

CPIM

CENTER FOR PUBLIC INVESTMENT MANAGEMENT



A PROGRAM BROUGHT TO YOU BY:

JOSH MANDEL

TREASURER OF OHIO

SEC 111: Basics of Internal Controls

Introduction

Donald R. Owens
Shareholder

Internal Audit and Risk Advisory Services
CPA, CFF, CIA, CFSA, CRMA, CBA

Schneider Downs & Co., Inc.
41 S. High Street
Suite 2100
Columbus, OH 43215

Email: dowens@schneiderdowns.com

Work Phone: (614) 586-7257

Cell Phone: (614) 271-8551

Fax: (614) 621-4062

Agenda

- Internal Control Drivers
- Control Activities, Considerations and Types
- Process vs Internal Control
- Control Structure/Automated Controls
- Summary

What Drives the Need for Internal Controls

Integrity of Accounting Records

- Transactions and events that have been recorded have occurred and pertain to the entity.
- All transactions and events that should have been recorded have been recorded.
- Amounts and other data relating to recorded transactions and events have been recorded appropriately.
- Transactions and events have been recorded in the correct accounting period.
- Transactions and events have been recorded in the proper accounts.

Validation/Existence of Assets/Funds

- Assets/funds exist and are accounted for
- Entity holds or controls the rights to assets/funds

What Drives the Need for Internal Controls

- Assertions/Objectives
 - Completeness and Accuracy
 - Timeliness
 - Compliance (laws, regulations, policies, procedures, etc.)
 - Authorization and Validation
 - Valuation
 - Safeguarding
 - IT Reliability
- Risks



What Drives the Need for Internal Controls

Risk/Threats

Financial Capture and Reporting

Legal/Regulatory Compliance

Operational/Transaction

Reputation

Entity Culture

Vendor/Sub-contractor

Technology

Fraud

Liquidity/Treasury

**External
Competitors/Economy/Innovations**

Organizational Strategy

Environmental

**Interdependency on Other Business
Units**

Safety and Security

Human Capital

Other

Market/Price

What Drives the Need for Internal Controls

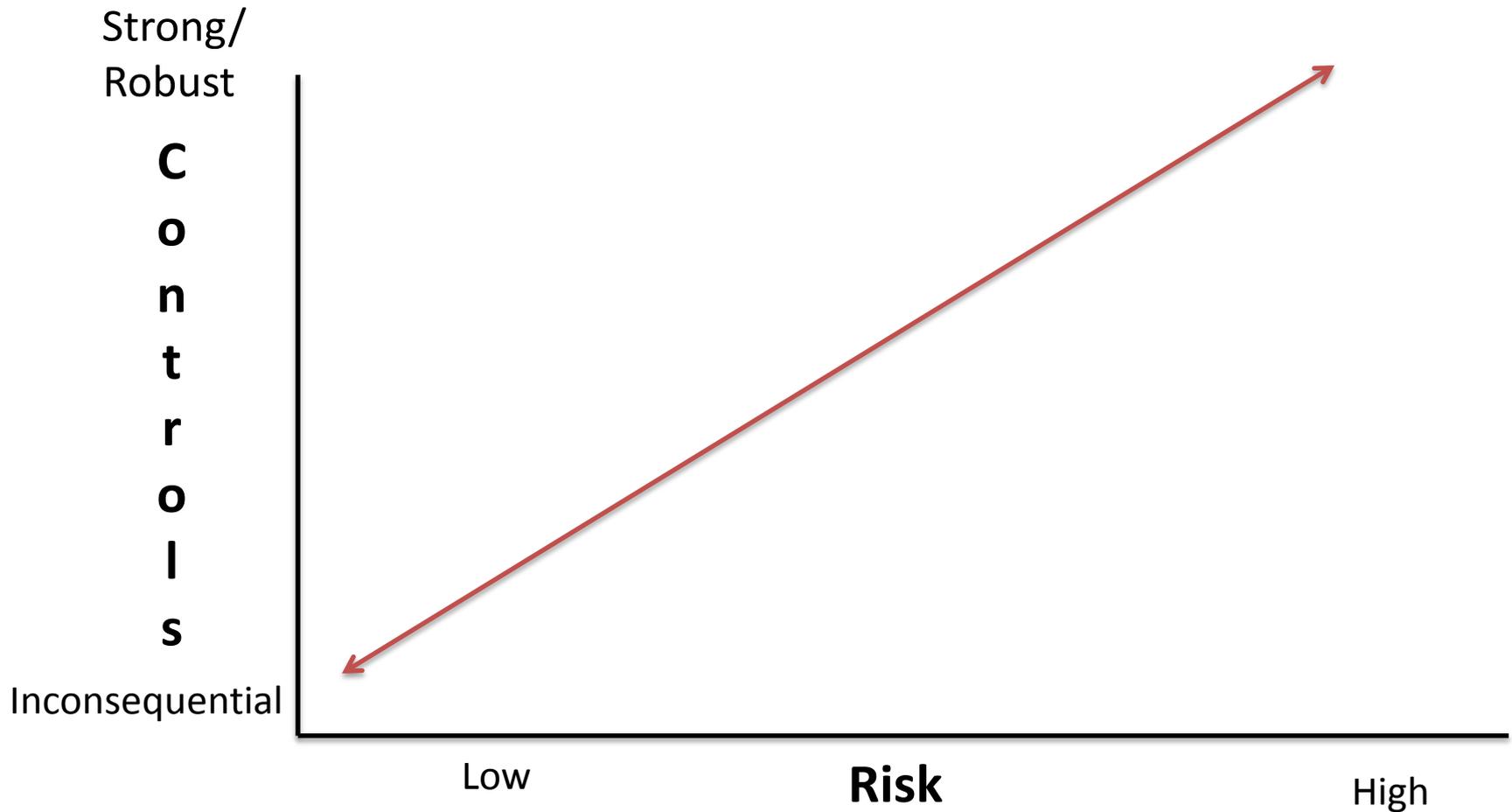
Risk Management

- Risk Acceptance (risks in the normal course of business)
- Risk Appetite (determined based on strategy/long-term business plan)
- Risk Tolerance (point at which potential impairment occurs, entering crisis mode)

Risk Attitude

- Knowledge of risk
- Commitment (or lack of) to manage
- Culture of organization

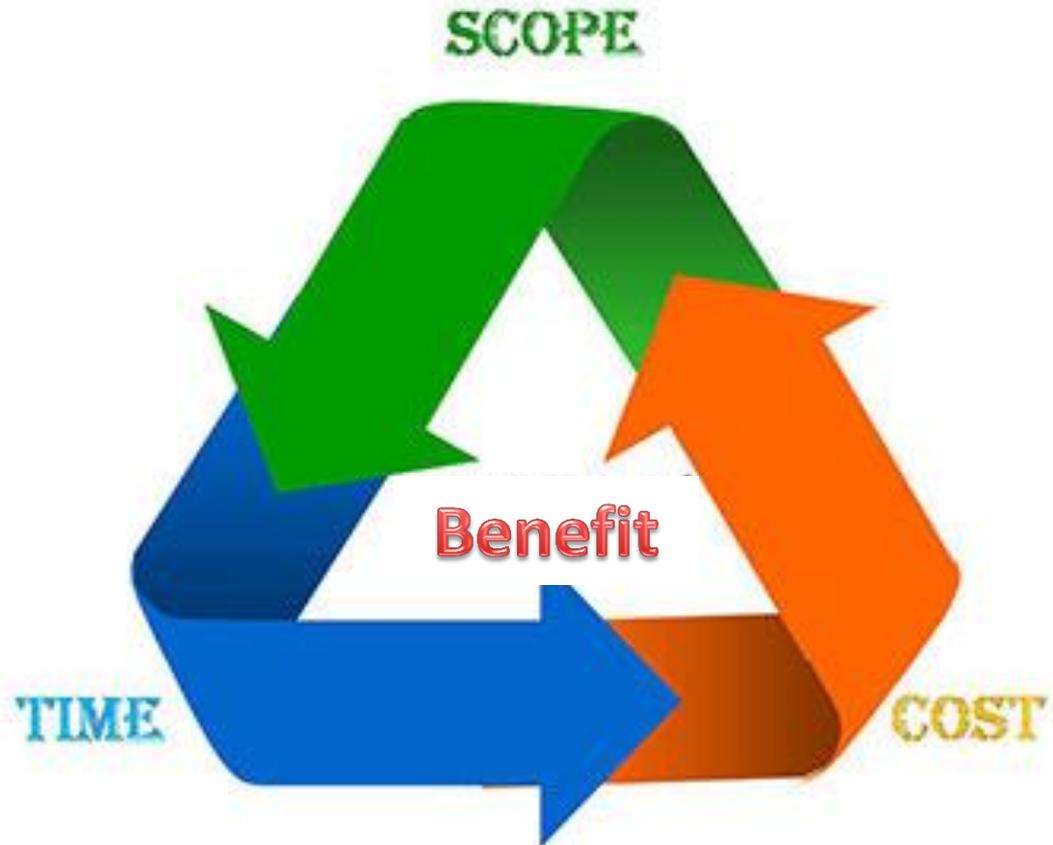
What Drives the Need for Internal Controls



What Are Internal Control Activities

- Any action taken by management, the board, and other parties to manage risk and increase the likelihood that established objectives and goals will be achieved. Management plans, organizes, and directs the performance of sufficient actions to provide reasonable assurance that objectives and goals will be achieved.
- Control activities are actions, supported by policies and procedures that, when carried out properly and in a timely manner, manage or reduce risks.
- An effective internal control helps to ensure that an organization achieves its operations, financial reporting, and compliance-related objectives and goals.

Control Considerations



Control Considerations

Unacceptable Risks

Loss of Major Assets
Poor Business Decisions
Noncompliance
Increased Cycle Time
Public Scandals

Excessive Controls

Bureaucracy
Reduced Productivity
Complexity to Execute
Increase of No-Value
Activities

Types of Controls

- Preventive – control identifies the exception/unexpected condition prior to completion of the activity (e.g., validation of inventory when received). A sub-component of this control type is corrective controls (e.g., edit checks in an application) of preventative (corrective controls “prevent” a condition from being realized at the conclusion of the related activity).
- Detective – control identifies the exception/unexpected condition post completion of the activity (e.g., reconciliations, loan file review, financial statement analysis, budget to actual comparisons).

Process vs Internal Control

A **process** is a series of actions or operations, a step-by-step progression of activities, culminating in an end/expected outcome/means to an end. A process may have internal embedded internal controls or internal controls external to the actual process.

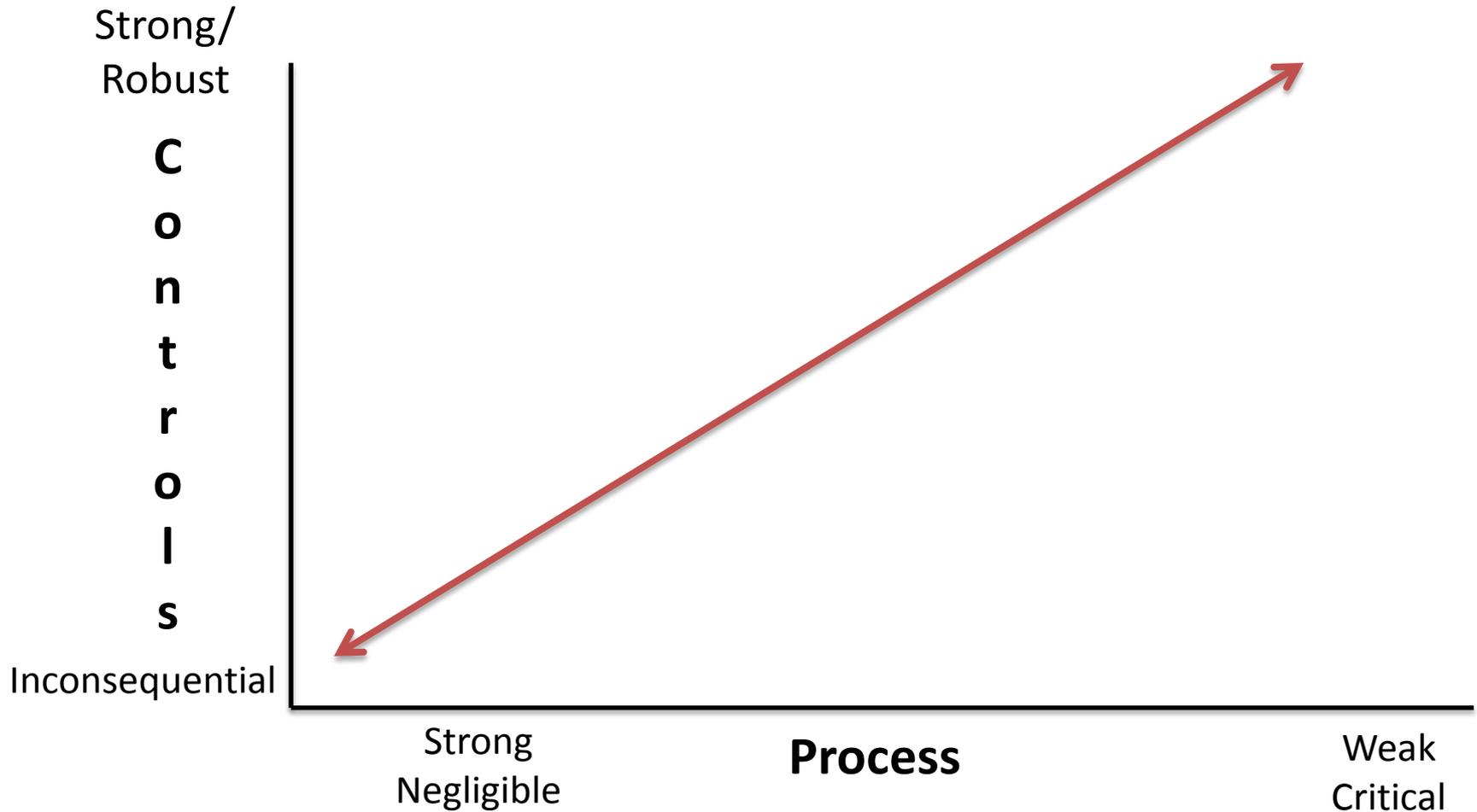
An **internal control** is a checkpoint where validation occurs/is made – e.g., an approval / a reconciliation. While a process has defined goals and objectives, the internal controls are intended to ensure the defined goals and objectives are met.

Process vs Internal Control

Does mature well designed process diminish the need for internal controls?



Process vs Internal Control



Documenting Controls

Control Criteria - When documenting controls, the details of the control must contain the following elements/attributes to evidence that the control is properly designed:

- What is the purpose of the control / objectives to be realized
- Who (title, position, area, etc.) is responsible for executing the control
- How does the mechanics of the control work / what are the executable tasks performed (include reports and other key information produced)
- When is the control executed (timing / frequency)
- To whom is information disseminated (reconciliations, management and exception reports, etc.) when an exception is identified

Control Alignment

Control Design

- Aligned with relevant risks, objectives and goals
- Expected frequency of execution is appropriate
- Assigned to competent and objective individual

Control Effectiveness

- Evidence available to support that the control is operating as intended.
- Executed at a frequency appropriate to the associated risk.

Risk of Control Failure

How Much Evidence Do You Need to Establish That Internal Controls Are Effective?

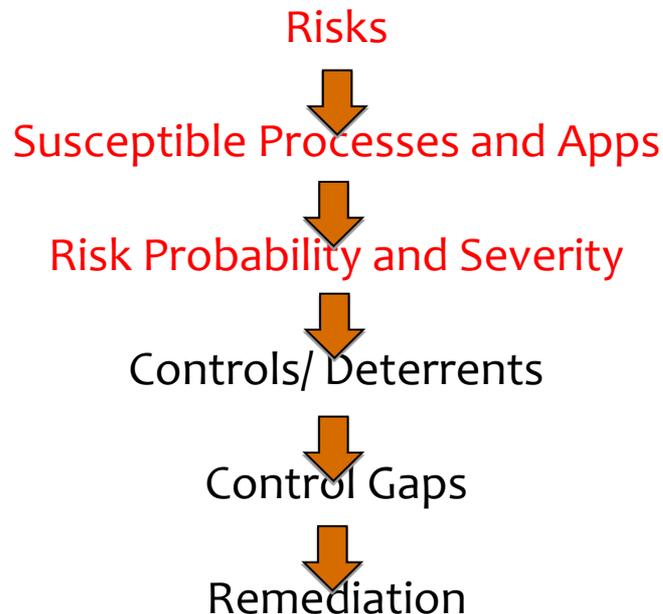


Capturing Risk and Controls

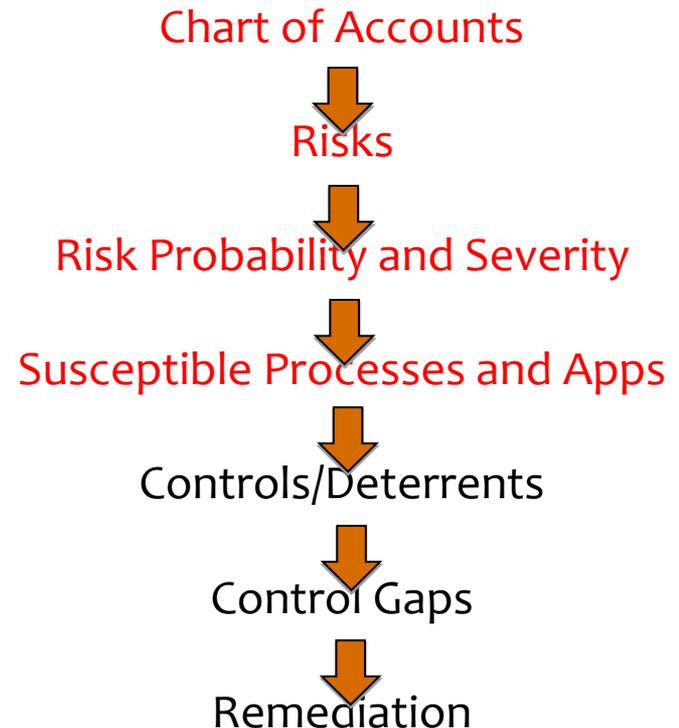
Controls and Risk

(Code of Conduct, Hiring Practices, Whistleblower Procedures)

Institutional Approach



Financial Statement Approach



Controls Alignment

Control Life Cycle (discovery-resolution)

-> Analyze -> Identify -> Confirm -> Investigate/Escalate -> Report/Track -> Resolve

It is critical when assessing the design and operating effectiveness of a control that the control life cycle (analysis of control results through to resolution of exceptions disclosed) be considered.

Control Validation/Assessment

-> Assess Control Performance -> Identify Unexpected Gaps -> Strengthen Control

Process or Control?

For each order received, a customer service specialist completes a corresponding physical order form/processing ticket that is kept with the order throughout processing and shipment.



Process or Control?

New providers are subject to an application review process; Provider Relations personnel reviews include application verification, subcontracting criteria for national providers (Hiring Procedure), tax status, pricing, MBE status, accreditation for DME providers and insurance coverage, including adding the company as a certificate holder.

Process or Control?

All new users, transferred users, and promoted users are setup with access through an electronic form. Access is setup based upon the users' job title and duties.



Process or Control?

Returns to the vendor (e.g., recalls, warranty exchanges, DOA) are shipped following predefined inventory return instructions.



Process or Control?

New hires, including temporary personnel, are subject to background checks and drug screening conducted by a firm specializing in such checks.



Process or Control?

Refurbished inventory (i.e., tested with no trouble found or parts were replaced) receives a new part number per client requirements.



Automated Controls

- Embedded in an applications
- Eliminates the risk of the control not being performed (manual controls can be easily circumvented if not monitored)
- Consists of one or multiple edit checks residing in the logic of the application

Automated Controls

To conclude on the effectiveness of an automated control, one may have to validate each individual edit check separately (more often than not, the only valid means of concluding on the effectiveness of each edit check within a processing sequence is to challenge each edit check independent of the other edit checks unless the application is designed not only to reject the entry but to report on which fields did not pass).

Automated Controls

Validating Automated Controls

- Test Environment
- Benchmarking
- Change Controls
- Sampling/Data Analytics

Examples of Automated Controls

- Double entry general ledger system
- Wire transfer limits
- Data validation (e.g., social security number, birth date)
- PO system/three way match

Summary



Summary

Threes Lines of Defense

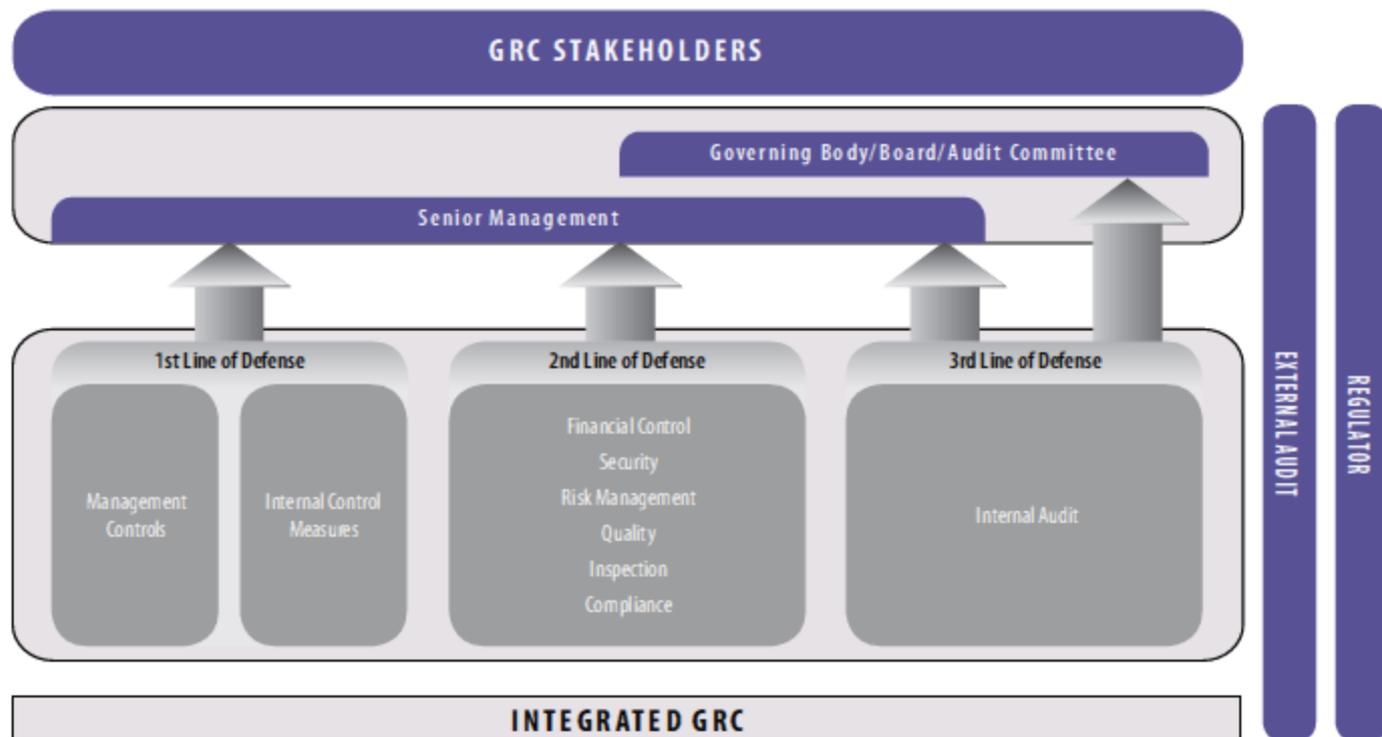


Figure 1: The IIA's "Three Lines of Defense"⁹³

Conclusion

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