

SIKS Smart Auditing 2015

Next-level Assurance of the Completeness Assertion

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Agenda

- Challenges & Case
- Wrap Up
- Discussion

Challenge 1

You are the franchisor of a Chinese restaurant franchise with 1,000 locations.

I run one of them. My franchise only records half of the meals sold.

How do you detect my unrecorded sales?

Challenge 2

Seemingly similar, you are the franchisor of a hotel franchise with 1,000 locations.

I run one of them. My hotel regularly rents out rooms without recording.

How do you detect my unrecorded rentals?

Intermezzo

The solutions of challenges 1 & 2 can be implemented as internal controls, but is that sufficient for prevention?

If yes, why? If no, what is missing?

Challenge 3

You are in charge of a dealer network of 1,000 stores.

By coincidence, a few dozen fake stores are located. Moreover, it appears many more may exist.

How do you detect all these unauthorized stores and new arising ones as early as possible?

Challenge 4

You are on the management team of a western IT device production company that wants to outsource five licensed production units to the East.

You know a competitor was plagued by a lot of cloned unlicensed production units.

What is your approach to prevent this from happening to you?

Case

You are the franchisor of a hair salon franchise with 1,000 locations that has the exclusive right to sell and use hair products of a high-end brand.

I run one of them as a franchisee. In order to underreport royalties to the franchisor, my salon doesn't record clients that did not make a reservation and paid cash. Furthermore, my salon often dilutes or replaces the high-end hair product with counterfeit, and sells the original product to the customer under the counter.

What is your approach to keep me honest and offer the customer 100% assurance that she gets the genuine product in her hair? What is the added value, as return on investment, for franchisor, producer, franchisee, tax agency and internal and external auditor?

Challenge 5

You are at a tax revenue agency that wants to rely on a royalty receiver's internal control over completeness of revenue.

What are your key criteria in screening?

Note:

A royalty (sometimes, running royalties, or private sector taxes) is a usage-based payment made by one party (the "licensee") to another (the "licensor") for the right to ongoing use of an asset, sometimes an intellectual property (IP).

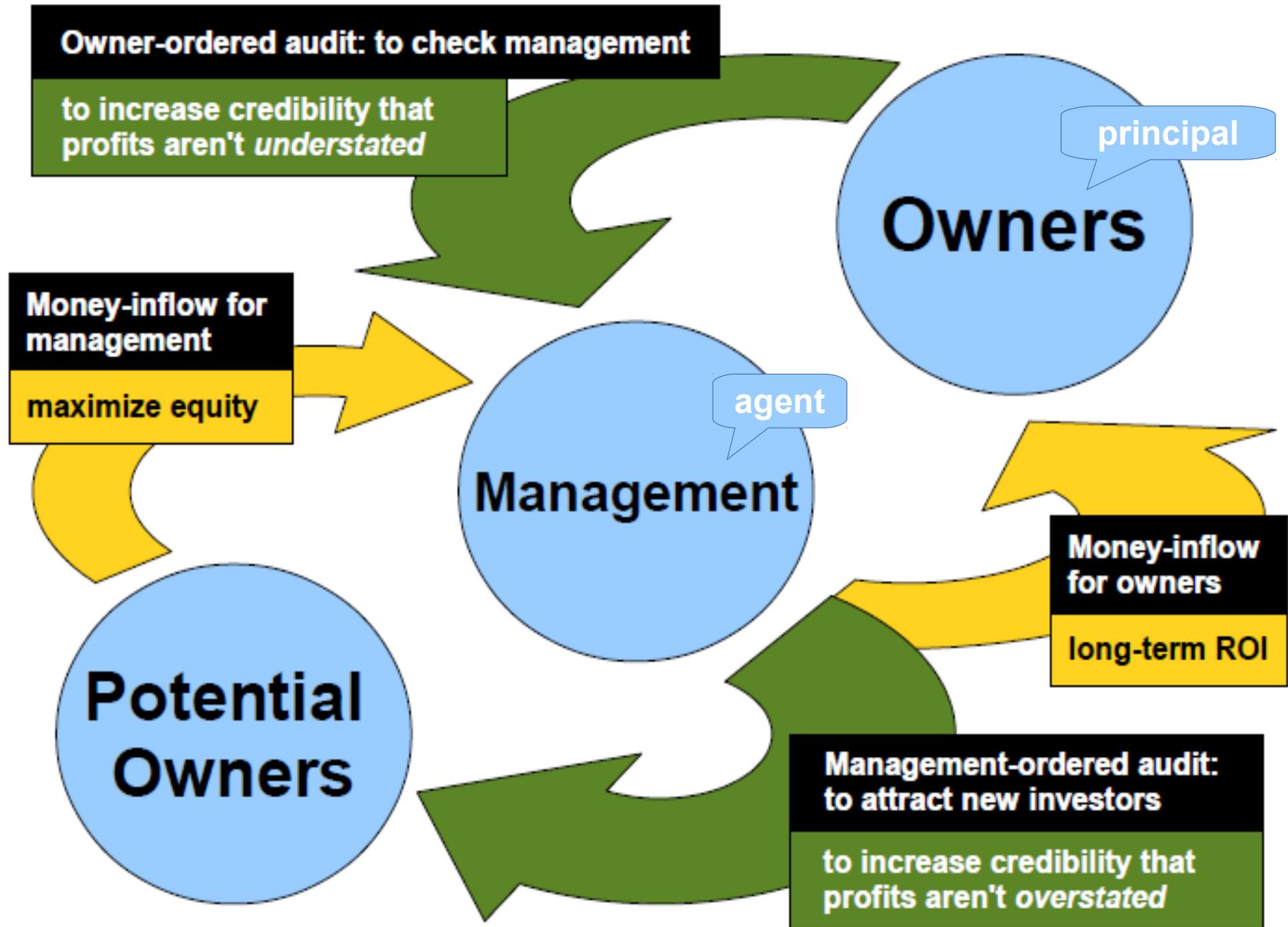
Royalties are typically agreed upon as a percentage of gross or net revenues derived from the use of an asset or a fixed price per unit sold of an item of such, but there are also other modes and metrics of compensation. Source: Wikipedia.

Challenge 5 Check List

- ✓ Outsourced key points of 1st recording (Unit of Measurement)
- ✓ Multiple outsourcings for one key point (POS & CCTV)
- ✓ Customer co-records or co-verifies at point of sales
- ✓ Reward policy in place for buyers of fake
- ✓ Activation codes, sensors and RFIDs on production units
- ✓ Assurance report shows use of norm equations
- ✓ Presence of industry norm model: top-cycle business process
- ✓ Assurance report shows assessment of coverage of buy side sell side connectivity in outsourced key points of 1st recording
- ✓ Grip on full spectrum of suppliers & supply chains

Wrap Up

Owner-ordered & Management-ordered Auditing

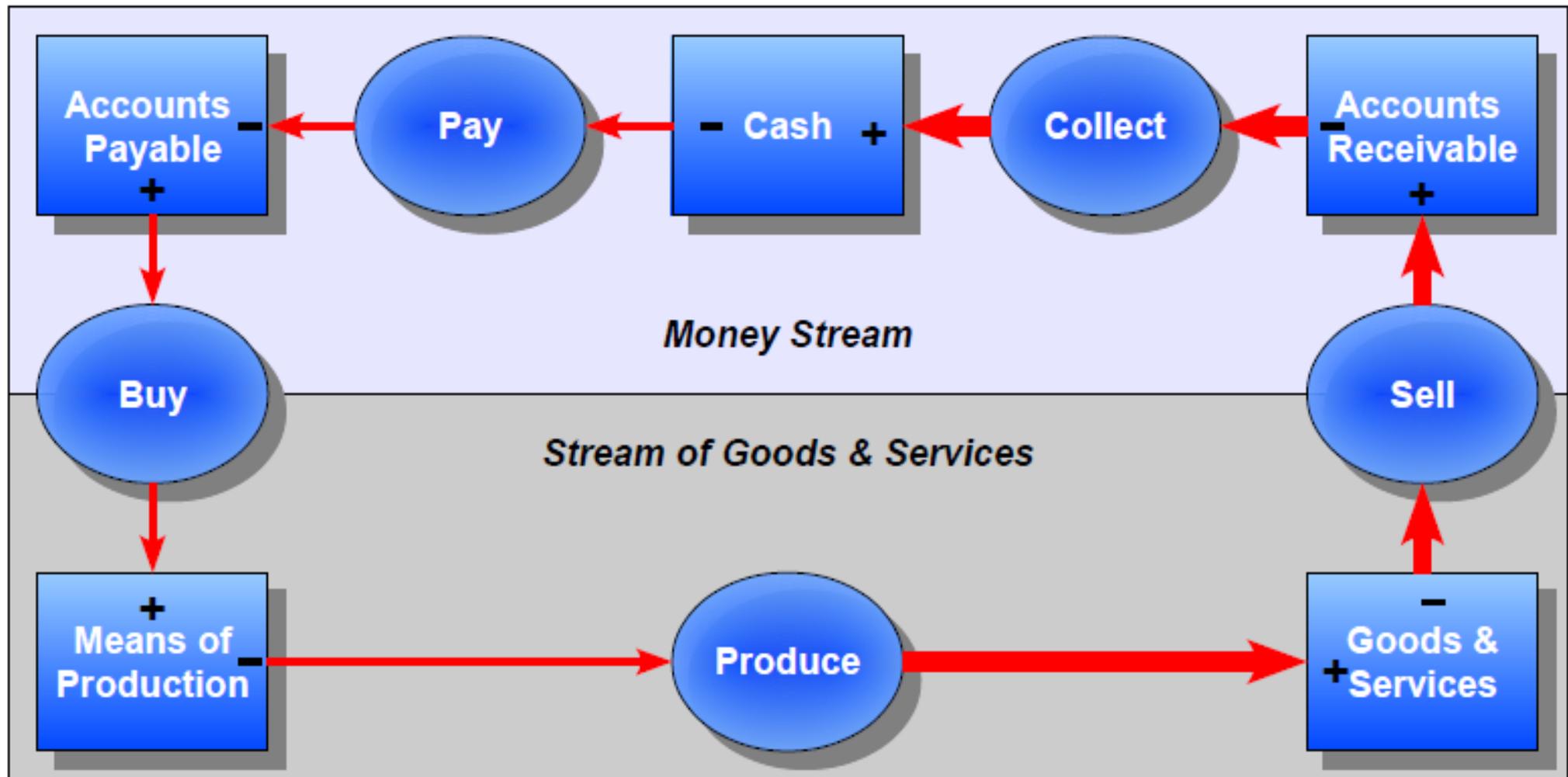


Audit Assertions

- Owner-ordered Auditing
 - Overstated: Correctness
 - Understated or unstated: **Completeness**
- Management-ordered Auditing
 - Relating to classes of transactions
 - Occurrence, **Completeness**, Accuracy, Cut-off, Classification
 - Relating to assets, liabilities and equity balances at the period end
 - Existence, **Completeness**, Rights & Obligations, Valuation
 - Relating to presentation and disclosures
 - Occurrence, **Completeness**, Classification & Understandability, Accuracy & Valuation

Integrated Owner-ordered & Management-ordered Audit Approach

Is this integrated approach somewhere recognized, proven or implemented?



Capturing "understanding the client's business" in a top-cycle model, originated in UK & Germany, matured in Netherlands in 1930s-1990s

Revenue Assurance

- **Top-cycle model: Quantitative & Qualitative**
From mental model to process model:
no juridical laws, instead scientific laws of nature about product transform from buy to sell, in particular *absence of transform* of product parts or product properties, thus law of conservation (UoM)
- **Quantitative mainstay**
Completeness of Return On Investment (ROI) and thus completeness of profits (revenue minus expenditures) that generate ROI
- **Qualitative mainstay**
Control actions of Agents according to Principal's interest (agency theory)

Integrated Audit Equations

Understatement
Overstatement

Accounts Receivable (asset, \$):

$$\boxed{\text{Beginning Balance}} + \boxed{\text{Selling Price} \times \text{Inventory Sold}} - \boxed{\text{Ending Balance}} \Rightarrow \boxed{\text{Cash Collected}}$$

Inventory (asset, #UoM!):

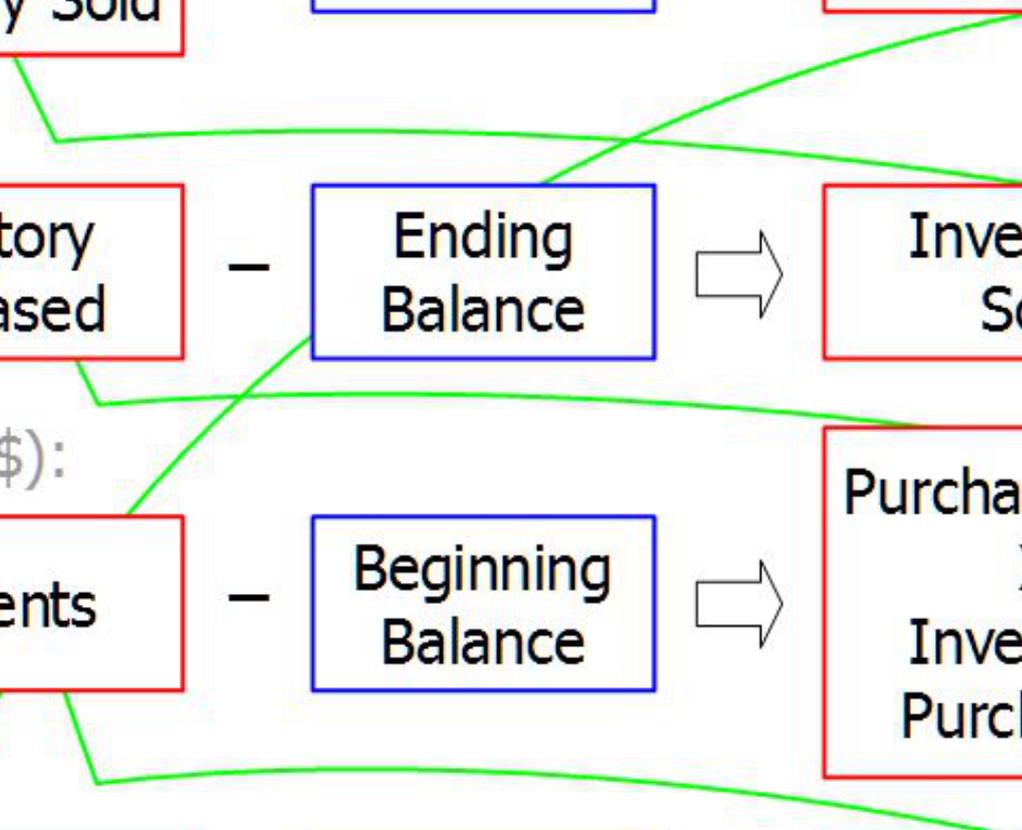
$$\boxed{\text{Beginning Balance}} + \boxed{\text{Inventory Purchased}} - \boxed{\text{Ending Balance}} \Rightarrow \boxed{\text{Inventory Sold}}$$

Accounts Payable (liability, \$):

$$\boxed{\text{Ending Balance}} + \boxed{\text{Payments}} - \boxed{\text{Beginning Balance}} \Rightarrow \boxed{\text{Purchase Price} \times \text{Inventory Purchased}}$$

Cash (asset, \$):

$$\boxed{\text{Beginning Balance}} + \boxed{\text{Cash Collected}} - \boxed{\text{Ending Balance}} \Rightarrow \boxed{\text{Payments}}$$



Challenge 6

How to involve owners in smart audit oversight?

For example, pension fund depositors and beneficiaries over pension fund management that orders and pays the audit.

Challenge 7

How does smart auditing provides stakeholders with assurance that management did not dump and understate Non-Product Output (NPO), like waste and pollution?

Challenge 8

How to move assurance of completeness upstream to the point of first recording, in near real-time, while framing materiality for single data items?

Challenge 9

How to get off-balance sheet derivatives back on the balance sheet? Covering \$700 trillion, equalling 10 years worldwide gross domestic product.

Which internal control measures can the audit profession articulate and attest for the micro-to-macro reporting channel from each individual financial institution to a governmental systemic risk agency?

Connecting indicators on the micro-level (FpML: Financial product Mark-up Language) to macro-level indicators (Bookstaber).

Discussion

- Accountability relationship, agent/management towards principal/owner, Ijiri, 1975 & McCarthy, 1982:

“In general, an entity's power to control resources is provided by someone else, who in return demands that the entity account for the resources under its control”

- Internationalize owner-ordered auditing
 - Why?
 - How?
 - Pull?
 - Push?