



Hiding in the Shadows

Financial Misreporting and the Role of the Internal Auditor



Institute of Internal Auditors

17th Annual Conference

May 2019

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Financial Misreporting- What have we heard?

2

Financial Misreporting

- Definitions
- Why do organizations misreport?
- Common instances of financial misreporting

3

The Role of Internal Auditor in Financial Misreporting

4

Internal Audit Activities and skills in Detecting Financial Misreporting



COMPANIES

How Kenya Power cooked books ahead of 2017 poll pressure

FRIDAY, NOVEMBER 30, 2018 10:18

“Kraft Heinz to restate nearly three years of financial reports after investigation”

CORPORATE

Sacked Haco Tiger Brands MD under probe over profit scandal

WEDNESDAY, MAY 27, 2015 11:00

Scandals in accounting leave investors exposed

TUESDAY, FEBRUARY 13, 2018 21:30

[Home](#)[Business](#)[Local](#)

Reinsurers fined for price fixing

Nissan charged for hiding Sh4.5 billion former CEO's pay



by Mike Njoroge

— December 10, 2018 in Business News

COMPANIES

Audit reveals Nakumatt suffered Sh18bn fraud

FRIDAY, MARCH 16, 2018 10:10

“KushCo Holdings to Restate Prior Financials”

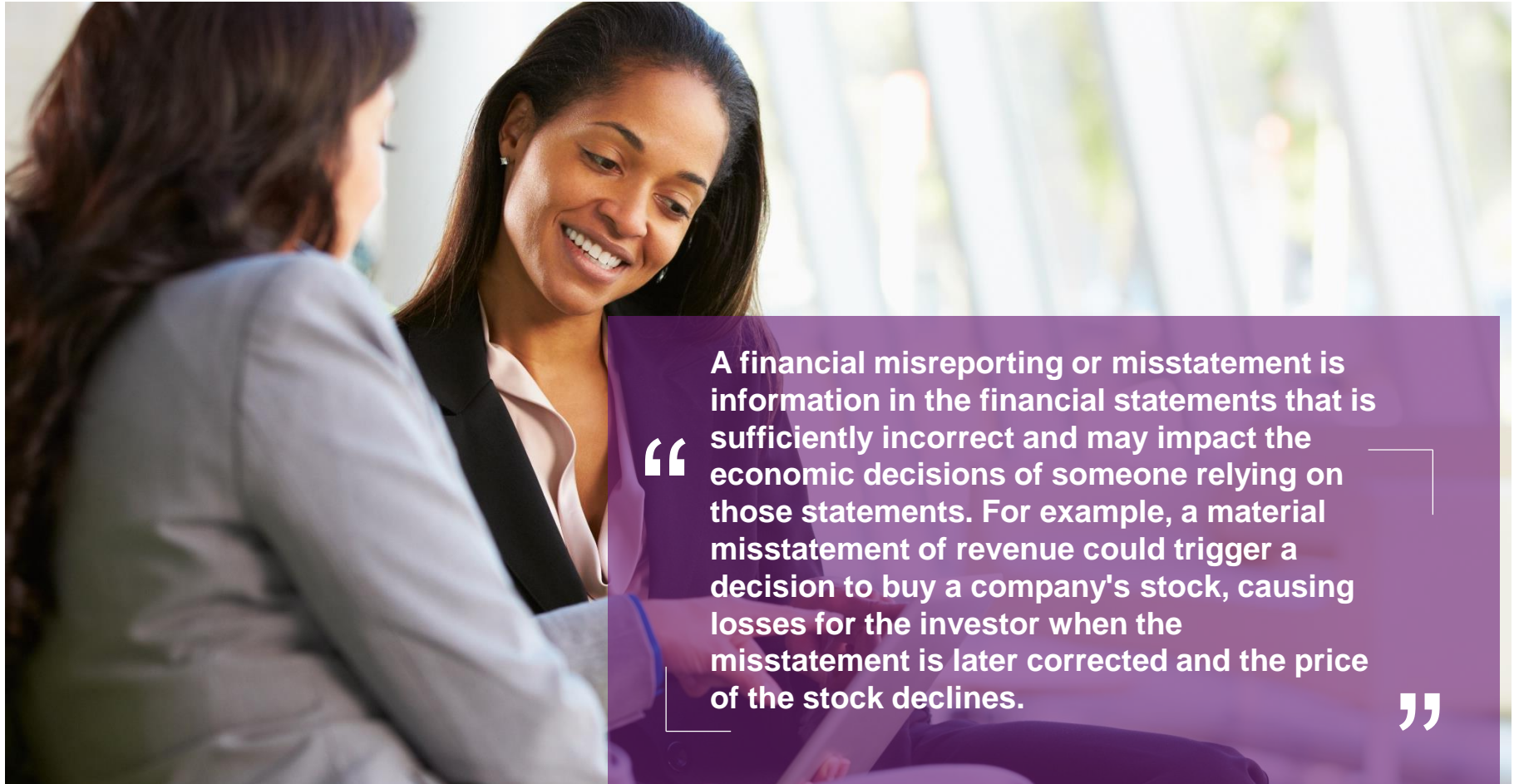


02

What is Financial Misreporting?



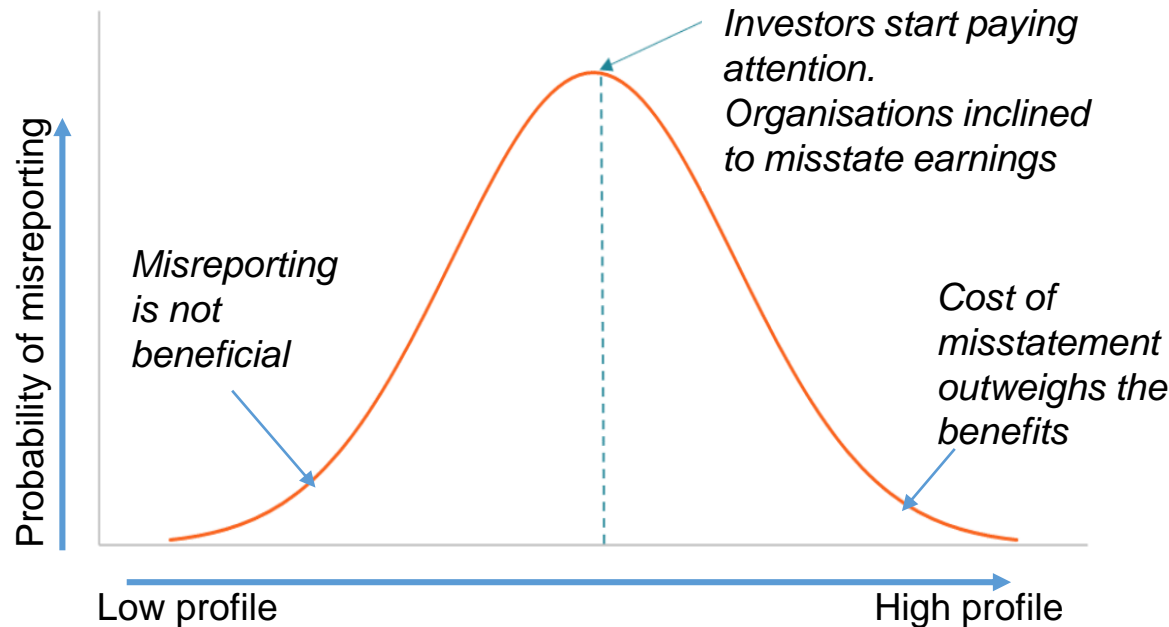
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A financial misreporting or misstatement is information in the financial statements that is sufficiently incorrect and may impact the economic decisions of someone relying on those statements. For example, a material misstatement of revenue could trigger a decision to buy a company's stock, causing losses for the investor when the misstatement is later corrected and the price of the stock declines.

”



**Growth in public scrutiny, media coverage and investor interest.*

A study carried out by three college professors (*Delphine Samuels, Daniel J. Taylor and Robert E. Verrecchia*) indicated that, when it comes to financial misreporting, organizations weigh the costs and benefits i.e. probability and consequences of getting caught in scandal against the potential for a higher stock price.

Using a combination of modelling and regression analyses, the study revealed that, as organizations grow and attract media attention misreporting first increases, reaches an inflection point, and then decreases.

**Personal incentives:**

Employees may be tempted to manipulate financial statements for personal gain.

**Market pressures:**

Due to changing market trends, companies may misreport financial statements to protect stock value and attract investors.

**Corporate unethical culture:**

Companies with fraudulent operations such as 'Ponzi-schemes' will misreport their financial reports to avoid detection.

**Errors of omission or commission:**

Some misreporting could be as a result of inadvertent errors leading to misstatements.

- 1 False asset valuations
- 2 Omitting expenses
- 3 Over (under) statement of revenue
- 4 Recording fictitious sales
- 5 Fraudulent valuation of inventory





03

The Role of an Internal Auditor in Financial Misreporting



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IIA

IIA Standard: 2120.A1 and 2130.A1 state that;

Internal Auditors have the responsibility of providing assurance on the reliability and integrity of financial and operational information.



IIA

ASSURANCE

Internal Auditors have the responsibility to provide assurance to the BAC on:

1. Financial controls;
2. Financial risks; and
3. Governance structures within the finance function.

CONSULTING

Internal Auditors can provide consulting services to the finance function. This could include:

1. Consulting on developing a new financial reporting system; and
2. Consulting on development of finance manuals and operating procedures.



Other Frameworks

SARBANES OXLEY ACT

The Sarbanes Oxley Act requires all financial reports to include an Internal Controls Report. This shows that a company's financial data are accurate and adequate controls are in place to safeguard financial data.

CAPITAL MARKETS
AUTHORITY

The Internal Control Standards has been developed by CMA to ensure maintenance of proper records and the reliability of financial and other information used within and published by the business.

CENTRAL BANK OF KENYA

There should be a process of internal controls, independent reviews and audits to ensure the adequacy, integrity, accuracy, reasonableness, effectiveness and reliability of financial information and ICAAP.

01



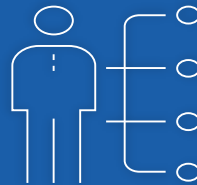
Entity level controls

Builds understanding of how the control environment supports accurate and complete financial reporting.

The focus is on the control environment which the organisation uses to promote integrity and assurance in financial statements.

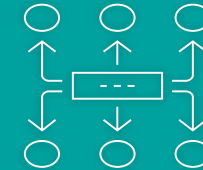
Provides insight into the quality of controls and how they are implemented throughout the cycle of a process. These could be manual or automated controls

02



Process level controls

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Root cause analysis

Analyses identified issues for their root cause and traces it back to an ineffective or lacking control.



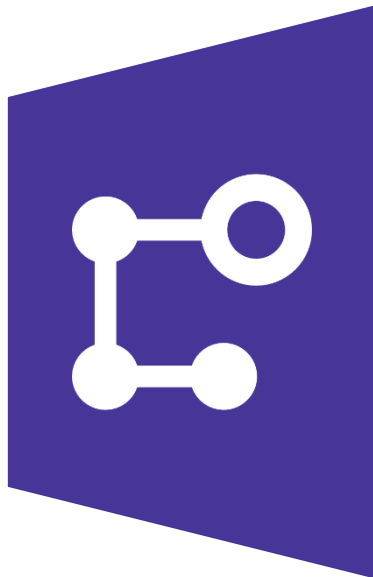
Making financial audits a routine

Internal audit should redefine their internal audit plans to include routine reviews of financial statements and controls over financial reporting.

Reliability and integrity of financial and operational information

The internal auditors shall be reviewing the reliability of financial statements. The process involves scrutinizing:

1. Whether the Financial reports are correct, dependable, apt and complete.
2. Whether there are any suitable operations to govern the record-keeping and reporting of the business.



Compliance with Laws, Regulations and Contracts with regard to financial reporting

Internal Auditors should review current systems and processes to make sure that the business is in compliance with applicable laws, regulations and contract terms and conditions.

Prevent and Detect

Some internal controls make it harder for anyone to commit fraud and or misreport financial information. Controlling access to your **accounting software and digital records** is one way to do this.

Other controls focus on catching errors, for example, **by comparing two independent sets of records for one set of transactions.**

Monitoring performance can also be a way to detect errors. If the cash flow for the quarter is way off from what you had budgeted, the reason could be unexpected expenses or income. It could also be that someone made a major error in entering the quarterly data.



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Internal Audit Activities and skills in Detecting Financial Misreporting



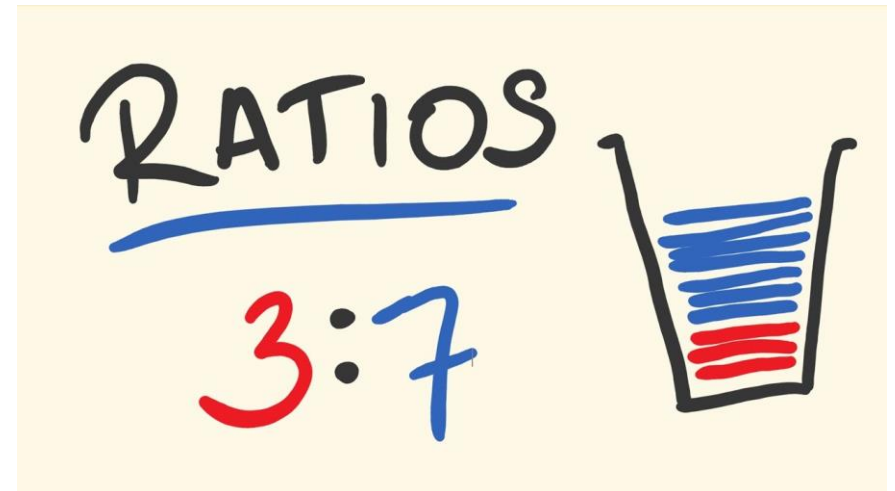
Understand accounting rules and basic principles



Internal auditors should be able to understand, interpret and apply accounting principles prior to performing any financial audits



**Calculate key ratios from a company's financial statements
(Data Analysis)**



**Review revenue process activities and associated rules
(agile auditing for constantly changing revenue streams)**



Test the integrity of the financial reporting tool / involvement when implementing a new accounting system

**How does the ERP used by the organization support financial reporting?
Internal Auditors must have IT skills**



**Review financial processes
and their accountability**





Q & A



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Thank
you

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