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INTERNAL CONTROLS "101"

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Overview of Topic

- Internal Controls - The Basics
- Components of Internal Controls
- Benefits of Internal Controls
- Management / Public officials responsibilities for Internal Controls
- Lack of Internal Controls - Lessons Learned



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Internal Control –The Basics

Definition

A process effected by those charged with governance & management designed to provide reasonable assurance about the achievement of the entity's objectives with regard to:

- reliability of financial reporting;
- effectiveness and efficiency of operations;
- compliance with applicable laws & 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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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 association's **reputation**.
- **Adherence** to internal policies and procedures.
- **Efficient** operations.

THESE ARE ALL DESIRABLE OUTCOMES



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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.

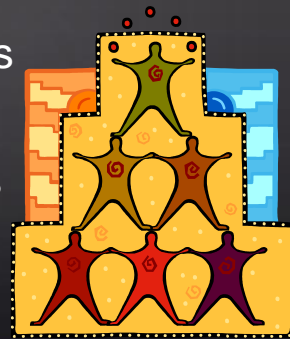


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Control Environment: Starts at the Top!

- “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
- Think of the pension accounting changes**



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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 Village here)”



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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.

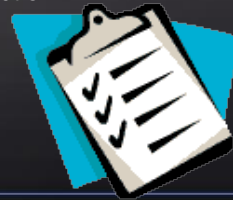


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Information & Communication

- 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

- Monitoring is a **process that assesses** the quality of the internal control performance over time
- Processes to ensure timely **modification of policies and procedures**, as needed



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Monitoring



A process that assesses the quality of internal control performance over time

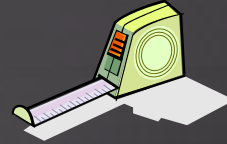
- Management / supervisory reviews
 - Critical when it is impractical to segregate duties
- Analytical review (see next slide)



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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 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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Partial List of Control Procedures

- Segregate incompatible duties
 - Single person [*ideally*] should not
 - Collect + Record + Reconcile + Deposit
- Periodic reconciliations & verifications
- Incorporate “edit” checks into computer systems

Date	Amount	Daily Balance
10/20	\$ 738.97	
10/21	504.82	
10/22	504.81	
10/23	504.81	
10/24	504.81	
10/25	504.81	



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SAS 55 / 70 / 78 NOW AU-C 315

- The Committee of Sponsoring Organizations of the Treadway Commission (COSO) framework essentially defines internal control as a process, effected by an entity's board of directors, management and other personnel.



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COSO

- This process is designed to provide reasonable assurance regarding the achievement of objectives in effectiveness and efficiency of operations, reliability of financial reporting, and compliance with applicable laws and regulations.



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COSO

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



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Internal Control Structure SAS 55

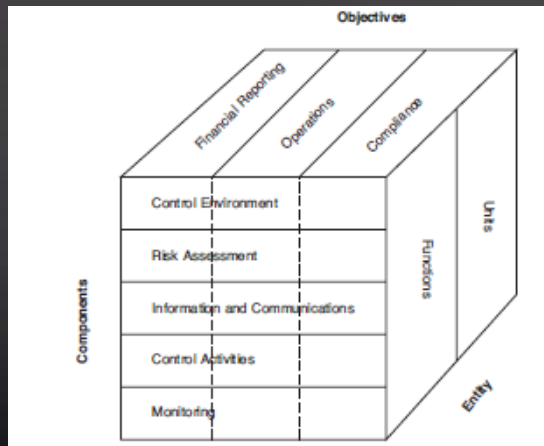
- There is a direct **relationship between an entity's objectives and the internal control components** it implements to provide reasonable assurance about their achievement. In addition, internal control is **relevant to the entire entity**, or to any of its operating units or business functions. This relationship is depicted as follows:



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Components/Objectives/Entity



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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. 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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FYI – 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 Service Organization Control (SOC 1) report.



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FYI - Typical SO'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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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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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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Responsibilities for Controls

- System of Internal Controls should be developed by “Management”
- It is Management’s primary responsibility to develop proper controls
- Internal controls assists the government in realizing their mission and objectives



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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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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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Responsibilities for Internal Controls

- 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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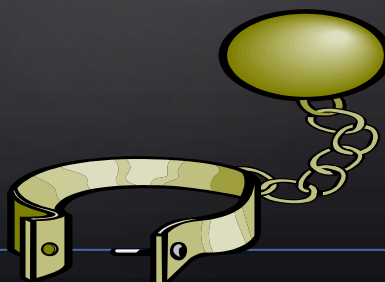
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Management's Responsibility for Fraud

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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Indigents Care Fund

- One person with all lines of responsibility



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Always Remember.....

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