OHIO AUDITOR OF STATE
KEITH FABER

Internal Controls & Proper Public Purpose

November 6, 2019

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?

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.

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Internal Controls: Five Components

More than just control procedures

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

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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.

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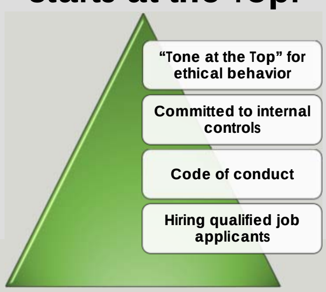
Control Environment

- 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.

Control Environment: Starts at the Top!



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)"*

Risk Assessment

Answer: Ask more questions!

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

Particularly critical when things change!

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.

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.

14

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

3 Sources for Internal Control Guidance

#1 COSO

#2 GAO's Green Book

#3 AICPA AU-C 315

COSO
COMMITTEE OF SPONSORING ORGANIZATIONS OF THE TREADWAY COMMISSION

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 – 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 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.

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GAO U.S. Government Accountability Office

- 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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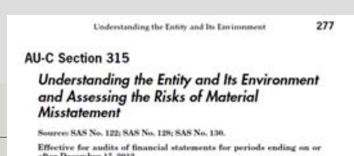
AICPA AU-C 315

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.


Understanding the Entity and Its Environment 277

AU-C Section 315

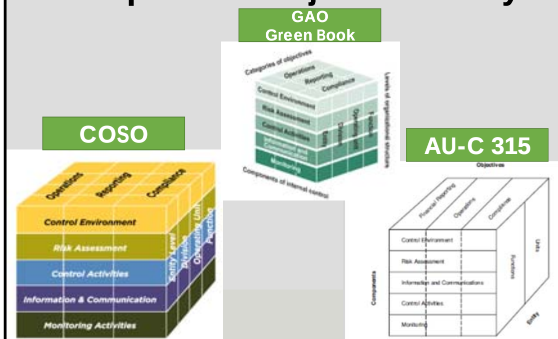
Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement

Source: SAS No. 122; SAS No. 128; SAS No. 130.

Effective for audits of financial statements for periods ending on or after December 15, 2012.

24

Components/Objectives/Entity



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.

AICPA Service Organization Control Reports
AICPA
SERVICE ORGANIZATIONS
SOC
aicpa.org/soc
Formerly SAS 70 Reports

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
- 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

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)

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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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Segregation of Duties

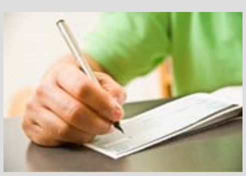
AU-C 240
- Inadequate segregation of duties or independent checks increases the susceptibility of misappropriation

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.



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. "

*"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 Ohio Compliance Supplement

*"This generally may occur where the government either has no statutory authority (or the government exceeded the authority statute provides) for the expenditure or there is **no proper public purpose** for the expenditure."*

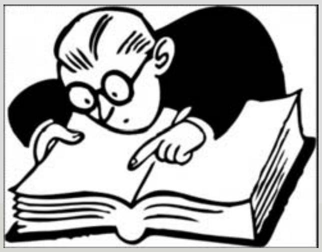
Proper Public Purpose

AOS Bulletins

- 2003-005
- 2004-002
- 2014-002
- 2014-003

Proper Public Purpose

What Does It Mean???



Proper Public Purpose

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.

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!

Proper Public Purpose

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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