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The merging of the controls environment and financial reporting

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The Sarbanes-Oxley Act has proved a stern test for finance departments and there is clear evidence that companies are taking a more cautious approach to external reporting. Some would argue that more concern for the integrity of financial reporting is long overdue and should be a matter of normal practice. As a result, a new range of technical solutions is emerging which seek to combine controls reporting and financial reporting.

Every finance professional is aware of the importance of the controls environment in ensuring the integrity financial reporting, but the introduction of the Sarbanes-Oxley Act elevated its importance to a new and more visible level. Responsibility for controls and reporting on their effectiveness could no longer be 'sub-contracted' to an internal audit department. The well publicized events around Enron and others produced a regime in which controls had to be documented and demonstrated to have been working throughout the accounting period under review.

In practice most large enterprises routinely exercise an appropriate level of financial control over group reporting and many argued that the stern requirements of Sarbanes-Oxley were excessive. Indeed, any CFO worth his salt would insist that the controls in his underlying systems and processes were robust. Without such confirmation how could a CFO have faith in the numbers produced and published?

But the record shows that theory and practice are not always aligned. The high volume of material control weaknesses disclosed in the early days of Sarbanes-Oxley indicated that many processes could not withstand close scrutiny. Furthermore, although US companies on average still report their statutory results more quickly than their European counterparts, the speed of the close (sometimes called the Fast Close) slowed down by as much as 7 days as hesitant CFOs sought to obtain confirmation that controls were definitely in place and working before broadcasting their results to the world. The emphasis under Sarbanes-Oxley changed from a passive interest in controls, to a "show me" it's working attitude.

Demonstrating that controls are effective is not as straightforward as it might first seem. The Reporting Supply Chain is a continuum which in a multi-national organization stretches across multiple sites, currencies, accounting practices and systems – not to mention staff of widely different capability in different geographies. Exercising control in these conditions is a significant challenge but proving their effectiveness is altogether more onerous.

The controls in question are of two main types. Firstly, there are application controls that are designed to ensure that data processed in the group reporting system is authorized, complete and accurate. Secondly, there are controls relating to the computing environment, for example, that interfaces between one part of an application and another are reliable and that data is secure. Historically, controls testing has been the domain of auditors, but Sarbanes-Oxley effectively handed responsibility to group finance. The latter neither had the tools nor the time to take on the burden, so new tools entered the market to fill the vacuum.

Initial attempts at filling the void were a hodge podge of ideas. External auditors and other specialist organizations offered databases of controls and recommended tests, but these were no more than glorified checklists that were documented and managed separately from the group reporting application. Without a direct link between the controls and the financial results it was impractical to provide a satisfactory level assurance on the integrity of the numbers.

However, we are now beginning to see the emergence of integrated controls and financial reporting in which the controls environment is tested at every (material) level of the enterprise and electronically ‘signed’ off by a responsible financial controller at each reporting entity.

In this situation a CFO can draw comfort from the fact that each of the controllers has signed up to the effectiveness of controls in their location. But more importantly it is possible to see the direct impact of any control failures or weaknesses on the reported numbers. For example, part of the close procedure may be the agreement of all bank reconciliations. Using the new breed of tools the inability to agree a balance is noted as a control failure in the relevant subsidiary and the bank balance reported up the line is flagged as red - signifying a control failure. Successive consolidations up the group hierarchy propagate the control weakness along the Reporting Supply Chain until ultimately the bank balance reported in the provisional group balance sheet is also flagged. In other word there is a direct link between a control failure and the balance sheet.

Based on this information the CFO can drill down on the reported control weakness to identify the offending subsidiary and the materiality of the amounts involved. A decision can then be taken on whether to allow more time to complete the reconciliation or to press ahead regardless.

Leveraging experience in business intelligence tools, the software industry is coming up with even more compelling ways of reporting controls effectiveness. Controls dashboards, comprising colorful dials and gauges are beginning to emerge which give visual cues of the state of controls testing, for example, percentage complete and percentage failed.

Sarbanes-Oxley may have been the catalyst for change but the coalescence of controls and financial reporting makes sound business sense. Although a relatively nascent discipline all CFOs, stakeholders and market commentators will welcome a development that helps build confidence in the integrity and robustness of financial reporting.

About the author

Gary Simon, Group Publisher of *FSN* and Managing Editor of *FSN Newswire*, is a graduate of London University, a Chartered Accountant and a Fellow of the British Computer Society with more than 25 years experience of implementing management and financial reporting systems. Formerly a partner in Deloitte for more than 16 years, he has led some of the most complex financial reporting and information management assignments for global enterprises in the private and public sector. His latest book, "*Fast Close to the Max*®" is now available from FSN Publishing Limited.

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