

Signs of Business and Financial Risk

The seeds of financial fraud are sown in the combination of business and financial risks facing a company and the inability of existing internal controls to cope with them. If the audit committee expects to monitor risks effectively, it must first understand them. Then, by recognizing that a



strong internal control system is the key to risk management, it can create the right tone at the top to foster the growth of suitable controls. Our brochure *A Guide to Forming and Running an Effective Audit Committee* discusses some risks a committee should consider. The following further illustrate the business and financial risks that might serve as potential signs of financial fraud.

1 General

1. There are no policies regarding acceptable business practices, conflicts of interest or code of conduct established, monitored or communicated.
2. There is no structure to ensure that exposure to general business risks is kept within reasonable limits.
3. There are no well-defined business plans or policies for monitoring the company's performance.
4. Authority and responsibility within the company is neither properly structured nor formally assigned.



2 Management Characteristics

1. There is a high degree of management involvement in the day-to-day operations of the company.
2. Management is inexperienced and does not have the requisite knowledge to operate the business effectively.
3. There is a high turnover of senior management or board members.
4. Clear and potentially significant attitude or morale problems among management exists.
5. There is difficulty in determining the organization or individual(s) that control(s) the company.
6. There are expectations arising from a recent acquisition by or of the company that could predispose management to misstate financial results.
7. Management is inclined to accept unusually high business risks.
8. Management's financial reporting philosophy is to seek ways to maximize or smooth earnings.
9. Management's compensation depends, to a significant degree, on the company's earnings.
10. Management does not encourage, implement and monitor controls over the accounting system.
11. Management does not use system reports for monitoring and controlling areas of the business for which they have responsibility.
12. Management has an adversarial relationship with the internal and/or external auditors.
13. Management is not responsive to internal control recommendations from the external auditors.
14. There is undue emphasis on planning the amount of reported earnings.

15. There are expectations arising from a recent acquisition by or of the company that could predispose management to misstate financial results.

2. There are indications of deteriorating financial condition.

3. The company is experiencing a poor or deteriorating financial position and management has personally guaranteed significant debts of the company.

4. Internal budgets are set at levels that are so unrealistically high that they encourage erroneous reporting of performance.

5. The company is unusually dependent on debt financing or especially vulnerable to changes in interest rates because of variable rate debt.

6. There is a potential change of control in the company.

7. There are complex underlying calculations involved in determining the amount of transactions/balances.

8. There are significant judgments involved in relation to the accounting treatment of transactions, or valuation of assets and the classification of balances.

9. There are material adjustments recorded at or near the end of accounting periods.

10. There are material sales recorded at or near the end of accounting periods.

11. There were significant audit adjustments arising from client errors made in prior audits.

12. There are unexplained relationships or financial trends.

13. There are significant and complex transactions with affiliates.

14. There are assets or transactions that are unusually susceptible to misappropriation or other manipulation.

15. There have been complex new accounting pronouncements or changes in accounting policy that could materially affect the financial statements during the period.

16. There is excess productive capacity and/or declining demand.

17. The company has been involved in suspected illegal acts.

3 Industry Conditions

1. The performance of the company has been significantly different from others in its industry.

2. There are unusual or materially adverse matters that could affect the company or its industry.

3. The company operates in a high-risk industry.

4 Operating and Financial Conditions

1. There are significant bank accounts or subsidiary or branch operations in tax-haven jurisdictions for which there appears to be no clear business justification.

5 External Conditions

1. The financial statements will be used in connection with negotiations relating to an acquisition or disposal of a significant business.

2. There are statutory or regulatory requirements that could affect the financial stability of the company.

3. The financial statements will be used in connection with litigation or a significant inquiry by a regulatory agency.



Personnel

1. There are potentially significant attitude or morale problems among employees.
2. There are indications of financial stress of employees or adverse relationships between the company and its employees that might increase the risk of misappropriation of assets.
3. Personnel in accounting functions lack sufficient experience or ability.
4. There are bonus arrangements for employees based on results that the employees could manipulate.
5. There are excessive time pressures or distractions for

employees while preparing the financial statement information.

6. Employee job responsibilities, reporting relationships and constraints are loosely structured.
7. There are no clear hiring policies and procedures.

Systems

1. The risks associated with the development, acquisition and use of information systems are not properly considered.
2. New information systems have been implemented or there were significant changes to existing systems.
3. There were disruptions or breakdowns in the information systems.
4. Appropriate information security policies and procedures do not ensure the integrity of information systems or, if the policies and procedures can provide assurance, they are not monitored.
5. The controls in the information system do not ensure the completeness and accuracy of the accounting records or that the transactions were authorized.
6. The company does not have appropriate information systems for each significant area of the business to provide accurate, timely and relevant information in a suitable format to assist with controlling the business.
7. Transactions are processed manually when automated systems are available.
8. The accounting and information systems do not ensure that the accounting records satisfy financial and reporting requirements.
9. The accounting system does not distinguish between transactions undertaken or assets held in a fiduciary capacity and transactions undertaken on behalf of the company itself.
10. Strategic systems plans do not exist or are not related to the company's business plan.