

Critical Controller and Financial Skills

Today's presenter

Frank Ryan, MBA, CPA, CGMA

FRyan1951@gmail.com | (717) 891-2707 (cell) | @FrankRyanCPA

Frank Ryan is a Crisis Manager for troubled firms and a syndicated author on economic and political issues. He is a retired Marine Colonel who served in Iraq and Afghanistan. Frank is an expert on economic warfare. He has worked as the former interim CFO of a bank and has extensive board experience at public and not-for-profit organizations. He is also a former adjunct faculty member who taught accounting and economics.

Frank also served three terms in the Pennsylvania House of Representatives and retired from the legislature in November 2022. He was also the Vice Chair of the PSERS Retirement Fund and Chair of its Audit Committee.

Frank is the author of two books:

Life Lessons Learned – Amazing Stories of my walk across America for Children

Revolutionizing Accounting for Decision Making

Course Description

Our profession is at a crossroads.

Not since the CPA Vision project has the need for informed, vibrant critical thinking CPA professionals been more apparent.

The strategic, operational and tactical management of the finance function of an organization will be examined emphasizing those most crucial issues to the financial executive, our organizations and our ultimate customer – the public.

Our responsibility is to maintain the orderly functioning of commerce and we will explore those traits necessary for us to be a truly value-added member of a management team effectively guiding our organizations during challenging times.

Course Learning Objectives

At the completion of the course, the student will:

- Identify the importance of professional skepticism, the public interest, subordination of judgement, and critical thinking skills for the financial executive.
- Recognize the impact of uncertainty as it relates to risk management, decision making and our professional responsibilities.
- Identify and recall critical thinking errors as they relate to a changing economic environment to include tariffs, re-industrialization, federal deficits and debt levels.
- Recognize the importance of financial capacity, to include banking, vendors, suppliers, and employees in a rapidly changing environment.

1. Broad-based Business Knowledge, Professional Skepticism, Subordination of Judgment, and the CPA

CPA vision

- **Vision Statement: Where we're going**
- CPAs are the trusted professionals who enable people and organizations to shape their future. Combining insight with integrity, CPAs deliver value by:
 - *Communicating the total picture with clarity and objectivity,*
 - *Translating complex information into critical knowledge,*
 - *Anticipating and creating opportunities, and*
 - *Designing pathways that transform vision into reality*
- Source: www.aicpa-cima.org

CPA core values

- “Core Values”: What we stand for:

- ***CONTINUING EDUCATION AND LIFELONG LEARNING:*** CPAs highly value continuing education beyond certification and believe it is important to continuously acquire new skills and knowledge
- ***COMPETENCE:*** CPAs are able to perform high quality work in a capable, efficient, and appropriate manner
- ***INTEGRITY:*** CPAs conduct themselves with honesty and professional ethics
- ***ATTUNED TO BROAD BUSINESS ISSUES:*** CPAs are in tune with the overall realities of the business environment
- ***OBJECTIVITY:*** CPAs are able to deal with information free of distortions, personal bias, or conflicts of interest”

- Source: www.aicpa-cima.org - Core Values

What is Critical Thinking

(www.criticalthinking.org)

- Intellectually disciplined process
- Conceptualizing ideas
- “Applying, analyzing, synthesizing, and/or evaluating information gathered from, or generated by, observation, experience, reflection, reasoning, or communication” (source: www.criticalthinking.org)
- Inductive Reasoning: “Bottom-up”, specific examples used to derive general propositions
- Deductive Reasoning: “Top-down”, general propositions deduced to specific examples

Who is the Public?

- “A distinguishing mark of a profession is acceptance of its **responsibility to the public**. The accounting profession's public consists of clients, credit grantors, governments, employers, investors, the business and financial community, and others who rely on the **objectivity and integrity** of certified public accountants to **maintain the orderly functioning of commerce**. This reliance imposes a public interest responsibility on certified public accountants. The public interest is defined as the collective well-being of the community of people and institutions the profession serves.”
- 0.300.030 The Public Interest

AICPA Code of Professional Conduct

- “As professionals, certified public accountants perform an essential role in society. Consistent with that role, members of the American Institute of Certified Public Accountants have responsibilities to all those who use their professional services. Members also have a continuing responsibility to cooperate with each other to improve the art of accounting, maintain the public's confidence, and carry out the profession's special responsibilities for self-governance. The collective efforts of all members are required to maintain and enhance the traditions of the profession.”
- 0.300.020 Responsibilities

Attuned to broad-based business knowledge

- CPA's and financial executives are being relied upon increasingly for greater insight into risk, strategy, and operations of the business
- COVID-19 exposed serious flaws in our supply chain, risk response, and manufacturing vulnerabilities
- The suddenness of the failure of FTX, Silicon Valley Bank, Signature Bank and concerns about deposit insurance and reserves reinforced the CPAs responsibility to understand the entire economic spectrum and to maintain the orderly functioning of commerce.
- Enterprise Risk Management emerges as critical to the organization
www.coso.org

Professional skepticism

- “Independence of mind is the state of mind that permits a *member to perform an attest service* without being affected by influences that compromise professional judgment, thereby allowing an individual to act with integrity and exercise objectivity and professional skepticism”
- “Independence in appearance is the avoidance of circumstances that would cause a reasonable and informed third party who has knowledge of all relevant information, including the *safeguards* applied, to reasonably conclude that the integrity, objectivity, or professional skepticism of a *firm* or member of the *attest engagement team* is compromised”
- AICPA-CIMA Code of Professional Responsibility Section: 0.400.21

Subordination of judgment

- Expanded standard to CPAs in industry and government as well as CPAs in public practice
- Expanded standard to include work done as a volunteer
- Proposes changing the subordination of judgment standard from “disagreement or dispute” to “difference of opinion”
- The concept of “substantial use of accounting” is gaining ground in the United States

2. Risk, Uncertainty and internal controls

Continuous Turmoil Prompted ERM

- “The Committee of Sponsoring Organizations’ (COSO) mission is to provide thought leadership through the development of comprehensive frameworks and guidance on enterprise risk management, internal control and fraud deterrence designed to improve organizational performance and governance and to reduce the extent of fraud in organizations.” (source: coso.org)
- References:
 - Greenspan – “Age of Turbulence: Adventures in a New World” 2008
 - Greenspan – “The Map and the Territory – Risk, Human Nature, and the Future of Forecasting”
 - Bryce Hoffman – “American Icon – Alan Mulally and the Fight to Save Ford Motor Company”
 - Louis V. Gerstner, Jr - “Who Says Elephants Can’t Dance?”, 2002
 - Meredith Whitney – “Fate of the States – New Geography of American Prosperity”
 - Francis X. Ryan and Matthew Ryan (editor) – “Revolutionizing Accounting for Decision Making”

What is Enterprise Risk Management?

- Enterprise risk management is a **controlled**, deliberate **thought process** which includes the **entire organization** to include the board of directors, management, and other personnel.
- ERM is applied in **strategically, operationally, and tactically**
- ERM is intended to **identify potential events**
- ERM is intended to **manage risks** within a level of **risk tolerance**
- ERM provides **reasonable assurance** strategically.

Components of Enterprise Risk Management

- Internal Environment
- Objective Setting
- Event Identification
- Risk Assessment
- Risk Response
- Control Activities
- Information & Communication
- Monitoring

Source: coso.org

Audits of Systems of Internal Controls

- **SOC 1 - SOC for Service Organizations: ICFR**
- **Report on Controls at a Service Organization Relevant to User Entities' Internal Control over Financial Reporting (ICFR)** These reports, prepared in accordance with AT-C section 320, *Reporting on an Examination of Controls at a Service Organization Relevant to User Entities' Internal Control Over Financial Reporting*, are specifically intended to meet the needs of entities that use service organizations (user entities) and the CPAs that audit the user entities' financial statements (user auditors), in evaluating the effect of the controls at the service organization on the user entities' financial statements.

Audits of Systems of Internal Controls

- There are two types of reports for these engagements:
 - Type 2 - report on the fairness of the presentation of management's description of the service organization's system and the suitability of the design and operating effectiveness of the controls to achieve the related control objectives included in the description throughout a specified period.
 - Type 1 – report on the fairness of the presentation of management's description of the service organization's system and the suitability of the design of the controls to achieve the related control objectives included in the description as of a specified date.
- Use of these reports is restricted to the management of the service organization, user entities, and user auditors.

Audits of Systems of Internal Controls

- **SOC 2® - SOC for Service Organizations: Trust Services Criteria**
- **Report on Controls at a Service Organization Relevant to Security, Availability, Processing Integrity, Confidentiality or Privacy** These reports are intended to meet the needs of a broad range of users that need detailed information and assurance about the controls at a service organization relevant to security, availability, and processing integrity of the systems the service organization uses to process users' data and the confidentiality and privacy of the information processed by these systems.

Audits of Systems of Internal Controls

These reports can play an important role in:

- Oversight of the organization
- Vendor management programs
- Internal corporate governance and risk management processes
- Regulatory oversight

Background and scope of the Fiduciary Issue

- What is a Fiduciary?
- Prudent Expert
- Professional skepticism
- Subordination of judgment
- Fiduciary Duties
- Transparency – risks and rewards

Key Fiduciary Concepts – Fiduciary

A person is a fiduciary with respect to a pension benefit plan to the extent (i) he exercises any discretionary authority or discretionary control respecting management of such plan or exercises any authority or control respecting management or disposition of its assets, (ii) he renders investment advice for a fee or other compensation, direct or indirect, with respect to any moneys or other property of such plan, or has any authority or responsibility to do so, or (iii) he has any discretionary authority or discretionary responsibility in the administration of such plan. All such persons shall be guided by the prudent expert and/or the prudent person standard of care.

Key Fiduciary Concepts – Duties

- Undivided loyalty;
- Always putting the client's interests first;
- Utmost good faith and fair dealing;
- Full and fair disclosure of all material facts, and;
- Full and fair disclosure of all actual or potential conflicts of interest;

Prudent Person and Prudent Expert

- Prudent Person – operates with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent person acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims;
- Prudent Expert - the Prudent Expert Standard encompasses the standard fiduciary obligations outlined above, but in addition requires their application in a manner that an expert in the field would use.

3. Errors and pitfalls in critical thinking

Enterprise Risk Management and the Accounting Profession

- Enterprise Risk without logical thought is haphazard at best
- The Accounting profession and Auditing standards reinforce enterprise risk as a basic concept

Objectivity

- “Objectivity is a state of mind, a quality that lends value to a member's services. It is a distinguishing feature of the profession. The principle of objectivity imposes the obligation to **be impartial, intellectually honest, and free of conflicts of interest.**”
- 0.300.050 Objectivity and Independence (.02)

Critical Thinking Errors

- Appeals to Pity
- Argumentum ad Populum
- Argumentum ad Hominem
- Reductio ad Absurdum
- Mollification
- Argument from Authority
- The Gambler's Fallacy
- Sunk Cost Fallacy
- Appeals to Tradition
- Appeals to the New
- Confirmation Bias

*Above list partially adapted from Chapter 4 in "Business Law: The Ethical, Global, and E-Commerce Environment" 15th Edition, Miller/Barnes/Bowers/ Langvardt, 2012

Critical Thinking Errors

■ Appeals to Pity

- *Appeal to the compassion of society towards the “innocent”*
- *The elderly, children, veterans*
- *Politics and the media*
 - Veterans benefits
 - Military spending
 - Education
 - Social Security/Medicare
- *Have you ever been encouraged to do something unethical because the result would aid the “innocent”?*

Critical Thinking Errors

■ Argumentum ad Populum

- *“Argument to the people”*
- *Is the majority always right?*
 - *“Bandwagon Fallacy”*
- *Ethical decisions may not be the popular decision.*
 - Revenue Recognition issues
 - Many energy firms in the late 1990s (including Enron) booked revenue as a merchant instead of an agent
 - *Grossly inflated revenue figures*
 - *BUT: energy firms did it to remain competitive*

Critical Thinking Errors

■ Argumentum ad Hominem

- *“Argument against the man”*
- *Attack the motives/qualifications of the individual, not the actual decision or point-of-view.*
- *Politics and the media*
- *Bethany McLean & Enron*
 - McLean was a journalist for Fortune magazine
 - In 2001, she questioned the valuation of Enron and how they even made money
 - Jeff Skilling publicly attacked her as “unethical” because she had obviously “not done her research”
 - *NEVER ADDRESSED HER ACTUAL QUESTION*

Critical Thinking Errors

■ Reductio ad Absurdum

- *“Slippery Slope Fallacy”*
- *Politics and the media*
- *Marketing*

■ Mollification

- *Downplaying past bad conduct or decisions by blaming problems on external circumstances.*
 - *“They were not ordinary times”*
 - *Everyone else was doing it*
 - *Competitive forces required it?*

Critical Thinking Errors

■ Argument from Authority

- *Related to Argumentum ad Hominem*
- *Position vs. qualifications vs. experience*
 - Does Warren Buffett always make good investment decisions?
 - *Or does his name give him leverage in today's investment negotiations? (Bank of America investment)*
 - *What about "The Buffett Rule"?*
 - Meredith Whitney and financial projections.
- *Are people with experience or in positions of authority always ethical?*

Critical Thinking Errors

■ The Gambler's Fallacy

- *Independent events affect future outcomes.*
- *If something happens more frequently than normal now, it will happen less frequently in the future (balancing)*
- *Not getting caught in the past does not mean you won't get caught in the future.*
 - How long did Bernie Madoff escape questions about his investment firm?
 - Acting unethically (or illegally) as a firm without negative consequences may mean you're just lucky (not right)

Critical Thinking Errors

■ Sunk Cost Fallacy

- *Common in business and government projects.*
- *Doesn't have to be related to financial costs.*
- *If you made one unethical decision, do you make another to cover it up?*
 - If you made a mistake with a client, how do you react?
 - Ponzi schemes

Critical Thinking Errors

■ Appeals to Tradition

- *This is how we've always done things.*
- *Are traditions always ethical?*
- *Are the acceptable behaviors from 100 years ago still acceptable today?*

■ Appeals to the New

- *It's new, it must be better.*
- *But what are the second and third-order effects of this "new way"? Do we know the ramifications?*
 - Financial Leverage & Derivatives

Critical Thinking Errors

■ Confirmation Bias

- *The act of favoring information that confirms your own beliefs.*
- *Ignoring information that refutes your beliefs.*
- *Standards of Objectivity?*
- *Have you ever ignored red flags or signs of financial/accounting fraud because you didn't want to believe they were true?*
- *"We don't see things as they are; we see them as we want them to be." – Anais Nin (author)*

4. Financial Capacity, and strategic partners

Financial Capacity

- Financial Capacity is the representation by year of all available sources of funds.
- Financial capacity analysis includes a risk understanding of the likelihood of those funds being available.
- The sources of funds include:
 - *Free Cash Flow*
 - *Working capital net of short term lines of credit used*
 - *Financing opportunities for fixed assets*
 - *Equity*

External Funds Needed

- The External Funds Needed model is a mathematical representation of the Statement of Cash Flows
- Incredibly easy to use
- Model's simplicity is the basis of a planning tool for cash needs
- Basic Premises include:
 - *Growth consumes cash (use of funds)*
 - *Spontaneous assets and liabilities are directly correlated with growth in revenue*
 - *Net income is a source of cash*
 - *Dividends and capital spending consume cash*
 - *Debt service consumes cash*

External Funds Needed - Percent of Sales Method

$$EFN = \frac{SA}{S} \Delta S + \Delta FA - \frac{SL}{S} \Delta S - \Delta RE \pm MISC$$

- EFN = Amount of external funding to maintain its present condition
- SA = Increase proportionately as sales increase
- ΔS = Increase in sales that causes the need for external funding
- ΔFA = Required to meet increased demand
- SL = Increase proportionately as sales increase
- S = Existing sales level
- $\Delta RE = (S + \Delta S)(PM)(1 - PO)$ or $(S + \Delta S)(PM) - \$Div$
- MISC = Any other changes to the company's cash flow

External Funds Needed

- Negative EFN represents “more than enough” funds available internally and with current capital to continue operations
- BUT negative EFN can become substantially positive within a short time frame
 - *Prepare for the need for external financing when you CAN and not when you MUST – waiting until external funds are critical may lead to substantial increases in the cost of financing*

Strategic and operational risk analysis

- Developed to help companies properly and effectively evaluate the strategic and operational opportunities and risks
- Aids the CPA and financial executives in protecting the organization from unanticipated risks from a variety of sources:
 - *Industry and economic trends*
 - *Customers*
 - *Suppliers*
 - *Competitors*
 - *Employees*
 - *Financial Institution relationships*
 - *Government regulators*

Strategic and operational risk analysis

- Industry and economic trend risks
 - *Overall macro-economy*
 - *Industry group analysis*
 - *Pandemics*
 - *Loss of world currency status*
 - *Bankruptcy/insolvency of governmental units*
 - *Economic trends*
 - Federal Reserve policy and the effect on interest rates
 - Unemployment
 - Business spending and investment
 - Long-term AND short-term trends

Strategic and operational risk analysis

- Customer risks

- *Concentration of sales*

- Higher concentration drastically increases the risks to the company of a loss of a single customer
 - Loss of customer does not need to be customer service related; loss could come from a number of sources

- *Collectability of revenue*

- Related to concentration of sales
 - Increasing collectability issues could cause a firm to break debt covenants, increasing the cost of debt

Strategic and operational risk analysis

■ Suppliers and vendor risks

- *As with customers, a concentration of suppliers can pose significant risks to a company*
 - Are there going concern issues with any suppliers?
 - How is your overall relationship with the vendor?
- *How are your suppliers perceived by the public and government regulatory bodies?*
 - Legal issues against suppliers could affect your company
 - COVID-19 changed the perspective on supply chain vulnerabilities
 - Extreme events, while extreme, must be planned for regarding the impact on supply chain vulnerability and the impact on the survival of the organization

Strategic and operational risk analysis

- Competitor risks

- *Most “obvious” risk to your market share*
- *BUT what are your competitors really doing?*
 - Competitor sources of financing and cost of capital
 - Other industries and business sectors
 - Corporate leadership
 - Acquisition history and excessive goodwill
 - *Most mergers and acquisitions don’t bring value to an organization*

Strategic and operational risk analysis

■ Employee risks

- *The loss of a key employee could devastate a growing business*
- *Attracting the right talent*
- *Retaining the right talent*
- *Employee engagement*
- *Impact of performance appraisals*
- *How effective is the HR Function?*

Strategic and operational risk analysis

■ Financial institution risks

- *Banking relationships have been and will continue to be affected by Dodd-Frank and other financial regulatory reforms*
- *Effect of Tier 1 Capital ratios on lending*
- *Effect of leverage on the bank's own balance sheet*
- *Are you considered a higher risk in the eyes of the bank and regulators?*
- *Community banks and costs of regulatory compliance*
- *Lending in a post COVID-19 environment*
- *Beware of a liquidity trap due to pandemic*

Strategic and operational risk analysis

■ Regulatory risk

- *Effect of court decisions on expansive authority of the EPA*
- *U.S. DOT regulations and the impact on freight costs*
- *Utility commission regulations in each state/municipality*
- *Power of the states' Department of Health to create environment of life-sustaining versus non-essential business models and regulations*
- *OSHA oversight and regulations*
 - Employee thresholds

Critical success factor

- A critical success factor is anything the presence or absence of which could cause the success or failure of the firm
- Tied deeply into the strategy of the organization
- Reflects the vision, mission, and strategy of the company
- Crucial to enterprise risk management and forecasting

Risk assessment

- **Inherent** and **residual** risks must be considered
- The **probability** of an event is crucial
- The **impact** of either a favorable or unfavorable event must be evaluated
- The **correlation** coefficient needs to be analyzed and validated
- **Methodologies** and **techniques** for risk assessment should be continuously reviewed

Seminal Event

- A seminal event is one in which your actions at the time will have a significant effect on your life.
- How you respond will materially alter the rest of your life.
- Your actions can be viewed as a crossroads
- Your response will follow you your entire life.
- The public is depending upon us
- Our family is depending upon us
- Our profession is depending upon us.

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