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Members in Business and Industry

September 2003

AICPA

American Institute of Certified Public Accountants

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Get Ready for the 2003 AICPA Fall Business and Industry Conference

As the role of financial executives in business comes under closer scrutiny, it's crucial to develop both the "hard" number skills and the "soft" people skills that are needed for the strategic role of the CPA.

The **2003 AICPA Fall Business and Industry Conference**, co-sponsored with the Canadian Institute of Chartered Accountants, is where you'll learn how to sharpen your strategic decision-making skills, streamline business processes and strengthen the leadership qualities you need to stay on top. It will take place Oct. 13–14 at the Disney Contemporary Resort in Lake Buena Vista, Fla.

Highlights include:

- Updates on Six Sigma, Sarbanes-Oxley, strategic thinking and the state of the profession.
- Sessions covering post-merger integration, process-based accounting, performance measurements and project management.
- Topics relating to critical personal and human resource skills: Upgrading your team; resolving conflict; how to sell your ideas; executive coaching.
- Intensive full- and half-day workshops devoted to both the hard and soft skills so critical to professional success.
- A two-part session on quantitative analysis and interpretation of the data—understanding what it means.
- The AICPA Industry Hall of Fame Award, sponsored by Ajilon Finance.

This conference prepares you for expanded responsibility in business and finance. If you're a CFO, a controller or aspire to become one, you'll want to attend this important conference. Register by Sept. 12 and save $50. For more information:

https://www.cpa2biz.com/CPE Conferences/default.htm

Using Audit Software to Help Ensure Meeting Sarbanes-Oxley Requirements

By Richard B. Lanza, CPA, PMP

Sarbanes-Oxley regulations are now a fact of life for any public company doing business in the United States. The time for solutions is upon us.

Will CEOs and CFOs be ready to sign off on the validity of their financial statements? Initially, baseline documentation will be drafted and used but, as time goes on, validation efforts will move quickly to monitoring control gaps. Such monitoring will require efficient audit software that preferably should be independent and, therefore, a stand-alone package rather than integrated with the company's enterprise resource planning (ERP) system. This article focuses on the need for including such tools in building an effective internal control system while maximizing return on investment. A recent study by IDC showed that business analytics returned an average payback of 112%, with the majority of organizations having a full investment payback in less than one year. Thus, a company can validate its internal controls under Sarbanes-Oxley and also gain a solid return through improved business intelligence using audit software.

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More Timely Reporting

Sarbanes-Oxley is the buzz within all public companies today, but even private companies are joining in. A recent survey noted that 58% of private companies are instituting changes to improve their accounting practices in response to the new act. Of particular note are the following sections:

Section 302. CEO and CFO certifications of quarterly and annual reports.

Section 409. Disclose to public on a "rapid and current basis" material changes to financial condition or results of operations. Although the Securities and Exchange Commission has not fully ruled on the definition of "rapid and current basis," it is expected that the timeframe will be in line with 8-K filings or five business days but may go to as low as two business days.

Section 404. Requires annual assessments of the effectiveness of internal controls over financial reporting, including an attestation from an external auditor.

One main effect of the Sarbanes-Oxley regulations is that CFOs will need to dig much deeper into how their companies control their financial reporting, as well as disclose material changes in their operations. For many companies, the documentation and validation of internal controls will be an entirely new experience and will take months, if not years, of consistent effort to be completed. This effort will identify a host of control gaps and high risk areas for more current monitoring. It will also make organizations more aware of changes as they arise as they will not have the luxury of monthly disclosure cycles to disclose material changes. There is even talk of finance chiefs hiring full-time controls or disclosure managers.

To successfully manage high-risk areas as they are identified, transactions could be independently and continuously monitored close to the point at which they occur. Data analysis technologies capable of continuous monitoring that run alongside ERP systems can add an additional control layer and improve the process of checking compliance with controls and exception reporting. This may sound futuristic and unattainable, but it does not have to be. By focusing the monitoring on the most risky areas, a company can start slowly while maximizing its ROI.

Auditors refer to this as continuous monitoring. The audit and control professions have discussed this concept, and although some organizations have successfully implemented continuous monitoring systems, until recently there has not been widespread adoption of this approach. The main technological barrier has been the practical issue of implementing a system that is non-intrusive on operational processes. Another barrier is that ERP systems are built to be transactional engines and not analytical and exception reporting tools. Therefore, the reports in ERP systems have not provided a stable foundation for such monitoring.

Transactional analysis technologies, such as ACL (www.acl.com) and IDEA (www.caseware.com), and even Microsoft Access (www.microsoft.com), are now being used to develop lightweight continuous monitoring applications, side-stepping the barriers posed by ERP systems. These tools can be up and running within a week with fantastic results. On the higher end, organizations are looking to data warehouses such as those provided by Cognos (www.cognos.com), SAS (www.sas.com) and Business Objects (www.businessobjects.com). Regardless of the solution, the technology underpinnings to enable an effective continuous monitoring strategy should include several key components:

- Independence from the system that processes the transaction.
- The ability to compare data and transactions across multiple platforms.
- The ability to process large volumes of data, and
- Prompt management notification of transactions that represent control exceptions.

With these four components in place, CFOs will find compliance with Sarbanes-Oxley legislation much more achievable.

Developing a Timely Reporting System

Given the magnitude of effort required, there is much focus these days on documenting and then independently validating internal controls around the financial reporting aspects of an organization. This initial step is being taken to create a baseline of internal control gaps, key risk areas and issues within the information channels of the company for use in future monitoring.

While initial documentation is being completed, the following questions should be asked of business process owners:

- What are your highest risk areas within the process?
- What process will be put in place to continue an appropriate level of evaluation of internal control, especially control gaps, on an ongoing basis?
- How is the quality and timeliness of information critical to decision making validated on a timely basis? Examples include market/customer, human resource, competitor, physical environment and financial indicators.
- How are you notified of control issues in your process?
- Do you believe you need more timely notification of process issues than you are currently receiving?
- How will these monitoring processes be made efficient (i.e., through automation)?

By answering these questions, business process owners will highlight opportunities for improved internal controls and key areas for bolstering their information channel. For instance, an organization may discover it has a high risk in its retail point-of-sale systems.

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Resource Consumption Accounting: Three Pillars of RCA

By B. Douglas Clinton, CPA, PhD, and
David E. Keys, CPA, CMA, PhD

This is Part Two of a three-part series. Part One ran in the Apr. 2003 issue and Part Three will run next month.

Resource consumption accounting (RCA) is based on three central concepts or "pillars" that provide important benefits. The three pillars are 1) specific perspectives regarding resources, 2) the use of a quantity-based approach, and 3) the nature of costs. There are several facets or dimensions to each of these three central concepts.

First, RCA is fundamentally resource focused, yet it is comprehensive in scope. Resource pools in RCA include *all* resources (including costs to serve resources). RCA recognizes that some resources exist to serve other resources. Thus, their cost should be assigned to those resources. This requirement of RCA results in *fully costed resources*.

Drivers are identified for *all* resource pool-to-consumer relationships (including both activities and other resource pools as consumers of those resources). This requirement strives to achieve a cause-and-effect relation to properly reflect operational costs in cost assignment.

The resource focus in RCA makes specific requirements for accounting for capacity. These requirements include:

- Defining and managing capacity where it resides—on the resource.
- Making excess/idle capacity visible through full disclosure but not arbitrarily allocating it to products or other cost objects.
- Consistent use of a capacity-supplied concept (e.g., theoretical or practical capacity) for denominator volume.

RCA also allows for a process- or activity-based focus by defining specific procedures for implementing activity-based costing. Procedures required are designed to provide consistent ABC implementation that applies sound cost management principles. Currently, there are many different versions of ABC and methods of implementation that can result in significantly different results from one application to another. While embracing the fact that resource consumption is fundamental to cost incurrence, RCA recognizes the benefits of ABC systems that are properly applied.

RCA accounting requires resource-to-activity cost assignment but uses simultaneous allocation mechanisms to do so. This technique accounts for nonreciprocal and reciprocal resource-to-resource and resource-to-activity interrelationships.

Second, RCA uses quantifiable output measures for resource pools. RCA decouples dollar or cost value relationships from the relationships defining resource consumption. RCA measures all resource outputs in quantifiable units rather than dollars. Only then are the cost assignments made to resource quantities.

This decoupling of the output quantification process from the dollar valuation process provides a consistent perspective regarding the understanding of resource consumption versus application of cost. As stated by Sedgley and Jackiw (2001, 11), "Dollars, therefore, do not feature in the relationship definition; they merely serve to value quantities once the relationship has been defined." Moreover, "A cost model that utilizes the quantity-based method to express the complete flow of the relationship…is referred to as a quantity structure" (2001,15) (Sedgley, D. J. and C. F. Jackiw. (2001) *The 123s of ABC in SAP.* John Wiley & Sons, Inc.: New York, NY).

The quantity-based approach of RCA provides an unambiguous distinction between the consumption of resources and the assignment of costs. Distinguishing these pieces can facilitate variance analysis by separating consumption quantity versus value. Continuous data tracking of *actual* consumption only requires accounting for quantities defined in the relationship. Capacity analysis is facilitated since resource costs are assigned only when used.

Third, RCA recognizes two important dimensions of the nature of costs. The first dimension is the initial/inherent nature of costs in that they are either fixed or proportional in their resource consumption patterns. Strategy and organizational choices determine whether costs are fixed or proportional when they are initially incurred.

The second dimension is that the potential nature of proportional costs may change at the point of resource consumption. Resources supplied in a proportional manner can be consumed in a pattern consistent with fixed cost treatment. Thus, the method of cost assignment should treat proportional costs as either proportional or fixed as consumption patterns dictate. In contrast, the inherent nature of a fixed cost does not change with consumption patterns.

Next month: Part Three, Capacity Management and Costing in RCA

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The Importance of Measurement Systems

By Susan B. Hughes, CPA, PhD

This is a report on the strategic planning session at a recent AICPA Business and Industry Conference.

According to Jeffrey Ellis, Associate Professor of Strategic Management at Babson College, the CEO perspective on business strategy is "a fully integrated viewpoint that finds the most valuable future at an acceptable risk." To determine the organization's current position and to develop estimates of the value of various future directions, measurements are critical. Most measurement systems have been designed and developed by accounting and finance personnel. As such, it is important for

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these professionals to be integrally involved in the strategic planning process.

Effective strategic planning occurs when the focus is on the entire business unit, not on the traditional functional silos of accounting, finance, marketing, production and human resources. The process should focus on finding those aspects of the value chain in which the company or unit performs services or produces products that are unique and valuable to its customers. Next, the unit must determine how to best leverage its position to maximize its future earning potential. Two exercises that the strategic planning team may find useful are the SWOT and "essence of profitability" models.

SWOT

Within a SWOT analysis, the company identifies its strengths, weaknesses, opportunities and threats. Strengths and weaknesses are internal to the organization. These include physical facilities, personnel, product lines, research and development activities, culture and distribution channels. Opportunities and threats are external, and include competitors, economic conditions, demographic trends, global implications and consumer preferences. After the strengths, weaknesses, opportunities and threats are identified, they should be used to develop strategic alternatives that are integrated and unique for an entire business.

Essence of Profitability

This is similar to a value chain analysis; however, it concentrates on only four pieces of the value chain. Planners work to identify what generates customer value, what aspects of the product and/or service are difficult to copy, what competencies are distinctive, and what it is that the company offers that is rare. The factors in each area should be evaluated to determine what contributes to profitability and what contributes to sustainability. Those items that contribute to profitability and sustainability should be leveraged to maximize future performance.

Professor Ellis recommends that individuals involved in the strategic planning process work to reduce both bureaucracy and the level of detail. The strategic planning objective should be to move fast and not get bogged down in details and rules. In addition, the planning process should result in strategies that can be accomplished with a series of small steps. Planners should have a view of the future, they should recognize the merits of what the company does today and build on these strengths to reach the future objective. To accomplish this, planners need to design a process in which they are able to incorporate a series of emerging initiatives to accomplish a plan. Planners also need to remember that most opportunities occur outside the enterprise. To capitalize on them, the organization must be ready to adapt.

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Through automated monitoring at a tactical level, business process owners can monitor daily or even hourly transaction flows through their sales registers. Monitoring reports would be considered a control activity, as well as a sign of a properly functioning information and communication channel. Reports may include reviews of a high number of void/refund transactions by employees, extracting large sales discounts or the instances when a refund is posted to a credit card different from that of the customer. For listings of reports for the various areas, and other free tools, go to www.auditsoftware.net/community, an independent site devoted to improving audits and business intelligence through the use of audit software.

Through more periodic or "continuous" exception analysis, finance functions can more confidently report on their internal control effectiveness at each applicable period end while improving their ROI.

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