**Internal Controls**

**&**

**Proper Public Purpose**

November 6, 2019

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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

**Proper Public Purpose**
- Criteria
- What Does It Mean?

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### Internal Control - The Basics

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......

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

Internal Controls: Five Components

More than just control procedures

Control environment
Information & communication
Risk assessment
Monitoring
Control activities/procedures

Internal Controls Objectives

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 government’s reputation.
Adherence to internal policies and procedures.
Efficient operations.
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.

Control Environment: Starts at the Top!
“Tone at the Top” for ethical behavior
Committed to internal controls
Code of conduct
Hiring qualified job applicants

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
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)”

Particularly critical when things change!

Answer: Ask more questions!

What could go wrong?
Could the same thing happen to us as xxx entity?
How can we avoid it?

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 these 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.

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.

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.
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
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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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.
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 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 management and board.

Internal control is geared to the achievement of objectives in one or more separate but overlapping categories.

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

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.
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.

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.
Typical SO’s

Examples of typical SO’s:
- Payroll processing
- Income tax processing
- 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

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

Internal Controls

Internal controls can help assure that balances and transactions are:
- Accurately recorded
- Complete
- Properly cutoff
- Existed
- Occurred
- Properly classified
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

Responsibility for Controls

MANAGEMENT!

MANAGEMENT!

MANAGEMENT!

Responsibility for Controls

System of internal controls should be developed by management
Management needs to clearly define expectations
Management must have understanding of information and be able to ask questions

It is management’s primary responsibility to develop proper controls
Management must understand that segregation of duties has associated costs
Management must monitor controls

Management must be committed to development and maintenance of controls
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.

Common Policies

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

Segregation of Duties
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.

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

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

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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Segregation of Duties

- Inadequate segregation of duties or independent checks increases the susceptibility of misappropriation
  - AU-C 240

- Absent or inadequate S.o.D may be deficiencies, significant deficiencies, or material weaknesses
  - AU-C 265

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Segregation of Duties

- Should reduce the opportunities to allow any person to be in a position to both perpetrate and conceal errors or fraud
  - AU-C 315

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

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Proper Public Purpose
Proper Public Purpose

State ex rel. McClure v. Hagerman, 155 Ohio St. 320 (1951), provides that governmental expenditures should serve a **public purpose**.

Proper Public Purpose

“A finding for recovery for an illegal expenditure may be made only where the auditor has concluded that the public office does not possess the legal authority for the expenditure in question.”

“AOS Ohio Compliance Supplement

“Governmental entities, without regard to their specific nature, may not expend public monies unless they are for a **proper** (i.e. valid) public purpose.”

“AOS Bulletins

2003-005  2004-002

2014-002  2014-003
In McClure, the Ohio Supreme Court offered the following guidelines to determine a public purpose:

- Whether the expenditure is for or promotes the public health, safety, morals or general welfare;
- Whether the primary objective is to promote a public purpose, although it may incidentally advance a private interest;
- If there has been a prospective legislative determination of a proper public purpose.

The courts will not substitute their judgment for that of the authorities unless the authorities exercise of judgment or discretion is shown to have been unquestionably abused.

In general, if the principal benefit is for the public, an expenditure is not invalid merely because a private party derives an incidental benefit.

A public officer's determination that a contemplated expenditure serves a valid public purpose is generally not subject to question unless this determination is "palpably and manifestly arbitrary and incorrect."
Proper Public Purpose

Alcohol is always a no-no!

In some instances, where a public office has incurred late fees, penalties, and/or interest charges because of a public officer’s gross negligence by failing to properly remit payments - the amount of penalties, etc. may be determined to not serve a proper public purpose.

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Internal Controls & Proper Public Purpose

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