

BLACK HOLES IN ACCOUNTING

By: Ron Lutka, CMA

*Black holes
areas of undesirable activities
that go unchecked --
can destroy an entire organization*

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Black holes in organizations can be defined as: "An area of an organization where, unbeknownst to management, an abundance of undesirable activities occur or a lack of desirable activities occur in abundance, both of which destroy organizations."

The above definition contains three important characteristics:

1. Destruction must be occurring to the organization.
2. There must be an abundance of undesirable activity or a lack of desirable activity in abundance, not merely an occasional occurrence.
3. Management must have an absence of awareness of the root cause of the destruction.

Destruction must be occurring to the organization. Fading margins, cash shortfalls, lost sales, increasing costs are typical problems one can find in organizations.

A common area for black holes to form is in the reporting function. Since accounting is heavily skewed toward reporting, there are ample opportunities for black holes to form. For example, if the margins reported to management are prepared from inaccurate cost and sales data, then of what value are the reported margins?

There must be an abundance of undesirable activity or a lack of desirable activity in abundance, not merely an occasional occurrence. For the failure of basic activities to negatively impact the performance of an organization, the failures must occur in volume. Issuing an incorrect dealer commission cheque one month is not a black hole-creating item.

However, issuing incorrect dealer commission cheques to 22 dealers each month for seven consecutive months can be. Similarly, applying the wrong discount to a customer invoice doesn't create black holes; however, applying the wrong discount to 300 customer invoices can.

In addition, the broad range of black hole-creating items that are "in play" has an effect on the possibility of black holes forming. The likelihood of a black hole forming increases as more types of failures of basic activities occur. Management must have an absence of awareness of the root cause of the destruction. This is what makes black holes so vicious, and why companies often don't know the real reasons they are starting to list or have gone under.

Items that create black holes become more prevalent over time as they compound unrestrained. One black hole-creating item, such as not removing the splinters from the shelving unit prior to delivery, repeated over and over each workday, causes other black hole-creating items to form — such as damages caused to returned product during the unpacking and warehousing process or reduced cash inflow. The damage can manifest, unnoticed, to the point where the survival of the organization is threatened.

Flow and formation of black holes

Actions constitute activities. Activities constitute business processes. Business processes constitute quality products produced and delivered at an affordable price. Quality products produced and delivered at an affordable price constitute profits. Profits constitute survival.

The failure of basic activities in volume leads to the formation of black holes that threaten an organization's survival. These failures cause or aggravate problems higher up the hierarchy of activities. Management often sees the problems but not their root causes.

Within the area of basic activities, repetitive actions are high in number. Therefore, someone interested in eradicating black holes from the organization must delve into such areas to eliminate the root causes.

Since black holes in organizations form when basic activities fail, the investigation into the root causes of black holes must take place in the trenches, below business processes and at the level of actions and activities.

Locating and eradicating black holes

Black holes are pervasive and elusive, having developed immense survival power, and they must be cornered before they can be eradicated. Therefore, a systematic approach is required to locate items that create black holes. The systematic approach must be designed to unearth irrational thoughts and actions that are often an integral part of, if not the genus of, black holes.

Eradicating black holes is best accomplished on a gradient, resolving small black hole-creating items as they are discovered, rather than conducting a company-wide review to find all possible black hole-creating items and then setting out to eradicate them in one dramatic swoop. If black holes are not approached on a gradient, the process required to eradicate them can overwhelm anyone attempting to do so. This gradient or "peeling back the layers of an onion" approach is fruitful because it:

- Untangles a complicated and irrational web
- Views the problem in small increments
- Makes each step less complicated and less irrational

After eradicating a handful of black hole-creating items in one area, that corner of the organization could have shifted enough to render a large portion of any company-wide review irrelevant, or at least less relevant. Therefore, the review process should not get too far ahead of the repair process. In addition, after many small black hole-creating items have been located and eradicated, larger items can be tackled because the organization will be more transparent and better aligned, allowing for better decision making and better execution when undertaking larger repairs.

Below are examples of the types of black hole-permitting and black hole-creating items that can cause black holes to form in the accounting process.

Holes in the net Balance sheet accounts not reconciled

Errors and fraud have an opportunity to grow when balance sheet accounts are not reconciled to sub-ledgers, supporting documentation and to physical assets.

Though a poor practice, it is not rare for large and small companies to leave a bank account not reconciled for close to a year, despite the fact that such omissions raise auditor concerns. Failure to reconcile balance sheet accounts is not in itself destructive; however, it allows destructive actions to remain unnoticed and unresolved.

Transactions not reconciled

Opportunities exist to catch errors and fraud by reconciling non-balance sheet accounts in addition to reconciling balance sheet accounts. Reconciling sales to goods shipped, reconciling work orders issued to work orders completed and reconciling raw materials purchased to raw materials used are examples of reconciliations that can help catch destructive actions.

In one instance, reconciling work orders issued to work orders completed enabled a company to catch installers “cherry picking” easy installation jobs and neglecting to perform the difficult ones. In another instance, reconciling raw materials purchased to raw materials used helped a company spot a contractor who, in collusion with a company engineer, was intentionally over billing for raw materials.

Poor audit trails

The better the audit trail between the numbers reported and source documents and physical universe assets, the less likely it is that a black hole will form in the accounting function.

Non-standardization

Errors occur more easily in a non-standardized environment; however, non-standardization is not an error. When routine work is standardized, the workers do not need to determine how a function needs to be performed. Rather, they execute what has been previously determined and set as a standard, whether by themselves or by another party. Standardized workflow makes it easy for practitioners to know what to do and when to do it. Unusual or atypical items, as well as problems and mistakes, are easier to identify by those performing routine work. They can then handle the errors, preventing them from creating black holes.

Limited knowledge of systems

In an attempt to become more efficient, some organizations employ computer generated journal entries. These journal entries are generated each month based on reprogrammed logic such as booking \$100 to an expense called “damages during shipping” for each vehicle sold. These journal entries may become inaccurate over time because such journal entries usually have no owner overseeing their integrity. Unfortunately, this black hole-permitting item is common within organizations. Computers are wonderful workhorses. However, like all other aspects of organizations, they require management. Tax rates and tax eligibility change, duty rates and duty eligibility change, errors occur, procedures change.

If nobody understands the basis and calculations behind computer generated journal entries, and if the integrity of

such calculations is not tested regularly, black holes can form.

Creating black holes in accounting Transactions not captured

Customer returns not captured and entered into the management information system is an example of a black hole-creating item. Actual damage occurs because of this “lack of desirable activity” when a liability is not recorded on the company financial records and in the customer account. For instance, crediting the customer account for the return would reduce the near-cash asset “receivables” and reduce sales, which are important for management to be aware of for cash flow forecasting. Also, to not credit the customer would anger the customer and cause the customer to doubt the integrity of the company. Potentially, customer relations could weaken and the customer could be lost.

Erroneous journal entries remain uncorrected.

Erroneous journal entries left uncorrected can snowball into many misunderstood recordings on the general ledger. A problem of reversing the wrong amount out of an accrual account one period can compound when the balance remaining in the accrual account is reversed out in a subsequent period. The original incorrect reversal can lead to a subsequent incorrect reversal. Although the accrual account is now correct, the offsetting accounts likely remain incorrect. This in turn can lead to a chain of subsequent incorrect journal entries. When someone discovers that an account is incorrect, they must properly trace back the sequence of errors or they will likely create another erroneous journal entry. A black hole can begin to form in this way.

Assets and liabilities omitted from the balance sheet. A classic example of a black hole-creating item is the inaccuracy of, or absence of, recording assets and liabilities that arise because of contractual arrangements. For example, a distributor who earns a bonus when certain sales volume milestones are met acquires an asset that might erroneously be omitted from the company’s financial records until a cheque is received. Conversely, violating a clause in an agreement can cause an organization to incur a liability. This liability can easily be overlooked and not be recorded on the company’s books. Delayed or omitted recording of a negative tax assessment is another example of a liability that might be erroneously omitted from the balance sheet.

Recording of transactions not kept current

Fixed assets put into use during the period but not recorded accordingly render the accounting records inaccurate. As do deposits made at a bank but not entered into the general ledger during the same accounting period. Not keeping current with accruals for warranty provisions, write-offs if they become necessary, and with provisions for marketing allowances and concessions are additional time-sensitive ways accounting records can become inaccurate and lead to the creation of destructive black holes.

Mergers and acquisitions occurring faster than the organization can absorb

Organizations have a finite ability to absorb change. No matter how many resources are applied to preventing disconnections, misalignment, confusion and other potential black hole-creating items from developing, they will develop during a complex merger or acquisition.

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