

COSO STUDY ON FRAUD IN FINANCIAL REPORTING

by Carlo di Florio

Introduction

I have been asked to address the topic of fraud in financial reporting generally and what is known as the COSO Report in particular. During the course of the discussion, we'll explore the U.S. experience in dealing with this issue through the perspective of the private-sector Commission — COSO - established to study fraud in financial reporting and make recommendations. At the end of the day, the aim is to discuss an overall framework for “good” corporate governance and internal control and highlight examples of how this is being implemented in the U.S. The intent is to place the discussion in the context of a larger international dialogue on private sector financial accountability and transparency.

I. Overview of COSO

- At its core, corruption involves fraudulent financial reporting. Whether through slush funds, shell companies or kickback schemes, the bribe payment is generally disguised and fraudulently reported.
- Experience shows that these violations of law, regulations and policies are generally the result of deficiencies in corporate governance and internal controls.
- It was in the 1940s that a discussion of internal control methodologies first appeared in U.S. audit literature and practice. But it was the period from 1972-76 which brought the issue to centre stage. Then, saw the Watergate scandal unfold in the United States, and subsequent investigation revealed that companies were engaged in questionable political campaign finance practices and clear foreign corrupt practices. The ensuing scrutiny by the SEC and Congress contributed greatly to the enactment of campaign finance laws and the 1977 FCPA, which criminalised transnational bribery and required companies to implement internal control programs.
- Indeed, in the immediate several years following, the SEC and the American Institute of Certified Public Accountants introduced proposals that management be required to report on the condition of internal control in publicly held companies. Between 1978 and 1985, the AICPA issued a number of Statements on Auditing Standards which related to internal controls.
- Regulatory and standard proliferation, however, is replete with headlines about frauds and corruption in major corporations, “surprise” losses, business failures, and lawsuits from the investing public against boards of directors and senior management.
- In response, a private-sector initiative, called the National Commission on Fraudulent Financial Reporting (commonly known as the Treadway Commission) was formed in October 1985. It had as its major objective to identify the causal factors of fraudulent financial reporting and to make recommendations to reduce its incidence. The Commission was jointly sponsored and funded by 5 main professional accounting associations and institutes. [the American Institute of Certified Public Accountants (AICPA), American Accounting Association (AAA), the Financial Executives Institute (FEI), The Institute of Internal Auditors (IIA) and the Institute of Management

Accountants (IMA)].

- The Commission issued its initial report in 1987, and among other initiatives, recommended that the organisations sponsoring the Commission work together to develop integrated guidance on internal control.
- Consequently, the Committee of Sponsoring Organisations (COSO) was formed and it commissioned Coopers & Lybrand to study the issues and author the report.
- It is worthy to note that a number of separate and unrelated events underscored the importance of the need for such an integrated framework. In 1991, Congress passed a law requiring management of large financial institutions under FDIC oversight to issue annual reports on the effectiveness of their internal control systems. That same year, the U.S. Sentencing Commission adopted guidelines for use in assessing penalties for businesses found guilty of so-called “white collar crimes.” The Guidelines permit significant reduction in penalties for entities which have in place an effective system for detecting and preventing violations of laws, such as the FCPA.

II. COSO — Internal Controls

- The COSO study took more than three years and involved extensive research and discussion with corporate leaders, legislators and regulators, auditors, academics, outside directors, lawyers and consultants. Despite differences of orientation and agenda, opposing interests came together to solve a common problem.
- The result was the COSO Report entitled “Internal Control — Integrated Framework.” The COSO Report does two important things: 1) it presents a common definition of internal control, and 2) it provides a framework against which entities can assess and improve their internal control systems. Related to corruption in particular, the COSO standard has become one of the principle benchmarks which U.S. companies use in evaluating their compliance with the U.S. FCPA.
- **Internal Control Integrated Framework** — COSO broadly defines internal control as a process, effected by an entity’s board of directors, management or other personnel, designed to provide reasonable assurance regarding: 1) the efficiency of operations; 2) the reliability of financial reporting; and 3) compliance with applicable laws and regulations.

To achieve these objectives, effective internal control consists of establishing five interrelated components: the control environment, risk assessment, control activities, information and communication, and monitoring. Let’s take a brief look at each of these:

1. The “**control environment**” is what sets the tone of an organisation and provides discipline and structure. It includes the integrity and competence of the entity’s people; management’s philosophy and operating style; and the way management and the board assign authority and responsibility.
2. “**Risk assessment**” is the identification and analysis of risks to determine how they should be effectively managed. Once risks have been identified, sourced and measured, steps must be taken to avoid, transfer, or otherwise reduce the risks to acceptable levels. As an example, to evaluate the risk of bribery and corruption in the procurement process, one might analyse how engineering may create specifications that favour specific vendors, how purchasing may unfairly award contracts, and how accounting may record kickbacks.

3. The “*control activities*” are the policies and procedures that help ensure that management’s directives are carried out. These include such practices as authorisation, reconciliation and segregation of duties. Such activities would permeate the entire organisation, at all levels and in all functions. Of course they must be customised to reflect the entity’s specific control environment, objectives, and tolerance for risks.
4. “*Information and communication systems*” produce operational, financial and compliance related reports, and they also notify personnel of their role in the internal control system. These systems must provide a means for moving important information to the very top of the organisation and for receiving inputs from external parties. As an example, consider information of corrupt practices coming from a whistleblower — e.g., a marketing clerk within the organisation - or a whistleblower — e.g. a vendor - outside the organisation. In short, internal and external information must be identified, captured, and communicated in a form and time frame that enables people to carry out their responsibility.
5. Finally , “*monitoring*” is a process that assesses the quality of the system’s performance over time. When deficiencies are discovered, they must be reported and appropriate remedial action taken.

All five components must be present and functioning effectively to conclude that internal control over operations is effective.

In the interest of time, I would now like to move on and touch on COSO’s most recent study on fraudulent financial reporting.

III. COSO — Landmark Study on Fraud in Financial Reporting

- This landmark study was released in March of this year. It was based on analysing a decade of SEC enforcement cases and it presents a profile of the frauds committed, the companies and individuals involved, and the consequences of the frauds. The report is particularly useful to anyone involved in corporate governance. More information about the study can be found on the website (www.aicpa.org) of the American Institute of Certified Public Accountants.
- **METHODOLOGY:** The study analysed 200 randomly selected cases of alleged financial fraud investigated by the SEC. about 2/3 of the 300 SEC probes into fraud between 1987 and 1997

IV. Summary of COSO Study on Fraud in Financial Reporting —PRINCIPLE FINDINGS

- The study found that typical financial reporting fraud schemes involved the overstatement of revenues and assets:
 - In more than half the cases, revenues were recorded prematurely or fictitiously
 - About half of the fraud involved overstating assets by understating allowances for receivables, overstating the value of tangible assets, and/or recording non-existent assets
- In the past decade, most fraud in financial reporting among public companies was committed by smaller corporations, with well below \$100 million in assets.
- Top senior executives were frequently involved. In 83% of the cases, the CEO, the CFO or both

were named as being associated with the financial statement fraud.

- The boards of directors of these companies were dominated by insiders and directors with significant equity ownership and little apparent experience serving on the boards of other companies
- Most audit committees met only about once a year or the company had no audit committee at all.
- Audit firms of all sizes were associated with companies committing financial statement fraud.
- Cumulative amounts of frauds were relatively large in light of the relatively small sizes of the companies involved. The average misstatement or misappropriation of assets was \$25 million.
- Some companies committing fraud were experiencing net losses or were in close to break even positions in periods before the fraud. Pressures of financial strain or distress may have provided incentives for fraud for some of companies
- This report provides investors, financial professionals and regulators with valuable information regarding where they might direct their focus. For example, a regulatory focus on companies with market capitalisation over \$200 million may inadvertently fail to target those companies most frequently engaged in fraud. The audit committee and board practices of smaller companies may warrant particular attention.

IV. Conclusion and Lessons Learned

The increased private sector financial accountability and transparency initiatives described present substantial benefits to the evolution of sound corporate governance.

- The most obvious benefit of COSO was to provide managers with a comprehensive and integrated approach to assessing and controlling business risks in an era where the pace of change — commercial, political, social and regulatory — is ever increasing.
- COSO has also greatly expanded the concept of internal control, and by providing a “common language” has facilitated multi-disciplinary dialogues on this important topic
- As COSO has caused thousands of U.S. companies to rethink their approach to managing and controlling risks, new basic principles of management are emerging, setting off a paradigm shift in how corporate governance is effected.
- As we will hear, other countries have undertaken their own initiatives in establishing national standards for corporate governance and internal control. To the extent these systems improve transparency, integrity and governance, they are indeed to be developed and embraced