

OHIO AUDITOR OF STATE
KEITH FABER

LGOC

Internal Controls

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Agenda

Internal Controls

- Internal Controls - The Basics
- Components of Internal Controls
- Benefits of Internal Controls
- Management / Public officials responsibilities for Internal Controls
- Common policies

Segregation of Duties

- Standards/Guidance

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Internal Control –The Basics

AU-C 315.12 defines system of internal control as:


The system designed, implemented, and maintained by those charged with governance, management, and other personnel to provide reasonable assurance about the achievement of an entity's objectives with regard to:

- Reliability of financial reporting
- Effectiveness and efficiency of operations
- Compliance with applicable laws and regulations

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Internal Control –The Basics



- How do you prevent errors?
- If an error occurs, will you detect it timely?
- Preventing errors is a shared concern of both management & auditors.

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What do Internal Controls look like?

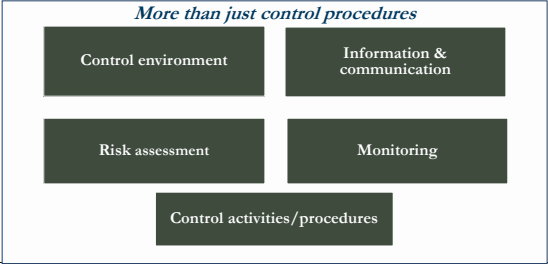
- **Plans, methods, policies, and procedures** used to fulfill the mission, strategic plan, goals, and objectives of the entity
- **Continuous built-in component of operations** that provides *reasonable assurance, not absolute assurance*, that an entity's objectives will be achieved
- **Not one event, but a series of actions** that occur throughout an entity's operations

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Internal Controls: Five Components

More than just control procedures

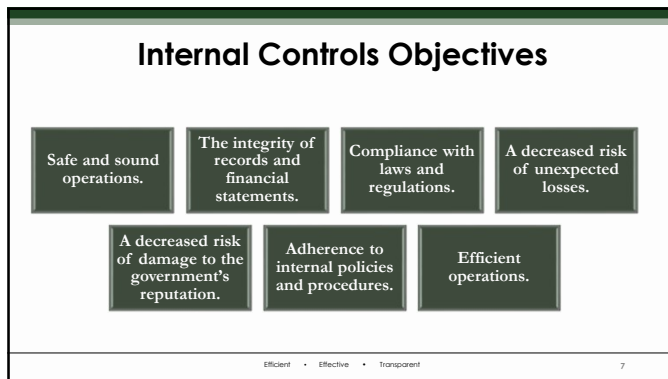


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graph TD
    CE[Control environment] --- IC[Information & communication]
    RA[Risk assessment] --- M[Monitoring]
    CA[Control activities/procedures]
  
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Risk Assessment

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

- Ask yourself: How do I avoid reading the following headline while drinking my morning cup of coffee?



*“\$50,000
embezzlement
Found at (insert
name of **your**
entity here)”*

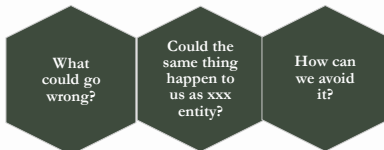
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Risk Assessment

Answer: Ask more questions!



Particularly critical when things change!

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Information and Communication Systems

- 1. Internally generated data, along with external events, activities, and conditions are necessary for a business to make informed decisions.
- 2. 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

- 1. 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.
- 2. Entity should have those issues reviewed by someone other than the individual responsible for that accounting function.
- 3. Entities should have procedures in place regarding how these items are followed up.

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Information & Communication Examples

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



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Monitoring

Monitoring is a process that assesses the quality of the internal control performance over time

- Management / supervisory reviews
 - Critical when it is impractical to segregate duties
- Analytical review (see next slide)

Processes to ensure timely modification of policies and procedures, as needed

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Monitoring



Analytical Procedures:

- Compare what is reported with what was expected/reasonable
- Collect / pay what was estimated?
- Cash collected – is it reasonable in relation to the # of transactions processed?
- Voided transactions: reasonable?
- Any “unusual” transactions?

Use budget and actual reports!!!

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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:

- Operations
- Financial Reporting
- Compliance areas

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Types of Control Activities/Procedures

Automated (Application)

- Built in computer controls
- Are generally preventative in nature
- i.e. Edit checks, automated computations

Monitoring Controls

- Typically performed by Management
- Occur after the transaction has been processed through the accounting system.
- Are generally detective in nature
- i.e. Review month-end budget vs. actual reports

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Example Control Procedures

Segregate Incompatible Duties

- Single person *[ideally]* should not:
 - Collect + Record + Reconcile + Deposit
- Will cover further in the next section

Periodic Reconciliations & Verifications

Incorporate "Edit" Checks Into Computer Systems

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How do we implement internal controls?

Management Establishes Policies and Procedures

Communicate To Personnel

Review Periodically

Adjust As Needed

Repeat

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Control Examples

Larger Entity	Smaller Entity
<ul style="list-style-type: none"> • <u>Control:</u> <ul style="list-style-type: none"> • Invoices are reviewed prior to payment to determine that the goods or services were received and the payment is for the proper amount/proper public purpose • <u>Control Evidence:</u> <ul style="list-style-type: none"> • Invoice is marked "ok to pay" by the department employee who has knowledge of the expense 	<ul style="list-style-type: none"> • <u>Control:</u> <ul style="list-style-type: none"> • Bills are presented to the Board of Trustees for review prior to payment to determine that the goods or services were received and the payment is for the proper amount/proper public purpose • <u>Control Evidence:</u> <ul style="list-style-type: none"> • Review and approval of the bills is documented in the Board Minutes

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Control Examples

Larger Entity	Smaller Entity
<ul style="list-style-type: none"> • <u>Control:</u> <ul style="list-style-type: none"> • Bank Reconciliation is reviewed and approved by the Finance Director after being prepared by the Accounting Clerk • <u>Control Evidence:</u> <ul style="list-style-type: none"> • The Bank Reconciliation is initiated by the Finance Director 	<ul style="list-style-type: none"> • <u>Control:</u> <ul style="list-style-type: none"> • Bank Reconciliation is reviewed and approved by Township Trustees after being prepared by the Fiscal Officer • <u>Control Evidence:</u> <ul style="list-style-type: none"> • Review and approval of the Bank Reconciliation is documented in the Board Minutes

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3 Sources for Internal Control Guidance

#1

COSO

#2

GAO's Green Book

#3

AICPA AU-C 315

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COSO framework essentially defines internal control as a process, effected by an entity's:

- Board
- Management
- Other Personnel

This process is designed to provide reasonable assurance regarding:


- Achievement of objectives in effectiveness and efficiency of operations,
- Reliability of financial reporting,
- Compliance with applicable laws and regulations.

COSO is not a required internal control structure – just an option/source.

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COSO – Internal Control



- Internal control is a process. It is a means to an end, not an end in itself.
- Internal control is not merely documented by policy manuals, systems, and forms. Rather, it is put in by people at every level of an organization.
- Internal control can provide only reasonable assurance, not absolute assurance, to an entity's senior management and board.
- Internal control is geared to the achievement of objectives in one or more separate but overlapping categories.

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- GAO's Green Book is a required internal control structure for federal agencies.
- May also be adopted by state & local gov's.

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AU-C 315

A direct relationship exists between an entity's objectives and the controls it implements to provide reasonable assurance about their achievement.


The entity's objectives and, therefore, controls relate to financial reporting, operations, and compliance; however, not all of these objectives and controls are relevant to the auditor's risk assessment.

AU-C Section 315
Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement
 (Supersedes SAS No. 122section 315)
 Source: SAS No. 145.
[SAS No. 145: Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement](#)
 Effective for audits of financial statements for periods ending on or after December 15, 2023.


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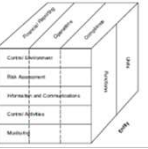
Components/Objectives/Entity



COSO



GAO Green Book



AU-C 315


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Deficiency in Internal Control

I/C deficiencies result in errors which occur in the normal course of operations and are not detected or corrected timely. These are due to:

- 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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Service Organizations (SO's)

- 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 Service Organization Control (SOC 1) report.
- A SOC 1 report provides your auditors the necessary understanding of your SO's systems and the operating effectiveness of their controls



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Typical SO's

Examples of typical SO's:

- Payroll processing
- Income tax processing
- Self-insurance claim processing
- EMS billings
- 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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Benefits of Internal Controls

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



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Internal Controls

Internal controls can **help** assure that balances and transactions are:

- Accurately recorded
- Complete
- Properly cutoff
- Existed
- Occurred
- 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 are used only for allowable purposes

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Internal Control: An Evolving Process

Monitor Internal Controls for the need for change

- Changes to policies and procedures
- Changes to laws, regulations, grant requirements, etc.
- Communicate changes to employees

Not enough to implement internal controls

- If the controls aren't working – change the internal controls

Controls must be followed

- EVERY time not just SOME of the time
- Not following the control process one time is too many-
 - That might be when fraud/misuse, errors, or misstatements occur

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Internal Controls in the Remote and Hybrid Work Environment

Reviews

- Electronically transmitted, and reviewed remotely
- Saved emails and instant messages possibly serve as control evidence
- Accounting System may allow for approvals to be evidenced electronically

Human Element

- Don't forget about the people behind the processes
- Consider checking in daily/weekly with your team
- Video more often than telephone or email

Monitoring

- Continuously discussing processes
- Demonstrates that someone is always assessing the situation
- May serve as a fraud deterrent

Segregation of Duty Issues


- Only certain employees are going into the office
- May need to reassign duties temporarily

Security

- Secure portals to transmit documents

Document

- Document any changes made to internal control procedures
- Auditors will likely review the changes



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Responsibility for Controls

MANAGEMENT!

MANAGEMENT!

MANAGEMENT!

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Responsibility for Controls

Who Is Considered Management?

The person(s) with executive responsibility for the conduct of the entity's operations.

For some entities, management includes some or all of those charged with governance; for example, executive members of a governance board or an owner-manager.

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Responsibility for Controls


System of internal controls should be developed by management	It is management's primary responsibility to develop proper controls	Management must be committed to development and maintenance of controls	Management needs to clearly define expectations
Management must understand that segregation of duties has associated costs	Management must monitor controls	Management must have understanding of information and be able to ask questions	Management is front line to find a theft

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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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Common Policies

Credit Cards	Cell Phones	Public Records	Cash Mgmt.
Equipment	Personnel	Travel Expenses	Budgets
Cybersecurity			

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Focus of Internal Control

Integrity of Information	Authorization
<ul style="list-style-type: none"> How accurate is the information used to process the information? Who approves the information or changes to the information before and after input into the system? Examples: Employee and Vendor Information 	<ul style="list-style-type: none"> Who has access to the information? Who has authorization to change or alter the information? Are changes to information approved? Examples: Access to the vendor and payroll master file is limited and changes to the vendor and payroll master files require approval

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Segregation of Duties

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Segregation of Duties Definition

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

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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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Focus of Internal Control

Segregation of Duties	Review and responsibility
<ul style="list-style-type: none"> Who has responsibility for authorization, recording, and safekeeping? Examples: <ul style="list-style-type: none"> No single person should: Prepare bills, Receive money, Record receipts, Deposit money, Reconcile bank accounts No single person should: Authorize payments, Disburse funds, Reconcile bank accounts 	<ul style="list-style-type: none"> Work should be regularly checked Examples: <ul style="list-style-type: none"> Payroll: Personnel records, Employee pay rates, leave entitlements, Verify payroll reports agree to the bank statements Vendor: Vendor Master File, Vendor Payments Bank Reconciliations: Review all information on the bank reconciliation, including the underlying information

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Segregation of Duties in Standards/Guides

Council of Sponsoring Organizations (COSO)	Green Book (GB)
AU-C's (US Auditing Standards)	Ohio Administrative Code (OAC)

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Assignment of Responsibility & Delegation of Authority

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

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

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

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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 117-2-01(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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Document Internal Controls

Maintain Documentation of Internal Controls being performed

- Assists in the internal review process
- Provides evidence to auditors



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Lessons Learned			
City	County	County	School
<ul style="list-style-type: none"> • Payroll Clerk • Stole nearly \$68,000 • Writing additional payroll checks to herself 	<ul style="list-style-type: none"> • Utility Clerk • Stole nearly \$15,000 • Adjusting and voiding customer accounts and pocketing cash payments 	<ul style="list-style-type: none"> • Clerk of Courts • Stole over \$17,000 • Used various schemes, including reversing deposits, altering deposit slips, and pocketing cash payments paid to the Court 	<ul style="list-style-type: none"> • Account Clerk • Stole over \$500,000 • Used various schemes, including issuing checks to himself, using the District's credit card to make personal purchases, and pocketing cash from athletic events and student fees
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Take-Aways
Importance of Internal Controls <ul style="list-style-type: none"> • Reliable financial reporting • Effective and efficient operations • Compliance with laws and regulations • Assets safeguarded against unauthorized acquisition, use, or disposition
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Take-Aways
What should you do now? <ul style="list-style-type: none"> • Determine policies necessary for your entity • Determine if your entity has any service organizations • Determine if your entity has adequate segregation of duties or compensating controls • Ensure procedures are in place so controls identified in your policies are operating effectively
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