3 Financial Reporting Areas Prone to Material Weaknesses

...and 3 measures to improve the internal control deficiencies that cause them.

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It's been just over a decade since the Sarbanes-Oxley Act was introduced, but insufficiencies in internal controls over financial reporting are still common. Last year, the SEC received a total of 1,814 amended 10-K filings and 3,019 amended 10-Q filings, suggesting a relatively high error rate.1

A study released last year reported the top three areas in inancial reporting that are vulnerable to material weaknesses: Income taxes, revenue recognition and liability and accrual estimations. 2 In this list, learn why these areas can be problematic, and how companies can tighten internal controls to help minimize the risk of misstatements.

1. Income taxes

According to a recent Deloitte study, 27% of companies with errors cited issues with income taxes, ranking this oversight as the leading cause of material weaknesses in relation to U.S. GAAP failures.3

There are many reasons why internal controls are weak in this area, but on a high level, income tax accounting is complex and prone to error because its rules are derived from many sources, and often hinges on estimations and assumptions.4 In addition to day-to- day income tax challenges, extra acquisitions or divestures by an organization require an assessment of income tax guidelines, creating new complications.

1 DisclosureNet. N.p., n.d. Web. 17 Apr. 2013. <www.disclosurenet.com>.
2 Henry, Chao, and Paul Foote. "Material Weaknesses in Internal Controls a Decade after Sarbanes-Oxley." Accounting Today. Web CPA News, 23 July 2012. Web. 17 Apr. 2013. http://www.accountingtoday.com/news/material-weaknesses-internal-controls-sarbanes-oxley-63369-1.html.
3 "Material Weaknesses and Restatements: Is Tax Still In the Hot Seat ?" Deloitte. Deloitte, 2011. Web. 25 Mar.2013.http://www.deloitte.com/assets/Dcom-UnitedStates/Local%20Assets/Documents/Tax/us_tax_materialweaknesses_012011.pdf
4 "Income Tax Accounting." PwC. PricewaterhouseCoopers, n.d. Web. 18 Apr. 2013. http://www.pwc.com/us/en/audit-assurance-services/accounting-advisory/accounting-for-income-tax.jhtml.

Method to improve internal controls – Implementing a disclosure management cycle

Identifying the leading causes of errors in financial reports, 23% of companies pointed toward lack of internal review, and more specifically, "either not enough levels of review, not at the right level of precision/detail, or not enough time for reviews to occur."5 Instituting a formal Disclosure Management Cycle (DMC) within the organization is one way that companies can tighten internal controls to help mitigate errors.

Since income tax accounting is riddled with intricacies and requires a significant time for review, a DMC formalizes the financial reporting process in twelve steps, and is conducive to creating a work back schedule. Accountants can build ample review time into the steps, eliminating the time crunch at year-end.

2. Revenue recognition

Revenue recognition is one of the highest risk areas in the accounting space. Again, the difficulty with revenue recognition is increasing convolutions and evolving revenue models. PwC notes that "there are many complex rules for recognizing revenue when contracts/ arrangements have more than one revenue generating activity."6

In a PCAOB study, 44% of small US auditing firms surveyed experienced at least one "significant audit performance deficiency", the majority of which were related to revenue recognition.7

Due in part to such difficulties, FASB and the IASB are currently pursuing a joint venture wherein the model for revenue recognition may change significantly. The rules associated with revenue recognition are already evolving quickly, but companies can expect even larger changes this year, which will necessitate a tightening of internal controls over reporting these numbers.

5 "Material Weaknesses and Restatements: Is Tax Still In the Hot Seat ?" Deloitte. Deloitte, 2011. Web. 17 Apr. 2013. http://www.deloitte.com/assets/Dcom-UnitedStates/Local%20Assets/Documents/Tax/us_tax_materialweaknesses_012011.pdf

6 "Revenue Recognition." PwC. PricewaterhouseCoopers, n.d. Web. 17 Apr. 2013. http://www.pwc.com/us/en/audit-assurance-services/accounting-advisory/revenue-recognition.jhtml.

Method to improve internal controls – Monitoring rules and regulations
Organizations can tighten internal controls here by finding a reliable solution that automatically monitors new rules and regulations.

This way, when FASB and the IASB issue new pronouncements relating to revenue recognition, organizations immediately become aware of implications and can adjust internal controls to reflect the changes. Sourcing software that not only houses these updates, but also issues real-time alerts on changes will help reduce filing errors and keep organizations on the leading edge of reporting.

3. Liability & accrual estimations

It's not surprising that another susceptible area to material weaknesses in internal controls involves estimations.8 In an industry where accuracy is paramount, when it comes to liability and accrual estimations, finance professionals must roughly calculate cash flow in and out of the organization based on pending transactions.

A study published last year reveals that from 2004-2011, 676 rule violations in financial reports were attributed to weak internal controls on liability and accrual estimations.9

Method to improve internal controls – Precedent research & benchmarking
By their nature, estimations are difficult to handle, and will continue to challenge financial reporting teams. But there are small ways that organizations can strengthen internal controls to ensure estimations are aligned with best practices. Teams can conduct precedent research on how peer companies handle liability and accrual estimations. Using a disclosure filings research on how peers treat the subject.

7 Hoffelder, Kathleen. "Accounting Watchdog Raps Small Audit Firms." CFO.com. CFO Magazine, 21 Mar. 2013. Web. 18 Apr. 2013. http://www3.cfo.com/article/2013/3/auditing_audit-inspections-pcaob-jay-hanson-jeanette-franzel

This information can be used as a benchmarking tool, allowing an organization to align itself with best practices and ultimately reducing the risk for material weaknesses in these estimations.

How Certent DisclosureNet can help:

Certent DisclosureNet is an integrated disclosure management and disclosure research solution that significantly reduces the chance of reporting errors; including those that lead to material weaknesses.

1. *Certent DisclosureNet Streamlines Your Disclosure Management*
   Our enterprise disclosure management solution connects directly with your company's data sources – whether Microsoft Excel or ERP- and cascades data through the entire report production process. DisclosureNet ensures that a single version of your data is updated in real-time.

   Always with finance professionals top of mind, our cloud-based or in-house software enables simultaneous multi-user collaboration and employs the industry's most sophisticated validation technology, drastically reducing the risk for errors in your reports.

2. *Certent DisclosureNet Gives You Access to Accounting Rules and Regulations*
   DisclosureNet provides finance professionals with access to FASB, IASB-IFRS, SEC Rules, PCAOB standards, rules and regulations. By making these standards full-text searchable, it's easy to locate specific inquiries using Boolean search logic.

   Never miss an update again. DisclosureNet enables you to set alerts on upcoming pronouncements and accounting standards updates, so you're aware of any changes immediately.

8 Henry, Chao, and Paul Foote. "Material Weaknesses in Internal Controls a Decade after Sarbanes-Oxley." Accounting Today. Web CPA News, 23 July 2012. Web. 17 Apr. 2013. http://www.accountingtoday.com/news/material-weaknesses-internal-controls-sarbanes-oxley-63369-1.html.
9 Henry, Chao, and Paul Foote. "Material Weaknesses in Internal Controls a Decade after Sarbanes-Oxley." Accounting Today. Web CPA News, 23 July 2012. Web. 17 Apr. 2013. http://www.accountingtoday.com/news/material-weaknesses-internal-controls-sarbanes-oxley-63369-1.html.

3. *Certent DisclosureNet Enables Real-Time Benchmarking and Precedent Research*
   With a database of over 20 million public filings from U.S., Canadian, and Australian regulatory bodies and UK financial statements, DisclosureNet receives real-time filings from direct connections with SEDAR, SEC EDGAR and the ASX.

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