* INTERNAL CONTROL ENVIRONMENT

Topics to be Covered

- Background
- Integrated framework of internal control
- Five elements of internal control
- Practical examples
- Other audit pitfalls
- Resources

Background

SCO's Internal Control Guidelines

California Government Code Section 12422.5 required the SCO to develop internal control guidelines applicable to each local agency

See the Guidelines at:

http://www.sco.ca.gov/Files-AUD/2015_internal_control_guidelines.pdf

EFFECTIVE 1/1/2015

SCO's Internal Control Guidelines

Overview:

- Based on current internal control standards and practical guidance published by various organizations (AICPA, GAO, OMB, COSO, IIA…etc.)

- Contain suggested methods to address the components of internal control

- <u>However</u>, these are only <u>guidelines</u>

SCO's Internal Control Guidelines

"...to assist local agencies in establishing a system of internal control to safeguard assets and prevent and detect financial errors and fraud."
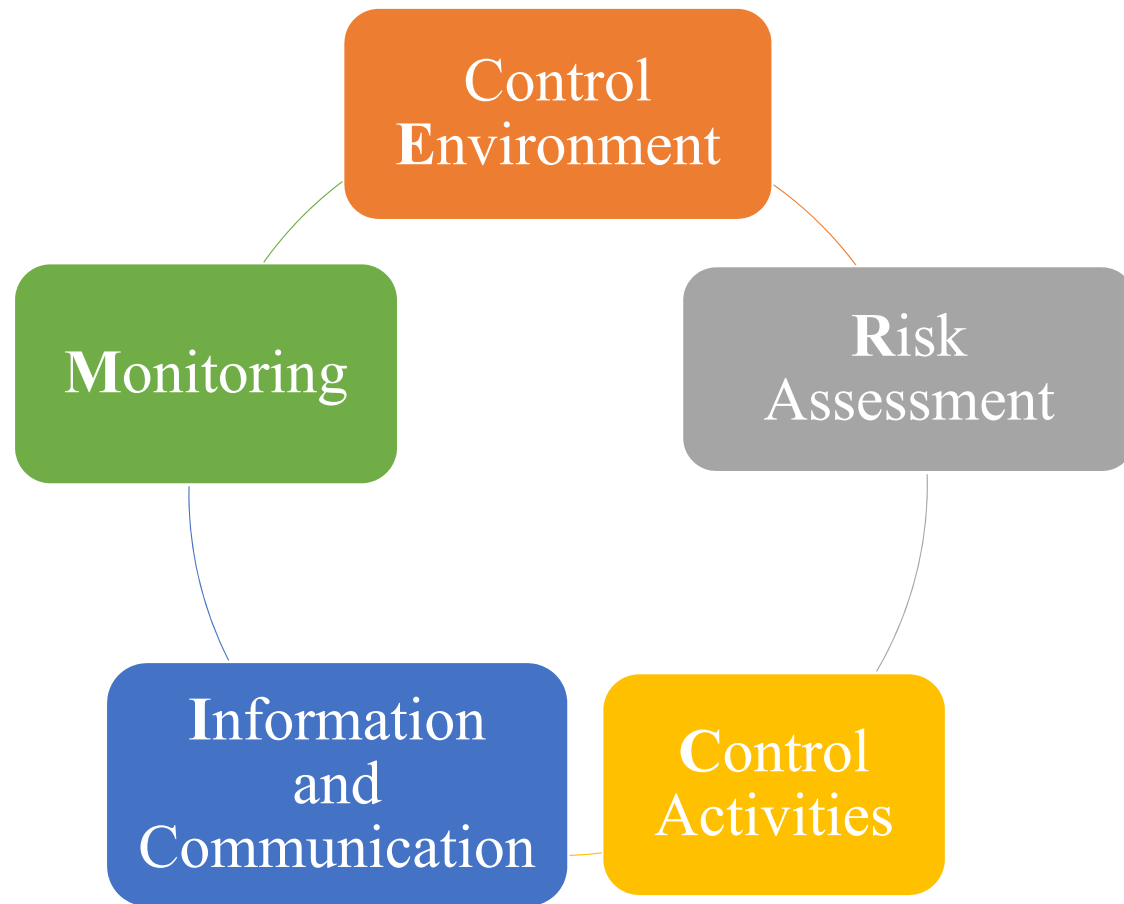
Internal Control Guidelines

California Local Agencies

Integrated Framework
of
Internal Control

Five Components - CRIME

Integrated Framework of Internal Control Must Provide For:

- **Favorable** *control environment*
- **Periodic** *risk assessment*
- **Effective** *control activities* (design, implementation and maintenance)
- **Effective** *information and communication*
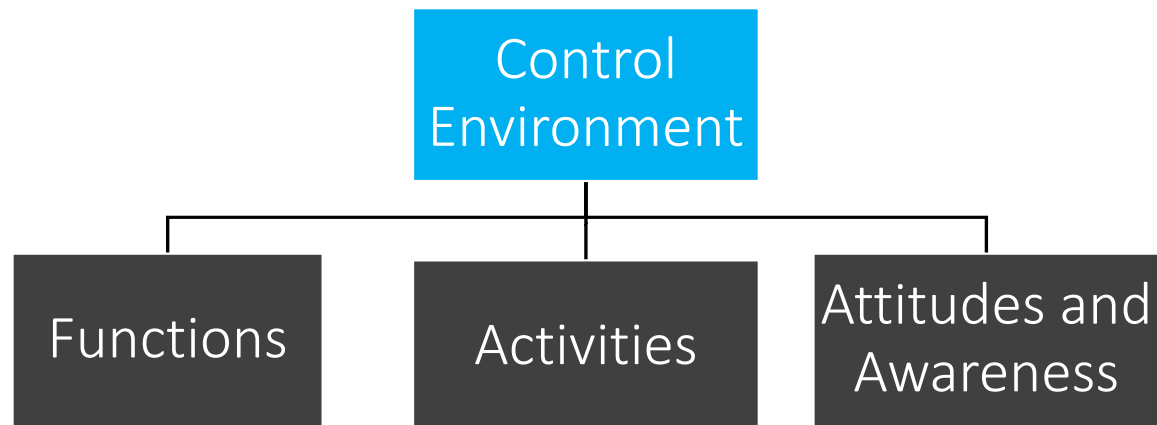- **Ongoing** *monitoring*

Five Elements of Internal Control:

Control Environment

Control Environment - Definition

- Includes both Management and Governing Board

Control Environment - Elements

Should include some or all of the following elements:

1. Organization's <u>integrity and ethical</u> values
2. Governing board's <u>oversight responsibilities</u>
3. <u>Assignment</u> of authority and responsibility
4. Process for <u>attracting, developing, and retaining employees</u>
5. Measures, incentives and rewards to drive <u>accountability for performance</u>

Control Environment - Pitfalls

- Lack of clear assignments for review and approval processes

- Lack of activities of oversight committees

- Skill set of those in charge of governance

- High turnover of employees at any level

Foundations of Control Environment

ORGANIZATIONAL STRUCTURE
- Establish appropriate responsibility and designate authority
- Commit to attract and retain qualified staff
- Provide ongoing training and recognize employees achievements and contributions

INTEGRITY AND ETHICAL VALUES
- Management Culture and Practices: Code of Conduct; Individual accountability; Transparency
- Oversight: City Council (independence from Management); Measure V Committee, Investment Commission;

ACCOUNTING PRACTICES AND POLICIES
- Reflect management's understanding of controls, competence and operation style
- Institutional memory of how and why things were done in the past is not lost and serve as an important model to capture how things are done currently

Control Environment Evolution

SUDDEN CHANGE

- Recession
- Council majority change
- Accounting or legal compliance
- Response to material error or increased exposure to risk
  - Fraud or exposure to fraud/loss
  - Audit finding
  - Material breech of internal control

ORGANICALLY GROWN

- Turn over and/or promotions in staff
- Personal preferences or style
- Technology evolution
- Trainings and/or other affiliations to best practices

Five Elements of Internal Control:

Risk Assessment

Risk Assessment - Definition

- <u>Identification</u>, <u>analysis</u>, and <u>management</u> of risks relevant to the preparation and fair presentation of financial statements

Identify ➡ Analyze ➡ Manage

Risk Assessment - Definition

- On an **on-going** basis, management should attempt to **identify** and **assess** potential risks that could prevent management from fully meeting its responsibilities

Risk Assessment – Fraud Triangle

Pressure

- Severe business pressure, for example:
  - Unrealistic budgetary goals
  - Cash flow pressures
  - Economic decline
  - Maturing debt or restrictive bond covenants

Risk Assessment – Fraud Triangle

## **Pressure** (continued)

- Immediate financial needs, for example:
  - Substance abuse
  - Involvement in an expensive relationship
  - Excessive debt
  - Medical/financial emergencies of family members

Risk Assessment – Fraud Triangle

Factors contributing to the facilitation of the fraud

Collusion circumventing good controls **11%**

5% Other

Opportunity
- Examples:
  - Lack of monitoring
  - Employee turnover/lay off
  - Weak design of internal controls

Reckless dishonesty regardless of controls **21%**

Weak internal controls **61%**
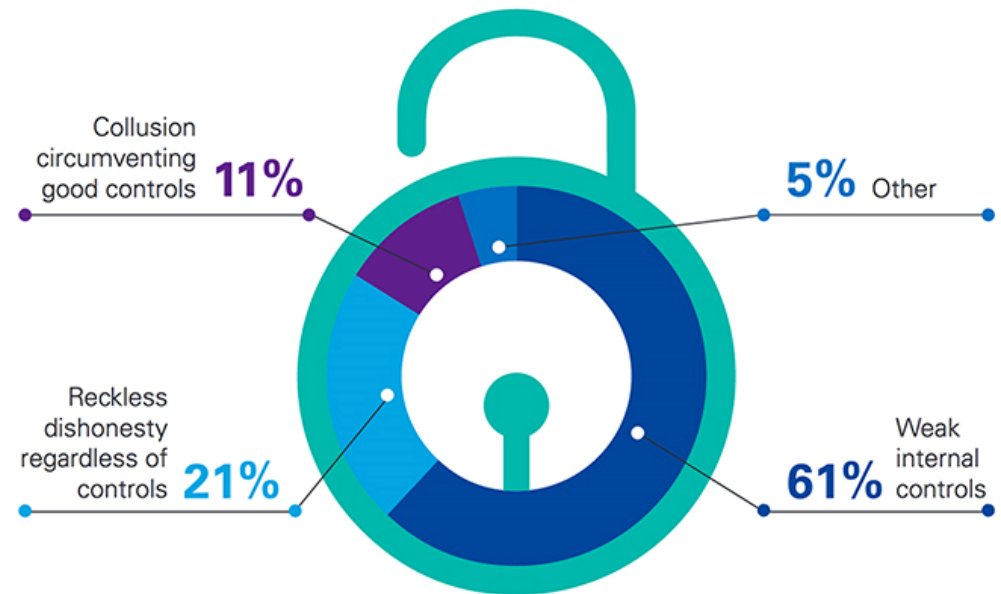
Source: Global Profiles of the Fraudster, KPMG International, 2016

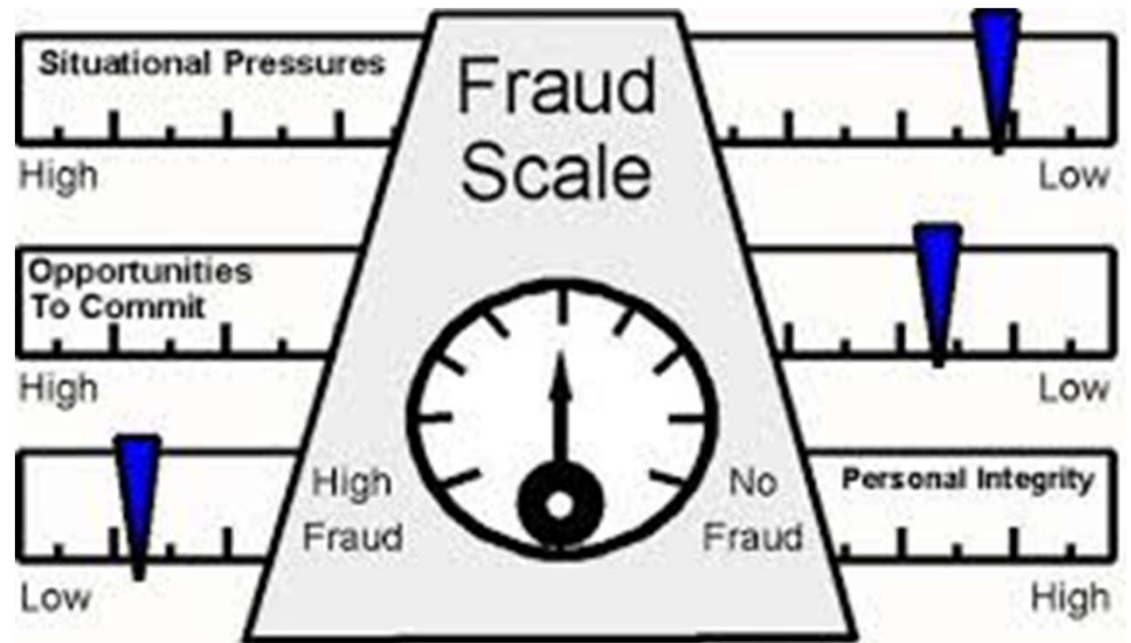# Risk Assessment – Fraud Triangle

Rationalization

- Examples:
  - "It is for the good of the organization."
  - "I am just borrowing the money."
  - "I am getting what I deserve."
  - An attempt to depersonalize his/her actions.

Fraud Scale

- Replaces rationalization
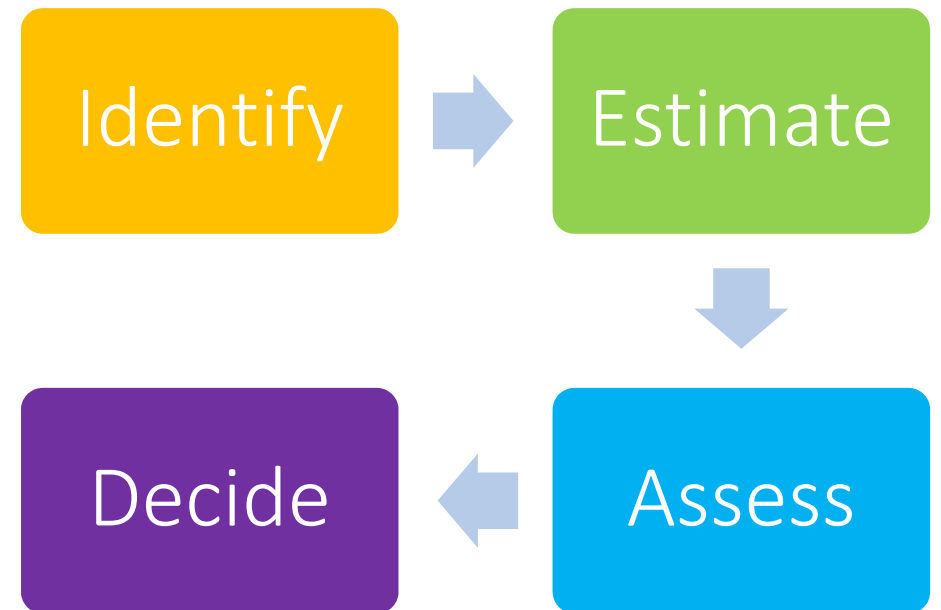- Financial statement fraud
- Observable
- Ethical decisions

Risk Assessment –Pitfalls

- Lack of staff training at various levels to assist in managing risks

- Changes in software not evaluated

- Holes in the year-end closing process

- Insufficient training for new staff, new grant programs, or new operations

Risk Assessment Process

Identify → Estimate → Assess → Decide

Risk Assessment

Identify vulnerability: **what could go wrong?**

- **Operation risk** refers to the unexpected failure in organization's daily operations, which could be caused by personnel and/or processes.
- **Compliance risk** is the risk of not maintaining compliance with laws or regulations

Risk Appetite Statement

➤ Risk Appetite is the amount of risk, on a broad level, that an organization is willing to accept in pursuit of value; it reflects the enterprise's risk management philosophy and in turn influence's the entity's culture and operating style.

Risk Tolerance

➢Risk Tolerance is the acceptable level of variation relative to the achievement of a specific objective, and often is best measured in the same units as those used to measure the related objective.

Risk Appetite   Risk Tolerance

Low Level   High Level
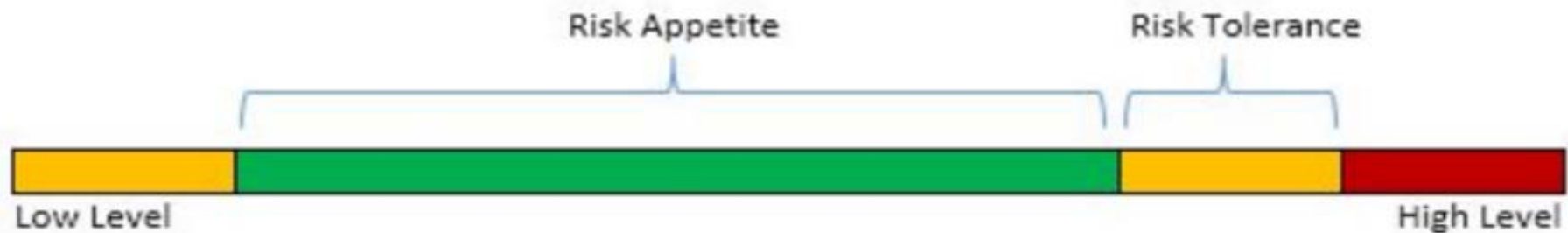
Five Elements of Internal Control:

Control Activities

Control Activities – Definition

- Policies and procedures that help ensure that management directives are carried out.

Control Activities – Overview

Establish through policies and procedures to:

- Achieve management directives

- Respond to identified risks in the internal control system

Control Activities – Overview

Benefits vs. Cost

- Benefits > Cost of control activities

- For smaller governments, an **appropriate** second person may be a member of the governing body

Control Activities – Types

1. Authorization
- Activities should be authorized in accordance with local government's policies and procedures

2. Performance reviews
- Local governments should perform analyses of financial data

Control Activities – Types

3. Information processing
- Application controls
- General IT controls

4. Physical controls
- Tangible + Intangible

Control Activities – Types

5. Segregation of duties
- Should segregate:
  - Authorization
  - Recording or reconciling
  - Custody of assets

Commonly used control activities

Authorization

Review and approval

Verification

Reconciliation

Physical security over assets

Segregation of duties

Education, training and coaching

Performance planning and evaluation
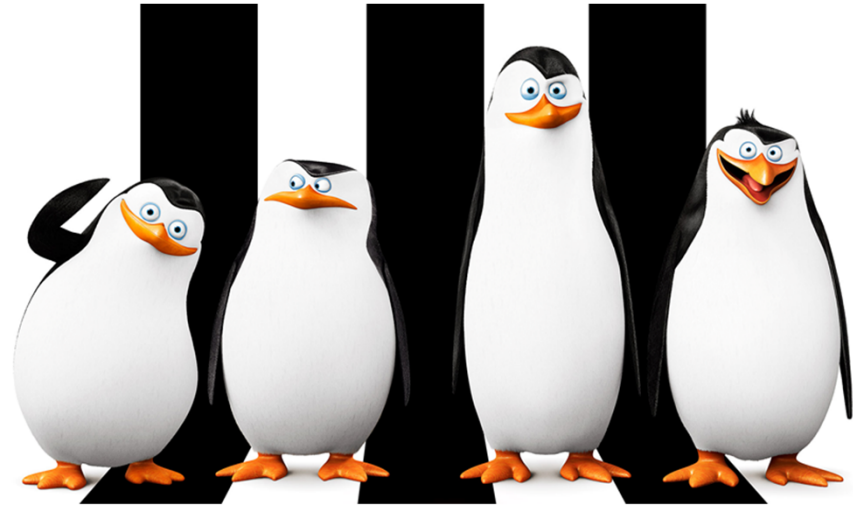
Control Activities Limitations

Judgment

Breakdowns

Management override

Collusion

Costs versus benefit

Resource limitations

Balance of Control and Risk

Control are put up to reduce risk, but the controls can be so stifling as to prevent the organization from meeting its goals.

It is important to find a balance in the controls to mitigate risk, but still allow the flow of the business functions to occur.

Five Elements of Internal Control:
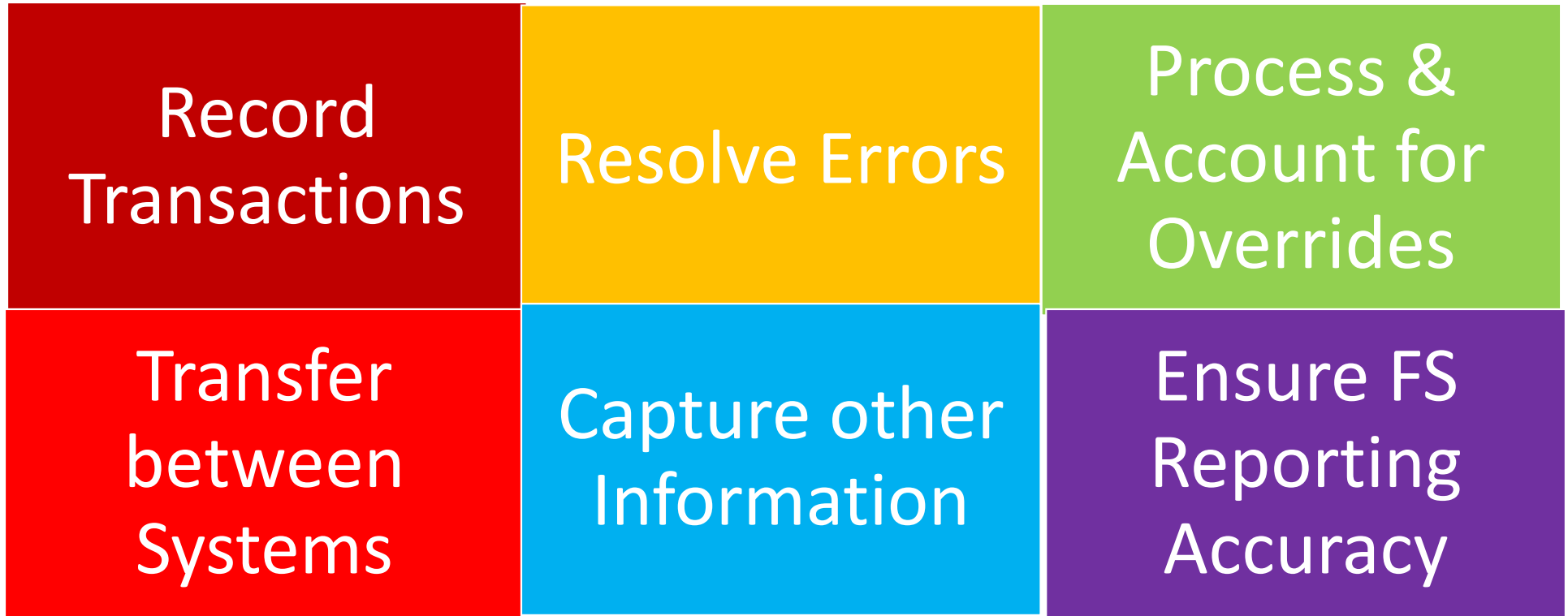
Information and Communication

Information & Communication – Definition
Information System

- Enables the organization to obtain, generate, use and communicate transactions and information in order to **maintain accountability** and **measure and review the organization's performance or progress** toward the achievement of objectives

- Involves people, processes, data and/or technology (not just the IT system)

Information & Communication – Definition

- Information System includes:

|		
Record Transactions	Resolve Errors	Process & Account for Overrides
Transfer between Systems	Capture other Information	Ensure FS Reporting Accuracy

Information & Communication – Definition

Communication System

- Consists of methods and records established to **identify, capture**, and **exchange useful information**

- Ensures information is **timely** (i.e. useful), **sufficiently detailed**, and **appropriate** to the user

Information & Communication – Overview

- Effective flow of information and good communication is the key

- Communication should be multidirectional and lateral

- There should also be a way for external parties to provide feedback to the local government
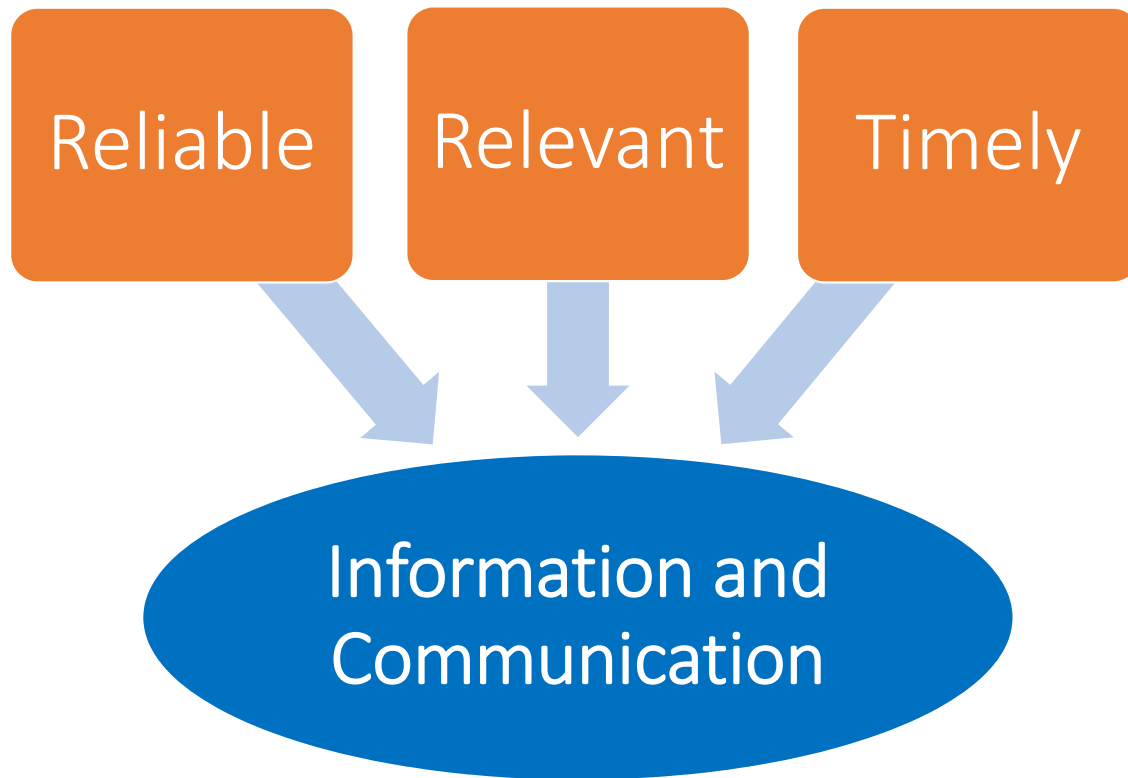
Information & Communication – How to Apply?

Job descriptions for all personnel

- Documented?

Policies and procedures

- Detailed expectations and actions?

- Articulate distinct responsibility and accountability of each involved?

- Communicated to the appropriate personnel periodically?

Information & Communication – Audit Pitfalls

- Delayed reporting or failure to report throughout the year

- Lack of formal policies and procedures

- Ineffective FS Closing Process – fail to analyze and support all balances

- Inconsistent fee schedules

Communication Opportunities

- ❖ Monthly or quarterly reports
- ❖ Board agenda items and decisions
- ❖ Staff meetings
- ❖ Inter-Department meetings
- ❖ Networking with Peers

Causes of Miscommunication

1. Misaligned Vocabularies
2. Messy Thinking
3. Faulty Definitions
4. Faulty Civility
5. Sloppy Language Habits
   - Use of Acronyms
   - Jargon and Colloquialisms
   - Assumptions, Stereo, and Allusions
   - Buzzwords
6. Government-Speak and Legalese

Fixing miscommunication and missed communication

- <u>Active listening</u>: *missing out on essential information in instructions, meetings, trainings, conference calls, and one-on-ones.*

- <u>Practicing mindfulness</u>: *paying attention on purpose*

Fixing miscommunication and missed communication

- Rehearsing: *Rather than listen to the other person's point of view, you might be tempted to start forming your argument.*

- Mind Reading : *making assumptions about what the other person thinks or feels instead of asking questions*

- Filtering: *Filtering may involve zoning in on the points that reinforce your argument, or discounting anything you don't want to hear.*

Five Elements of Internal Control:

Monitoring

Monitoring – Definition

- A process that is used by management to **assess** the effective operation of internal controls over time

- Should be done on an **on-going basis** and taking **remedial actions** when necessary

Process of Monitoring

- ✓ Analyze Monthly and Annual Reports
- ✓ Correct audit findings
- ✓ Establish regular Self-Assessments
- ✓ Utilize technology enhancements
- ✓ Troubleshoot unexpected results

Are you Monitoring?

- Are the controls present and functioning?
- Is the information complete, timely, and accurate for the decision makers?
- Has your risk tolerance changed?
- Do your procedures and assignments align with Policies and Practices?
- Are there changes in accounting standards, technology, or regulatory environment?
- Are there new exposures to risk that need to be assessed?

Effects of Monitoring

- ✓ Improve performance
- ✓ Facilitate decision making
- ✓ Support Strategic Goals and Objectives
- ✓ Added value

Better with ice!

Other Audit Pitfalls

Other Audit Pitfalls

- Negative balances in the GL in inappropriate accounts unmonitored

- Balance sheet accounts unreconciled

- Lack of variance analyses throughout the year and at year-end

- When the auditor asks a question that results in an **Audit Adjustment** – is it indicative of an internal control problem?

Additional Resources

Additional Resources

- *Governmental Accounting Auditing, and Financial Reporting* (2012) (i.e. the Blue Book), Chapters 42 & 43

- GAO's *Internal Control Standards, Internal Control Management and Evaluation Tool* (http://www.gao.gov/products/GAO-01-1008G).

- COSO's *Internal Control – Integrated Framework 2013.* Executive Summary can be downloaded from COSO's website (http://www.coso.org/IC.htm)

Questions??