

Accounting and accountants

This chapter discusses the work of the company accounting department and the system called 'internal control' which is used to provide reasonable assurance regarding the reliability of the corporate financial statements. It will also introduce independent accountants and the auditing profession, as well as discussing the external audit.

Chapter Structure

- Introduction
- Accounting function
- Accounting database
- Recording transactions
- Organization of data within the general ledger
- Control and audit
- The accounting profession
- Summary
- Discussion questions

Introduction

We are going to start off this chapter by looking at the accounting system within a company and how it maintains its records. If you want just to be able to read financial statements, you may prefer not to learn about the processes through which the data in them are collected. On the other hand, a successful manager in

a multinational is bound to have responsibility at some point for a free-standing operating unit and therefore for oversight of its accounting system. In addition, understanding where the information comes from is always going to help understand the information itself, and this is of course true of that provided by financial statements.

The chapter introduces the systems such as internal control and internal audit that are there to safeguard the company's **assets** and underpin the accuracy of the records. It then looks at the audit performed by external independent accountants and introduces the wider field of corporate governance. A more detailed review of audit, internal control and corporate governance is to be found in Chapter 16.

Accounting function

All businesses need a financial accounting system that tracks all the economic transactions that the business undertakes, records them logically in a database, and provides reporting tools to communicate information useful to decision makers. This system is a prime resource of the business and should provide:

- controls to ensure that only legitimate expenses are paid;
- systems to ensure that debts to suppliers are well tracked and paid when due;
- systems to calculate salary payments to employees and deduct social security and other charges;
- controls to ensure that all customers are correctly invoiced, and that customers in turn pay what they owe;
- controls to safeguard the company's assets;
- information to management on a regular basis to enable them to run the business efficiently;
- information to the authorities to support payment of taxes;
- information to shareholders on the health of the company and to help determine dividends;
- information and measurements to others with whom the company has performance-related contracts (debt covenants, employee bonus schemes, **joint ventures**, franchises, licences etc.);
- information to those who lend money to the company and to suppliers;
- information that represents the company to all outside interests and all stakeholders.

Notice that while the first six objectives are wholly internal to the operation of the company, the other five involve providing information to those who are external to the company. We could describe the first six functions as being those of financial control and the others as those of financial reporting.

The accounting department of a company needs to meet these objectives, and this is mostly done through feeding the company's database, and then using the aggregate data to prepare reports about the company's activities. The nature of



BETWEEN THE LINES

Different companies have different needs – in a large, publicly held company the shareholders will usually be remote from the management, whereas in a small, family company, the managers are often also major shareholders. We will generally assume that the typical company we are dealing with is a large multinational, but will point out differences for smaller businesses as we go along. In this case, a small, family business will often want to keep information secret, while a multinational will generally be keen to give information (accounting reports are normally on the group's website).

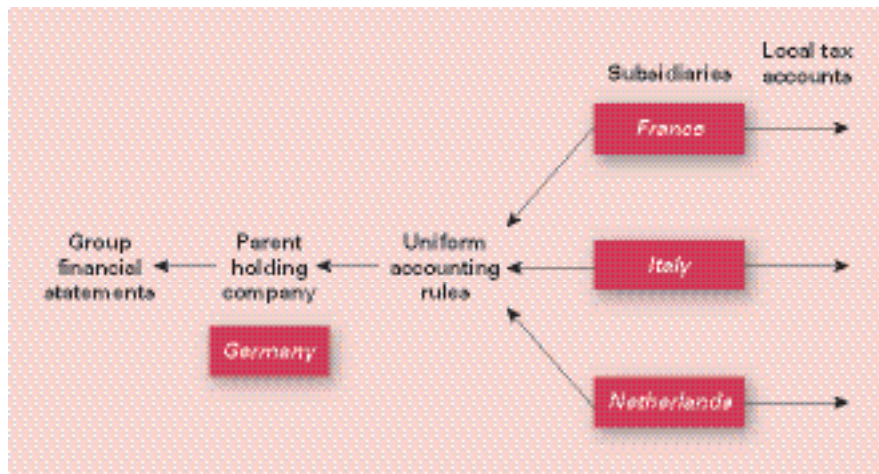
the accounting department will vary enormously depending upon the size of the company. A very small business may simply use a part-time book-keeper to process transactions and maintain the database, or use an outside accounting firm to do this. The largest global groups will have enormous accounting departments in each operating unit, together with a large head office unit to gather together data from throughout the group. In an international group, the management of the group is controlled mostly through uniform accounting systems which involve subsidiaries in sending data regularly to head office (or via regional offices) to enable central and regional management to know what is happening. In this sense it would be impossible to manage an international group without accounting.

Usually such a group will have an internal accounting manual which lays out the procedures to be followed in accounting for typical transactions in order to ensure a uniform treatment of operations worldwide, without which management would have difficulty in interpreting the accounting information. The accounting manual may run to several volumes and is usually available in several languages.

In fact global companies have problems because national accounting rules differ from country to country. The national rules should normally be followed for tax purposes, so the group has to have a reporting system which is capable of delivering uniform data worldwide for management purposes and for the group financial statements, while also providing potentially different data in each country to suit local tax requirements. This is one of the reasons that large companies welcome worldwide convergence on IFRS. Potentially, group accounts and individual company accounts can use exactly the same rules. Too much should not be made of the existing differences, since they centre on one or two areas of accounting and generally, therefore, the transition from one set of accounts to the other is not that complicated. At the same time, this is a problem that multinationals have to address, and one that is costly in terms of hiring professionals to deal with it. Very often a multinational will choose to have uniform internal systems, and then ask its accounting advisers in each country, who are familiar with the subtleties of the local regulations, to liaise with the local tax officials and prepare a revised set of accounts for local reporting purposes (see Figure 2.1).

Figure 2.1

Group reporting flows



In principle the company's accounting function should provide systems that capture all the transactions that the company undertakes. The main categories of this are:

- sales
- purchases
- payroll
- treasury
- investment in long-term capacity.

These transactions involve an interaction with other departments, and the exact split of responsibility between the accounting function and the operating department will vary according to the nature of the business and the technology used.

In the *sales* area, there are many combinations possible. In a hotel, for example, the reception desk ('front office') generally also operates customer billing and cash collection, and then passes the transactions on to the accounting function ('back office'). In retailing, very often sales representatives call on retailers and take orders in person. The sales person then transmits the order to the company where the system captures it as an instruction to the warehouse and a linked instruction to the accounting department to issue an invoice. Increasingly companies are enabling their customers to access their intranet to place orders directly into the company system, which are then, through the computer, translated into delivery instructions and an invoice.

The accounting department will normally have a data file for each customer, will control credit levels and will send out monthly statements of account to the customer and track payment when that is due. The issue of credit control is occasionally a problematic one which gives liaison difficulties between accounting staff and sales staff. The accounting department will want to make sure that where credit is given, the customer does pay the bills in due course. The sales department on the other hand wants to sell as many units as possible, and easy credit helps them to do this, so they may be less demanding in their assessments of creditworthiness.

The capture of *purchases* has its own problems. Here the company will often have a system of purchase orders or requisitions where a manager with authority to purchase supplies must sign a requisition, a copy of which goes to the accounting department to alert them to the fact that a purchase is in hand. Later, when the goods are received, a delivery document is sent to the accounting department and then the invoice. The accounting department marries all these together and puts them into the system. The supplier data file is then checked with the monthly statement sent by the supplier to ensure that all invoices have been recorded.

Finally the account is authorized and paid. In a small company this is relatively straightforward, but in a big operation it can be very complicated and the potential for error is considerable. This explains why there are specialist companies who review purchases, particularly for large stores, and often recover large amounts of money. Equally, this explains the success of scams where a fraudster sends out invoices for small sums for, say, listing in an internet directory, and some large companies will pay the invoice, although no order was ever placed and the directory does not exist.

The *payroll* is usually a specialist function within accounting. It calls for special knowledge in that in many countries the employer is responsible for deducting social security charges from the employee, sometimes the employee's income tax is deducted by the employer, and then there may be pension schemes and other voluntary schemes, such as savings or membership of a staff social club, to which the employee contributes. This means that each employee's pay file is individual and probably quite complex. Small companies will often subcontract this function to an accounting firm or a specialist service company. The possibilities for error are considerable, and where government deductions are involved, there may be fines for making mistakes. The accounting involved is also quite complex in that the company deducts money from the individual's pay packet and then has to pay this to government departments, pension funds and so on.

The *treasury* function is one where all the others meet up: treasury controls all the receipts and payments into the company's bank accounts, as well as any cash tills that might exist (company accountants do not like cash floating around). Evidently this is the area where authorizations are most stringently required and also where accurate coding of transactions is essential. The treasury unit works very closely with the company's bankers. Accessing the bank's accounting system in real time, the treasury knows exactly how much money is in each of the company's accounts at the close of banking business and then lends out any surplus, perhaps on the overnight market (yes, you can lend money just overnight, provided you have enough of it to do so in large quantities).

The accounting system is organized with separate data files for each bank account, so that the company's information can be checked directly against the statement put out by the bank. This provides a regular control on the accuracy of the company's records – all charges and revenues that have gone through the bank should also be in the company's records. The company regularly (ideally at least once a month) prepares a 'bank reconciliation'. This is a document which compares the balance on the bank account as seen by the bank, with the balance on the corresponding data file within the company. These two will rarely agree because of time lags in transactions going through the bank account, but the differences can and must be identified as a check on the accuracy of both

sets of records (in a large company this can involve cross-checking hundreds of transactions). One way of conducting a fraud is to make payments without entering them in the company's accounting records. These payments will show up as differences on the bank reconciliation, but if nobody reviews the reconciliation, they will stay outside the company records.

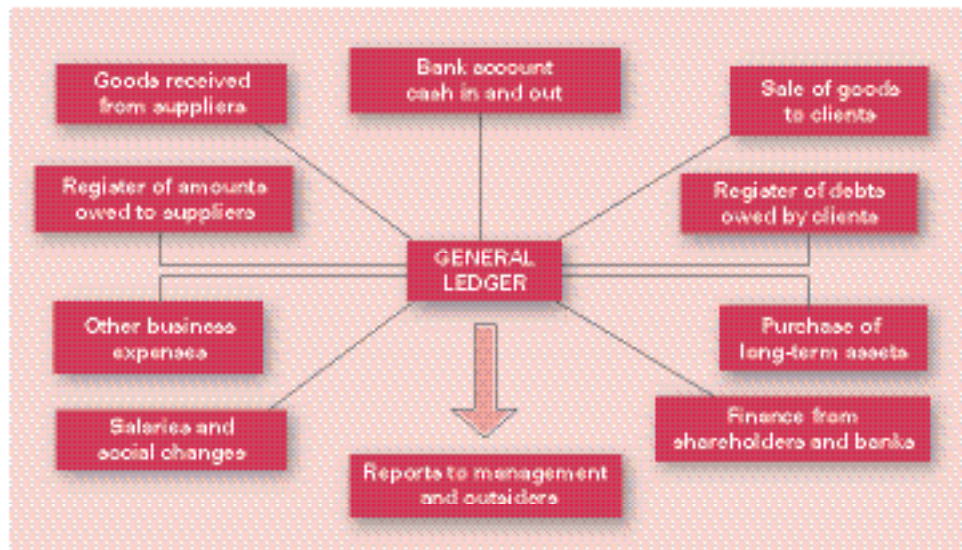
You can see that the accounting unit has a quite complex set of tasks and objectives. Its prime function is to capture information for the company and to ensure that customers pay their bills and that suppliers are paid – it is a service function to help the company to operate efficiently. However, most company frauds are going to involve obtaining money via the accounting department, so the staff and systems have to be organized to prevent this. Therefore they may seem less than keen on giving a service and rather too inclined to demand bits of paper, and signatures, which appear to be obstacles to the free running of the company.

Accounting database

Coming back to the central issue of accumulating information, a company's financial accounting system is organized to provide data for a central database (the *general ledger*) which is then used as the source of information used by management internally and for external reporting purposes. The accounting database normally looks as shown in Figure 2.2.

Figure 2.2

The financial accounting database



Recording transactions

Information flows into the database through several layers of processing which summarize and resummairize individual transactions to build up to aggregates for the year's activities (Figure 2.3).

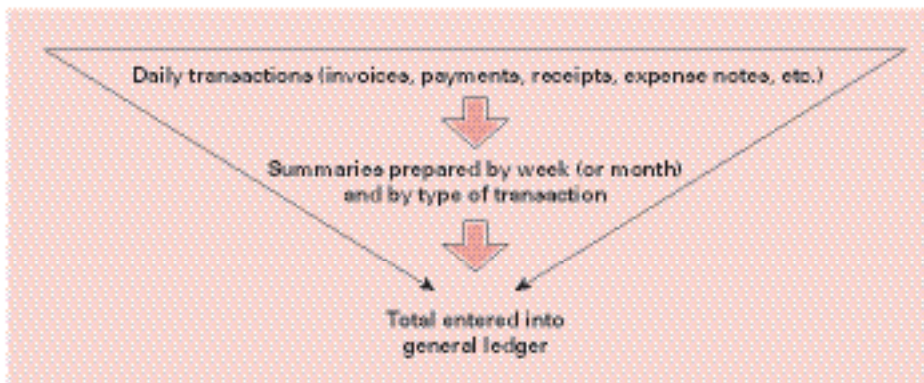


Figure 2.3
Building aggregates

Journals are used to build up the periodic summaries and feed aggregated data into the general ledger. The general ledger is then used as a source for the preparation of periodic income statements (or ‘profit and loss accounts’) and statements of financial position (or balance sheets). This kind of approach was particularly useful when all entries in the database were made by hand, and is still used even though virtually all systems in companies are computerized. The essential idea is that while aggregated data are needed in the ledger, to enable management summaries to be prepared, the system must be capable of being interrogated to confirm that a particular transaction has or has not taken place, so it must be possible later to go from the monthly figure in the ledger, for example, back through the journals to the individual transaction. This is both because accounting departments have regularly to deal with queries, and because the transactions are subject to checking by internal or external auditors. There must be what is called an ‘audit trail’ to show the links and provide evidence that the initial transaction was authorized. Computerized systems may very well carry out the intermediate stage between the individual transaction (known as a ‘prime entry’ in the trade) and the ledger total. Once the first entry has been keyed in, the system will organize a batch of similar transactions and ‘post’ this to the ledger, but it is normally organized also to provide a printout of each batch, which becomes the bridge between prime entry and ledger. Of course, there could be several intermediate levels.

Some decisions have to be taken as to what level of detail is going to be useful within an accounting system. At one extreme an accounting system might record every single transaction separately so that its annual profit and loss account is a detailed list of every transaction that has taken place over the year. At the other extreme the profit and loss account could be one figure representing the net difference (profit or loss) of the whole year’s revenues and expenses.

The exact point at which one makes a decision about the degree of detail to be kept will vary with the specific circumstances of each company, its size and the nature of the business being carried out. However, as guidelines, the final records should obviously, as a minimum, keep information aggregated for a whole accounting year on each of the separate categories (of the income statement and statement of financial position) which will appear in the annual financial statements. Normally, though, the database will be much more detailed. It will need to be capable of delivering information about each individual operating unit within a company, so that an analysis which shows the profitability of each unit for management purposes can be produced without difficulty. This information is aggregated for the purposes of the published financial statements.

The precise form taken by the general ledger and the journals, and the classification of items, will vary from one system to another. In some countries (e.g. France, Belgium, Greece, Spain) there is a State-mandated system, generally known as a *chart of accounts* or accounting plan. In other countries (e.g. Germany, Switzerland, Austria) there are widely used standard charts whose adoption is voluntary. Generally anglophone countries do not use standard charts of this kind, but large companies with uniform systems worldwide must develop in effect their own chart of accounts. A nationally standardized chart has certain advantages in terms of staff training, lower audit costs and cheaper software, but has typically been rejected by anglophone professions as being too restrictive.

In large companies the system may well be partitioned to enable the major operations (sales, purchases, treasury and payroll) to operate independently of each other – with links to the central ledger to ensure the integrity of the system. In this way the specialist functions can operate dedicated systems which not only maintain the ledger but issue invoices or bank transfers, issue monthly statements to customers, provide analysis of outstanding items, etc.

XBRL (eXtensible Business Reporting Language) is set to revolutionize accounting data handling and reporting in this context. Instead of treating accounting information as a block of text, XBRL provides an identifying tag for each individual item of information, such as individual accounts in a chart of accounts. These tags are computer readable and enable automated processing of accounting and related business information by computer software. The specific tags of individual data items are defined in taxonomies. These function as dictionaries. Different taxonomies can coexist and be linked for reporting purposes. This offers a viable solution to link IFRS and national reporting taxonomies. Indeed, national jurisdictions may need their own taxonomies (like a standard chart of accounts and specific reporting formats) to reflect their local accounting regulations, but XBRL could automatically convert them in a generally accepted IFRS taxonomy. Once the appropriate XBRL taxonomies are established and the data are gathered accordingly, different types of reports using varying subsets of the data can be produced with minimum effort. The accounting department could, for example, quickly and reliably generate internal management reports, financial statements for publication, tax and other regulatory filings, as well as credit reports for lenders. XBRL would remove time-consuming and error-prone data-handling processes and improve data accuracy through automated data checks.

The IASB has developed an IFRS taxonomy which it updates regularly. The SEC encourages companies to file XBRL tagged data and offers free software to help investors manipulate the tagged data. An investor can, for example, compare sales in different companies by using this kind of system. They can in effect construct their own analysts' reports comparing companies in the same field.

Organization of data within the general ledger

When the data about the accounting transactions of the company reach the general ledger they will be stored according to a system which has been in existence for hundreds of years: the double-entry system. The first written account of the system appeared in 1494 (by Luca Pacioli) and the fact that the system is still in use today will give you some idea of its practical effectiveness.

First, the general ledger is organized into a series of ‘accounts’ – data files – each of which is used to record transactions of a particular type. For example, if your business is selling books, you would need one account in which to record sales, another to record the cost of the books sold and a series of accounts to record the various different types of expense incurred in the business (advertising, rent of premises, heat etc.), as well as accounts for financing and investments in property, inventory etc. (This is the minimum – if more analysis were useful, then more accounts would be used.)

Each account within the general ledger is organized in a particular way. The account has two columns for figures and some space to write in explanatory remarks and cross-referencing details. The left-hand column is always referred to as the *debit column* and the right-hand column is called the *credit column* (there seems to be no satisfactory explanation for the derivation of these words). Debit and credit are also used as verbs, so one says ‘debit insurance expense’ to mean a figure should be entered into the left-hand column of the insurance expense account. In formal, manual book-keeping there are no plus or minus signs; the value of an account is the difference between the debit and credit columns, and can be either a debit balance (more left hand than right) or a credit balance (more right hand than left).

A traditional manual ledger account would look as shown in Figure 2.4.

| Account number: | | Account name: | | |
|-----------------|-----------|---------------|-------|--------|
| Date | Narrative | Ref. | Debit | Credit |
| | | | | |

Figure 2.4

Layout of a manual ledger account

A computerized printout often preserves the same format, but may also provide a running balance perhaps in a third column out to the right, or elsewhere on the printout.

The exact form in which the accounts are kept is not of essential interest for our purposes – what is important is how the figures are arrived at and what they mean, rather than the detail of the methodology of the data file. However, one normally comes across accounting statements, notably one’s bank statement, from time to time, and knowledge of the notation system is useful to that extent. An example of a personal bank statement is shown in Figure 2.5.

If you were looking at a financial accounting textbook intended for accountants, then the whole of the discussion of accounting rules and techniques would involve notation involving debits and credits – making entries in left-hand and right-hand columns. This notation system is largely redundant for our purposes, and we will use non-specialist signs and tools such as worksheets to explain what is going on. Since you are not going to run an accounting system, a detailed knowledge of the notation is not useful and tends to divert attention from the reality of what is actually going on.

Figure 2.5

Example of a personal bank statement

| CREDIT SUISSE | | | | |
|----------------------|-------------------------|----------------------|-----------------------|----------------|
| <i>Genève</i> | | | | |
| <i>Compte privé</i> | | | | |
| <i>Date</i> | <i>Narrative</i> | <i>In our favour</i> | <i>In your favour</i> | <i>Balance</i> |
| 170709 | Balance brought forward | | | 2 726.50 |
| 260709 | Receipt IIM | | 348.00 | 3 074.50 |
| 270709 | Credit card settlement | 1 791.65 | | 1 282.85 |
| 280709 | Receipt DIP | | 7 589.70 | 8 872.55 |
| 300709 | Monthly payments | 3 700.70 | | 5 171.85 |
| 90809 | Cash – ATM | 500.00 | | 4 671.85 |
| 160809 | Cash – ATM | 500.00 | | 4 171.85 |

Credit = in your favour
Debit = in our favour

Control and audit

The accounting system, as we have seen, fulfils a number of different functions, being both an information system and a security or control system. In both cases it is essential that the system is efficient and effective. Without an effective system, central management (a) do not know reliably what is going on in the company, and (b) cannot safeguard the shareholders' interests. In recent years, this issue has come to be seen as more and more important – the well-known corporate embarrassments, such as the fall of Barings Bank, the large loss at the French Société Générale and the reporting problems of Royal Ahold, would almost certainly not have been possible with tighter systems – in the jargon, tighter internal control. Public concern has grown to the point where many companies publish a statement in their annual report to the effect that the directors are satisfied that they have in place an adequate system of internal control. One of the main objectives of the internal control system is to ensure the integrity of the information system and the security of the company's assets. In that sense it is heavily relied upon by external auditors in assessing the viability of the company's records. In this section we will take a closer look at how a system of internal control operates and its links, through internal audit, to the external audit.

Internal control

Internal control has recently become more important because of the focus on corporate governance and the demands this places on boards of directors and executives to implement and demonstrate control over business operations. One of the most authoritative definitions of internal control comes from COSO (Report of the Committee of Sponsoring Organizations of the Treadway Commission).

Defining internal control

The COSO definition of internal control has become widely accepted and is referred to in other international control frameworks as well. According to COSO, internal control is broadly defined as a process, established, operated and monitored by those charged with governance and management of a company (board of directors, management and other personnel) to provide reasonable assurance regarding the achievement of objectives in the following categories:

- the effectiveness and efficiency of the company's operations
- the **reliability** of its financial reporting and
- its compliance with applicable laws and regulations.

As a process, internal control goes beyond policies and procedures and also includes factors such as corporate culture, systems and organizational structures. The COSO definition underscores the importance of the relationship of control and objectives. Without objectives, talking about control is meaningless. From a broad managerial perspective, the COSO report identifies three categories of control objectives. The first category addresses a company's basic business concerns, including performance and profitability goals and safeguarding of resources (basically an efficiency concern). The second relates to the preparation of reliable financial statements and related financial data derived from such statements. The third deals with complying with those laws and regulations to which the company is subject. Within the COSO framework financial reporting concerns are a basic objective of a system of internal control although not an exclusive one.

Internal control: system components

According to COSO, a system of internal control consists of five interrelated components:

- *control environment* – attributes of the people conducting the company's activities and the environment in which they operate, influencing overall control consciousness;
- *risk assessment* – identification and analysis of relevant risks as a basis for determining ways to manage those risks;
- *control activities* – policies and procedures established and executed that enable management's directives to be carried out;
- *information and communication* – identification, capture and exchange of information for the conduct and control of operations in a form and timeframe that enables people to carry out their responsibilities;
- *monitoring* – assessing of performance of internal control over time and making modifications as conditions change.

These five interrelated components are relevant for each internal control objective. For example, accurate financial reporting builds on a supportive control environment with a strong ethical commitment of corporate management, identification of relevant threats and exposures (erroneous record-keeping, unacceptable accounting rules, unrecognized fraud and embezzlement of assets, loss or theft of data, etc.), efficient information gathering and processing routines and appropriate control policies and procedures to manage financial reporting risks (good document design, accounting manuals, organizational measures, checks and balances, etc.).



COSO – COMPONENTS OF A SYSTEM OF INTERNAL CONTROL (extracts)

Control environment

The control environment sets the tone of an organization, influencing the control consciousness of its people. It is the foundation for all other components of internal control, providing discipline and structure. Control environment factors include the integrity, ethical values and competence of the entity's people; management's philosophy and operating style; the way management assigns authority and responsibility, and organizes and develops its people; and the attention and direction provided by the board of directors.

Risk assessment

Every entity faces a variety of risks from external and internal sources that must be assessed. A precondition to risk assessment is establishment of objectives, linked at different levels and internally consistent. Risk assessment is the identification and analysis of relevant risks to achievement of the objectives, forming a basis for determining how the risks should be managed. Because economic, industry, regulatory and operating conditions will continue to change, mechanisms are needed to identify and deal with the special risks associated with change.

Control activities

Control activities are the policies and procedures that help ensure management directives are carried out. They help ensure that necessary actions are taken to address risks to achievement of the entity's objectives. Control activities occur throughout the organization, at all levels and in all functions. They include a range of activities as diverse as approvals, authorizations, verifications, reconciliations, reviews of operating performance, security of assets and segregation of duties.

Information and communication

Pertinent information must be identified, captured and communicated in a form and timeframe that enable people to carry out their responsibilities. Information systems produce reports, containing operational, financial and compliance-related information, that make it possible to run and control the business. They deal not only with internally generated data, but also information about external events, activities and conditions necessary to informed business decision-making and external reporting. Effective communication also must occur in a broader sense, flowing down, across and up the organization. All personnel must receive a clear message from top management that control responsibilities must be taken seriously. They must understand their own role in the internal control system, as well as how individual activities relate to the work of others. They must have a means of communicating significant information upstream. There also needs to be effective communication with external parties, such as customers, suppliers, regulators and shareholders.

Monitoring

Internal control systems need to be monitored – a process that assesses the quality of the system’s performance over time. This is accomplished through ongoing monitoring activities, separate evaluations or a combination of the two. Ongoing monitoring occurs in the course of operations. It includes regular management and supervisory activities, and other actions personnel take in performing their duties. The scope and frequency of separate evaluations will depend primarily on an assessment of risks and the effectiveness of ongoing monitoring procedures. Internal control deficiencies should be reported upstream, with serious matters reported to top management and the board.

Source: COSO, Internal Control – Integrated Framework, Executive Summary

The internal control system is intertwined with a company’s **operating activities** and exists for fundamental business reasons (see objectives to be accomplished by the system). Internal control is most effective when controls are built into the company’s infrastructure and are a part of the essence of the company’s operations: internal control should become part of the company’s DNA. ‘Built in’ controls support quality and empowerment initiatives, avoid unnecessary costs and enable quick response to changing conditions. From this perspective, an accounting information system functions as an integral part of an internal control system and is thus more than a bundle of coordinated information flows. In fact, accounting information flows are intertwined with risk assessment processes, hierarchical and horizontal (between different functional departments) communication routines and specific control activities to ensure both the validity, completeness and accuracy of financial reports and the integrity of the resources they report on.

Control activities

Control activities usually involve a *policy component* and a *procedures component*. A policy establishes what should be done, while procedures are the actions to implement procedures. For example, a policy might call for a creditworthiness review before a customer order is formally accepted. The procedure is the actual credit check, performed in a timely manner and with attention given to the factors set forth in the policy, such as financial guarantees, the payment history of the client and the balances of outstanding orders and sales invoices due.

A common and useful way to classify control activities is in relation to the timing of their occurrence – *preventive, detective* and *corrective controls*. Preventive controls are policies and procedures designed to prevent an error or fraud from occurring. For example, a creditworthiness check on new customer orders prevents shipping goods and recognizing receivables in the balance sheet for which no full payment will be received. Preventive financial controls, such as validation and edit checks on the input of transactions before they are recorded, will prevent **material** misstatements in accounting records, whether by error or fraud, from occurring during transaction processing in the accounting system. Detective controls are policies and procedures that are designed to detect errors or fraud that might preclude the achievement of specific business or process objectives.

Detective financial controls will be built into the accounting system to spot material misstatements that may occur in processing transactions. Corrective controls are usually linked to detective ones and aim at correcting problems in a timely manner.

Strong preventive controls are essential to support the effectiveness of information and control systems. In an accounting system that processes a high volume of transactions, a lack of preventive controls on the input of transactions before they are recorded can render detective and corrective controls ineffective in detecting and correcting errors in a timely manner. Preventive controls can take a myriad of forms. Within the context of an accounting information system they can be programmed validity and edit checks, file transmission controls, automated posting to ledgers, and automated summary checks and reports. These types of preventive application controls are usually accompanied by preventive control measures of an organizational nature, such as an appropriate system of delegation and accountability, linked with a structure of formal approvals and what is known as 'separation of functions'.

While all of the accounting transactions are centralized ultimately on the general ledger, it is good management practice to split up the way the transactions are initiated, recorded and processed into different functional units, partly to allow for the development of specialist skills (division of labour) and partly to provide an environment where fraud becomes difficult. This is known as *separation of functions* or as segregation of duties. It calls for the separation of the four basic functions of transaction processing:

- authorizing transactions
- executing transactions
- recording transactions and
- safeguarding resources resulting from consummating transactions.

A simple example would be that where a payment has to be made, the payment is authorized by one person, the cheque drawn by another person, the cheque signed by a third and the general ledger entry made by a fourth. Each person is responsible for ensuring that they process nothing which is not correctly supported by documents and authorizations, and therefore in theory at least four people would need to be in collusion for a fraudulent payment to be made without a significant risk of detection. Equally, at least four people should have checked that the transaction is valid and has been correctly categorized. Separation of functions is a nice example of an efficient preventive control, in the sense that it simultaneously supports different types of control objectives: safeguarding of assets, ensuring the validity, completeness and accuracy of recorded information and compliance checking.

Separation of functions is obviously easier in a large company than in a small one, and it also has the effect of increasing the costs of each transaction. There is therefore a difficult trade-off between the costs and the level of assurance. But even in small companies with only a few employees it is usually possible to assign responsibilities in a way that achieves the necessary checks and balances. Alternatively, oversight of incompatible activities by the general manager can substitute functional diversification. Recall the payments example. In small companies it is not uncommon that the general manager is the only person authorized to approve outgoing payments and that monthly (or daily) bank statements are to be delivered unopened directly to him or her for review of outgoing payments.

There is, however, the psychological problem that people get used to routines and after a while do not check effectively. Indeed, in a system where everyone knows there are five other people checking the transaction each link in the chain may start to rely on someone else doing the job properly leading to a general failure. This is one of the reasons why monitoring activities, involving assessment by appropriate personnel of the design and operation of controls on a timely basis, is a necessary component of an effective internal control system.

Even with strong preventive controls, detective and corrective controls remain necessary. The internal control system will typically include routine checks such as inspection of the monthly bank reconciliation and outstanding customer and supplier accounts, all of which provide areas where fraudulent items can be kept outside the system but also where company records can to an extent be checked against the records of outside organizations with which the company deals. Many companies keep asset registers where lists of computers and desks and so on (to say nothing of cars, plant etc.) are maintained and these should be checked periodically against the physical existence of these items. Equally, where staff have access to large quantities of goods (supermarket staff, factory workers etc.) it is usual to have security systems that control what goods the employees are taking in and out of the business.

It should be clear, however, that a good system of internal control can provide only reasonable (not absolute) assurance regarding the achievement of the major control objectives, including the effectiveness of the accounting and reporting systems. Each system of internal control has its inherent limitations. Internal control heavily relies on human judgement in decision-making and this can be faulty. Control activities are bound by cost–benefit considerations due to resource constraints and they can break down as a result of a simple error or mistake. Internal controls can always be circumvented through the collusion of two or more people. Additionally, management usually has the ability to override the internal controls if that suits their personal interests better.

The US Sarbanes – Oxley Act of 2002 (commonly referred to as SOX) made executive management responsible not just for establishing, evaluating and assessing over time the effectiveness of internal control over financial reporting and disclosure, but also for periodically asserting its effectiveness (see Chapter 16 for further details). In the EU, no equivalent of the SOX requirements on internal control currently exists. As to accounting system specifications, the Fourth and Seventh



BETWEEN THE LINES

Why should you check goods being taken *in* to a company? It is not always relevant, but a sophisticated fraud is easy to operate in something like a bar where the barman takes in, for example, a bottle of whisky then, when a customer asks for a measure of whisky, the barman serves the customer from his private inventory and keeps the money. This way the customer is not cheated and the bar owner does not necessarily have any idea anything is wrong. The barman is robbing the business by using its infrastructure, but the main internal controls generally focus on the relationship between the value of sales and the value of the liquor consumed, and the barman is circumventing these controls by bringing in liquor.

Company Law Directives implicitly require companies to maintain accounting records enabling them to prepare financial statements, but explicit requirements on form and content of the accounting records and related controls are left to national legislation. This has led to divergent national requirements in European countries, but none has legal requirements comparable to the SOX requirements to publicly disclose conclusions regarding the effectiveness of internal control with regard to financial reporting.

Internal audit

Most large companies have an internal audit department. The primary task of internal auditors should be to examine and evaluate the adequacy and effectiveness of the company's internal control system and the quality of performance in carrying out assigned responsibilities. In fact, the internal audit function can be considered to be part of the monitoring component of the internal control system. It should be stressed, however, that the primary responsibility for establishing and maintaining the internal control system does not belong to the internal audit function but to the CEO, along with **key management personnel**. The internal audit function's primary responsibility is to evaluate the effectiveness of internal control and thus contribute to ongoing effectiveness.

One of the key issues for a proper functioning of an internal audit function is its independence: the internal audit department should be independent of the activities they audit. The independence of the audit department should be assured through their organizational position and authority within the company and through recognition of their objectivity. Of crucial importance is their reporting line: it is generally recommended that internal auditors report directly to either the (audit committee of the) board of directors, the CEO or a committee of top corporate executives.

The scope of internal auditing potentially covers all activities within the company. In some companies, internal auditors are heavily involved with operational controls, such as periodically monitoring production quality, testing the timeliness of shipments to customers or evaluating the efficiency of production processes (operational internal audit). In other companies the internal audit function will focus primarily on compliance and financial reporting issues (financial internal audit). So, in practice, the scope of the activities of the internal auditors tends to vary considerably, depending on the company's management.

Typically (and we will focus now on responsibilities of the internal auditors that are related to financial reporting) the department consists of a team of several people whose job is to visit the group's different sites and check whether accounting policies and procedures (usually documented in a policies and procedures manual) and related controls are being followed correctly and remain effective. Partly the task is psychological: if people know that at any time in the year the internal audit department may call in to check the accounting transactions and see whether the procedures in the group manual have been followed, they are encouraged to apply the procedures more thoroughly and anyone who was contemplating fraud is discouraged . . . the internal audit department thus acts as a preventive control measure.

The internal audit department can help create a culture within the company that says the accounting function has a vital role to play and that members of it are valued for their technical knowledge and their skill in handling the sometimes

difficult interpersonal situations that can arise. Equally, this department can provide important feedback about application problems to those who design and maintain the procedures. A difficulty in operating group-wide systems is that not all operating units are the same size (and therefore may have quite different accounting structures and personnel) and not all have the same type of operations.

By way of example of the problems that can arise when trying to instal uniform systems, here is an actual example taken from a group which had both electronics and entertainment interests. Within the entertainment division was a subgroup which ran London theatres and produced live theatrical shows. The head office internal audit department were conducting an exercise to fix levels of expenditure authority within operating units, as part of the internal control structure. They said that the chief executive of this subgroup could sign contracts only up to an individual value of £500 000. Beyond that he should seek authority from the chief executive of the entertainment division. The chief accountant of the theatrical subgroup said this was not possible because the group did not know the value of many contracts which were signed. The internal audit manager was dumbfounded—how could the chief executive sign contracts without knowing their value? Should he not be replaced at once (and maybe the chief accountant too)?

The chief accountant explained that theatre contracts in the West End of London are usually open-ended. They provide for a minimum weekly rental (generally against a percentage of sales) and, as long as this is exceeded, the **contract** can run indefinitely. Indeed, the object of the exercise is to find a single production that could potentially run for years. So while the minimum weekly rental might be (say) £50 000, the show could run for two or three years, or only two or three weeks, so the value of the contract could be anything from £200 000 to £20m or more. The internal audit manager then understood, but pointed out that the chief executive of the worldwide group could only sign contracts up to £10m without the approval of the board of directors. In the end, they agreed to write a special authority for the theatre subgroup, based on maximum weekly figures.

Getting the 'control environment' right is a very tricky problem in a large group. Ideally you want the accounting departments of the different units to be efficient and useful contributors to the team, who are willing to provide a high quality of service to help with the efficient running of the unit. On the other hand, the integrity of the group system and the necessity to provide inputs whose justification can be demonstrated, if necessary years after the event in a tax investigation, demand that accounting staff insist on the presentation of the appropriate paperwork and the required authorizations. Accounting staff in remote subsidiaries sometimes have a particularly difficult time since they have a line responsibility to the chief executive of their **subsidiary**, but a functional responsibility to the head office accounting managers. Locally employed staff, particularly in areas where unemployment is high, may fear losing their job if they upset the local chief executive, and may therefore not apply systems correctly.

The internal audit team should make frequent but unscheduled visits to subsidiaries to make spot checks on recent transactions but also to reinforce the local accounting unit if there are problems. The internal audit team should have a reporting responsibility within the head office, and not to local managers, although of course they should discuss local problems with operational management on site.

It follows from this that working in internal audit is not a particularly easy job. It is necessary to have a wide knowledge of the group's operations and information systems. A great deal of time is spent away from home visiting remote subsidiaries and often either working in foreign languages or with people who are obliged to use their second or third language, and who, of course, have different cultural backgrounds and therefore different understandings about their role and responsibilities. People in either accounting or operational roles often resent also what they perceive as an intrusion from head office, without understanding that without effective accounting systems the group cannot continue to exist for very long.

The Institute of Internal Auditors (IIA) has played a major role in the development of the internal auditing profession. Established in the US in 1941, the IIA has grown into a highly respected international organization and has taken a leadership role in providing professional guidance for internal auditors. The IIA establishes ethical and practice standards, provides education and promotes professionalism through its worldwide network. It sponsors a certification programme leading to the designation of Certified Internal Auditor (CIA) for those who meet the examination and experience requirements. The IIA's Standards for the Professional Practice of Internal Auditing are divided in attribute standards for the internal auditor and the internal audit department and performance standards for the performance and reporting of internal audit activities.

STANDARDS



DEFINING INTERNAL AUDITING

Internal auditing is an independent, objective assurance and consulting activity designed to add value and improve an organization's operations. It helps an organization accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control and governance processes.

Source: Institute of Internal Auditors (www.theiia.org)

STANDARDS



INSTITUTE OF INTERNAL AUDITORS: STANDARDS FOR THE PROFESSIONAL PRACTICE OF AUDITING

Attribute standards

1000 Purpose, Authority, and Responsibility. The purpose, authority, and responsibility of the internal audit activity should be formally defined in a charter, consistent with the *Standards*, and approved by the board.

1100 Independence and Objectivity. The internal audit activity should be independent, and internal auditors should be objective in performing their work.

1200 Proficiency and Due Professional Care. Engagements should be performed with proficiency and due professional care.

1300 Quality Assurance and Improvement Program. The chief audit executive should develop and maintain a quality assurance and improvement program that covers all aspects of the internal audit activity and continuously monitors its effectiveness. The program should be designed to help the internal auditing activity add value and improve the organization's operations and to provide assurance that the internal audit activity is in conformity with the *Standards* and the *Code of Ethics*.

Performance standards

2000 Managing the Internal Audit Activity. The chief audit executive should effectively manage the internal audit activity to ensure it adds value to the organization.

2100 Nature of Work. The internal audit activity evaluates and contributes to the improvement of risk management, control, and governance systems.

2200 Engagement Planning. Internal auditors should develop and record a plan for each engagement.

2300 Performing the Engagement. Internal auditors should identify, analyze, evaluate, and record sufficient information to achieve the engagement's objectives.

2400 Communicating Results. Internal auditors should communicate the engagement results promptly.

2500 Monitoring Progress. The chief audit executive should establish and maintain a system to monitor the disposition of results communicated to management.

2600 Management's Acceptance of Risks. When the chief audit executive believes that senior management has accepted a level of residual risk that is unacceptable to the organization, the chief audit executive should discuss the matter with senior management. If the decision regarding residual risk is not resolved, the chief audit executive and senior management should report the matter to the board for resolution.

Source: Institute of Internal Auditors, 2007 (www.theiia.org)

External audit

In most jurisdictions the financial statements of medium and large companies must be submitted to an independent audit. This is often referred to as *statutory audit* and is usually carried out by independent firms of auditors. Audit has evolved differently in different countries, and the object of the audit is not uniform. In some countries, the auditor has a quasi-legal role to check for the legality of the company's activities and its annual statements, whereas in other countries the auditor is checking the accounts on behalf of the shareholders. In both cases the audit firm is usually appointed in fact by the management of the company, but the responsibility both for keeping accounts and for preparing the annual financial statements is that of the management of the company, not that of the external auditors.

The external auditor expresses an opinion on the representational fairness of the financial statements in conformity with generally accepted accounting principles. While the company's system of internal control should provide reasonable assurance regarding the reliability of financial statements, the external auditor

brings the assurance to a higher level. It is, however, not the responsibility of the external auditors to detect fraud. While external auditors should certainly report fraud if they spot it and they will normally comment on the adequacy of the internal control system to prevent fraud, their job is not to search for fraud, even if many people think that it is. In a modern multinational, the management are looking to the statutory auditor to provide reassurance to outside stakeholders that the financial statements of the company are a valid representation of the company's financial position and performance. This is part of the very broad role played by financial statements, and the fact that the information is independently verified is probably one reason why the role is so broad.

Nearly all multinationals have their financial statements audited by one of the four international audit networks which dominate the business:

- PricewaterhouseCoopers (PwC)
- KPMG
- Ernst & Young
- Deloitte.

These four firms are probably better known than many of their clients and one of their logos on the audit report (published within the financial statements) carries a high level of reassurance to users in general and the capital markets in particular. As a consequence, any company with ambitions is likely to use one of these firms. In addition, they have worldwide networks and are capable of delivering an audit anywhere in the world. This is quite important in that the multinational generally prefers to have a single firm responsible for all its subsidiaries, not least because this reduces the risk of lack of coordination between countries. This tends to reinforce the dominant position of the 'Big Four', as they are known, since other audit firms cannot offer the global service.

The basic statutory audit consists of two tasks:

1. to check that the accounting database effectively picks up all the company's activities and is correct;
2. to check that the financial statements drawn up from it are a correct representation of what is in the accounting database, use appropriate accounting policies and are a reasonable representation of the company's real state (but this last aspect may not always be part of local audit requirements).

The audit firm maintains a master file on the company and in this is collated all the relevant information necessary for the annual audit. This includes items left outstanding from the previous audit for subsequent management action and an analysis of the company's systems. When starting a new audit, the first requirement is to check the accuracy of the systems chart. Having established the current system and internal controls in place, the next step is to check how well these work. This is done by sampling the transactions of a particular (short) period. If this checking reveals that the internal control system is correctly applied, the auditor can go on to carry out verifications of things like inventory valuations, bank reconciliations (comparing the client's bank records with the statements provided by the bank), customer accounts, supplier accounts and so on. Only if the internal control system is thought to be ineffective will more detailed checking be done.

Once satisfied with the database, the auditor looks at the financial statements and the interpretation of the database which has been made in these. The nature

of the company's business does not necessarily change every year, so there need not be any queries at this point, but as new transactions appear, so there may well be disagreement about how these are represented. Such disagreements are usually resolved more or less amicably between the audit staff and the chief accountant, but occasionally there can be substantial disagreement – usually because a change in treatment would diminish profits (we will be looking at cases throughout this book). In such circumstances things can be very tense and large companies have been known to bring in legal opinion, or consult another firm of auditors, when trying to insist on their view of the financial statements. The auditor can, in some countries, even be replaced, but this generally sends a bad signal to the market. The auditor's only threat is to refuse to sign the audit report at all (very extreme) or (more normally) to say that they will be obliged to include a reservation in their audit report which details the matter in dispute.

Although the auditor signs a public report, there is also usually a private report which is given to the management, and is known as a *management letter*. This, unlike the published report, does not follow any prescribed formula but rather comments on the audit findings for the year, highlights potential areas of weakness and makes recommendations. This is something which the following year's audit will revisit to see what action has been taken.

The conduct of the audit is regulated in three ways. Firstly, the statutory audit, by definition, is mandated by a government statute (such as a company law or a commercial code) which will prescribe the objects of the audit and normally specify whether client confidentiality applies or not. In the second place there will normally be a national professional association for auditors which will provide detailed audit regulations. Finally the audit firm itself will have its own internal procedures which all its staff follow – for reasons of efficiency and also to enable the firm's management to assess the degree of risk in the audit and similar issues.

The audit firm has a potentially difficult relationship with its client because, on the one hand, the outside world depends upon the rigour of the audit firm to ensure that the company maintains proper accounts and gives adequate reports while, on the other, the audit firm is in effect appointed by the management, must negotiate with the management and, in many countries, hopes to be able to sell supplementary services such as tax advice and management consultancy to the audit client. This problem is part of the issue of *auditor independence*. Regulators are concerned that, since auditors are at the front line of corporate regulation, they should be independent of management and provide an appropriate control on management. Other aspects of the independence issue include restrictions on employment of former audit firm employees by the client and the necessity of auditor partner rotation over time.

Companies listed on the US stock markets are obliged to appoint an *audit committee* whose members liaise with the statutory auditors. The Sarbanes – Oxley Act requires that all members of the audit committee are independent. The company should also disclose whether or not the audit committee includes at least one member who is a financial expert. The idea is that this committee provides a knowledgeable forum free from the influence of operating management where shareholder representatives can discuss audit problems. SOX even requires that the audit committee appoint the firm of external auditors. The role of the audit committee is growing in a context where society is becoming more and more concerned with corporate governance issues.

NESTLÉ*Report of the group auditors to the general meeting of Nestlé S.A.*

As Group auditors we have audited the Consolidated Financial Statements (balance sheet, income statement, cash flow statement, statement of recognized income and expense and changes of equity and annex) of the Nestlé Group for the year ended 31 December 2007.

These Consolidated accounts are the responsibility of the Board of Directors. Our responsibility is to express an opinion on these group accounts based on our audit. We confirm that we meet the legal requirements concerning professional qualification and independence.

Our audit was conducted in accordance with Swiss Auditing Standards, and with International Standards on Auditing, which require that an audit be planned and performed to obtain reasonable assurance about whether the Consolidated Financial Statements are free from material misstatement. We have examined on a test basis evidence supporting the amounts and disclosures in the Consolidated Financial Statements. We have also assessed the accounting principles used, significant estimates made and the overall Consolidated Financial Statements presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the Consolidated accounts give a true and fair view of the financial position, the net profit and cash flows in accordance with International Financial Reporting Standards (IFRS) and comply with Swiss Law.

We recommend that the Consolidated accounts submitted to you be approved.

KPMG Klynveld Peat Marwick Goerdeler SA
20th February 2008

Source: Nestlé, Financial Statements, 2007 © 2008 Nestlé SA

Corporate governance

In recent years, more and more government and shareholder attention has been given to the question of how management's freedom of action may be limited by outside interests – a topic known as corporate governance. Corporate governance issues arise whenever ownership of a company is separated from its management. There are many issues in this area which cause concern to investors and governments. Abuses by management are not necessarily widespread, but sometimes the remuneration of top executives seems out of all proportion to the effort put in; sometimes managers are either implicated in or unaware of frauds taking place within the company, or indeed of risk-taking by middle management. Some company bosses are thought to be able to operate virtually as dictators, with no effective monitoring of their activity within the company.

Criticism in this area, articulated for example in the financial press, has produced a number of different outcomes. At a general level, most companies are not insensitive to the views of the outside world and make at least a token response

by disclosing in their annual report some details of their activities in sensitive areas. Notably, companies are increasingly making voluntary disclosures about their interaction with the environment, their involvement with their employees and the wider community, and their policy on issues such as the use of child labour by subcontractors. In addition, institutional investors such as insurance companies and pension funds increasingly provide a checklist of corporate governance matters to the directors of the companies in which they plan to invest. Only if the board can satisfy them on these points will they go ahead and make an investment.

Many countries have specific rules, regulations and public guidance on corporate governance. Governance regimes tend to differ due to historical, economic and cultural influences. However, with the emergence of global markets national governance structures came under greater public scrutiny and these pressures resulted in a number of government or quasi-official reports (Viénot I and II in France, Cromme in Germany, from Cadbury to Higgs in the UK, OECD) and, more recently, in somewhat converging codes of conduct in most countries which tend to recommend the installation of supplementary controls on management and the distancing of management from the audit. The first plank of such an approach calls for companies to appoint a chairman who is not also the chief executive, and for the board to include 'non-executive' or independent directors who can bring experience and independence to the boardroom. The non-executive directors, aside from normal board meetings, are then called upon to form at least two key committees: the compensation committee (which fixes executives' pay packages) and the audit committee. The audit committee should provide a forum where external and internal auditors can discuss audit issues without line management being present. Sometimes there exists a third committee, the nomination committee, charged with the responsibility of proposing to the board any new executive or non-executive directors. It is generally recommended that a majority of the nomination committee members are non-executive directors.

The basic idea is that the non-executive directors have no role in the day-to-day running of the company, but are there to safeguard investors' interests and to provide ethical controls. Of course, for this to work, the individuals must be experienced in business matters and be willing to take a strong line within the board. It is not clear that this always works, not least because appointment of non-executive directors generally falls to the chairman or chief executive. However, in principle, the non-executives should be in a position to determine what is a fair pay package for senior executives by reference to market conditions. Equally, they should provide some protection for staff who wish to express concerns in the context of internal controls and audit. A frequently encountered problem in large companies is that even if staff are aware that some fraud or abuse is taking place, they are reluctant to report it because they fear that no action will be taken but their position will be made untenable. The existence of an audit committee should make it possible for staff to raise issues which are passed up the audit chain and not discussed with operational management until an investigation has taken place.

In some countries, notably Germany and the Netherlands, large companies have a two-tier board system where a management board runs the company on a day-to-day basis, but this reports to a supervisory board. The supervisory board represents investors and staff, receives regular reports on corporate activity and can replace the management board if they wish.

In the US, the Sarbanes – Oxley Act has been the main initiative to strengthen corporate governance after the Enron collapse. The SOX created the Public Company Accounting Oversight Board (PCAOB), strengthened auditor independence rules, increased accountability of company officers and directors, mandated top management to take responsibility for the company's internal control system, enhanced the quality of financial reporting and considerably increased white-collar crime penalties. We will come back to these developments in Chapter 16.

In Europe, the European Commission plans to modernize company law and enhance corporate governance. In October 2004, the European Commission formally established the European Corporate Governance forum to encourage the coordination and convergence of national codes of corporate governance through regular high-level meetings.

The accounting profession

It is worth spending a few moments to look at the accounting profession as such. In the anglophone world we tend to use the terms 'accountant' and 'auditor' interchangeably, and we tend not to distinguish very clearly between those people who operate independent public accounting firms and those who work for companies or in the public sector. Not the least reason for this is that there is no clear worldwide definition of what an accountant does and, indeed, the training and licensing arrangements and type of work done vary somewhat from country to country. For our purposes we will distinguish between the following categories:

1. independent auditor
2. independent accountant
3. company accountant.

Independent auditors are specialists who work in audit firms and are licensed either directly or indirectly by the government to carry out the *statutory audit* (i.e. independent audit required by company law) of large companies. An individual who works in this way has generally completed a university degree and then studied for professional exams. These exams are typically under the supervision of a professional organization (e.g. American Institute of Certified Public Accountants) and a candidate must also spend at least three years as a student in a public auditing firm. In some countries, such as the UK, success in the professional examination, allied with the necessary practical experience, confers an auditing licence automatically and this is issued by the professional body. In other countries (e.g. Germany) the auditor must register with a government supervisory body.

In fact many auditors leave public practice fairly early in their careers, either to undertake wider management careers or to work full time for a company. In anglophone countries, such accountants may well remain members of their professional body, but in many continental European countries, membership is linked to public practice and anyone leaving public practice leaves their professional body at the same time. This leads to professional bodies being quite different in size and nature. The Institut der Wirtschaftsprüfer (the only body for auditors of public companies in Germany) has approximately 18 000 members, while the Association of Chartered Certified Accountants (one of four bodies in the UK whose members may work as auditors) has more than 100 000 members.

The precise nature of the audit and the relationship between auditor and client vary from place to place. In France, the auditor has a public responsibility to report to the public prosecutor any evidence of a client's failure to comply with the law discovered during the audit. However, in most countries the company's information must be kept confidential by the auditor. There are also differences as to what the auditor is commenting on in the audit report – sometimes it is simply conformity with local accounting rules, while sometimes the auditor is saying that the image of the company given by the annual financial statements is not misleading. This difference is quite important since the user of the financial statements is being offered a different level of reassurance about the information.

It is relatively rare for audit firms to offer only an audit service, although France and Germany in particular say that the auditor, for reasons of independence, may only provide audit services to an audit client, even if they may offer other services to non-audit clients. Anglo-Saxon audit firms generally used to offer a wide range of consulting services to their audit clients and, indeed, provision of the audit was seen by some as the means of access to selling a wide range of consulting services. The Sarbanes – Oxley Act of 2002 put a stop on these practices, by prohibiting audit firms from providing a wide range of non-audit services to audit clients.

Independent accountants are a related branch of the profession. In some countries a network of firms has developed which offer accounting services to (generally small) businesses. In France there are, for example, the Experts Comptables, in Germany the Steuerberater and in the Netherlands the Accountant-Administratieconsulent. These firms specifically do not offer statutory audit for large companies and their principal role is in providing the accounting function for companies that are either too small to have an in-house service or that prefer to outsource the function. They may also provide tax and general business advice.

Company accountant, on the other hand, is a function not necessarily covered by any professional organization, and indeed many company accountants do not have any specific accounting training. At the management end of company accounting, the larger companies tend to engage former auditors or others with specialized professional training to run their accounting function. However, it is commonplace in both North America and continental Europe for people to study business at university, perhaps with an accounting specialization, and then go directly into a company and work in the accounting, internal audit and finance areas, building up a store of practical experience in that way.

Professional accounting bodies exist in most countries, but their nature may vary quite a lot depending on the nature of the economy within which they operate. In the developed world, the standards of professional exams for auditors are comparable, and indeed in the European Union are the subject of a harmonization statute (Eighth EC Company Law Directive), but in the developing world and in countries in transition to a market economy this is not necessarily so. Not all professional bodies have examination requirements for entry and not all are independent associations. For example, the Chinese Institute of Certified Public Accountants is an agency of the Chinese Ministry of Finance.

There are some regional bodies to which national bodies may belong, such as the Fédération des Experts Comptables Européens (European Accountants' Federation) or the Confederation of Asian and Pacific Accountants (CAPA). Finally there is, at a world level, the International Federation of Accountants (IFAC) which represents the profession worldwide and issues auditing standards and public sector accounting standards, as well as providing guidance on education and ethical matters.



Summary

In this chapter we have looked at the functioning of the company accounting unit and seen that its objectives are to provide accurate financial data about the company but also to provide controls which prevent the possibility of fraud. The company runs a permanent accounting database into which all transactions are recorded, processed and summarized, and from which one may at any point produce reports about the company's performance and financial position. The processing of transactions follows the same principles irrespective of whether it is computerized or not, but computerized accounting information systems are widespread and permit efficient accounting and sophisticated analysis.

In larger companies the accounting information system is an integral part of a 'system of internal control' which operates to safeguard assets, improve the reliability of accounting data, ensure compliance with applicable laws and contractual obligations and promote operational efficiencies. This system of internal control is usually backed up by an 'internal audit' function: dedicated staff checking that internal controls are applied and remain effective. Finally all public companies, and many private ones, are subject to independent audit by external auditors. These professionals also rely upon the internal control system and run sample checks on it in order to form an opinion on the accuracy of the company's financial records. They also give an opinion on the validity of the annual financial statements.

The external audit is a major part of a wider system of *corporate governance*, through which investors and other interested parties aim to monitor and control the behaviour of corporate managers, a subject which we will revisit later in the book. This involves the use of disclosures, adherence to codes of behaviour and the use of board members who represent investor interests. The term 'accountant' or 'auditor' is used fairly freely and there are a number of professional structures and education patterns which occur in different countries. Generally, statutory auditors must be licensed by government and have completed suitable professional training and minimum periods of internship.

Discussion questions

www.cengage.co.uk/walton_aerts2

1. What are the objectives which a company's accounting department should be aiming to achieve?
2. How is the company's accounting database organized and from where does it get its data?
3. How does the COSO report approach a 'system of internal control'?
4. Explain the difference between preventive, detective and corrective controls.
5. What is the relationship between internal control and internal audit?
6. What is the purpose of external audit, and who carries this out?