Control Mechanism for Fair Financial Reporting

Giyoul Lee*

Abstract:
Management should strive to report fairly the financial statements in accordance with Generally Accepted Accounting Principles(GAAP), which are management's representations of the company's financial position and results of operation. In other words, responsibilities for making fair presentations rest with management, but management often commits fraud tempted by various motives. Such motivations arise from desire to achieve personal gains, such as higher stock prices or bonuses, or to avoid financial difficulties his company may face. Management's fraud often shakes the public's confidence in the integrity of financial reporting and may result in ultimate collapse of financial market, even nation's economy. Because management is in position to manipulate documents, override internal control procedures, or collude with third parties to create fictitious documents, management fraud is extremely difficult to detect. Hence, preventing management fraud is more important. To that end, monitoring overall financial reporting process is vital. In addition, coordination among various monitoring functions cannot be overemphasized. Audit committee plays a key role in the monitoring process, but for the committee to perform prescribed duties effectively, the charter must specify membership requirement, terms of office, frequency and time of meeting. Above all, the committee must be composed of truly independent members free from financial interest and family relationships with the company, and with financial expertise. Members affiliated with the management or the company in one way or another must be excluded from the committee.

Key Words: Management fraud, Audit committee, External audit, Internal control

* Associate Professor of Accounting, Dankook University
email: gylee@dku.edu

I. Introduction

Management should strive for fair presentation of financial statements. Responsibilities for adopting sound accounting policies and principles, maintaining adequate internal control and making fair representations in the financial statements rest with management. But management commits fraud, called management fraud or fraudulent financial reporting, due to various motives. Fraudulent financial reporting is management's intentional misrepresentation or deception that results in materially misleading financial statements. An example is to overstate sales intentionally near the end of accounting period to increase reported earning. Management fraud is more difficult to detect than employee fraud(misappropriation of assets), because management can manipulate documents to hide misstatements, for example, by overriding internal control systems or collusion with other parties to create fictitious documents. Motivations for management fraud may come from desire to obtain higher stock price, bond offering, or to meet the stock analyst's expectation. Another may be the management's desire to postpone financial difficulties his company may face. Or the management may be motivated by personal gains such as bonus based on the company's net income, promotion, or avoidance of penalty for poor financial results. Management may be tempted to commit fraud where control environment for fraud prevention and detection does not exist. Management fraud often shakes the public's confidence in the integrity of financial reporting.

Upon hearing rumor that the Securities and Exchange Commission(SEC) may investigate Lucent Corporation for accounting misstatements, investors dumped its stock more than 20 percent in one day of March, 2001. Stock price of Cendant Corporation, which was formed from merger between CUC International and HFS Inc., was pummeled more than 40 percent in one day of April, 1999 on the news that the management of CUC International committed fraud before being merged. When the top management of the Cendant Corp. announced that CUC's accounting fraud had been deeper than initially estimated, the corporation's stock price was beaten down another 20 percent, losing more than $14 billion market value in one day. In addition to Cendant Corporation, companies such as Enron, Sunbeam, Waste Management, Informix and Phar Mor admitted all management fraud.

The U.S. Chamber of Commerce estimates that the annual cost of fraud exceeds $100 billion. On the other hand, the General Accounting Office(GAO) projects that accounting fraud costs the U.S. government almost $100 billion annually. This figure

combined with the U.S. Chamber of Commerce's estimate represents total cost of more than $200 billion to society, which would be ultimately absorbed by consumers and taxpayers. Management fraud destroys not only the companies involved but the stability of the nation's economy. The Treadway Commission's(1987) study shows that management fraud is accountable for more than a half of bankruptcies.

Management fraud also has a more detrimental impact: a loss of public confidence. Public confidence in the fairness of financial reporting is critical to the effective functioning of the securities market. A single incidence of fraudulent financial reporting may shake public confidence for the integrity of financial reporting, thus resulting in shake up or collapse of the securities market. Loss of public confidence increases the cost of capital to even companies not involved in management fraud. The board of directors is a monitoring mechanism to supervise management actions. The board often delegates the responsibility for the oversight of financial reporting process to the audit committee.

This study addresses the internal and external monitoring mechanisms for management's actions. The current study is organized as follows:
Agency problem is discussed in the next section, followed by characteristics of fraud. Then control mechanisms for internal and external environment are discussed. Conclusion is discussed in section 6.

II. Agency Problem

Principals(owners and shareholders) hire agent(management) to perform tasks for their benefits. When hired, agent often tries to maximize his own utility rather than those of the principals. The agent would prefer to see company's resources directed in a way that improve his welfare, even if it does not benefit the principals to the same degree. In this case, agency cost arises when management(agent) has opportunities to increase his own wealth to the detriment of the principals' interests. Principals(owners) need to protect themselves against such wealth transfers.

Jensen and Meckling(1976) describe the inherent conflict of interest between shareholders and management, which is exacerbated by inability of the owners(shareholders) to directly observe the management's performance. The need to monitor management stem from the divergence of interests between management and shareholders(Jensen and Meckling, 1976). The higher the management's ownership stake in the company, the greater the alignment between management's and shareholders' interests. Hence, lesser need to monitor management exists. But a

decrease in management's holding of ownership interests increases the shareholders' need to monitor management's actions.

Shareholders delegate responsibilities to oversee management's overall performance to the board of directors. The board of directors itself is a monitoring mechanism for management's performance. Theoretically, presence of outsiders on the board of director should increase the quality of monitoring. Because they are not affiliated with the management or the company, the outsiders can be independent representatives for the shareholders' interests. However their willingness may face limitations, because information asymmetry exists between outsiders and insiders(management). Outsiders have less information on organization's operational activities than insiders. This information asymmetry hinders the board of directors' ability to serve as a monitoring mechanism for management.

The board delegates responsibilities for overseeing and monitoring financial reporting process to the audit committee. The committee members may become acquainted with significant matters affecting financial reporting, such as accounting policies and principles, accounting estimates, internal controls, contingent liabilities, etc., by participating in the entire financial reporting process. As a result, the audit committee helps the board of directors discharge its duties properly by providing information they have known while performing their duties. Pincus, et al. (1989) note that the audit committee is viewed as a monitoring mechanism to improve the quality of information flow between principals(owners) and agent(management).

III. Characteristics of Corporate Fraud

Fraud differs from error in that underlying action results in intentional misstatements. Two types of intentional misstatements are defalcations, often called employee fraud, and corporate fraud, often called management fraud or fraudulent financial reporting. Employee fraud involves theft of a company's assets. An example is a clerk taking cash at the time sale is made, while not entering the sale in a cash register. Misappropriation of assets may also take a form of stealing assets or causing a company to pay for goods or services not received. On the other hand, corporate fraud may often take a form of concealing wrongdoing by creating fictitious documents and records or through collusion. Management is often motivated to commit fraud for various reasons, such as achieving a company's goal, attempting to avoid financial difficulties his company may face, or personal greediness to obtain more bonus. Because of management's attempts to hide his intentional misstatements,

the auditor may have extreme difficulties to detect those material misstatements during his routine audit procedures. In addition, the auditor is not trained to identify the authenticity of documentation.

Management fraud, often called fraudulent financial reporting, is the management's misrepresentations or deception leading to materially misleading financial statements. An example is to overstate sales deliberately near the end of accounting period to increase earnings. Management fraud is more difficult to detect than employee fraud, often called defalcations or embezzlement, because management is in position to manipulate documents to hide misstatements, to override internal control system or to collude with third parties to create fictitious documents. Management fraud often shakes public's confidence in the integrity of financial reporting, which is critical for effective functioning of securities market. But a single incident of management fraud stirs public's confidence for the integrity of financial reporting, thus resulting in shake up or collapse of the securities market, or even the nation's economy. Hence the management fraud is a serious crime, but how much it occurs is difficult to know. Publicly known management fraud is just a tip of iceberg.

The Securities and Exchange Commission(SEC) releases Accounting and Auditing Enforcement Releases(AAERs) when management fraud occurs at publicly traded companies. The Treadway Commission(1999), upon studying on AAERs of management fraud occurred between 1987 and 1997, reports the followings:

-Some companies committing fraud experienced net losses or were in close to break even in periods preceding the fraud. The managements of those companies might have been pressured of financial strain or distress.

-Some were experiencing downward trends in net income in periods preceding fraud, whereas others were experiencing upward trends in net income. The management might have been tempted to reverse downward or to preserve upward trends.

-Most of the frauds were committed by improper revenue recognition, overstated assets, and understated expenses.

-Revenue fraud was perpetrated by recording fictitious revenue or recording revenue prematurely. Assets were overstated by recording fictitious assets, assets not owned, or capitalizing items that should be expensed.

-The top management(chief executive officer) perpetrated 72% of fraud, and chief

financial officer(CFO) committed 43% of fraud. When combined, 83% of fraud was committed by CEO or CFO(The figure does not add up, because some hold both positions).

-Most of the companies involved in fraud either had no audit committee or had audit committee that met once per year. In addition, most of the audit committee members(65%) did not have expertises in accounting or finance field.

-Board of directors were dominated by inside directors and "grey" area directors(outsiders with special ties to the company or management). About 60% of the directors were insiders or "grey" area directors.

-Proxy statements showed that directors and officers had family relationships in 40% of the cases. In more than 20% of the cases, the founder served as CEO, and officers held incompatible job functions such as holding both positions of CEO and CFO.

-Members of the board of directors and management hold 32% of their company's stocks.

-The average length of fraud extended 23.7 months and the frequency of fraudulent acts were fairly steady over that period.

-Most of the companies changed their auditors during the fraud period.

-Consequences of the management fraud often ended up with bankruptcy(50%) or significant change in ownership structure.

The Treadway Commission's findings were consistent with those of the Auditing Practices Board(APB) of England in that

-majority of the fraud were perpetrated by management

-management fraud rarely involved actual thefts or embezzlement of assets

-management fraud were rarely detected by external auditors

-more than a half of fraud was committed to boost stock prices or to disguise losses.

Implications of The Treadway Commission's study are as follows:

-Given that some of the companies involved in fraud experienced net losses or were in close to break even in periods preceding fraud, effective monitoring for companies to remain as going-concern status is needed.

-Monitoring the environmental, institutional, or personal pressures, such as pressure to obtain higher prices in stock or bond offering, bonus based on earnings, or stock

analyst's expectation, etc., is critical. To that end, the importance of internal control system cannot be overemphasized, In addition, the board of directors, audit committee, internal and external auditors must keep close watches on financial reporting process.

-For effective monitoring, majority of board of directors or audit committee must be composed of members who are truly independent(outside) from management, free from financial interest and family (close) relationships, and experts in accounting or finance.

-Effectiveness of outside(independent) directors' monitoring can be hindered by the quality and extent of information they receive. To discharge their overseeing responsibilities, those outside members should be able to access to reliable financial and nonfinancial information. By transferring information audit committee has obtained through its monitoring process, audit committee helps the board of directors fulfill its prescribed duties.

-The multi-period aspect that the fraud was extended over almost 2 years suggests the importance of reviewing interim financial statements, because those interim statements were not audited by external auditors.

In essence, the corporate environment within which financial reports are prepared is the most important factor to the reliability of financial reports.

IV. Control Mechanism for Internal Environment

The management bears ultimate responsibility for fair presentation of financial statements in accordance with GAAP. Financial statements are management's representation as to the company's financial position and results of operation.

Accounting department actually prepares the financial statements, but the chain of command supervising financial report preparation typically proceeds from the controller through the chief financial officer(CFO) to the chief executive officer(CEO). The legal department reviews documents for compliance with applicable laws and regulations. On the other hand, the internal audit department performs an appraisal function inside the organization to examine, analyze, and make recommendations on the company's internal control function and accounting records. The board of directors has the ultimate responsibility to the owners(shareholders) for monitoring management's performance and its accountability. But the board of directors generally delegates the responsibility to oversee the company's financial reporting process to audit committee. All these internal environment affects the credibility of financial

reporting.

1. Internal Control Systems

Accounting systems are the methods and procedures for collecting, summarizing, and reporting a company's financial and operating information. The management adopts internal controls to guide operations and prevent abuses of accounting systems. In essence, internal controls are policies and procedures that protect assets from misuse, that ensure reliability of accounting systems for financial reporting and that ensure compliance with laws and regulations. Internal control can never be regarded as completely effective, because it has inherent limitations. Even if an organization has an excellent internal control systems, its effectiveness depends on the competency and dependability of the people using the systems. In addition, management may override the procedures and instruct employees to cover up his wrongdoing. Hence, internal control provides only reasonable assurance.

The company's physical assets can be stolen, misused, or destroyed, unless they are protected appropriately. Nonphysical assets such as important documents and records may be damaged, stolen, or misplaced, but adequately designed internal control prevents such damages, theft, misuse, or misplacement, and ensures compliance with applicable laws and regulations such as environmental protection laws or safety regulations. To achieve those objectives, management is responsible for designing and applying five elements of internal control. They are control environment, risk assessment, control procedures, monitoring, and information and communication.

(1) Control Environment

The control environment reflects the management's overall attitude about the importance of controls. One of the factors that influence the control environment is management's philosophy and operating style. The management that overemphasizes operating goals and asks to deviate from control policies to attain the goal may indirectly encourage employees to ignore controls. The company's organizational structure, which is the framework for planning and controlling operations, also affects the control environment. Personnel policies such as hiring, training, evaluating, compensating, and promoting employees, also influence the control environment. In addition, job descriptions, code of ethics, and conflicts of interest policies must be parts of the personnel policies. The quality of internal control will be enhanced if only competent and honest employees are assigned for specific duties.

An effective board of directors must be independent of management to scrutinize management's activities and financial reporting. The board of directors delegates responsibility for internal control establishment, maintenance, and implementation procedures to management, but retains the authority to assess its effectiveness. Also an active and objective board may reduce opportunities that management overrides control procedures. The board delegates responsibility for overseeing financial reporting process to audit committee. The audit committee's independence from management and knowledge of accounting or finance are necessary ingredients to discharge its prescribed duties effectively.

(2)Risk Assessment

All organizations face a variety of risks from internal and external sources. Because economic, industrial, and operating conditions continuously change, management must assess those situations and take necessary actions to control them to achieve objectives of internal control.

(3) Control Procedures

Control procedures are policies and procedures to provide reasonable assurance that the company's objectives, including prevention of fraud, can be achieved. Statements on Auditing Standards(SAS) 94 and COSO Report(1992) note that control procedures include those ones that pertain to separation of duties, informational processing, physical controls, and performance reviews, which fall into the following five types of control procedures.

1) Adequate Separation of Duties

A person who has custody of assets must be separated from the one to account for those assets. For example, if a cashier receives cash from sale and is given the opportunity to record the sale, he may take cash and change the record to hide embezzlement. A person who authorizes transactions should be separated from the one in charge of custody of those assets. If the same person handles both functions, the possibility of defalcations may be doubled. A person with operational responsibility must be segregated from the one with recordkeeping duties. Otherwise, operating results would be manipulated to show improved performance.

2) Proper Authorization of Transactions and Activities

Every transaction must be properly authorized. If anyone in the entity could acquire assets at will, complete disorder may result.

3) Adequate Documents and Records

Transactions are recorded on basis of documents and records, which may include such items as sales invoice, purchase orders, sales journal, and employee time records. The documents must be adequate to provide reasonable assurance that all assets are properly controlled and all transactions are correctly recorded in time. Documents and records must be prenumbered to control over missing documents and prepared at the time when transactions occur, as soon as possible thereafter. Otherwise, chance for misstatements is increased. In addition, they should be designed in a manner that facilitates correct preparation.

4) Physical Control Over Assets and Records

It is vital to protect assets and records. If assets or records are left unprotected, they may be stolen, damaged, or lost. The organization must use physical precautions such as fenced warehouse for inventory to protect its assets from theft, vandalism, or weather. When a company is equipped with highly computerized systems, protecting computer equipment, program, and data files from unauthorized access, temperature and humidity must be considered. Fireproof safes and safety deposit boxes to protect such valuable assets as cash and marketable securities are important physical safeguards.

5) Independent Check on Performance

The last procedure is the continuous and independent check to assess whether the four elements mentioned above are complied, because persons are likely to forget or fail to observe instructions, unless someone monitors their performance. A person responsible for check must be independent from those performing assigned tasks.

(4) Monitoring, Information and Communication

Monitoring function by management deals with continuous assessment to evaluate whether internal control is operating as planned and any modifications are needed to accommodate change in operating environment. These information may also come from, for example, studies on internal control, and internal or external auditors′ reports. But for the internal audit department to perform appraisal function effectively, it must be independent from the chain of the command within the organization.

Well designed and operated internal control can safeguard assets by preventing theft, misuse, or misplacement. In addition, the system helps accounting department generate reliable financial information and the entity comply with applicable laws and

regulations.

2. Internal Audit

The Institute of Internal Auditors defines internal auditing as "independent and objective assurance and consulting activity that is designed to add value to improve an organization's operations."(IIA 1999)

To perform their assignments effectively, internal auditors must be independent of line functions in an organization, but they cannot be completely independent of the company as long as employer-employee relationship exists. "Independence" must be exerted in all scope of services internal auditors perform and can be enhanced when the internal audit director reports directly to the CEO for matters CEO has not been involved and to audit committee. On the other hand, "objectivity" in the definition means taking impartial attitude in performing duties.. If an internal auditor has subordinated his judgment to others, he lacks objectivity. "Assurance" activities mean those services that improve the quality of financial information, effectiveness of internal control, compliance with company, governmental, regulatory procedures, and efficiency of the company's operational procedures. But those services are limited to the aspects inside the organization. Internal audit department's "consulting" activities range from the one that emphasizes compliance with regulations or laws to that add value to the organization. Consulting services mean that internal auditors are dedicated to work with management to correct problems identified in the audit process, but they do not implement their recommendations, for which the management is responsible.

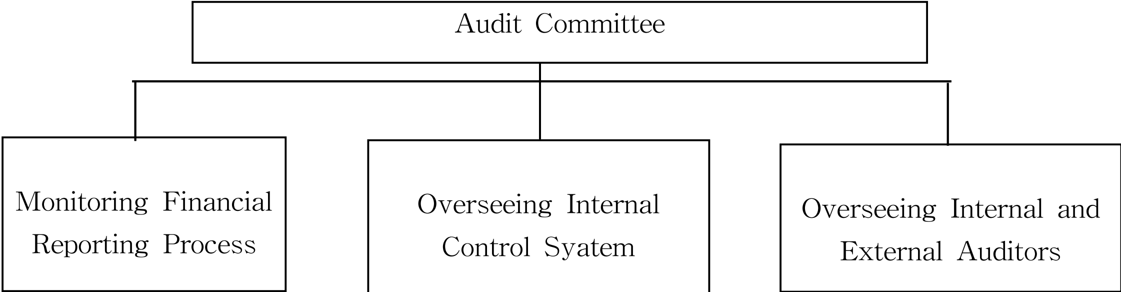
The Blue Ribbon Committee(NACD 2000) reports that the internal audit function helps audit committee perform its duties by facilitating information flow it has obtained through its appraisal duties regarding integrity of financial information. In essence, the internal audit department plays a watchdog role for the corporate environment within which financial reports are prepared. Its scope of duties include reviewing the reliability and integrity of financial and operating information, assessing internal control system to promote operational efficiency and effectiveness, adherence to the company, governmental, regulatory policies and procedures, and appraising efficient utilization of the company's resources.

3. Audit committee

National Association of Corporate Directors' Blue Ribbon Commission on Audit Committee describes audit committee as "a vital role in corporate governance. The

audit committee can be a critical component in ensuring quality reporting and controls, as well as the proper identification and management of risk."(NACD, 2000,p.1) The three key roles of the audit committee are shown in figure 1.

Figure 1 Major Roles of Audit committee



The audit committee is responsible for monitoring the financial reporting process, overseeing the internal control system and the works of internal and external auditors. The Treadway Commission(1987) reports that "the mere existence of an audit committee is not enough. The audit committee must be vigilant, informed, diligent and probing in fulfilling its oversight responsibilities."(p.41) For the audit committee to discharge its duties properly, the board of directors must adopt a charter which clearly describes the membership requirement and terms of office, duties and responsibilities, relationship with management, internal and external auditors, and frequency and timing of meetings. A written charter helps the member clearly understand his role. In addition, it provides the board of directors, management, and internal and external auditors with clear understanding of the committee's role. A written charter usually includes the followings: monitoring internal control system, overseeing internal and external audit function, relationship with management, reviewing interim financial statements, checking compliance with the code of corporate conduct, applicable laws and regulations, and reporting the committee's activities to the board of directors and shareholders.

(1) Monitoring Internal Control System

Well designed and implemented internal control structure reduces the risk of financial statements being materially misstated. In addition, it promotes operational efficiency, reduces risk of asset loss, helps ensure the reliability of financial statements, and compliance with laws and regulations. But for the internal control system to function properly as designed, the top management's philosophy and

operating style are important factors. Management must provide clear signals to employees about the importance of internal control. In other words, the tone set by top management, such as the corporate environment within which financial reporting occurs, is the most critical factor to the integrity of financial reporting.

The Treadway Commission(1987) reports that audit committee must review the internal control system periodically as a part of ongoing assessment regarding its effectiveness. In addition, the audit committee should occasionally discuss with internal and external auditors regarding their assessments of deficiencies in internal control. The audit committee should also monitor management's operating style to check whether management follows internal control system.

(2) Overseeing Internal Audit Function

Internal auditors play watchdog role for the corporate environment. But for internal auditors to discharge their duties, management and board of directors must fully support its staffing, activities, and independence. Management must provide internal audit department with adequate resources and personnel to help them perform audits with moderate frequency at all organizational levels, areas, and activities. Management and board of directors should ensure that internal audit director and staffs must be free of undue influence in performing their assignments. The audit 채 committee must communicate with internal auditors and allow them to access to the committee without limitation. A good relationship with internal auditors assist the audit committee in fulfilling its duties for the board of directors and shareholders. To ensure that internal auditors carry out their assignments, the audit committee should approve and periodically review the internal audit charter in which objectives, goals, internal audit schedules, staffing plans, and budgets.

The director of internal audit must inform audit committee of audit results, significant findings, and recommendations. To help assure independence, the audit committee should have the director talk directly to the committee and attend all the audit committee's meetings. Internal auditors' independence can further be enhanced when audit committee approves for appointment, replacement, reassignment, or dismissal of the director of internal audits. When the director is being replaced or reassigned, the audit committee must make sure that the reassignment does not represent management's attempts to cover up internal auditor's findings. The audit committee must also evaluate the adequacy of the size, staffing, and qualification. In addition, the audit committee must follow up to ensure that management has taken

appropriate steps for the internal auditor's recommendations.

(3) Relationship with External Auditors

Since the audit committee's primary interest is in the reliability of financial reporting, the audit committee should communicate with external auditors on ongoing basis to discuss the proposed audit scope and approach, restrictions encountered during the audit, disagreements with management regarding accounting principles, and audit findings and suggestions. In addition, the audit committee and management must assist external auditors to preserve independence. On the other hand, auditors must discuss with the audit committee regarding any irregularities or illegal acts they become aware of during the audit process.

The audit committee should be involved in the process of selecting and reappointing external auditors. The audit committee reviews the management's recommendation on the appointment of external auditors and ,in turn, recommends them to the board of directors, which asks shareholders for approval. In reviewing management's recommendation, the audit committee must meet privately with management and internal auditors to discuss quality of the audit services and other appropriate matters.

(4) Relationship with Management

Because management influences the integrity of financial reporting, the audit committee should continually assess the management's competence and integrity. Management, in turn, should provide the audit committee with various issues related to the corporate environment, such as business risks the company is facing, planned responses to them, status of any pending lawsuits, current issues affecting the company's operations, and any other major difficulties the company is experiencing.

Management may have different opinions on significant accounting issues from external auditors, especially when transactions are complex or GAAP is not clearly defined on a particular issue. In those cases, management may seek a second opinion from the other accounting firms. The management's decision to do so may be a legitimate attempt to obtain the proper opinion on a disputed issue. But management may be viewed to others as trying to obtain an opinion that coincides with management's interest. In either case, the management may put undue pressure to external auditors. When such a case arises, management should discuss the matter with the audit committee and explain reasons for shopping a second opinion.

(5) Reviewing Interim Financial Statements

Users of financial information rely heavily on interim reports ,such as quarterly reports, which were not audited but reviewed with limited scope. Most audit committees overlook the interim financial reporting process, even though that information is an integral part of the annual financial reports. The audit committee must review the process that interim financial reports are prepared to assess the reliability of those reports indirectly. In other words, the audit committee must review the internal control system that management has established to preserve integrity of the interim reporting process. In addition, the audit committee must be informed the extent of internal and external auditors' degree of involvement in interim reports.

To gain more insight into the fairness of interim financial reports, audit committee must have the following information:

-any deviation of actual results from the budget
-any significant change in financial ratio compared to those of the previous period
-any change in accounting principles compared with the one applied in the preceding period
-any change in internal control environment

Well defined ethical standards and written guidelines for acceptable behavior help establish atmosphere that encourages reliable financial reporting and fiduciary duties among employees. A company must establish a written code of corporate conducts for all employees. A code of conduct promotes the appropriate control environment when management shows clear signs for enforcement of the code. For the code of conduct to function properly as designed, management should establish procedures to monitor compliance with the code, and the audit committee must oversee the entire program.

Audit committee should also check compliance with applicable laws and regulations. To carry out those functions, the audit committee should review the effectiveness of internal control system. Audit committee must report its activities to the board of directors, which helps outside directors of the board gain financial information, and, thereby, discharge their duties properly.

Outside directors have less information than inside directors on the company's operating activities and its financial information, which hinders the outside directors' monitoring activities. By transferring those information that audit committee has obtained to the outside directors, the audit committee act as an efficient means to

reduce information asymmetries between outside and inside directors. The Treadway Commission(1987) recommended the SEC to require all public companies to include a letter signed by the chairperson of audit committee regarding the committee's role and responsibilities in financial reporting process in annual report. The Commission believed that such an inclusion would clarify the role of audit committee and encourage its members to fulfill its responsibilities diligently.

V. Control Mechanism for External Environment

Management is responsible for preparing financial statements in accordance with Generally Accepted Accounting Principles(GAAP). The auditor's responsibility rests with examining whether the financial statements are fairly stated in accordance with GAAP. The auditor must gather sufficient and competent evidence to afford a reasonable basis for his audit opinion on the fairness of the financial reports. On the other hand, the auditor has responsibilities beyond merely satisfying his contract with a client, extending his duties to the public, client, fellow practitioners, and society. The purpose of audited financial statements is to provide public with reliable financial information for them to use on their decision making. If the audited financial statements are determined not to be reliable, those who were harmed by those information may sue auditors to recover financial loss they suffered.

Ernst and Young(at then), the former auditor of CUC International, Inc., paid $335 million to the shareholders of the Cendant Corporation, because the accounting firm could not find corporate fraud in conducting the audit. But corporate fraud is hard to pinpoint, because management is in a position to conceal his wrongdoing through creating fictitious documents or collusion among management, employees, or third parties. For example, management can create falsified documents for transactions to look like legitimate ones. In auditing accounts receivable, the auditor may receive falsified confirmations from third parties who are in collusion with management. Such collusion may cause the auditor to believe that evidence is persuasive when ,in fact, it is not. Because of concealment aspects of fraudulent activities, even a properly planned and performed audit may not detect material misstatements. The auditor can only offer reasonable assurance that material misstatements in the financial statements, whether caused by error or fraud, are detected. The concept of "reasonable", not absolute, assurance means that the auditor is not an insurer of the correctness of the financial reports. Several reasons why the auditor is responsible for reasonable assurance are as follows:

a) The auditor gathers evidence from a sample of population, resulting in inevitable sampling risk of not uncovering a material misstatement.

b) Accounting information in a financial report includes complex estimates, which involve uncertainties and contingency depending on the outcomes of future events.

c) Corporate fraud is extremely difficult to detect, especially when there is collusion among management.

The SAS No. 82 provides guidance to auditors in fulfilling their responsibilities to detect corporate fraud. The ASB issued SAS No. 82 in an attempt to enhance the auditor's performance related to fraudulent financial reporting. SAS No. 82 reaffirms the auditor's responsibility to plan and perform audit to obtain reasonable assurance that financial statements are free of material misstatements, whether caused by error or fraud. While fraud is legal concept, the auditor's interest in fraud specifically relates to fraudulent acts that could cause material misstatements in financial statements. SAS No. 82 makes it clear that the auditor needs to consider two types of risk factors in the assessment of fraud. They are:

- Risk factors relating to misstatements arising from fraudulent financial reporting(management fraud)
- Risk factors relating to misstatements arising from misappropriation of assets(employee fraud)

Misstatements of the first case are intentional misstatements or omission of dollar amounts or disclosures in financial statements with the intention to deceive financial information users. They may include the followings:

- Manipulation, falsification, or alteration of accounting records or supporting documents and records from which financial statements are prepared.
- Misrepresentation in, or intentional omission from, financial statements of events, transactions, or other significant information
- Intentional misapplication of accounting principles relating to classification, manner of presentation or disclosures.

As possible symptoms of such intentional misrepresentation, SAS No. 82 lists the followings:

- Management's characteristics and influence over the control environment, such

as management's personal attitude, pressures, and styles relating to internal control and financial reporting process.

- Industry conditions, such as the economic and regulatory environment in which the entity operates.
- Operating characteristics and degree of financial stability pertaining to the nature and complexity of the company and its transactions.
- The company's financial conditions and its profitability.

Misstatements of the second case, often referred to as employee fraud or defalcations, are employee thefts of company assets, which may cause the financial statements not to be presented in conformity with Generally Accepted Accounting Principles(GAAP). SAS No. 82 lists possible causes for employee thefts as follows:

- Susceptibility of assets to misappropriation and the degree to which they are subject to theft
- Lack of controls designed to prevent or detect misappropriation of assets

SAS No. 82 requires the auditor to assess the risk of material misstatements of the financial statements due to fraud and to reflect that assessment in the audit procedures. In considering assessment, the auditor should consider both risk factors arising from the fraudulent financial reporting and the misappropriation of assets.

The assessment of the risk of material misstatements arising from fraud is a cumulative process, because the auditor may identify risk factors while performing his audit procedures. The auditor's response to the assessment is influenced by the nature and significance of the risk factors identified. In some cases, the auditor may think that his planned audit procedures are sufficient to detect the fraud. But ,in others, the auditor may have to modify his audit procedures after considering the nature of the fraudulent misstatements. The auditor's response to the result of the assessment may affect the audit process in the following ways:

-Professional Skepticism

Due professional care may require the auditor to have such attitudes as questioning mind and critical evaluation of audit evidence

- Assignment of Personnel

The knowledge, skill, and ability of audit personnel assigned to fraud-prone engagement should be commensurate with the auditor's assessment of the risk

level.

- Accounting Principles and Policies

The auditor may need to scrutinize management's adoption and application of accounting policies, particularly when they are related to revenue recognition, asset valuation, capitalization, and expense. The auditor needs to pay careful attention to whether accounting principles and policies are applied in an inappropriate manner to cause material misstatements.

- Controls

When a risk of material misstatements is related to the control environment, the audit procedures to assess the internal control procedures must be expanded.

In addition to the broad considerations mentioned above, the auditor may need to modify the nature of audit procedures to obtain more reliable evidence or additional corroborative information. This goal can be accomplished through modifying nature(for more effective test), timing(closer to the end of fiscal year), and extent(more samples for detailed test) of substantive tests to reduce the overall risk of material misstatements due to fraud. When fraud risk factors indicate risks to specific account balances or types of transactions, audit procedures may need to be modified at the account balance/class of transaction level. The followings are specific examples of the auditor's response:

-Visit locations or perform certain tests on a surprise basis, such as observing inventory count at a location where the auditor's presence was not announced or counting cash on a surprise basis.

-Request inventory counting at a date close to year end

-Perform a detailed review of the company's year end adjusting entries and investigate those that appear unusual

-Perform substantive analytical procedures at a detailed level. Conduct interview of personnel working in areas where a risk factor is present.

(1) Evaluation of Audit Test Results

When the audit test results identify misstatements in the financial statements, the auditor must consider whether such misstatements imply presence of fraud. If it is, the auditor should consider further implications of those misstatements, even though the effect is not material to the overall level of the financial reports. For example,

petty cash fund custodian's embezzlement of cash would be of little significance to the auditor, because the manner of operating fund and its size would be limited. On the other hand, when the matter involves management, it may indicate a more pervasive problem, even though the amount itself is not significant. In such cases, the auditor must reevaluate the risk of material misstatements due to fraud and its effect on the nature, timing, and extent of audit procedures and assignment of audit staff, such as more experienced audit personnel. If the auditor determines that the misstatements resulting from fraud involve material amounts or is unable to evaluate its effect, he should do the followings:

- Consider the implication for other aspects of the audit
- Discuss the matter with an appropriate level of management that is as least one level above those involved and with senior management
- Attempt to obtain additional evidential matter to determine its effect on the financial statements and the audit report thereon.

(2) Communication about Fraud to Management and Audit Committee

Whenever the auditor has determined existence of fraud, he should bring the matter to the attention of an appropriate level of management, even though it might have involved immaterial amounts. The auditor must report and discuss that matter to the audit committee.

VI. Conclusion

For the board of directors or audit committee to perform their prescribed duties, they must be independent of management. Because independent directors who serve on the board have less information about the organization's activities than insiders(management), the board's effectiveness to oversee and monitor management actions is severely hampered. But the audit committee plays an important role to reduce information asymmetry by providing information that the members have been acquainted from internal and external auditors during financial reporting process to the board of directors. Hence the auditor committee assists the board of directors to satisfactorily discharge its responsibilities.

The Wall Street Journal(July 17, 1998) reports that "..... audit committees are not always effectively doing their jobs. Investor activists attack such committees for lacking independence or financial expertise to uncover most financial reporting failures..... Audit committees need independent directors with sophisticated financial

backgrounds." Even though the existence of the audit committee or the board of directors can be perceived as high quality monitoring mechanism and as reducing the likelihood of management fraud, the committee may fall short of what it is perceived to do because of lack of independence and financial expertise. Inclusion of so called "grey area" directors into the committee may hamper its independence, because they are indirectly attached to the company. Such committees are considered to be creatures of the management for image making rather than watchdogs over the investors' interests. For the committee or the board to perform their prescribed duties effectively, they must be composed of truly independent directors.

In addition, the audit committee must have the written charter which includes membership requirement, terms of office, duties, relationship with management and auditors, frequency and time of meetings

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<국문요약>

공정한 재무보고를 위한 통제 메카니즘

이기열*

경영자는 수탁 받은 주주들의 부를 효율적으로 관리할 책임을 가지고 있으며, 수탁자산의 관리, 운영에 관해 재무보고 책임을 가진다, 이는 주주가 위탁한 자산이 적절하게 관리 운영되었는지에 대한 경영자의 성과평가임과 동시에 기업정보 이용자의 의사결정을 위한 정보제공의 의미도 갖는다. 경영자는 운영의 결과를 회계기준에 따라 투명하게 보고하여야 하나, 다수는 기업이 처한 내외적 어려움 또는 개인적인 욕심으로 인해 부정을 자행하며, 이러한 부정의 파급효과는 경영자와 기업은 물론 금융시장의 마비, 더 나아가서 국가경제의 혼란을 초래할 수 있다. 밝혀진 경영자의 부정은 빙산의 일각에 불과 할 뿐이며, 경영자는 직권을 이용하여 원천서류의 조작, 3자와의 공모 등을 통해 부정을 합법적인 거래로 위장을 하기 때문에 부정의 탐지가 쉽지 않다. 경영자의 부정은 사후발견보다는 사전예방이 훨씬 중요하며, 그러기 위해서는 재무정보가 작성되어지는 기업환경에 대한 전체적인 감시가 필요할 뿐만 아니라 기업내외부의 유기적인 협력체재의 통제시스템이 필요하다. 이 역할을 감사위원회가 담당한다. 그러나 감사위원회가 본연의 기능을 수행하기 위해서는 감사위원회의 역할과 책임, 자격, 규모, 모임시기 및 빈도, 활동에 대한 보고 등을 명시한 헌장을 채택하여야 하며, 재무나 회계영역의 전문가로 구성이 되어야 한다. 또한 경영자나 기업과의 재무적인 이해관계나 친분관계가 없는 독립성을 확보한 인사들로 이루어 져야지 만 경영자의 재무보고에 대해 객관적인 자세로 감시를 수행할 수 있다. 특히 외관상으로는 독립적인 것처럼 보이나, 기업과 연결고리를 가지고 있는 회색영역의 인사들은 배제되어야 한다

핵심주제어: 경영자의 부정, 감사위원회, 외부감사, 내부통제제도

* 단국대학교 경상대학 회계학전공 부교수