



# FINANCIAL REPORTING FOR DIRECTORS

*(What directors should know from the periodic financial reports and ratios presented to them)*

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# Presentation Agenda



- Directors' Responsibilities
- Constitution of the Board
- Role of the Audit Committee
- Internal Audit
- Elements of Financial Statements
- Ratio Analysis
- Financial Reporting Red Flags
- Best Practices
- Q & A

# About Me



- FCPA Rose Mwaura
- Governance Consultant & Financial Advisor
- Rockville Consulting Limited
- Past Chairman, ICPAK
- Director & Chair of BAC, Jubilee Life Insurance Company
- Member of Council & Chair of ARCC, KCA University Council
- Chair, Legal & Regulatory Committee, KNCCI
- Vice Chair, KEPSA Public Finance Sector Board

# DIRECTORS' RESPONSIBILITIES

# Directors' Responsibilities



With respect to financial statements directors have the following responsibilities:

- Prepare financial statements for **each financial period** that **give a true and fair view** of the **financial position** of the entity;
- Ensure that the entity maintains **proper accounting records**; and
- Explain the transactions** of the entity with **reasonable accuracy**.

# Directors' Responsibilities



- ❑ Assess the entity's **ability to continue as a going concern**, and make a representation on the same to shareholders and public
- ❑ Format of Representation:  
“Directors are not aware of any material uncertainties related to events or conditions that may cast doubt upon the company’s ability to continue as a going concern.”

# Directors' Responsibilities



- Safeguard assets** of the entity;
- Take **reasonable steps to prevent and detect fraud** and other irregularities;
- Prepare and present financial statements **in accordance with International Financial Reporting Standards (IFRS)** and in the manner required by the Kenyan Companies Act & other relevant Act (Insurance Act, Banking Act, Cooperatives Act) and regulatory requirements (CMA, CBK, NSE & SASRA).

# Regulators View on Role of Directors in Financial Statements



- ❑ Various regulators, Securities and Exchange Commission (SEC), Financial Reporting Council (FRC), Capital Markets Authority (CMA), JSE and others, are responsible for **mandating the corporate governance rules and skills requirements of board members.**
- ❑ To apply these skills, board members need to ensure they are knowledgeable about the **economics of the company and its business model.**

# Regulators View on Role of Directors in Financial Statements



- ❑ Enron's financial reporting might have been different if the board, alerted by Enron's growth in revenues and their complex sources, had begun to ask the types of questions necessary to understand the company's business model. A reliance on the systems and its data may not be enough.
- ❑ The Board can better assess whether the entity's financial disclosures are **appropriate, transparent and complete**, if they understand the financial accounting data.

# THE BOARD, AUDIT COMMITTEE & INTERNAL AUDIT

# Constitution of the Board



To discharge its responsibilities, the Board requires:

- Board members with relevant skills on development and analysis of financial statements;
- Board members with an inquiring mind;
- A Board Audit committee;
- Competent and independent Internal Audit
- Competent Management

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# Role of the Audit Committee



- ❑ To oversee the entity's system of internal controls and compliance with laws and regulations;
- ❑ To provide oversight of the financial reporting process;
- ❑ To provide oversight of the Internal Audit function;
- ❑ To provide oversight of the auditors and external audit process.

# Internal Audit



Sample of the duties of the Internal Audit function as it relates to the financial statements include:

- ❑ Evaluate adequacy of systems of internal controls, risk management and accurate financial reporting;
- ❑ Verify existence of assets; proper safeguards of assets.
- ❑ Assess compliance with Policies and Procedures, Laws & Regulations.
- ❑ Investigate occurrences of fraud, theft and embezzlement;
- ❑ Assess likelihood of achieving budget & other strategic goals.

# Internal Audit



It's critical to ensure Independence of Internal Audit (IA):

- ❑ Competent & trained IA Department
- ❑ Head of IA reporting functionally to the Audit Committee.
- ❑ IA Charter, approved by Board detailing purpose, authority and responsibility.
- ❑ Approved risk-based IA plan, IA budget and resource plan.
- ❑ BAC approving hiring and firing of Head of IA.
- ❑ BAC working with Management and Head of IA to determine inappropriate scope or resource limitations.

# ELEMENTS OF FINANCIAL STATEMENTS & RATIO ANALYSIS

# Elements of Financial Statements



Key elements of financial reports include :

- Statement of financial position – summarizes the assets, liabilities and shareholders' equity at a specific point in time.
- Detailed information about the entity's assets, liabilities and shareholder equity at the end of the reporting period.
- The income statement – also known as profit and loss statement shows how much an entity earned and spent over a specific period of time.

# Elements of Financial Statements



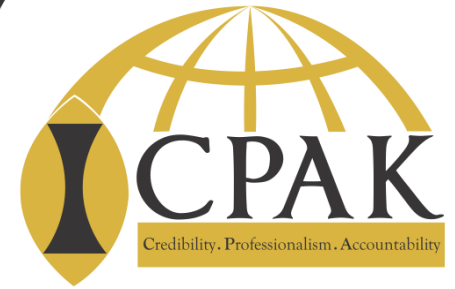
- ❑ Statement of cash flows of the entity – reports the entity’s inflows and outflows of cash;
  - ✓ Shows whether entity had net cash inflows or outflows based on the transactions over time.
  - ✓ Important - Profits do not correspond with cash.
  - ✓ The income statement indicates whether the entity made profit, a cash flow statement reveals whether it generated cash.

# Elements of Financial Statements



- ❑ Statement of changes in equity – provide details about all movements in the entity’s equity.
  - ✓ Identify the factors that caused a change in the owners’ equity over the accounting period.
- ❑ Explanatory Notes to the financial statements – detailed assumptions made by the accountant when preparing a entity’s income statement, statement of financial position and statement of changes in equity.

# Ratio Analysis



- ❑ Directors are often presented with ratio analysis on the financial statements.
- ❑ Ratios are used by directors, shareholders, investors, to analyze:
  - ✓ Accounting data to measure progress towards achieving the goals and objectives of the entity and benchmark performance.
  - ✓ Measure entity's success or failure.

# Ratio Analysis



Common ratios include:

- Growth ratios.
- Leverage ratios.
- Profitability ratios.
- Liquidity ratios.

# FINANCIAL REPORTING RED FLAGS

# Financial Reporting Red Flags



The skills and competencies of directors especially those in the audit committee will determine ability to identify red flags. These include:

- Sales Manipulation** - common ways of manipulating sales include recording sales before they have been earned or making up sales that do not exist.
- Sales can also be manipulated through recording deliveries to customers or storage owners as sales.

# Financial Reporting

## Red Flags



### ❑ Expense manipulation –

- ✓ Capitalizing expenses rather than expensing them.
- ✓ Recording current expenses in a future period to boost current earnings.
- ✓ Case of WorldCom – transactions in excess of US\$3 billion, accounted for as capital assets rather than operating expenses. Increased reported income and assets on the company's financial statements.
- ✓ Expense trends inconsistent with previous periods.

# Financial Reporting Red Flags



- ❑ **Unexplained increase in sales and sales through complex transactions –**
  - ✓ Used to manipulate revenue figures
  - ✓ Enron: between 1996 - 2000 sales increased more than 750% from \$13.3B in 1996 to \$100.8B in 2000.
  - ✓ Enron's financial statements were complex.
  - ✓ Misrepresented its earnings by modifying its statement of financial position to show favorable performance which eventually brought about its downfall due to fraud.

# Financial Reporting Red Flags



## ❑ **Incorrect asset valuation –**

- ✓ Inventory, accounts receivable and real assets may be overstated to inflate the entity's assets.
- ✓ Failing to record depreciation of assets, not writing off inventory that cannot be sold and not recording the full cost of raw materials.
- ✓ Steinhoff - Inflated its assets and profits by R250B in 2020 and recorded irregular transactions totaling to \$7.4 billion.

# Financial Reporting Red Flags



- ❑ **Improper disclosures** - misrepresenting the entity and making false representation in press releases.
- ❑ **Items marked “Other”** - (other expenses, other assets, other liabilities)
  - ✓ Require close scrutiny by directors if the percentage value is high in relation to the whole business.
  - ✓ Determine exactly what these items are, how often they occur and why management does not specify them clearly.

# Financial Reporting Red Flags



- ❑ **Hidden liabilities** - failing to record certain liabilities in the statement of financial position.
- ❑ **Management proposing to extend the period of depreciation of assets –**
  - ✓ reducing depreciation expenses can help boost profits.
  - ✓ Waste Management in 1998, applied fraud scheme by extending the duration of depreciation of its physical assets.

# Financial Reporting

## Red Flags



- ❑ **Overly high leverage ratios** indicate that the entity is taking up too much debt. This may be accompanied by falling sales or margins.
- ❑ The following data shows how leading retailers took up too much debt:
  - ✓ By 2020, Tuskys owed Ksh. 6.2 billion.
  - ✓ By 2018, Nakumatt owed Ksh. 30 billion.
  - ✓ By 2016, Uchumi owed Ksh. 123 million.

# Financial Reporting Red Flags



## ❑ **Monitoring and compliance issues –**

- ✓ Quality of corporate governance directly impacts monitoring and compliance issues.
- ✓ At Chase Bank quality of corporate governance and disclosures of Policies and Procedures was low.
- ✓ Board expertise, experience, composition, remuneration highly affected performance of the Board.
- ✓ Issues of understatement of insider loans and not meeting statutory ratios.
- ✓ Domineering CEO.

# Financial Reporting Red Flags



- ❑ **Weak internal controls and conflict of interest concerns**
  - ✓ Case of Uchumi Supermarkets.
  - ✓ Suppliers engaged without appropriate due diligence hence uncompetitive prices.
  - ✓ Continuous losses due to cash shortages, stock outages, loss of major customers.
  - ✓ CEO fired for alleged “gross misconduct and negligence”.
  - ✓ In 2015, Uchumi reported an after-tax loss of Kes 3.4B compared to 2014 reported profit of Kes. 364.3 M.

# Financial Reporting

## Red Flags



### ❑ Weak Internal controls and fraud risk assessments

- ✓ Case of Steinhoff
- ✓ Inadequate checks and balances to make sure management reported everything to the board.
- ✓ Inadequate segregation of duties giving too much power to management, hence opportunity to commit fraud.
- ✓ Use of intercompany loans to manipulate income and or reduce expenses.
- ✓ Controlling founder CEO.
- ✓ Insider trading – CEO fined R123M for information to inner circle.

# BEST PRACTICES

# Best Practices



- Board should be composed of about 50% of independent directors, for effective and objective governance.
- Some of the directors should have skills and competencies in finance, audit and risk.
- Formal independent process of selecting directors.
- Constitute a Board Audit Committee.
- Independence of Internal Audit.
- Take time to understand entity's operations and financial reporting.
- Question everything.

Q & A

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