

Finding Exciting Risks in Mundane Economic Data

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SHERLOCK HOLMES



Thinking Like Sherlock Holmes

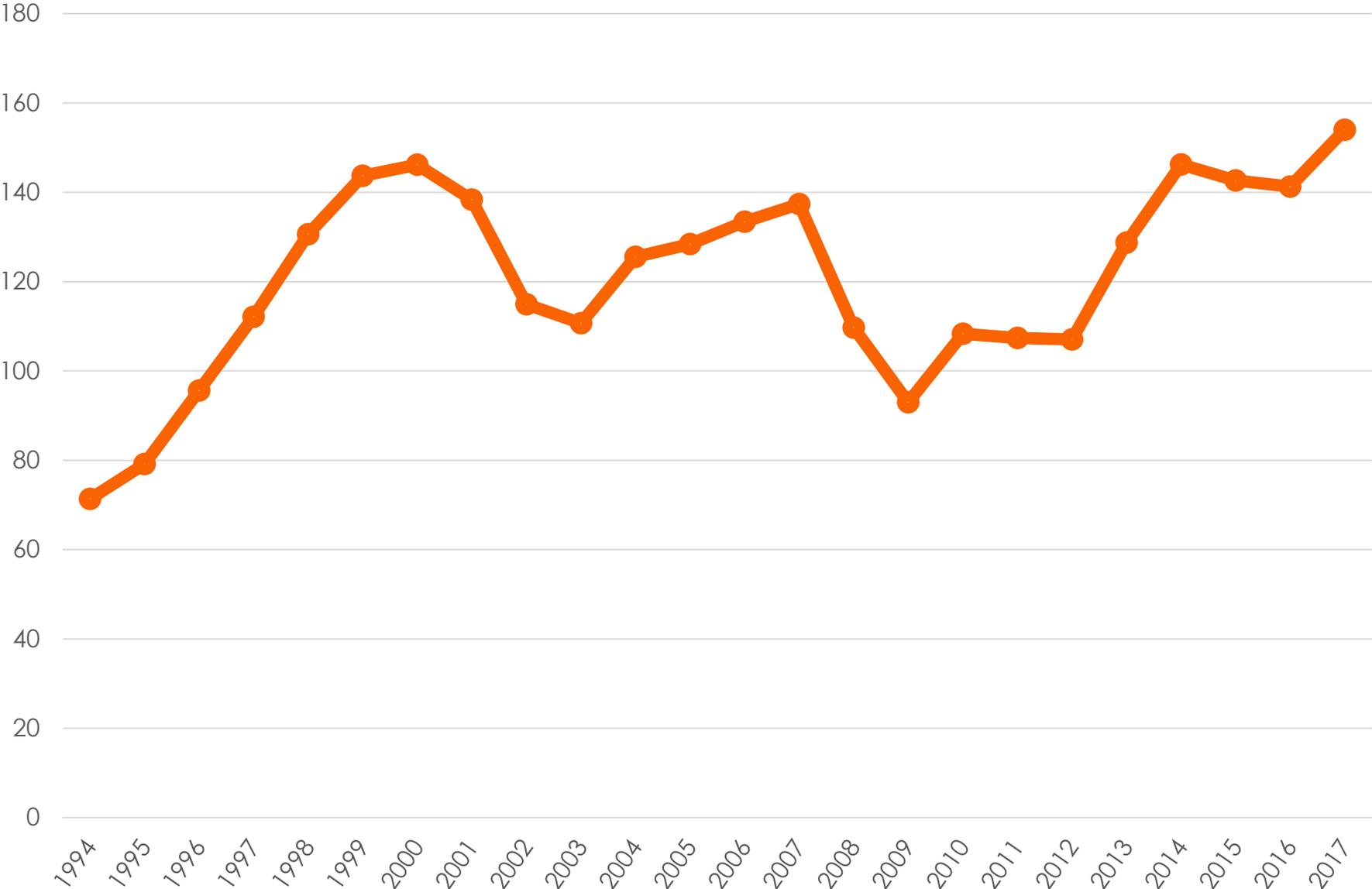
To understand the story behind each mystery, **you must be able to read the narrative correctly.** Fine-tune your detective skills by taking the time to **analyze each room that you walk into.** Sherlock was brilliant at that. He would see what was happening, observe items around, and construct a narrative that explained what had likely happened in the past. **See. Observe. Deduce.**

—North American Investigations blog post “7 Investigation Strategies from Sherlock Holmes,” 2013

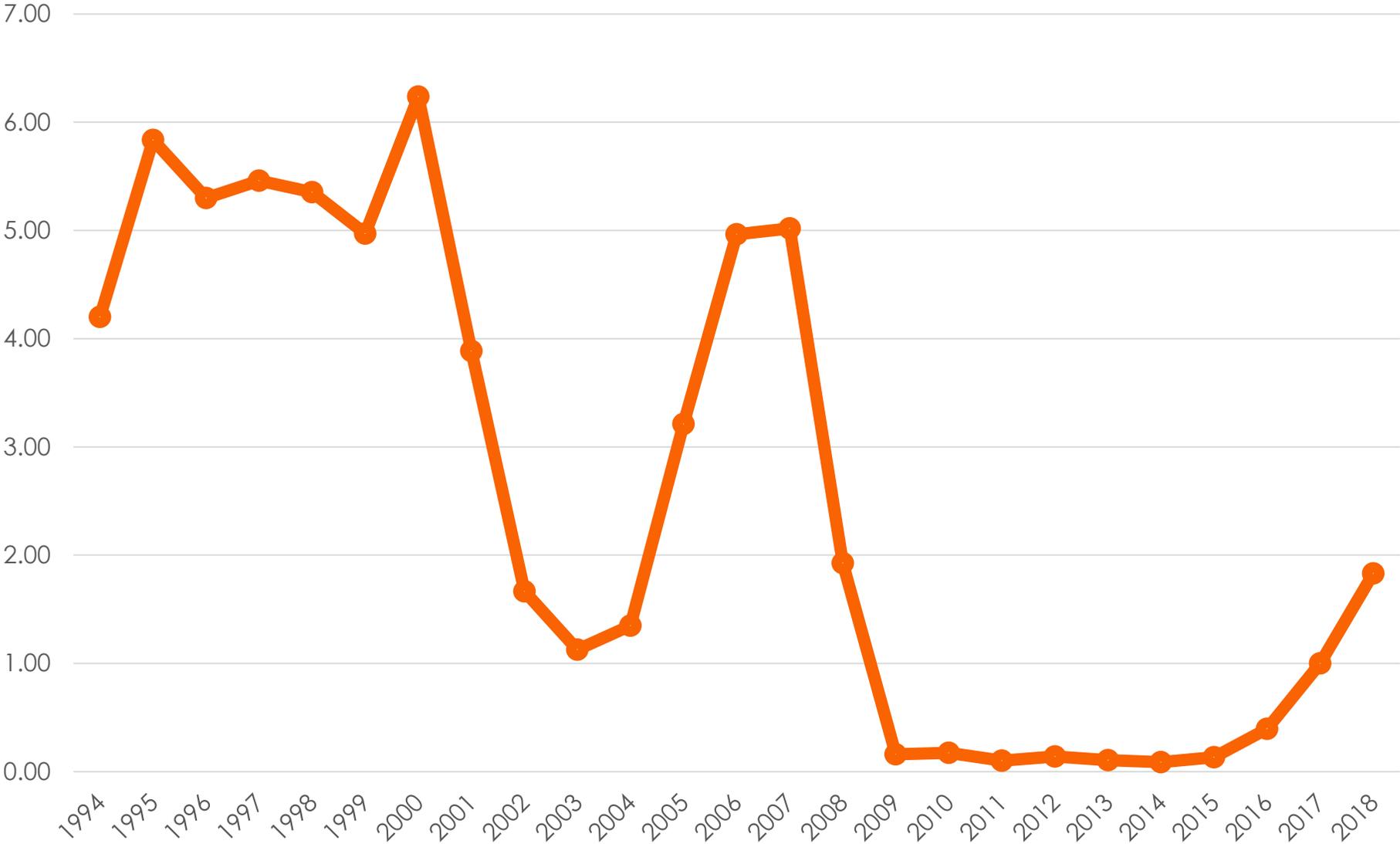
Reading the Economic Narrative



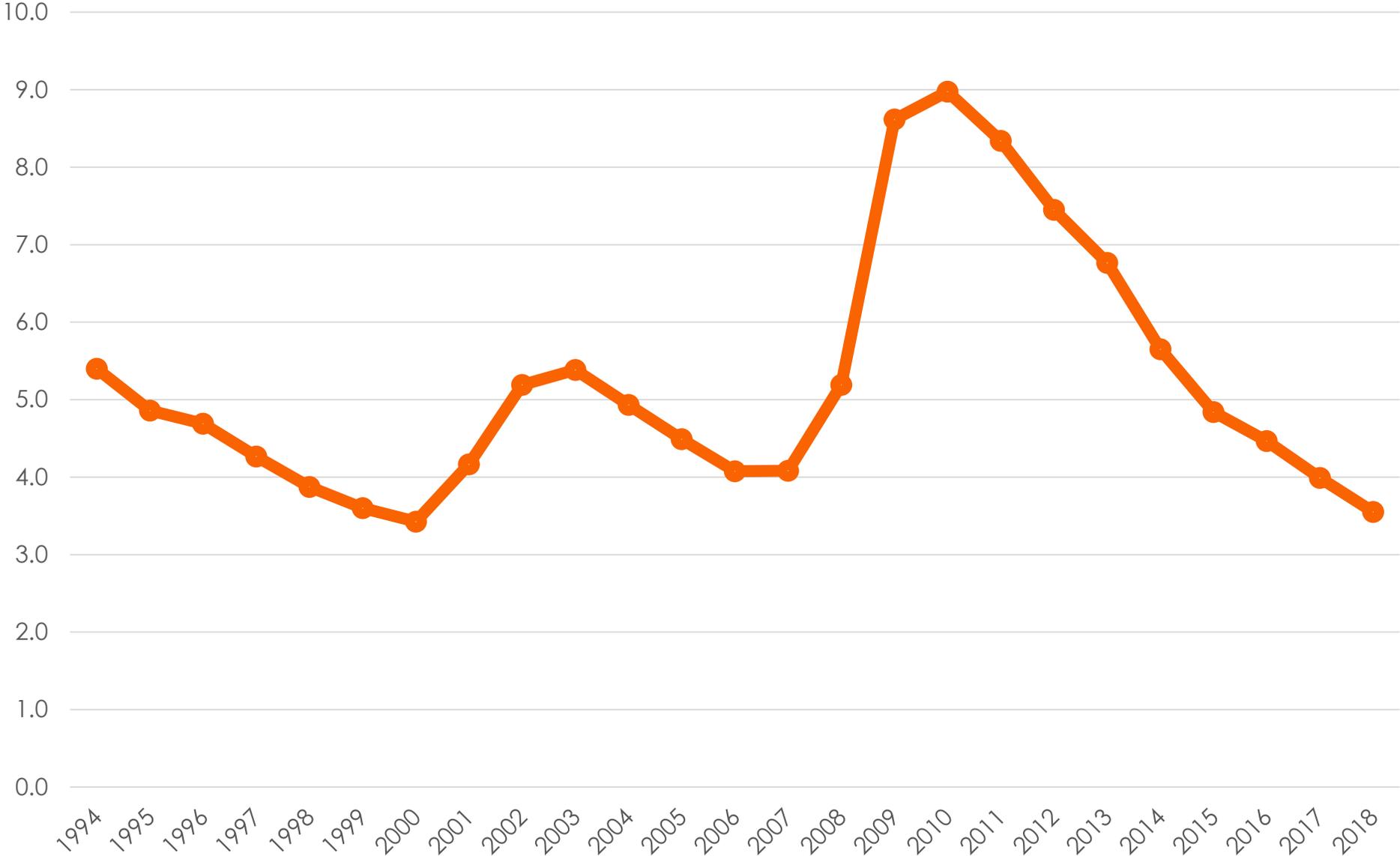
Stock Market Capitalization to GDP



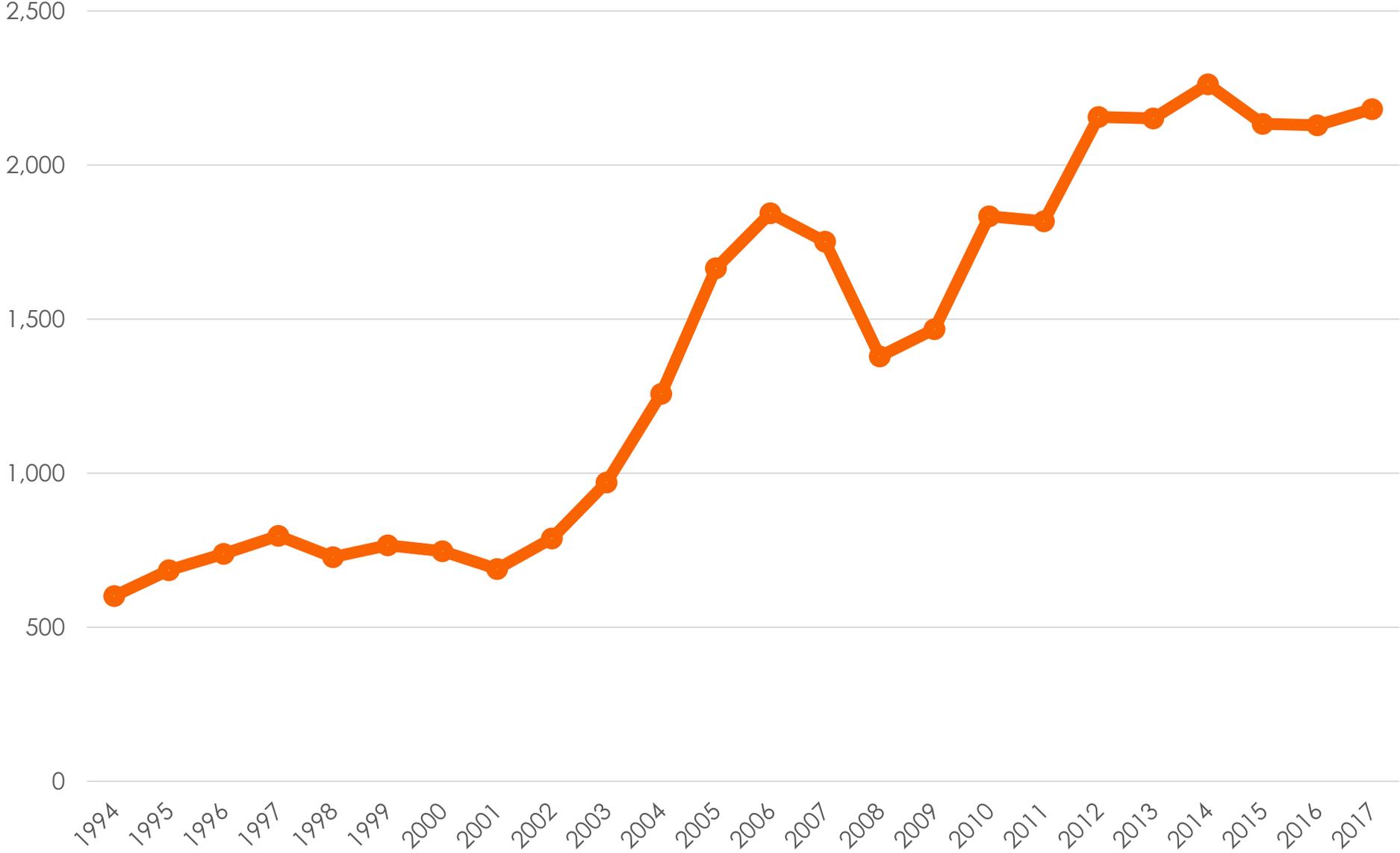
Fed Fund Rates



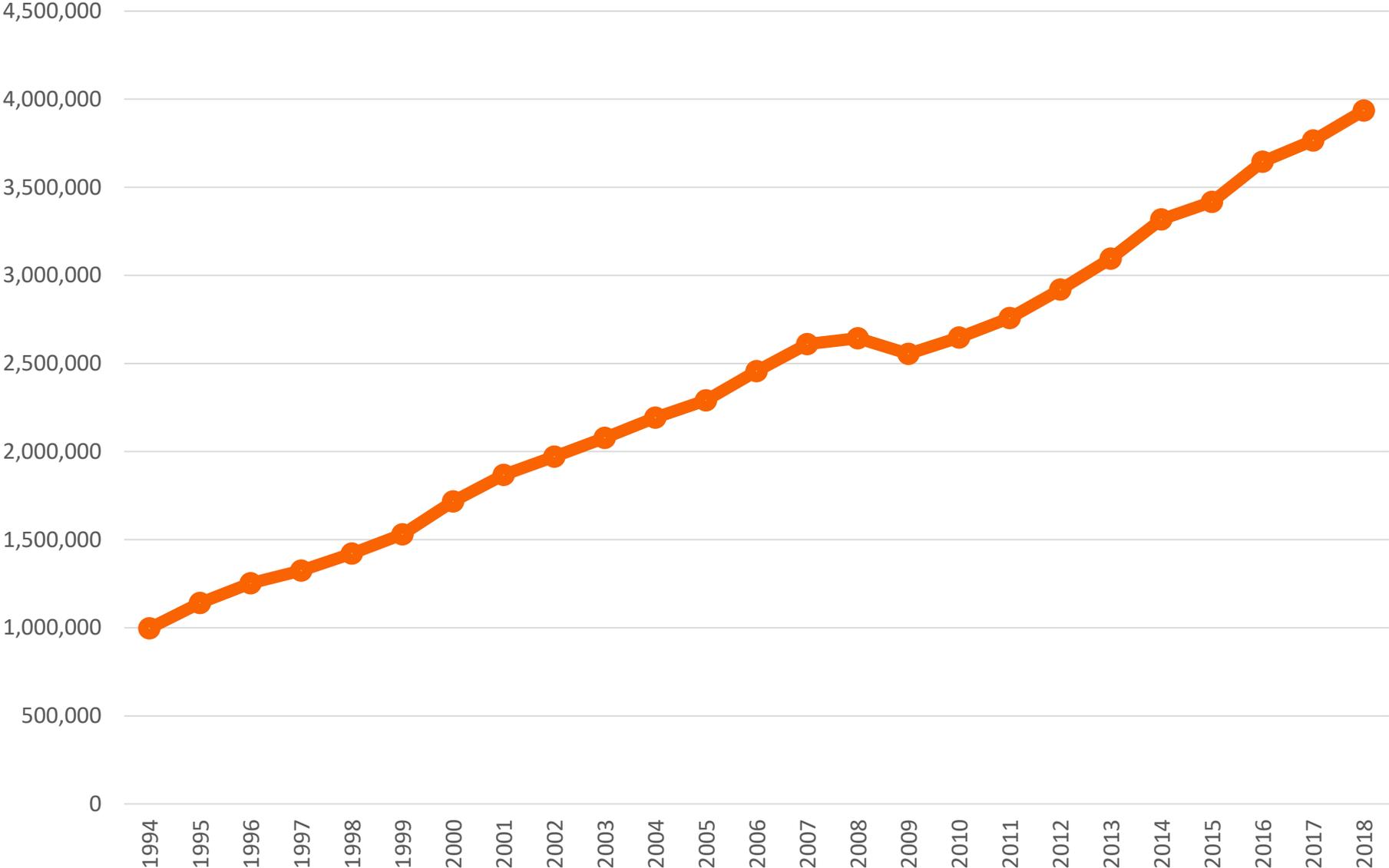
Unemployment Rate



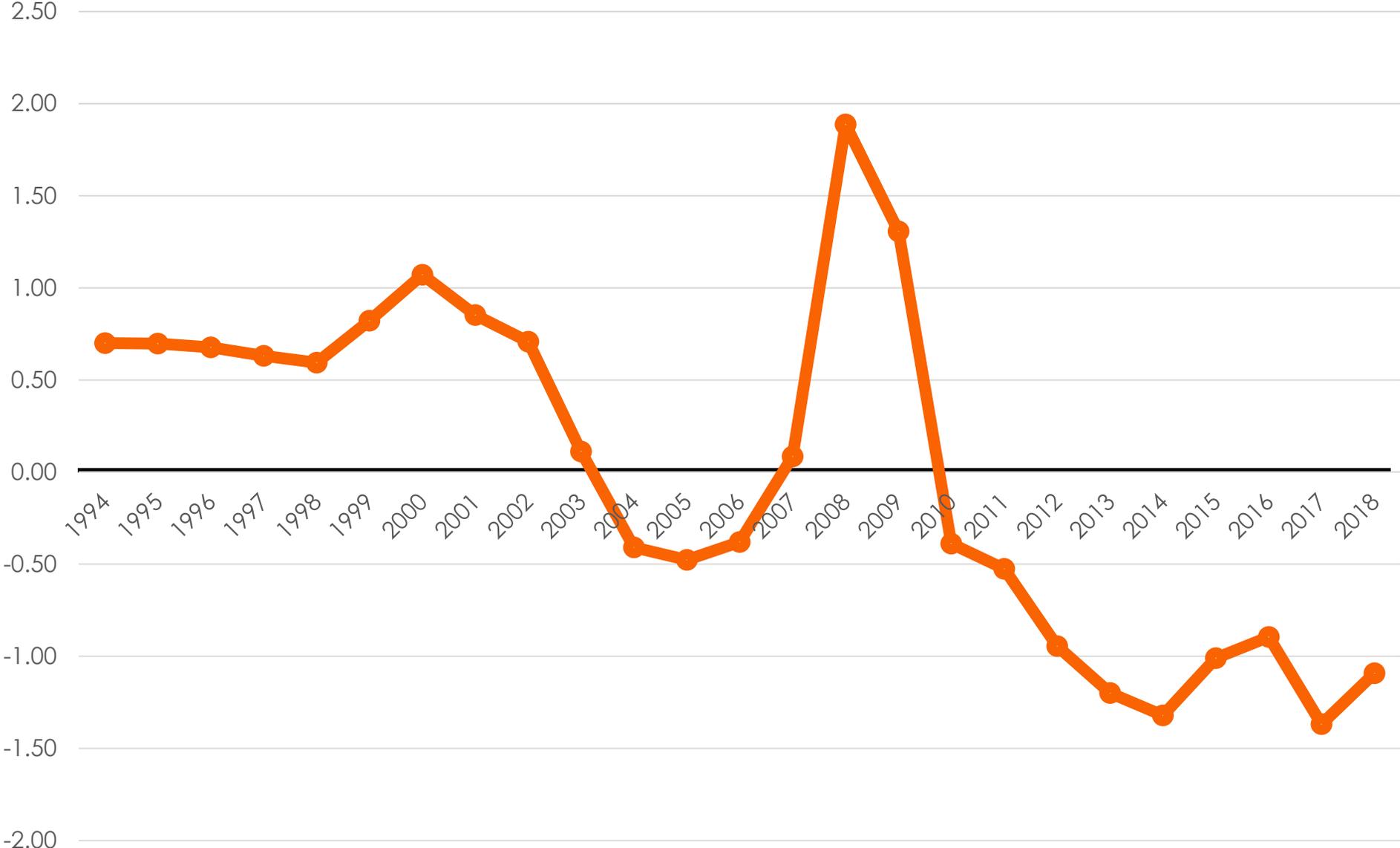
Corporate Profits



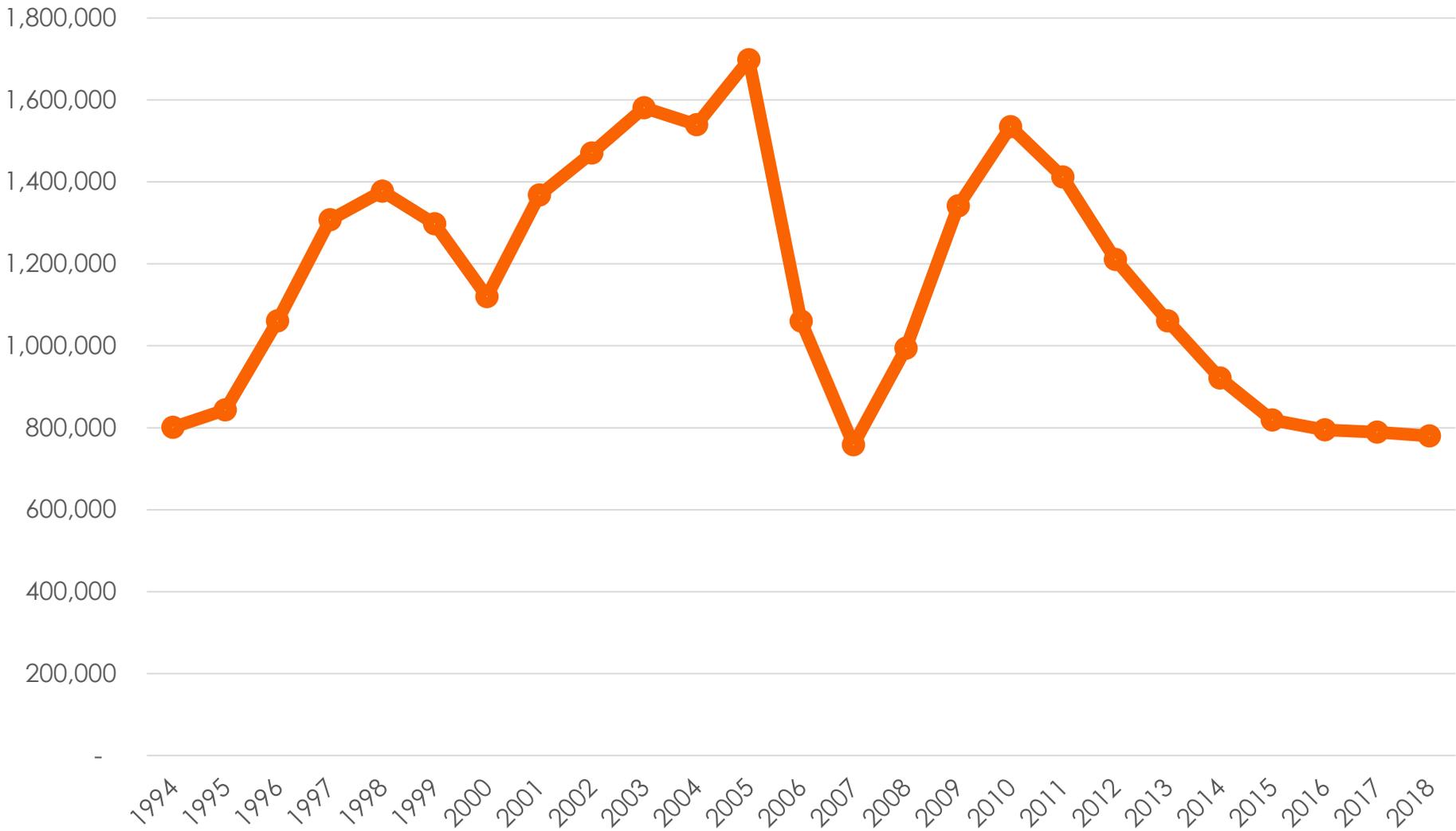
U.S. Personal Debt



Fed Financial Stress Index



Bankruptcies



HIGHS

Stock market value
is high

Corporate profits
are strong

Personal debt
at record highs

LOWS

Interest rates
at relative lows

Financial stress
close to 25-year low

Unemployment rate
at 10-year low

Bankruptcies
near 25-year low

Corrosive Complacency

While many things might cause the next recession, including geopolitical problems, struggling emerging markets due to the rising dollar, and growing non-financial corporate debt levels (to name a few), one that is more insidious is complacency. **Good times lead to overly optimistic forecasts and loosening of credit standards, which leads to risk mispricing.** And that leads to increasingly risky financial behavior, which sets the stage for the next recession.

— Elliot Eisenberg, the “Bowtie Economist”; October 11, 2018

Economic



Understanding
the Risks

Investment

Fraud

Economic Risk

The risk that funding will not be adequate to cover operating costs.

This risk also includes changes in outside economic factors such as economic strength and stability of significant and partner vendors, structure, and policies outside the organization's immediate control.

Consider employment indicators, disposable income factors, and consumer debt levels.



TAKATA

Investment Risk

The risk that the organization would make unfavorable investment decisions—

Decisions that are not aligned with approved investment strategies, or that the strategy inhibits the organization from selecting the most appropriate investments.

Includes investment selection and overall compliance with established strategy.

Consider market volatility, investment selection and management, diversification, and stock market cycles.



D A L L A S
POLICE & FIRE
PENSION SYSTEM



Fraud Risks

The risk of the occurrence of illegal acts characterized by deceit, concealment, or violation of trust.

Risks associated with dollar volume, non-conformance with ethical standards, and complexity of operations make detection more difficult.

The rapid change in technology **exacerbates** the risk of fraud.

theranos

Considering the Risks:

The Important
Questions to Ask
Right Now



The Important Questions to Ask Right Now about:

Economic Risk

- ▶ Are controls around granting of credit to and monitoring financial positions of customers sufficient considering high national debt levels?
- ▶ Have controls been established to monitor value of underlying receivables collateral for impact of market fluctuation?
- ▶ Are due diligence processes adequate to measure vendors' ability to fulfill contractual obligations considering potential economic corrections?

The Important Questions to Ask Right Now about:

Economic Risk

- ▶ Have controls been established to monitor vendor or supplier concentration risk?
- ▶ Has the organization established sufficient controls for identifying adverse financial and funding trends on a timely basis, and have action triggers been established?
- ▶ Do the organization's credit and financial monitoring processes adequately consider the possibility of inflated consumer confidence indicated by low rates of financial stress combined with high rates of debt?

The Important Questions to Ask Right Now about:

Investment Risk

- ▶ Have controls been established to assure that investments made by organization are consistent with strategic objectives, policy, and regulatory parameters?
- ▶ Are controls to assure adequate diversification of organization investments sufficient?
- ▶ Are controls to prevent the undue pursuit of yield sufficient given the prolonged low interest rate cycle?

The Important Questions
to Ask Right Now about:

Investment Risk

- ▶ Has the organization established controls to assure that investment decisions are made only by qualified individuals?
- ▶ Is the organization conducting “what if” modeling to consider the impact of higher interest rates or market corrections?
- ▶ Have controls been established to monitor impairment and valuation decline in a downturn?

The Important Questions to Ask Right Now about:

Fraud Risk

- ▶ Given record stock market value and corporate profits, are controls over financial reporting sufficient to assure that competitive pressures do not exert influence over reporting decisions?
- ▶ Is the organization's technology environment sufficient for preventing or detecting fraud?
- ▶ Are changes in the technology landscape creating incentives to overstate or make false claims about product capabilities?

The Important Questions to Ask Right Now about:

Fraud Risk

- ▶ Are controls at risk of being relaxed due to strong profitability?
- ▶ Are controls around the establishment of new vendors and disbursing of funds sufficient to prevent employee fraud given record debt levels?
- ▶ Has the organization established sufficient controls around the expense reimbursement process to ensure payments are made only for valid business purposes?



Discussion

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