



This issue focuses on the importance of an effective system of internal controls, how the system can directly impact the quality of a company's financial reporting, and the approach Randy Hunt CPA PC takes when analyzing a system of internal control and assisting client personnel to implement necessary improvements.



talking points

INTERNAL CONTROLS

On June 27, 2002, the Securities and Exchange Commission issued an order requiring the filing of sworn statements pursuant to Section 21(a)(1) of the Securities and Exchange Act of 1934. The order specified the wording and format of the statement to be signed, under oath, by the principal executive officer and the principal financial officer of every public company with previous fiscal year sales exceeding \$1.2 billion. Among the items to be certified by the CEOs and CFOs were that the financial reports contained no untrue statements of material facts, omitted no statements of material facts, and that the reports had been

reviewed by the company's audit committee. "D" day for most of the 947 companies was August 14th, the day that 2nd quarter 10-Qs were due in Washington, D.C.

How They Fared. In what should be a bit of a confidence booster for the investing public, the vast majority of CEOs and CFOs complied with the request, on time, and without restatement of any previously issued reports. A few chief executives were unable to sign on the dotted line for various reasons; some of the notables being the heads of Dynegey, TV Guide, Mirant and, of course, Adelphia, Enron and WorldCom.



RANDY HUNT

CPA PC

What Does This Have To Do With Internal Controls? Anyone reading this article could imagine that Adelphia’s system of internal controls was either nonexistent or so overridden by members of the controlling family that it was, well, nonexistent. No rocket science here.

What I did find to be almost incredible were the statements made by the Principal Executive Officer of TruServe Corporation, a Chicago-based wholesaler of building materials. Pamela Forbes Lieberman states:

“TruServ had for several years, from at least February 1997 through at least the end of 1999, inadequate internal controls relating to, among other things, various aspects of inventory management, accounts payable, cost of goods sold and accounting for certain income and expense items. Principally as a result of these deficiencies, TruServ reported a loss of \$131,143,000 for fiscal year 1999. In addition, based upon the information available and in accordance with generally accepted accounting principles, TruServ recorded an inventory pick up of \$22,200,000 in the fourth quarter of fiscal year 2000, some of which may have related to prior periods. Because the problems identified above were caused by systematic flaws in internal controls, and as TruServ did not take complete physical inventories at December 31, 1999, TruServ does not have information available to determine if it is necessary to restate its financial statements for 1999 or cost of goods sold for fiscal 2000.”

I don’t mean to unjustly pick on TruServ or Ms. Lieberman, who has only been with the

company since March of 2001. No doubt the company employs many hard-working and honest people who must be embarrassed by the situation they find themselves in, but what in the world happened in 1999 to prompt Ernst & Young to write a letter to the company in April 2000 declaring that a system of internal controls necessary to develop reliable financial statements did not exist during the year ended December 31, 1999?

Importance of a System of Internal Controls.

It is absolutely fundamental that, in an accounting system, each and every transaction be captured accurately. In the absence of a properly functioning system of internal controls, one cannot produce reliable financial statements – period. When analyzing the effectiveness of a system of internal controls, two aspects must be evaluated and tested at each point where a transaction is either 1) created or 2) changes hands: population controls and accuracy controls.

In the absence of a properly functioning system of internal controls, one cannot produce reliable financial statements – period.

Population controls ensure that *all* of the transactions generated by a function, such as the sales department, are captured into the accounting system. For example, someone might be responsible for making sure that, if the last invoice issued yesterday was number 500 and the last invoice issued today was number 535, the sales register shows 35 transactions the for day.

Accuracy controls relate to the amounts and quantities of a transaction. In the prior example, simply to ensure that you have all 35 invoices is not enough to know that all of the quantities and prices were recorded



RANDY HUNT

CPA PC

correctly. Sometimes the accuracy control is as straightforward as having a second person recalculate the extensions on the invoices, looking for errors. In computerized systems, the math is usually not a problem, but the computer might have some threshold limits to spot potential errors, such as a quantity greater than 1,000 when 98% of the transactions made in the normal course of business are for 500 or fewer items.

Randy Hunt CPA PC's Approach. I analyze existing documentation of the system of internal controls; ensure that population and accuracy controls are documented and, more importantly, being followed; review for appropriate segregation of duties; and evaluate personnel involved and their understanding of the system. Where I find deficiencies, I propose corrective actions and assist management to implement solutions.

To make this process as effective and efficient as possible, I will propose an affordable, fixed-fee arrangement to provide an initial analysis of your system of internal controls. I can usually complete the assessment in about two weeks. Please call Randy Hunt at (508) 833-8511 or drop an email to randy@randyhuntcpa.com.

Statement of Independence. I do not audit and issue opinions on systems of internal control of public companies. The recently passed Sarbanes-Oxley Act of 2002 prohibits consultants from providing audit services and auditors from providing consulting services to the same client. I also believe the Act should have gone further to prohibit firms servicing public companies from providing *both* audit and consulting services to its collective clientele.

Companies Unable To Certify Their Public Filings

ACT Manufacturing Inc.	Suspended 10-K and 10-Q filings due to bankruptcy
Adelphia Communications Corp.	Unable to complete 10-K and 10-Q for failings of prior management
Alaska Air Group Inc.	Change in accounting for leased aircraft return costs and capitalization of internally developed software
CMS Energy Corp.	Round-trip energy trading - \$122 million restatement
Consolidated Freightways Corp.	New CEO and CFO unable to perform internal review of F/S
Dynegy Inc.	Round-trip energy trading, hedge accounting, potential violations of laws related to public statements
Enron Corp.	Financial statements declared unreliable; prior management unavailable to assist in review of pre-bankruptcy filings
Gemstar-TV Guide International Inc.	Revenue recognized in 2001 not in accordance with GAAP - \$20 million restatement
IT Group Inc.	Suspended 10-K and 10-Q filings due to bankruptcy
The LTV Corp.	Suspended 10-K and 10-Q filings due to bankruptcy
McLeodUSA Inc.	Prior year filings might not be in compliance with SFAS 144 – "Accounting For The Impairment of Long Lived Assets"
Mirant Corp.	Exception for filings that were subsequently corrected
Qwest Communications International Inc.	Internal and external investigations underway into accounting policies, practices and procedures, and internal controls
TruServe Corp.	Inadequate internal controls - \$22.2 million restatement
WorldCom Inc.	Identified at least \$7.2 billion in restatements to prior filings

Source: <http://www.sec.gov/rules/extra/ceocfo.htm>

Randy Hunt CPA PC

297 Quaker Meeting House Rd, E Sandwich, MA 02537
(508) 833-8511 / (508) 833-9691 (fax)
randy@randyhuntcpa.com / www.randyhuntcpa.com