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The Basics of Internal Controls & Segregation of Duties

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COURSE AGENDA

Internal Controls, we will discuss the following:

- The Basics
- The Components
- The Responsibilities
- Lack of Internal Controls



Segregation of Duties



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INTERNAL CONTROL




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Internal Controls Overview & GAO's Green Book



Standards for Internal Control in the Federal Government






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Internal Controls Overview

- The Committee of Sponsoring Organizations of the Treadway Commission (COSO) framework
[://www.coso.org](http://www.coso.org) [https SAS 55 / 70 / 78](https://www.gao.gov/greenbook/overview)
Now AU-C 315
- **Green Book**
U.S. Government Accountability Office (GAO)
<http://www.gao.gov/greenbook/overview>




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Definition

- AU-C 315.04 defines internal control as a process, effected by those charged with governance, management, and other personnel, designed to provide reasonable assurance of achieving the following objectives:



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Objectives

- Reliable financial reporting
- Effective and efficient operations
- Compliance with laws and regulations.
- Internal control over *the safeguarding of assets* against unauthorized acquisition



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Objectives (Cont.)

- Safe and *sound* operations.
- The *integrity* of records and financial statements.
- *Compliance* with laws and regulations.
- A *decreased* risk of unexpected *losses*
- A *decreased* risk of *damage* to the association's *reputation*.
- *Adherence* to internal policies and procedures.
- *Efficient* operations.



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Internal Control Structure SAS 55

- There is a direct *relationship between an entity's objectives and the internal control components* it implements to provide reasonable assurance about their achievement. In addition, internal control is *relevant to the entire entity*, or to any of its operating units or business functions. This relationship is depicted as follows:



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Current Guidance

AU-C 315. A 68

More than just control procedures

Control environment

Information & communication

Risk assessment

Monitoring

Control activities/procedures

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Components/Objectives/Entity

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Control Environment

The effectiveness of internal controls rests with the people of the organization who create, administer, and monitor them. Integrity and ethical values are essential elements of a sound foundation for all other components of internal control. The commitment for effective control environment rests at the top. Reaching a conclusion about a financial institution's internal control environment involves a degree of subjectivity because of the intangible nature of measuring effectiveness.

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Control Environment: Starts at the Top!

- “Tone at the Top” for ethical behavior
- Committed to internal controls
- Code of conduct
- Hiring qualified job applicants



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Risk Assessment

- *Management should identify* risks relevant to financial reporting including external and internal events
 - Operating environment changes
 - New personnel
 - New technology
 - Accounting pronouncements
 - New or revamped information systems



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Risk Assessment

- Answer: Ask more questions:
 - What can go wrong?
 - How can we avoid it?
- Particularly critical when things change:
 - Reorganization, new systems or computers, new transaction types, etc.



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Information and Communication Systems

- Internally *generated data*, along with external events, activities, and conditions are necessary for a business to make informed decisions.
- Information system should provide sufficient detail to *properly classify* the transaction for financial reporting, and measure the value of the transactions.



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Information & Communication

- Management's monitoring activities may include using information from communications from external parties such as customer complaints and regulator comments that may indicate problems or highlight areas in need of improvement.
- Entity should have those issues reviewed by someone other than the individual responsible for that accounting function.
- Entities should have procedures in place regarding how these items are followed up.



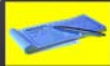
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Information & Communication Examples

- Customer calls regarding late fees assessed however customer has documentation they were not late.
- Customer calls regarding payments made by check not cashed timely.
- Call regarding customers not given a receipt.



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These all could be fraud indicators!!

Monitoring Controls

- Management and supervisory activities that determine whether management's objectives are achieved, including whether application or computer controls are working effectively.
- A process that assesses the quality of internal control performance over time AND timely *modification of policies and procedures*, as needed



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Control Activities/Procedures

- Control activities are the policies and procedures that help ensure management carries out its directives. Control activities should assure accountability in the entities operations, financial reporting, and compliance areas.



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Types of Control Activities/Procedures

Control procedures include:

- Automated (Application) – Built in computer controls
i.e. Edit checks, automated computations
(These controls are generally preventative in nature)
- Monitoring Controls - Typically performed by Management
i.e. Review month-end budget vs. actual reports occur after the transaction has been processed through the accounting system.
(These controls are generally detective in nature)



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Application Controls



- Application controls are activities directed at achieving control objectives for transaction cycles.
 - Can be done by anyone qualified and assigned to do them. Can be automated (edit checks, automated computations and updates of accumulated data, etc.)
 - Are generally preventive in nature.



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Internal Controls

- Even if you outsource or delegate some processing, you are not absolved from your duties to have controls over that activity
- The best way to accomplish this is to ensure your service organization has a type II SAS 70 audit (SOC 1)



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Typical Service Organization's

- Examples of typical SO's:
 - Payroll processing
 - Income tax processing
 - EMS billing services
 - Self-insurance claim processing
 - Investment purchases (transaction not pre-approved)
- Examples that are not SO's:
 - Bank checking account
 - Investment purchases (entity approves each trans.)
 - Purchased insurance policy
 - Purchase of utility services for your office building




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Typical Internal Control Categories

- Minutes
- Resolutions
- Bank Reconciliations/Statements
- Receipts/Pay-ins/Streams
- Disbursement/Vouchers/invoice/Streams
- Payroll
- Contracts
- Ohio Compliance/Uniform Guidance

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Typical Internal Control Categories (OCS)

- Direct Laws
- Indirect Laws & Statutorily Mandated Tests
- Stewardship
- Optional Procedures Manual




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REPORT OF INDEPENDENT ACCOUNTANTS

- Management's Financial Statements
- Audit Opinion
- Audit Report
- Auditing Standards in accordance with GAGAS & GAAS
- Basis of Accounting




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Responsibilities for Internal Controls

- Management must be committed to development and maintenance of controls.
- Management needs to clearly define expectations
- Segregation of duties has cost associated



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Who is Management?

- Smaller entities have elected officials such as Board of Trustees or Village Council but no layers of management.
- The elected officials would then function as management and have sole responsibility



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Management's Responsibility for Fraud

Management should assess risks and review fraud risk indicators to develop policies or controls to minimize the risk of a fraud occurring.



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Internal Controls

- Internal controls can help assure that balances and transactions are complete, existed, occurred, are accurately recorded, properly cutoff and properly classified



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Internal Controls

- Develop internal controls
 - To protect assets from loss
 - Ensure transactions are authorized
 - Ensure all funds are collected for services provided by the local government
 - Ensure restricted funds used according to allowable purposes



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Benefits of Internal Controls

- Safeguard and Protect public assets –
 - Public money
 - Public property
- Make responsible financial decisions via budgeting
- Properly manage government resources to achieve goals of government via internal controls



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Deficiency in Internal Control

- Results in errors which occur in normal course of operations and are not detected or corrected timely.
- Deficiency in *Design*
Existing control is either nonexistent or control in place does not address the specific control objective.
- Deficiency in *Operation*
Control not being performed by an individual being bypassed during daily operations.



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Internal Control Relevance

- Sufficient understanding of controls
 - Plan the audit
 - Determine nature, timing, and extent of tests to perform
- Control risk
 - Client's internal controls will not prevent or detect material misstatements timely



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Segregation of Duties



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Segregation of Duties Definition

GB 10.12
- 10.14

Process where management divides or segregates key duties and responsibilities among different people to reduce the risk of error, misuse, or fraud.

↓

So that no one individual controls all key aspects of a transaction or event, this includes separating the responsibilities for:

Authorizing Transactions	Processing & Recording Transactions	Reviewing the Transactions	Handling Any Assets Related to the Transactions
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Segregation of Duties in Standards/Guides

Green Book
(GB)

AU-C's
(US Auditing Standards)

Ohio Administrative Code (OAC)




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Various Standards

- AU-C 240
 - Inadequate segregation of duties or independent checks increases the susceptibility of misappropriation
- AU-C 265
 - Absent or inadequate S.o.D may be deficiencies, significant deficiencies, or material weaknesses
- AU-C 315
 - Should reduce the opportunities to allow any person to be in a position to both perpetrate and conceal errors or fraud
- OAC 117-2-04(D)(4)
- And on and on and on.....



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Assignment of Responsibility & Delegation of Authority

Mgmt. determines what level of authority each key role needs to fulfill a responsibility.

↓

Mgmt. delegates authority only to the extent required to achieve the entity's objectives.

↓

As part of delegating authority, management evaluates the delegation for proper segregation of duties.



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GB 3.08

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Segregation of Duties

**AU-C
240**

- Inadequate segregation of duties or independent checks increases the susceptibility of misappropriation

**AU-C
265**

- Absent or inadequate S.o.D may be deficiencies, significant deficiencies, or material weaknesses



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Segregation of Duties

AU-C 315

- Should reduce the opportunities to allow any person to be in a position to both perpetrate and conceal errors or fraud

OAC 117-2-04(D)(4)

- When designing the public office's system of internal control and the specific control activities, mgmt. should plan for adequate segregation of duties or compensating controls.



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In order to audit S.o.D we need:

An adequately updated understanding of the process

- How: AOS addresses this through narratives
- When: Beginning of the audit
- Why: Provides basis for further testing

Effective communication

- How: Face-to-face, electronic, policies
- When: Throughout engagement
- Why: Consistent approach



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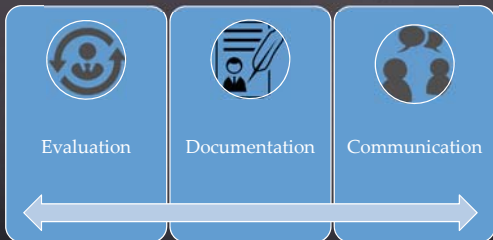
Benefits are not mutually exclusive



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How to make S.o.D a focal point



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Evaluation

Audit Strategy

- Discussion among audit Staff Members
- Discussion at pre-audits if needed
- Walk through of processes

Local Gov't

- Analyze internal control processes
 - Who is doing what
 - What are the possible risks



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Documentation

Auditors

- Discuss and complete narratives
- Segregation of Duties Matrix
- Utilize narratives to tailor audit procedures

Local Gov't

- Detailed policies and procedures
- Audit trail
- Evidence of implementation of controls



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Communication

Auditors

- Planning discussions
- Inquiries during the audit
- Audit report

Local Gov't

- Provide policies to all staff
- Update them regularly throughout the year
- Discuss known/identified issues with auditors



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When might there be an issue?

Any time an individual is serving in more than one of the key roles

- authorizing transactions,
- processing and recording them,
- reviewing the transactions,
- and handling any related assets

AND

- No compensating controls are in place



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Compensating Controls

Definition:

- A control that can limit the severity of a deficiency and prevent it from being a material weakness. Although they can mitigate the severity, they do not eliminate the deficiency.

Examples:

- Review of **detailed** reports
- Review/reperform reconciliation procedures
- Review/approve any adjustments (i.e. non-cash adj)

Caution:

- If compensating controls are monitoring controls
 - Evaluate they are adequate.



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Compensating Controls

If there are no SOD issues

- No compensating controls are necessary

SOD issues exist with effective compensating controls

- Evidence of the compensating control is needed

Identifiable issues w/o appropriate compensating controls

- A fraud risk exists
- An audit issue/ comment is likely needed
- If risk is significant, auditors may need to change the audit plan



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What are significant risks?

Risks may be determined as significant if:

- The accounting cycle is material
- Absent/inadequate safeguards
- Auditor judgment

If risks are significant, our audit reactions may include:

- No reliance on prior year control tests
- Additional management involvement in audit
- More sampling tests



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Does it mean there is fraud?

Difference between *fraud risk* and fraud.

- Evidence of a fraud risk area does not necessarily indicate fraud has occurred.
- We may modify the nature, timing and/or extent of our procedures in response to any heightened fraud risks identified.

Important to keep in mind that each case or scenario is different.

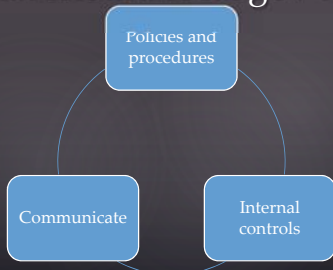
- Each potential fraud is unique, even within the same schemes.
- Many factors determine the handling and ultimate outcome of the issue.
- There is no black and white "rule book" or checklist.



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What should local gov't do?



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Establish Policies/procedures

Put it in writing:

- Could be formal Ordinances or resolutions, or
- Could be policy manuals or handbooks

Why?

- Formal way to ensure everyone is on the same page
- Written documentation can assist in identifying weaknesses or potential SOD issues
- Assists in the event of an emergency



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Establish Internal Controls

Internal Control System

- Controls should exist to prevent, detect, or deter misstatements or errors
 - i.e. – sign-offs/approvals, reconciliations/reviews, etc..

Segregation of Duties

- Evaluate who is doing what, and consider whether that has the potential to be an issue
- If so, implement some compensating control to reduce risk

Monitoring Controls

- Board/Admin. Should provide oversight to make sure controls are being followed
- i.e. – evidence of sign-offs/initials, reperformance of reconciliations, etc..



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Communication

Intra-entity

- Evidence should support that policies/procedures are communicated/understood by all
- Reasons for changes to procedures or why controls were overridden should be documented

Inter-entity

- Communication with vendors/related parties should occur at least occasionally
- Communication with auditors to assist in evaluating processes



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Benefits?

Efficient/Effective

- Mitigate the possibility of fraud
- Roles are clearly defined and adhered to
- Lowers the risk of material misstatement

Audit Impact

- Smoother audit through:
 - Less fraud risks
 - More informed auditors




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Summary

- Importance of evaluating and documenting policies and procedures
 - Strengthens organizational processes
 - Provide staff a better understanding
- Internal controls/ Segregation of duties helps mitigates risks
 - Fraud Risks
 - Financial statement error risks



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Questions





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