron, post-Andersen environment, your outside auditors are required by regulatory bodies to carry out more stringent exploration of "risk factors" in the conduct of their audit of your organization, and you - as the client - will play a key role in the process.

Auditors by nature exercise professional "skepticism" in the performance of their duties and will continue to do so - but now in a much more formalized way. They will be armed with "Risk Assessment Forms" and their audit will be conducted accordingly. Although an audit is not designed to uncover fraudulent financial reporting and misappropriation of assets, additional procedures in this area could uncover some internal control deficiencies in your organization.

The "risk factors" fall into several broad categories and these conditions could become breeding grounds for dishonest financial reporting and larceny and, therefore, will raise "red flags" to your auditors. Some of these risk factors include:

Risk Factors: Incentives and Pressures

- The organization's profitability is threatened by outside economic conditions, e.g., high degree of competition, market saturation, declines in customer demand, operating losses threaten bankruptcy, recurring negative cash flows from operations, etc.
- Excessive pressure exists for management to meet the requirements or expectations of third parties, e.g. investment analysts, institutional investors, significant creditors, or other external parties, including expectations created by management in, for example, overly optimistic press releases or annual report messages
- Available information indicates that management or director personal finances are threatened by the organization's financial performance
- There is excessive pressure on management or operating personnel to meet financial targets set up by the board of directors or management, including unrealistic sales or profitability incentive goals

Risk Factors: Opportunities

- There are significant related-party transactions not in the ordinary course of business or with related entities not audited or audited by another firm
- The organization has a strong financial presence or has the ability to dominate a certain industry sector that allows the organization to dictate terms or conditions to suppliers or customers that may result in inappropriate or non-arm's length transactions
- Assets, liabilities, revenues, or expenses are based on significant estimates that involve subjective judgments or uncertainties that are difficult to corroborate
- Significant operations are located or conducted across international borders in jurisdictions where differing business environments and cultures exist
- There are significant, unusual, or highly complex transactions, especially those close to period end, that pose difficult "substance over form" questions

- There are significant bank accounts or subsidiary or branch operations in tax-haven jurisdictions for which there appears to be no clear business justification

- There is ineffective monitoring of management as a result of (1) domination of management by a single person or small group (in a business managed by a non-owner) without compensating controls, or (2) ineffective board of directors or audit committee oversight over the financial reporting process and internal control

- There is a complex or unstable organization structure, as evidenced by (1) difficulty in determining the organization or individuals that have controlling interest in the entity, (2) overly complex organizational structure involving unusual legal entities or managerial lines of authority, or (3) high turnover of senior management, counsel, or board members

- Internal control components are deficient:

  - Inadequate monitoring of controls, including automated controls and controls over interim financial reporting (where external reporting is required)

  - High turnover rates or employment of ineffective accounting, internal audit, or information technology staff

  - Ineffective accounting and information systems, including situations involving reportable conditions

Risk Factors: Attitudes and Rationalizations

- Ineffective communication or implementation, support, or enforcement of the entity's values or ethical standards by management or the communication of inappropriate values or ethical standards

- Non-financial management's excessive participation in or preoccupation with the selection of accounting principles or the determination of significant estimates

- Known history of violations of securities laws or other laws and regulations, or claims against the entity, its senior management, or board members alleging fraud or violations of laws and regulations

- Excessive interest by management in maintaining or increasing the entity's stock price or earnings trend

- Management's practice of committing to analysts, creditors, and other third parties to achieve aggressive or unrealistic forecasts

- Management's failure to correct known reportable conditions on a timely basis

- Interest by management in employing inappropriate means to minimize reported earnings for tax-motivated reasons

- Recurring attempts by management to justify marginal or inappropriate accounting on the basis of materiality

- Strained relationship between management and the current or predecessor auditor, e.g. frequent disputes on accounting, auditing, or reporting matters; unreasonable demands, such as unreasonable time constraints regarding the completion of the audit or the issuance of the auditor's report; formal or informal restrictions on the auditor that inappropriately limit access to people or information or the auditor's ability to communicate effectively with the board of directors or audit committee; attempts to influence the scope of the auditor's work or the selection or continuance of personnel assigned to or consulted on the audit engagement

Clearly, your organization as a whole should benefit from being aware of the high risk areas and potential internal control deficiencies. You may wish to take this opportunity to reconsider your organization's control environment and take any steps necessary to ensure that potential risk areas are mitigated to the extent possible.

Items in this publication should not be considered official statements of position, nor advice for individuals or organizations without consulting a CPA. For further information, please contact the director in charge of your engagement or John Haslbauer, Henry Freire or Tom Sorrentino.

PKF

Certified Public Accountants
A Professional Corporation

29 Broadway • New York, NY 10006

Telephone: (212) 867-8000 • Telefax: (212) 687-4346

www.pkfnewyork.com • e-mail: info@pkfny.com

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