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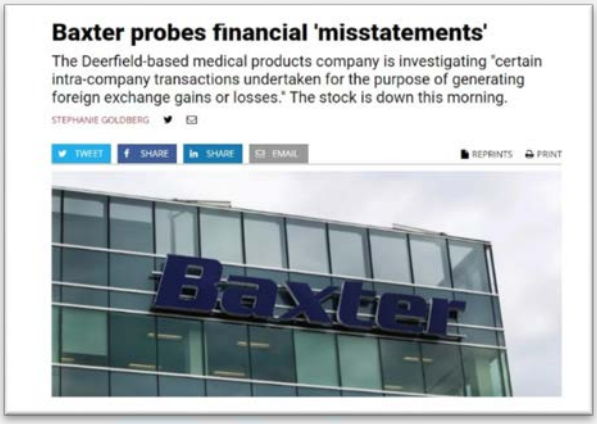
INTERNAL CONTROLS CONSULTING

The evolution of FinTech is information intelligence, which this service is based. Here we take a deep dive into issues facing organizations that are existential threats to executives and to the organization itself. Technology is evolving the risk landscape faster than most organizations can adapt. The result is losses and 'black swan' events which aren't black swans at all. "Currency Headwinds" is accountant-speak for 'didn't hedge FX' – this is the most bright example of where having simple internal controls on FX desks could have saved billions of dollars in losses, fines, and millions of man hours of headaches. It may be unpleasant to read this, but it's certainly better to read about a disaster and how to prevent it than have it happen to you. – Crediblock Team



Companies are always one simple mistake away from disaster. It's not about what you plan for, it's about what you forget. In the analytics business we call these risks known unknowns. That means, there are risks we know we do not know. In the financial business it's required to have a disaster recovery plan, why shouldn't every business? Similarly, at Crediblock.com LLC we believe all businesses should also have a financial disaster recovery plan – what happens if you don't hit your sales targets? What happens if the strong US Dollar becomes stronger? Almost every financial scenario can be hedged, insured, optimized, and thus planned for. We're not going to tell you how to run your business, we're going to model your risks and develop an appropriate strategy to mitigate risks, with a focus on market risks.

Every day there are new examples of what not to do, which is pretend that these risks don't exist, such as what happened recently with Baxter[1]:

Baxter probes financial 'misstatements'

> The Deerfield-based medical products company is investigating "certain intra-company transactions undertaken for the purpose of generating foreign exchange gains or losses." The stock is down this morning. Medical products company Baxter International is looking into what it calls "certain misstatements in the company's previously reported non-operating income related to net foreign exchange gains." "Baxter recently began an investigation into certain intra-company transactions undertaken for the purpose of generating foreign exchange gains or losses," the company said in a statement today. "These transactions used a foreign exchange rate convention historically applied by the company that was not in accordance with generally accepted accounting principles and enabled intra-company transactions to be undertaken after the related exchange rates were already known." Any adjustments to previously reported foreign exchange gains and losses may alter non-operating income results, Baxter said, adding that it cannot predict the duration or outcome of the investigation. **Shares of Deerfield-based Baxter fell about 10 percent today, closing at $79.08**. In an email to Crain's,

[1] https://www.chicagobusiness.com/health-care/baxter-probes-financial-misstatements

> Utterback wrote: "The stock appears to be reacting more to the accounting investigation and lack of financial results reported below the operating profit line than anything. . . .This sort of accounting investigation announcement is relatively unusual, and it adds some uncertainty to the firm's free cash flows and bottom-line results in recent years and going forward."

This problem is completely avoidable. According to CFO.com, about **half of companies hedge FX and commodity risks**[2]:

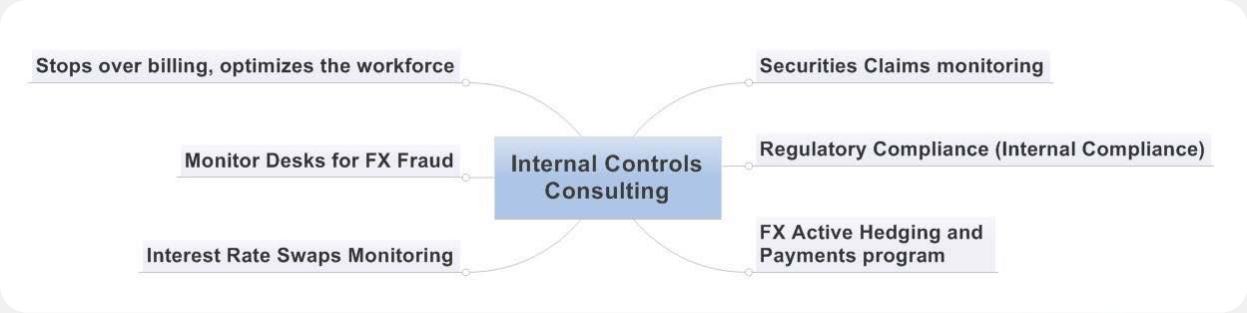
> *Forty-eight percent of nonfinancial companies listed on U.S. stock exchanges remained exposed to volatility in foreign exchange rates, commodity prices and interest rates in 2012 because they did not hedge them, according to* ***a new study by Chatham Financial****.*

Crediblock.com LLC offers corporate consulting services. First we will examine unusual risks such as balance sheet FX and commodity risk. We have experts in markets including Interest Rate Swaps, Securities, Commodities, FX, and derivatives. After analyzing money flows we will suggest and upon the agreement of management implement a hedging program. A key component of our internal controls services includes a cloud based platform that monitors employees for fraud, overbilling, underworking, and other optimizations key to maintaining proper internal controls. The fact is since the internal controls rule was passed, very few companies have implemented sufficient internal controls. Some examples of companies that have excellent FX hedging programs include Intel, Ford, McDonalds, Dow Chemical, and General Electric[3].

Also, having proper internal controls can stop internal fraud. Large banks have paid more than $6 Billion in fines arising from unethical behavior by their employees who were managing their FX desks[4].

CASE STUDY: AUDIT REVEALS DECADES OF GOVERNMENT WASTE, FRAUD AND ABUSE OF TAXPAYER MONEY[5]

[2] https://www.cfo.com/risk-management/2013/10/half-companies-hedging-currency-risks/
[3] https://www.gfmag.com/magazine/january-2017/currency-risk-managers-tame-volatile-markets
[4] https://www.reuters.com/article/us-banks-forex-settlement-idUSKBN0O50CQ20150520
[5] https://viconsortium.com/breaking-news/audit-reveals-decades-of-government-waste-fraud-and-abuse-of-taxpayer-money/



Some of those employees have been reprimanded, dismissed, and in some cases imprisoned; but the whole affair could have been avoided if their dealers were being properly monitored. The cost of implementing such a program is infinitely valuable, because a company can't afford NOT to do it. The potential costs of 'currency headwinds' are incalculable – it can be the end of a business. For example, in 2015 the Swiss National Bank (SNB) modified the fixed rate on EURCHF and the volatile moves in the Swiss Franc (CHF) caused retail FX brokers to close due to insurmountable losses[6]:

> ***Retail broker Alpari UK filed for insolvency on Friday****, while New York-listed FXCM Inc FXCM.N, one of the biggest platforms catering to online and retail currency traders, said it looked to be in breach of regulatory capital requirements after its clients suffered $225 million of losses. FXCM had to turn to Leucadia National Corp LUK.N, the parent of investment bank Jefferies, to quickly broker a $300 million loan that was expected to close Friday afternoon.*

This too, was avoidable with deep out of the money options on the CHF, OR a backstop such as a Currency Swap provided by the SNB themselves. Of course, FXCM couldn't get this because they are not a bank, and this has been the logic of the Swiss regulators that require all FX brokers to be banks[7]. In any event, through this risk management and analytics service, Crediblock can save you from situations such as "Currency Headwinds" and other unexpected risks by implementation of a risk management regime, which may include multiple I.T. systems such as cloud management tool, Enterprise Resource Management (ERP) including accounting monitoring, fraud detection, and FX risk management.

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[6] https://www.reuters.com/article/us-swiss-snb-brokers/swiss-franc-shock-shuts-some-fx-brokers-regulators-move-in-idUSKBN0KP1EH20150116

[7] https://ftalphaville.ft.com/2009/12/10/88266/swiss-regulator-dishes-out-first-forex-license/

Internal Controls Plan – why hire external experts

The reasons for hiring an independent outside firm are many (Objectivity, accountability, eliminating obvious conflicts of interest). Just as it is often required to hire independent accountants for an audit, it makes sense to hire an independent team to audit your internal controls. It's a process of optimization.

The paradox of hiring a consultant:

If your team had the same perspective you'd already be doing it.

If consultants were not needed, it wouldn't be a multi-billion dollar industry.

The first step is a free assessment. The process works like this: We will sign a confidentiality agreement (NDA) and you will provide access to your firm's internal operations (books & records, files, legal, etc.) We will examine the facts until we find $1 Million in potential liabilities. At that point, we'll use this example as a means to engage in an ongoing contract. We'll provide solutions for this and other items our team finds. Once our review is complete, our access credentials can be revoked and we will provide a report of our examination for your records.

Don't let 'group think' influence your decisions. It's you on the line for liabilities caused by a lack of internal controls. There's no cost to explore if this is right for you – put it to a board decision. No one will vote against safety and security or having an audit of your internal controls.

History of Internal Controls

Internal Controls have existed since the beginning of modern history – however they have become popularized in corporate culture in 2002 with the passing of Sarbanes-Oxley Act. Dodd-Frank also includes provisions for companies to require to have internal controls (but the monitoring of this compliance is non-existent). Of course, in this case, being compliant is not what's important – it's not having one of your business lines blow up. From Wikipedia:

> Internal control, as defined by accounting and auditing, is a process for assuring of an organization's objectives in operational effectiveness and efficiency, reliable financial reporting, and compliance with laws, regulations and policies. A broad concept, internal control involves everything that controls risks to an organization. It is a means by which an organization's resources are directed, monitored, and measured. It plays an important role in detecting and preventing fraud and protecting the organization's resources, both physical (e.g., machinery and property) and intangible (e.g., reputation or intellectual property such as trademarks). At the organizational level, internal control objectives relate to the reliability of financial reporting, timely feedback on the achievement of operational or strategic goals, and compliance with laws and regulations. At the specific transaction level, internal controls refers to the actions taken to achieve a specific objective (e.g., how to ensure the organization's payments to third parties are for valid services rendered.) Internal control procedures reduce process variation, leading to more predictable outcomes. Internal control is a key element of the Foreign Corrupt Practices Act (FCPA) of 1977 and the Sarbanes–Oxley Act of 2002, which required improvements in internal control in United States public corporations. Internal controls within business entities are also referred to as operational controls.

Notable examples of lack of internal controls include Enron, Madoff, Waste Management, Tyco, WorldCom, and Health South[8]. While these circumstances are labeled as frauds, proper internal controls could have

1. 1. 17 FRAUD

The term **fraud** means an intentional effort to deceive someone for profit; this is not limited to common-law deceit.

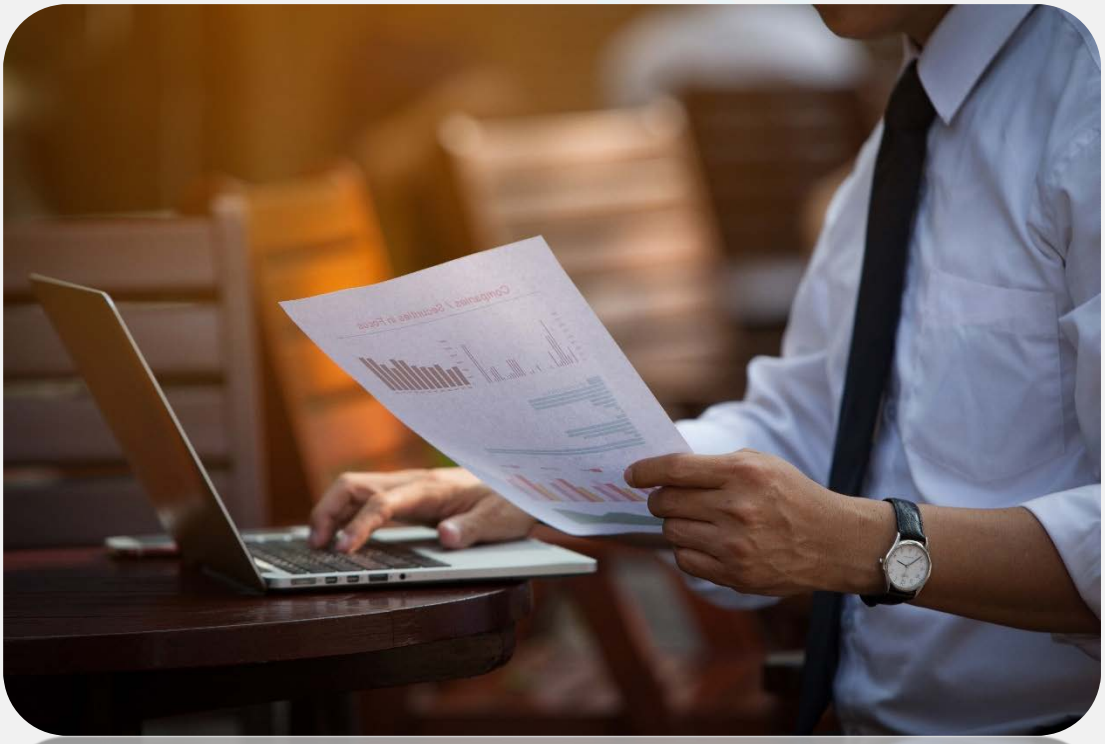
[8] https://www.fool.com/slideshow/5-biggest-corporate-frauds-us-history/

avoided the situation. Of course, it was the CEOs who willingly didn't implement internal controls which is why they are called fraud: Fraud is willful deception. If you are an accomplice in a fraud in which you can prove that you were a victim, and that you had no knowledge of the facts, you are not guilty of fraud.

In logic there is 4 types of information, which is important for any analyst to understand:

- KNOWN KNOWNS (Facts you know you know)
- KNOWN UNKNOWNS (Facts you know you don't know)
- UNKNOWN KNOWNS (Facts you don't know you know.. forgot)
- UNKNOWN UNKNOWNS (Facts you don't know that you don't know)

Any of them can be particularly dangerous. For example if you believe you are an expert in something, you may be overconfident. You may have biases that cloud your judgement in your actions or in managing those around you who will make critical decisions.



Types of risks

Internal Controls can vary depending on the organization, but generally can be categorized as follows:

1. Financing risks (debt/equity ratios, being overleveraged, paying too much for loans, etc.)
2. Balance sheet risk
3. Legal risk (including legislative risk, compliance risk)
4. Accounting risk (not presenting an accurate picture of the company financially)
5. Operational risks
6. Cybersecurity
7. X Factor (Representing unknown unknowns)

Avoiding worst case scenarios: Your insurance policy

Look at internal controls as operational insurance. Insurance companies provide common hazard insurance, errors and omissions insurance, and banks often provide fraud insurance (in case of hack or theft). Internal Controls is like a complex insurance policy but that comes with the solution: Not only can it protect you from the worst case scenarios that can be existential threats, but it can optimize your budget which leads to increased net profit and better numbers. Avoiding costly litigation is obviously preferable. Being hacked is no fun, and it can attract other hackers that learn of the new easy target. Financial firms have compliance rules and guides to follow, but every firm should. Whatever sector you're in, you should act as if – you're regulated. Internal controls is about good hygiene – keeping your organization fit and healthy. And this means each solution is custom – there isn't a one size fits all, or an automated process whereby managers can 'press' a button and solve a problem. This requires work and concentration.

"The supreme art of war is to subdue the enemy without fighting." – Sun Tzu

The low hanging fruit

Many companies suffer from lack of simple accounting controls. The reason is bureaucracy – the CFO that set it all up retired and the new guy wasn't informed where the bodies are buried. It's impossible for computer intelligence to run an organization (at the moment) – so that leaves for creating an operational manual that outlines every step workers take – similar to a Military operations guide. But do organizations do this? Those leaving a company are not incentivized to spend the extra time (such as nights and weekends) to train the replacements and/or create additional training guides to be followed. A great example of a company that does this well is McDonalds (MCD) – if you buy a franchise you have everything explained down to the minute detail. How many companies do that for their own workforce? Some do, just as we mentioned in the FX example, 50% of companies don't hedge their FX exposure, and that means that 50% do.[9]

Having algorithms run on your company's books can spot red flags and room for optimization, just like banks use for fraud detection.

[9] https://seekingalpha.com/article/3961171-why-currency-headwinds-are-going-to-define-earnings-in-2016

Business Intelligence & Analytics

Part of any internal controls consulting should include business intelligence & analytics specific to your company. What kind of market dynamics can change that can modify your risk profile? Are your sales connected to the economic cycles, or not? What are your competitors, and how will their strategy impact yours? Business is war, and war needs intelligence, analysis, and strategy. Having control over your internal controls means first developing a doctrine, from which you can build a solid strategy and then tactics. Many companies may have one in their head, but it needs to be on paper and read by all in the company. Having a motto isn't enough, it should include governance policies, philosophies, and operational issues which can serve as a guide and an auditing tool. Fortunately, today almost everything is electronic and what is electronic can be sorted into the most basic algorithm: Classification and Identification. Engineers and computer programmers do well as executives because in their fields you need to have such a structure or your system won't work.

Of course, creating a system of intelligence collection, analysis, archiving, and dissemination to your employees is healthy for any organization. That means there are positive side effects to implementing an internal controls policy.

Information Technology

High quality I.T. is critical for any organization, even if you aren't in a technical field. One of the most common misconceptions about I.T. is it involves computers. The most important commodity in I.T. is information, such as business intelligence. In the private company world, intelligence on your shareholders such as demographic data and background information can give you an indication of if you will be sued by y if you engage in z activity.

Information is power. Organizations shouldn't be held captive by their I.T. gurus who know this. Any internal controls analysis should include an in depth probe of an organization's I.T. systems including their network.

Do you mind if I probe your ports?

Crediblock.com LLC is a FinTech company that offers ***Information Services*** such as Internal Controls Consulting, Internet Marketing Consulting, Business Intelligence, software for the financial markets, and Market Data.