

Financial Statement Fraud Prevention

Internal Controls

- The first step in financial statement fraud prevention is strong internal accounting controls. Internal controls begin at the transaction level of accounting and dictate which employees can complete processes and tasks within the company. Internal controls may also be instituted outside the accounting office to strengthen company operations.

An example of an operational internal control is allowing certain employees the authorization of purchase orders. An employee who authorizes the purchase of an asset should not be allowed to choose where to purchase the asset. Setting dollar limits for authorized purchases or using approved vendors can help to enforce this control.

An important internal control for accounting is the segregation of duties. This ensures that more than one person handles certain financial information. A common segregation is in the cash accounts. The same employee is not allowed to sign checks, post them in the accounting system and reconcile the bank statement. This control prevents embezzlement. This type of segregation can be spread throughout the accounting department.

Audits

- Companies should test their financial information for accuracy by having an audit of their financial statements. This helps management understand where weaknesses are in their accounting department and allows them to take corrective measures quickly.

Audits should test the controls objectiveness. Are the transactions complete and valid regarding the information? Do the transactions appear reasonable? Is any information not being reported because of internal control limitations?

Audits should also test activities. Who is completing the task? Is a high level of security applied to financial information? Can the activity be easily reviewed in a timely manner?

Audits should also review the internal control process. Many publicly held companies are required by the Securities and Exchange Commission (SEC) to have their outside auditors attest to the effectiveness of internal controls.

Management Review

- The final step to prevent financial statement fraud is the management review of financial statements prepared for the company. Publicly held companies are required by the Sarbanes-Oxley Act of 2002 (SOX) to provide a written statement by management validating the accuracy of financial statements. This assures outside investors that management has seen the company financial statements and approves of the information as reported.

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