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The Basics of Internal Controls & Segregation of Duties

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COURSE AGENGA

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



United States Government Accountability Office
By the Comptroller General of the United States

September 2014

Standards for Internal Control in the Federal Government



GAO-14-704G



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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](https://www.coso.org) SAS 55 / 70 / 78
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

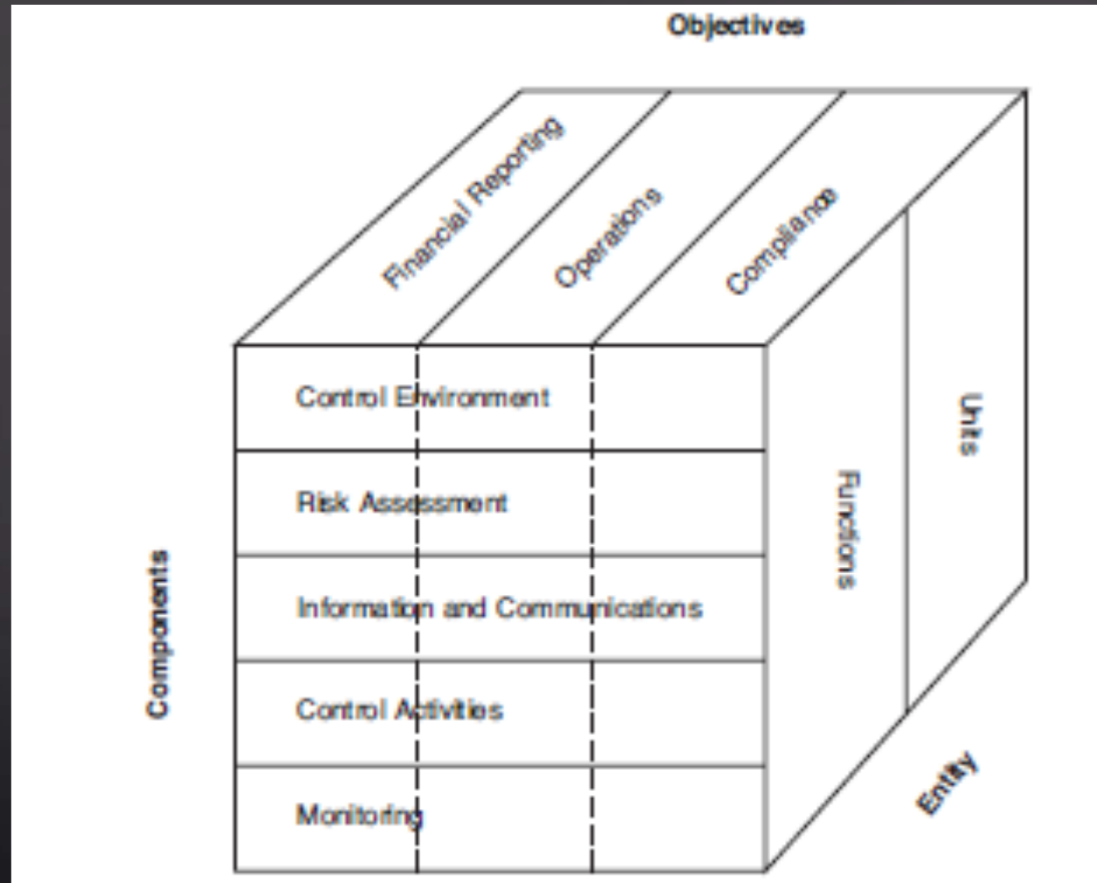
Control
activities/procedures



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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.

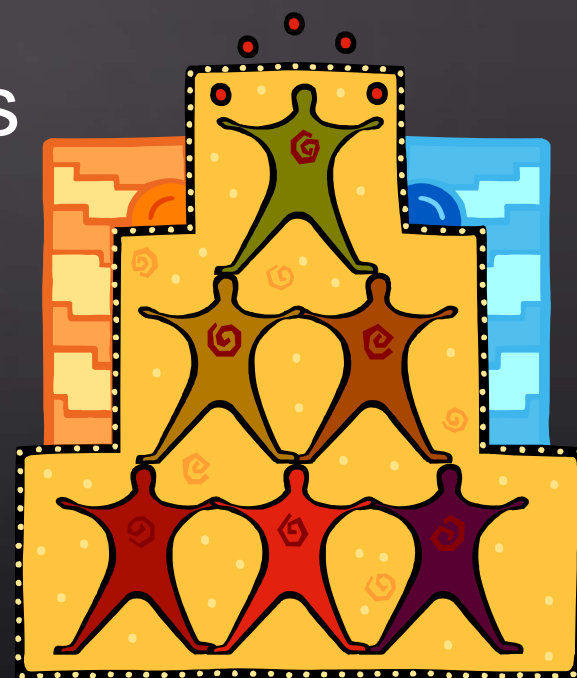


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Control Environment: Starts at the Top!

- “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.



These all could be fraud indicators!!



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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

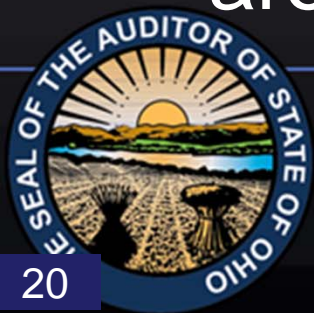


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Control Activities/Procedures

- 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

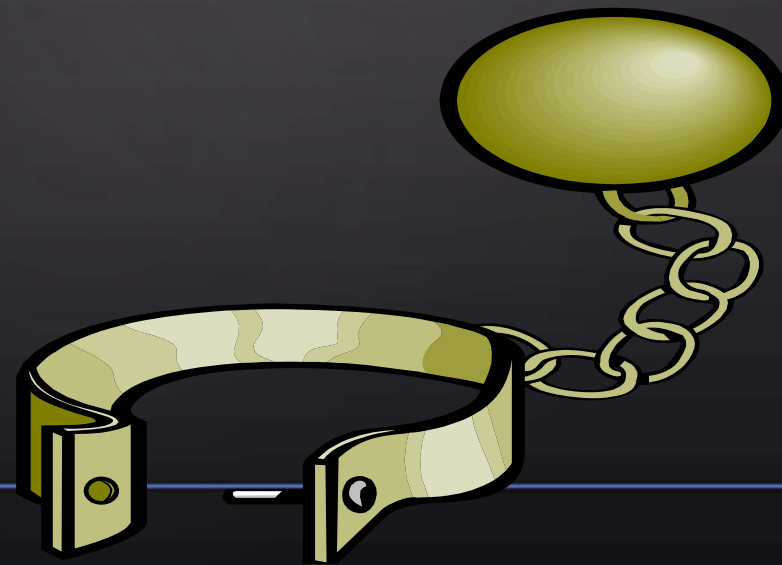


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Management's Responsibility for Fraud

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.

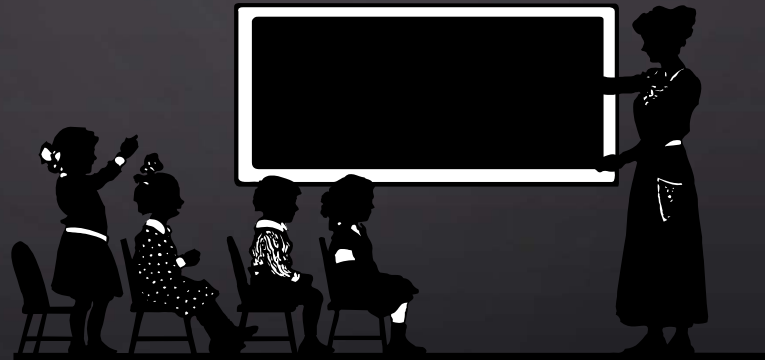


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Internal Control Relevance

- 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**

Segregation of Duties in Standards/Guides

Green Book
(GB)

AU-C's
(US Auditing
Standards)

Ohio
Administrative
Code (OAC)

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.

GB 3.08

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

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.

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

Benefits are not mutually exclusive



How to make S.o.D a focal point



Evaluation



Documentation



Communication



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

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

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

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

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.

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

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

Does it mean there is fraud?

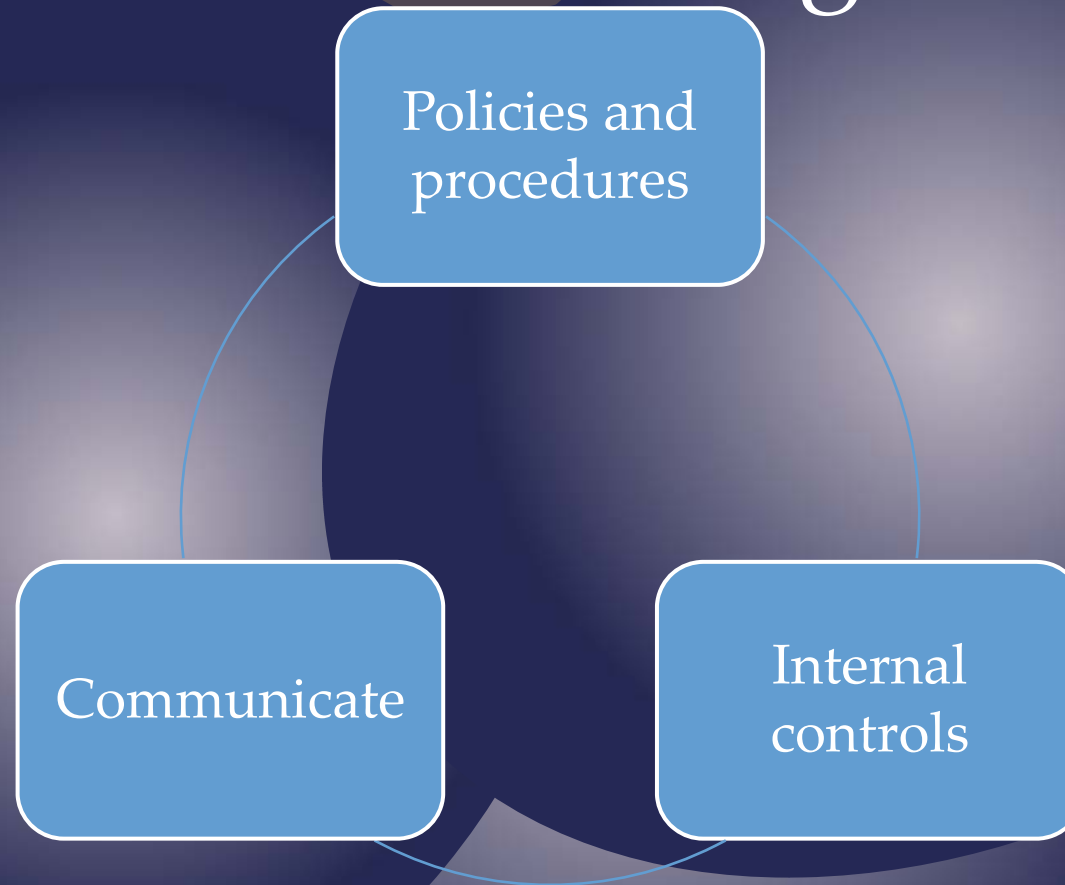
Difference between fraud *risk* and fraud.

- 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.

What should local gov't do?



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

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..

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

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

Summary

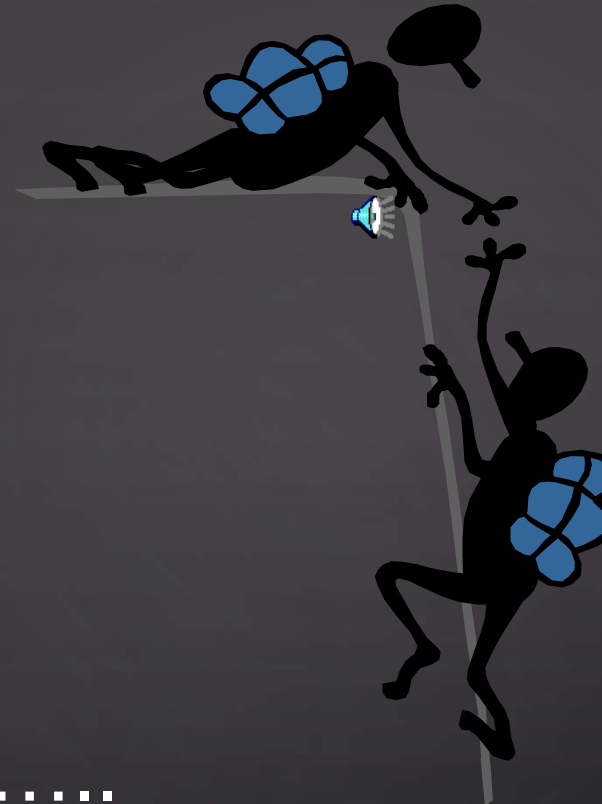
- Importance of evaluating and documenting policies and procedures
 - Strengthens organizational processes
 - Provide staff a better understanding
- Internal controls/ Segregation of duties helps mitigates risks
 - Fraud Risks
 - Financial statement error risks

Questions



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Always Remember.....
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