INTERNAL
CONTROL OVER
FINANCIAL REPORTING

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BACKGROUND: THE FINANCIAL STATEMENTS

The Four Financial Statements

• Income Statement (also referred to as: Statement of Earnings, Statement of Income, or Statement of Operations)
• Statement of Changes in Stockholders’ Equity
• Balance Sheet
• Statement of Cash Flows

The requirements for calculating and presenting the financial statements are mandated by Generally Accepted Accounting Principles (GAAP), written by the Financial Accounting Standards Board (FASB).
**BACKGROUND: THE FINANCIAL STATEMENTS**

**Financial Statements** – Public view of company performance.

- Audience is investors and creditors.
- Each financial statement contributes unique information about financial performance.
- Collectively, the financial statements should provide investors and creditors with enough information to rationally allocate funds in the markets.
- Management is responsible for the amounts reported on the financial statements and the system from which the financial statements are prepared.
- For publicly-traded companies the financial statements are subject to an audit by an independent accounting firm quarterly and annually.
BACKGROUND: THE FINANCIAL STATEMENTS

• The Securities and Exchange Commission (SEC) requires management to make disclosures in the public financial statements to emphasize that management is responsible for the information on the financial statements and the system that created the financial statements.

• A company’s Internal Control over Financial Reporting (ICFR) is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles (GAAP).
  • Publicly-traded companies are required to create and maintain an internal control system for financial reporting.
  • An evaluation of Internal Control over Financial Reporting is an integral part of the quarterly/annual audit of the financial statements conducted by an independent accounting firm.
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History:

• **Foreign Corrupt Practices Act** – motivated, in part, by more than 400 corporations making over $300 million in corrupt payments to foreign government officials while also filing inaccurate corporate financial statements to hide the payments.

• **Sarbanes-Oxley Act of 2002** – enacted to restore confidence in public financial reporting; made management’s responsibility for financial statements and internal control more visible in public disclosures.
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The Internal Control System is a set of policies and procedures that:

1. Pertain to the *maintenance of records* that accurately and fairly reflect the transactions of the company.

2. Provide reasonable assurance that transactions are recorded as necessary *to permit the preparation of financial statements*.

3. Provide reasonable assurance regarding the *prevention and timely detection of unauthorized acquisition, use, or disposition of the company’s assets*. 
INTERNAL CONTROL OVER FINANCIAL REPORTING

• Control systems can provide reasonable, but not absolute, assurance that financial statements are reliable and prepared in accordance with GAAP.

• Controls designed to generate reliable financial statements are more likely to succeed if the company’s culture reflects the importance of integrity and ethical values and a commitment to reliable financial reporting.
INTERNAL CONTROL EXAMPLE

Accounting Fraud in a Church
INTERNAL CONTROL OVER FINANCIAL REPORTING

Over a twenty-year period, the financial secretary of a local church stole $900,000 from her congregation. The church’s primary source of income is contributions from the Sunday offering. Each Sunday volunteers serve as attendants to pass the contribution plates, and two deacons are responsible for placing the cash and checks from the offering into a zippered bag and putting the bag into the office safe. Only the two deacons and the secretary know the combination to the safe. During her tenure, the financial secretary would retrieve the offering from the safe each Monday. She was responsible for counting the offering, recording the contributions in the accounting records, preparing a deposit slip and taking the funds to the bank. In counting the contributions, the financial secretary also kept track of the donations of individual members for tax reporting purposes.
The financial secretary paid and recorded all of the bills of the church. The administrative assistant opened all the mail and bills were forwarded directly to the financial secretary. When the financial secretary received the bills, she carefully reviewed them to determine if they were appropriate. In addition, she maintained a list of “approved” suppliers to help ensure that purchases were made at the lowest price and that church members’ businesses were patronized whenever possible. When bills were paid, she determined the accounts in which each bill would be recorded and wrote and signed the check for the payment. According to church policy, if a bill exceeded $1,000, two signatures would be required on the check.
INTERNAL CONTROL OVER FINANCIAL REPORTING ROLES AND RESPONSIBILITIES
MANAGEMENT’S RESPONSIBILITIES

• Design, implementation and monitoring of internal controls.
• Annually assess the effectiveness of internal controls.
• Evaluate any change in the company’s internal controls that has materially affected, or could likely materially affect, internal controls.
• Maintain documentation to provide reasonable support for management’s assessment.
• Provide quarterly and annual reporting of management’s assessment of internal controls.
• Keep the Audit Committee of the Board apprised of the operation and effectiveness of controls.
AUDIT FIRM’S RESPONSIBILITIES

• Obtain an understanding of each component of the company’s internal controls.

• Report timely to management and the Audit Committee any deficiencies in internal controls.

• Conduct an audit of internal controls following a top-down, risk-based approach that considers the whole financial reporting system with primary attention given to controls over financial reporting areas most susceptible to material misstatement.
AUDIT COMMITTEE’S RESPONSIBILITIES

• Oversee management’s preparation of financial statements and design and operation of controls.

• Oversee financial reporting under Sarbanes-Oxley.

• Review the assessment of financial reporting risks.

• Review management’s planned responses to the identified financial reporting risks.

• Discuss with management control deficiencies and their potential impact on financial reporting and nature of remedial actions.
AUDIT COMMITTEE’S RESPONSIBILITIES

• Evaluate the quality of management’s financial reporting and related disclosures.

• Oversee and monitor activities in the Internal Audit Department including reports from internal audit.

• Hire and oversee the external audit firm.
CATEGORIES OF INTERNAL
CONTROL DEFICIENCIES
INTERNAL CONTROL OVER FINANCIAL REPORTING

Internal Control Deficiencies –

Under SEC Reporting Provisions, if a single material weakness in the Internal Control System exists, then the Internal Controls are not effective.

There are three categories for reporting internal control weaknesses.
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Categories of Internal Control Deficiencies

1) **Material Weakness** - A deficiency that creates a reasonable possibility that a material misstatement of the company’s financial statements will not be prevented or detected on a timely basis.

2) **Significant Deficiency** – a deficiency that is less severe, yet important enough to merit attention by those responsible for oversight of the company’s financial reporting.
Categories of Internal Control Deficiencies

3) **Deficiency** – a deficiency where the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect misstatements on a timely basis.
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Critical Audit Matters

A critical audit matter is defined as any matter arising from the audit of the financial statements that has been communicated or is required to be communicated to the audit committee, and that relates to accounts or disclosures that are material to the financial statements, and that involves especially challenging, subjective, or complex auditor judgments.
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Common Internal Control Procedures:

1) Personnel: Well-Defined Job Descriptions, Background Checks, Mandatory Vacations, & Rotating Duties.


3) Prepare Budgets to Set Expectations and Measure Variances Between Actual and Budgeted Results.

4) Clear Credit Policies & Purchase Responsibilities.
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Internal Control Risks:

1) Remote work environments from the pandemic
2) Cybersecurity
3) Oracle compared to Morgan Stanley
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Recent SEC Actions for Deficiencies in Internal Controls over Financial Reporting:

- Grupo Simec S.A.B de C.V.
- Lifeway Foods Inc.
- Digital Turbines Inc.
- CytoDyn, Inc.
- Northwest Biotherapeutics, Inc.
INTERNAL CONTROL OVER FINANCIAL REPORTING

A good Internal Control System is hard to maintain because:

1) The company’s environment will change over time.

2) The company’s leadership and priorities will change over time.

3) Employee roles will migrate over time.
FINANCIAL STATEMENT DISCLOSURES
REQUIRED DISCLOSURE – MANAGEMENT’S STATEMENT ABOUT THE FINANCIAL STATEMENTS

Excerpts from Nike Annual Report (Form 10-K, 7/24/2020)

Management of NIKE, Inc. is responsible for the information and representations contained in this report. The financial statements have been prepared in conformity with accounting principles generally accepted in the United States of America (“U.S. GAAP”) and include certain amounts based on our best estimates and judgments. Other financial information in this report is consistent with these financial statements.
REQUIRED DISCLOSURE – MANAGEMENT’S STATEMENT ABOUT THE FINANCIAL STATEMENTS

Excerpts from Nike Annual Report (Form 10-K, 7/24/2020)

Our accounting systems include controls designed to reasonably assure assets are safeguarded from unauthorized use or disposition and provide for the preparation of financial statements in conformity with U.S. GAAP. These systems are supplemented by the selection and training of qualified financial personnel and an organizational structure providing for appropriate segregation of duties.
REQUIRED DISCLOSURE – MANAGEMENT’S STATEMENT ABOUT INTERNAL CONTROLS

Excerpts from Nike Annual Report (Form 10-K, 7/24/2020)

Management is responsible for establishing and maintaining adequate internal control over financial reporting, as such term is defined in Rule 13(a) - 15(f) and Rule 15(d) - 15(f) of the Securities Exchange Act of 1934, as amended. Internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of the financial statements for external purposes in accordance with generally accepted accounting principles in the United States of America.
REQUIRED DISCLOSURE – MANAGEMENT’S STATEMENT ABOUT INTERNAL CONTROLS

Excerpts from Nike Annual Report (Form 10-K, 7/24/2020)

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

Under the supervision and with the participation of our Chief Executive Officer and Chief Financial Officer, our management conducted an evaluation of the effectiveness of our internal control over financial reporting...Based on the results of our evaluation, our management concluded that our internal control over financial reporting was effective as of May 31, 2020.
REQUIRED DISCLOSURE – AUDIT FIRM’S OPINION LETTER

Excerpts from Nike Annual Report (Form 10-K, 7/24/2020)

We have audited the accompanying consolidated balance sheets of NIKE, Inc. and its subsidiaries (the “Company”)…and the related consolidated statements of income, of comprehensive income, of shareholders' equity and of cash flows…and the related notes...We also have audited the Company's internal control over financial reporting…

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects…in conformity with accounting principles generally accepted in the United States of America. Also in our opinion, the Company maintained, in all material respects, effective internal control over financial reporting…
CRITICAL AUDIT MATTER

Excerpts from Nike Annual Report (Form 10-K, 7/24/2020)

The critical audit matter communicated below is a matter arising from the current period audit...and that (i) relates to accounts or disclosures that are material to the consolidated financial statements and (ii) involved...especially challenging, subjective, or complex judgments. The communication of critical audit matters does not alter in any way our opinion on the consolidated financial statements, taken as a whole, and we are not, by communicating the critical audit matter below, providing a separate opinion on the critical audit matter or on the accounts or disclosures to which it relates.
CRITICAL AUDIT MATTER

Excerpts from Nike Annual Report (Form 10-K, 7/24/2020)

Accounting for Income Taxes
[Nike] recorded income tax expense of $348 million for the year…and has net deferred tax assets of $732 million…and total gross unrecognized tax benefits of $771 million... As disclosed by management, the use of significant judgment and estimates, as well as the interpretation and application of complex tax laws is required...to determine its provision for income taxes. The principal considerations for our determination that performing procedures relating to the accounting for income taxes is a critical audit matter are the significant judgment by management when assessing complex tax laws and regulations, including new temporary regulations and recent court rulings, as it relates to determining the provision for income taxes and other tax positions. This in turn led to a high degree of auditor judgment, subjectivity and effort in performing procedures and evaluating audit evidence...
INTERNAL CONTROL OVER FINANCIAL REPORTING

Additional Reading:

“The FCPA’s Internal Controls Provision,” William J. Stuckwisch and Matthew J. Alexander, Criminal Justice, Fall 2013

“Understanding Internal Control Over Financial Reporting” BDO Center for Corporate Governance and Financial Reporting, June 2019

Nike, Inc. Form 10-K (Annual Report), 2020