

Internal Control and Internal Auditing

Monitoring Internal Controls



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Create Opportunities

Learning Objectives

Participants should be able to:

- Recall the two major internal control frameworks
- Define the 5 internal control components
- Apply the internal control principles related to monitoring internal control
- Analyze internal audit strategies and approaches



We Need to Study Internal Controls!

Internal controls might be the most under studied management function within an organization and its importance is critical to both **protecting** the organization and **achieving** its objectives.

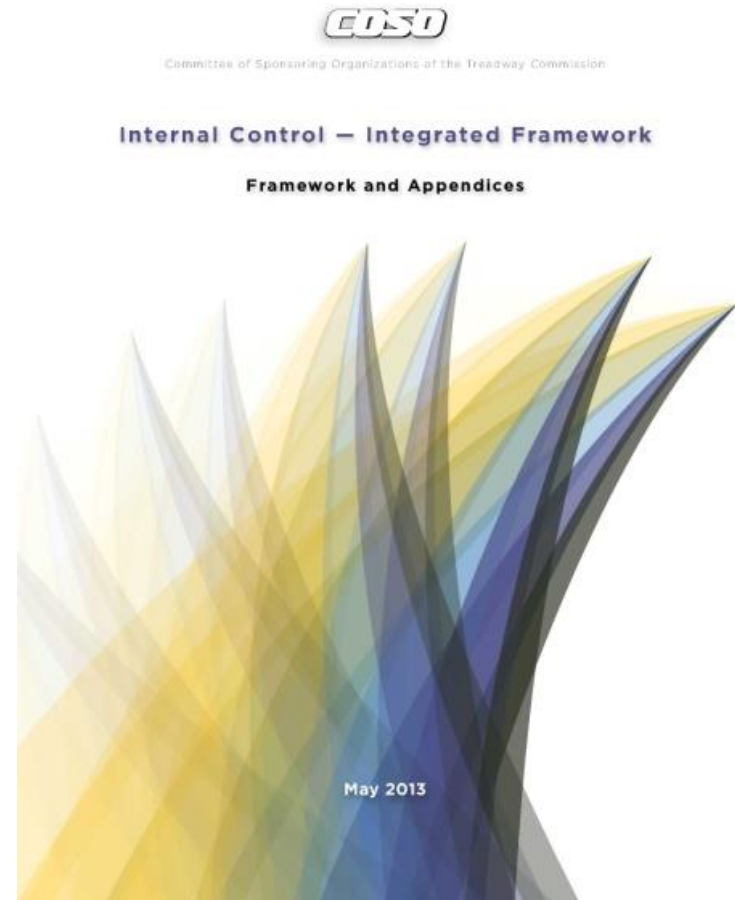
Why Do We Need a Internal Control Framework?

A framework is a basic conceptual structure to achieve an objective.

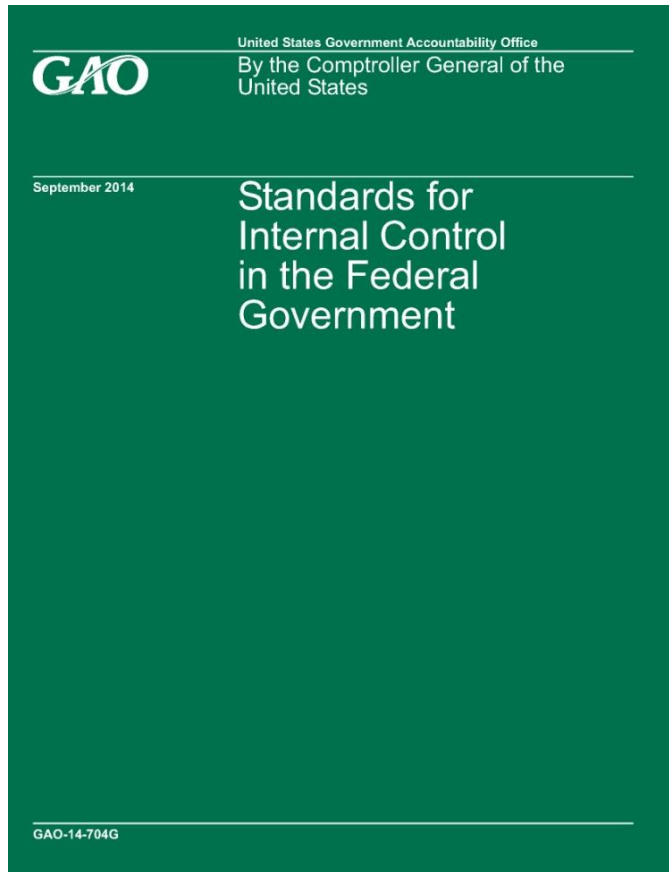
- Provides standards for management
- Provides criteria for auditors

Updated COSO Framework

Released
May 14, 2013



Standards for Internal Control in the Federal Government



The Green Book is on
GAO's website at:
www.gao.gov/greenbook

What's in Green Book for the Federal Government?

- Reflects federal internal control standards required per Federal Managers' Financial Integrity Act (FMFIA)
- Serves as a base for OMB Circular A-123
- Written for government
 - Leverages the COSO Framework
 - Uses government terms



What's in Green Book for State and Local Governments?

- Acceptable framework for internal control on the state and local government level under proposed *OMB Uniform Guidance for Federal Awards*
- Written for government
 - Leverages the COSO Framework
 - Uses government terms
- OMB and GAO believe Green Book is good for all governments. Sean does too.



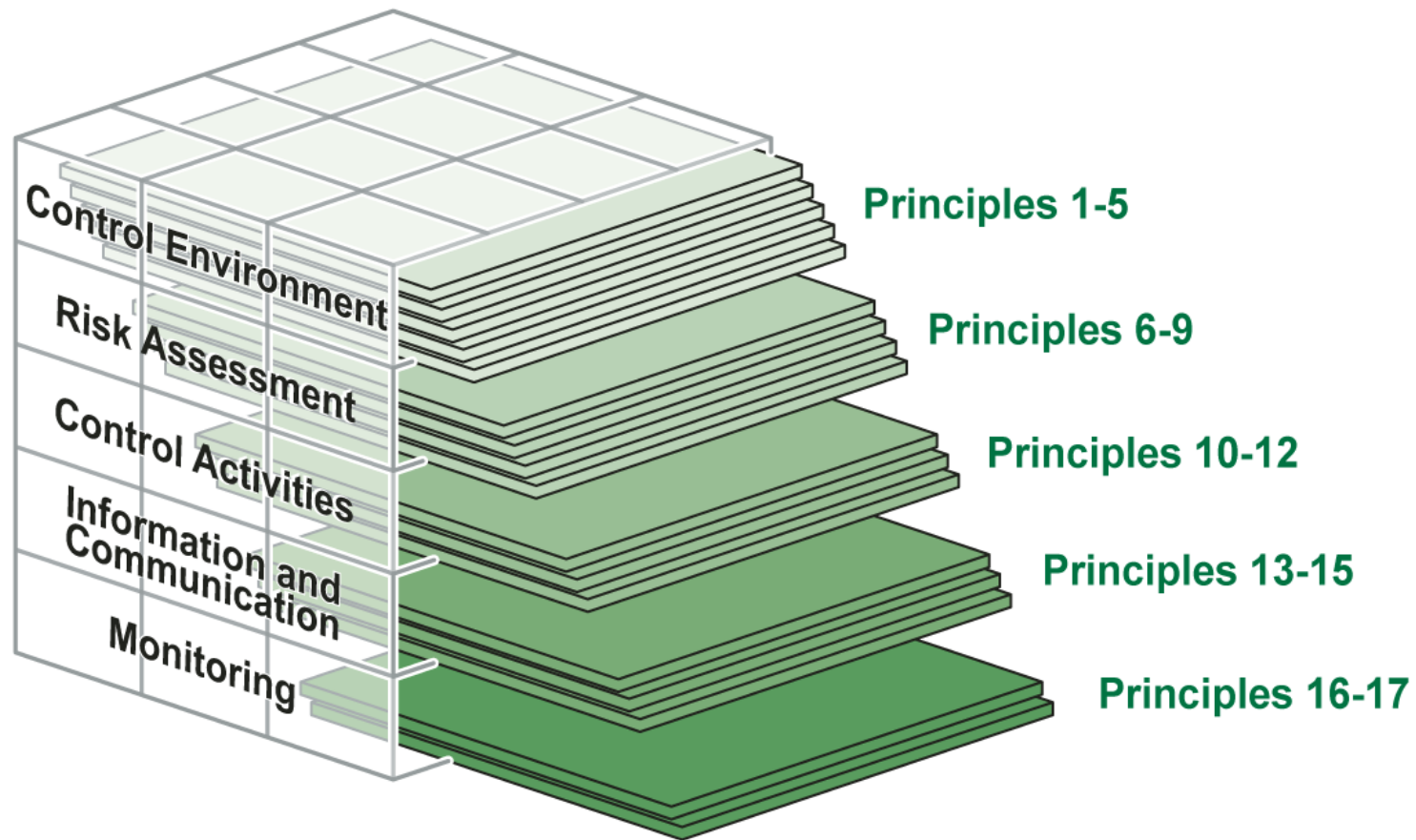
The COSO Framework

- Relationship of **objectives** and **components**
 - Direct relationship between objectives (which are what an entity strives to achieve) and the components (which represent what is needed to achieve the objectives)
- COSO depicts the relationship in the form of a cube:
 - The **three** objectives are represented by the columns
 - The **five** components are represented by the rows
 - The entity's organization structure is represented by the third dimension



Source: COSO

Components and Principles



5 Components and 17 Principles

Control Environment

1. Demonstrate Commitment to Integrity and Ethical Values
2. Exercise Oversight Responsibility
3. Establish Structure, Responsibility, and Authority
4. Demonstrate Commitment to Competence
5. Enforce Accountability

Risk Assessment

6. Define Objectives and Risk Tolerances
7. Identify, Analyze, and Respond to Risk
8. Assess Fraud Risk
9. Analyze and Respond to Change

Control Activities

10. Design Control Activities
11. Design Activities for the Information System
12. Implement Control Activities

Information & Communication

13. Use Quality Information
14. Communicate Internally
15. Communicate Externally

Monitoring

16. Perform Monitoring Activities
17. Remediate Deficiencies

Control Environment

The foundation for an internal control system. It provides the **discipline and structure** to help an entity achieve its objectives.



Control Environment

1. Demonstrate Commitment to Integrity and Ethical Values
2. Exercise Oversight Responsibility
3. Establish Structure, Responsibility, and Authority
4. Demonstrate Commitment to Competence
5. Enforce Accountability

Risk Assessment

Assesses the risks facing the entity as it seeks to achieve its objectives. This assessment provides the basis for developing appropriate risk responses.



Risk Assessment

- 6. Define Objectives and Risk Tolerances
- 7. Identify, Analyze, and Respond to Risk
- 8. Assess Fraud Risk
- 9. Analyze and Respond to Change

Control Activities

The actions management establishes through policies and procedures to achieve objectives and respond to risks in the internal control system.



Control Activities

- 10. Design Control Activities
- 11. Design Activities for the Information System
- 12. Implement Control Activities

Information & Communication

The quality information management and personnel **communicate** and use to support the internal control system.



Information & Communication

- 13. Use Quality Information
- 14. Communicate Internally
- 15. Communicate Externally



Monitoring

Activities management establishes and operates to **assess the quality** of performance over time and properly resolve the findings of audits and other reviews.



Monitoring

- 16. Perform Monitoring Activities
- 17. Remediate Deficiencies

Simplified COSO Questions

- What does management do to ensure they meet the objective?
 - (control activity)
- How does management communicate to others what they do?
 - (information and communication)
- Why does management do what it does?
 - (risk assessment)
- How does management ensure control activities are performed?
 - (monitoring)
- What does all that say about management?
 - (control environment)

Monitoring Overview

Since internal control is a dynamic process that has to be adapted continually to the risks and changes an entity faces, monitoring of the internal control system is essential in helping internal control remain **aligned** with changing objectives, environment, laws, resources, and risks.

Internal control monitoring assesses the **quality** of performance over time and promptly resolves the findings of audits and other reviews. Corrective actions are a necessary complement to control activities in order to achieve objectives.





Principle 16

Monitoring Activities

Management should establish and operate monitoring activities to monitor the internal control system and evaluate the results.

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Establishment of Baseline

- Current state vs. management's design at a certain point in time

$$\text{Design} - \text{Current State} = \text{Control Gap}$$

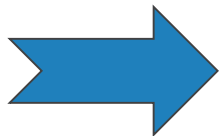
- Management either changes the controls design or improves the controls operating effectiveness
- Goal is to minimize the “Control Gap”



Internal Control System Monitoring

Management monitors controls through ongoing monitoring and separate evaluations.

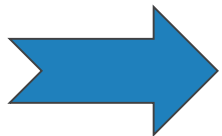
- Ongoing monitoring
 - Normal course of operations
 - Performed continually
 - Responsive to change
 - Examples:
 - ◇ Regular management and supervisory activities such as comparisons, reconciliations, and other routine actions.
 - ◇ Manual and automated.



A control designed to ensure other controls have been operating effectively on an ongoing basis.

Internal Control System Monitoring (cont.)

- Separate evaluations
 - Specific timing, objective, function or process
 - Scope and frequency is based on separate evaluations depending on:
 - ◇ Assessed risk
 - ◇ Effectiveness of the ongoing monitoring
 - ◇ Rate of change in the entity
 - ◇ Overall environment
 - Audits and evaluations – management can use the audits and evaluations of the others (greater objectivity).
 - ◇ Internal audit, external auditors, regulators, etc.

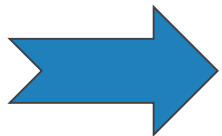


Internal control monitoring is a management function, however, others can provide information that is objective to the monitoring process.



Evaluation of Results

- Documentation of ongoing monitoring and separate evaluations
 - Take credit for what you do!
 - Required under the framework
- What should be and what is?
 - Document the Control Gap and any recommendations to remediate deficiencies.



Documentation drives performance.



Principle 17

Remediate Deficiencies

Management should remediate identified internal control deficiencies on a timely basis.

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Reporting of Issues

- **Timely** report internal control issues through established reporting lines
 - Internally to **person responsible** for control and **supervisor/management**
 - Externally if required.



Evaluation of Issues

- **Timely** evaluate and document internal control issues and the appropriate corrective actions.
 - Control deficiency?
 - ◇ Design issue
 - ◇ Implementation issue
 - ◇ Effectiveness issue

Corrective Actions

- **Timely** completion and documentation of corrective actions
- Audit resolution process ends after action has been taken that:
 - Corrects identified deficiencies
 - Produces improvements, or
 - Demonstrates the findings and recommendations do not warrant management action





Internal Auditing

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Association of Local Government Auditors



ALGA

ALGA empowers our local government auditing community through excellence in advocacy, education, communication, and collaboration to protect and enhance the public good while embracing diversity, equity, and inclusiveness.

Maryland Members

Anne Arundel County
Baltimore County
Board of Education of Howard County
Charles County
Frederick County
Harford County

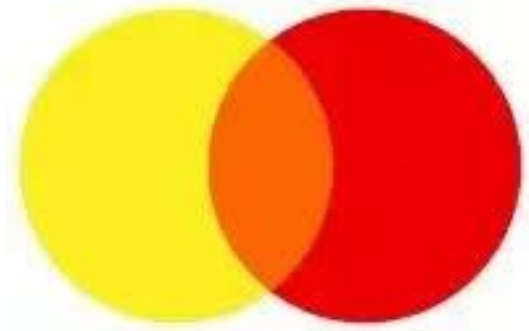
Howard County
Maryland-National Capital Parks & Planning
Maryland Judiciary*
Montgomery County, Office of Inspector General
Prince George's County Public Schools
Washington Suburban Sanitary Commission

* = 2018 Conference Attendee



Standards of Practice

- Yellow Book, *Government Auditing Standards*
 - Government Auditing Standards (GAO)
- Red Book, *International Standards for the Professional Practice of Internal Auditing*
 - Institute of Internal Auditors (IIA)
 - CIA credential issuer
- Orange Book
 - Both Yellow and Red Book



Branch of Government

*Legislative (Governance)

- Increased objectivity and independence
- Reports directly to oversight board
- Auditor protected against retribution
- Conducts audit to professional standards

Executive (Management)

- Lacks objectivity and independence
- Influenced by management by organizational chart
- Periodic evaluations to be used by management
- Not following accepted standards

* ALGA recommend practice



Auditor Independence (Objectivity)

- Auditors who are not independent might think they can't or shouldn't look into some programs or departments.
- Auditors who are not independent might not report significant problems to avoid retaliation.
- If either of these happens, serious problems might never be brought to your attention.
- If the problem eventually becomes public, you and your organization may be blamed for not knowing about it.





Internal Audit Opportunities

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Project Types

- Risk assessment (entity-wide, departmental)
- Survey
 - Questions and follow-up
 - “Micro”-reporting
- Performance audit
 - Performance based using KPI
 - Evaluation
 - Compliance related
- Agreed-upon procedures

Risk Management

RISK	DESCRIPTION	10%	10%	10%	15%	15%	15%	10%	10%	5%	100%
		Level of documented control procedures	Size or volume	New products, services or processing systems	Personnel turnover and mix	Complexity	Susceptibility to fraud	Information and reporting	Inherent Level of Risk to the Organization	Frequency mentioned during interviews.	Total Score
Data Breach	The risk that the organization's data is vulnerable from internal or external threats and should any of the data be comprised the Wolf Trap brand would be damaged.	2	5	4	3	5	4	5	5	3	4.05
National Park Service Relationship	Risk that the relationship with the national park service does not reflect that of a partner but rather creates additional complexities in order to accomplish business. In addition, the risk relates to the 2018 renewal of contract with NPS and the impact that specific contract terms has on the efficiency, flexibility, and capabilities of the organization.	3	5	4	3	4	1	2	5	5	3.35
Age of Venue- Filene Center	Risk that investment in the physical structure, sound equipment and other venue related technology is unable to be accomplished resulting in an outdated facility that may not support the mission of the organization.	3	5	4	3	4	3	1	4	3	3.35
Succession Planning	The risk that Wolf Trap's operations would be disrupted, particularly within smaller departments, due to current employees not available or having the capabilities to fill key positions should those positions be vacated for reasons other than termination.	5	2	1	5	3	2	3	5	5	3.35
Audience Competition	The risk that external competition makes it difficult to achieve the organization's mission, maintain consistent philanthropic support year to year, or adequately manage programming based on other venues desirability and pricing.	3	5	3	1	4	2	4	5	5	3.30

Categories

- Finance
- Housing, Social Service, Community Development
- Human Resources
- Information Technology
- Park, Recreation, Library
- Procurement, Contract Compliance
- Transportation and Fleet
- Public Safety
- Public Works, Capital Facilities
- Public Utilities
- Environmental

Internal audit should be more than just financial.

Finance Categories

- Cash handling
- Airport parking revenues
- Tax billing
- Credit card
- Assessor's office
- Wire transfers
- Departmental audits
- Payroll
- General disbursements
- Jail operations

Example Abstract (ALGA website)

Vendor Enrollment & Management

Release Date: 6/30/2017

Audit Shop Name: Jackson County

Audit Category: Finance

Purpose

Our objectives focused on assessing the level of strength of the County's vendor management control system. Our work focused on analyzing the design and implementation of controls as they relate to the risks discussed in this report.

Findings

Many standard controls have been implemented. Given the size of the County and the size of some departments, not all duties are segregated from other related duties. We conducted certain tests and did not identify any fraudulent activity. Nonetheless, we do report on control limitations for the purpose of ensuring management is aware of potential risks that are a natural outcome of these limitations.

Contact Information

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[http://jacksoncountyor.org/DesktopModules/Bring2mind/DMX/Download.aspx?](http://jacksoncountyor.org/DesktopModules/Bring2mind/DMX/Download.aspx?EntryId=43366&Command=Core_Download&language=en-US&PortalId=0&TabId=1740)

[EntryId=43366&Command=Core_Download&language=en-US&PortalId=0&TabId=1740](http://jacksoncountyor.org/DesktopModules/Bring2mind/DMX/Download.aspx?EntryId=43366&Command=Core_Download&language=en-US&PortalId=0&TabId=1740)



Example Abstract (ALGA website)

Audit of Employee Travel Expenditures: The City Should Pursue Improvements to Ensure Employee Travel Is Necessary, Reasonable, and Consistent With Policy

Release Date: December 12, 2013

Audit Shop Name: City of San José, Office of the City Auditor

Audit Category: Miscellaneous

Summary

During this audit, we: 1) reviewed a judgmental sample of employee travel expenditures for appropriateness and compliance with City policies and procedures; and 2) assessed the control environment for travel authorizations and expenses.

Description

At the City of San José, employees travel for a number of business needs. Prior to 2009, travel requests and approvals went through the City's Finance Department, but now, individual departments review, approve, and track travel on their own and the Finance Department has a more limited role. We reviewed approximately 300 trips, and found: • Some trips appeared more costly than necessary or reasonable. • Some travel activity and expense reimbursements appeared inconsistent with City rules, including the Employee Travel Policy and ethics rules. • Supporting documentation, including receipts and identification of expenses, was often missing. • The designated experts on the Travel Policy - departmental travel coordinators - did not always review and track travel activity/expenses, coordinate group or recurring trips to promote economical travel, or challenge questionable activities and expenses. These individuals' location within their departments' organizational structures and their exclusion from trip planning and approvals undermined their ability to perform these roles. • Some travel expenses, particularly those transacted through City procurement cards, escaped the attention of departmental travel coordinators and occurred without appropriate review or approval. Similarly, some forms of payment, such as gas cards and mileage reimbursements, were not factored into trip costs. • Weak controls over travel tracking and reporting, travel reimbursements, and cash advances resulted in poor record-keeping, late reconciliations, and payment errors. • Weaknesses in the City's Travel Policy and travel expense reconciliation form hampered disclosure of travel activity, and loopholes encouraged excess costs. Travelers needed clearer and updated guidance. To address these issues, the audit outlines 13 recommendations to the City Administration and the Finance Department. The Administration agreed with all the recommendations, and is following up on the instances of potential non-compliance identified during the audit.

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sanjoseca.gov/DocumentCenter/View/24846





Internal Audit “Pitfalls”

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Scoping an Audit

- **Too much** included in the scope
 - Not enough time or resources
- Objectives **unclear** or **too broad**
- **Missing expertise** in the staffing plan
- Unable to provide **organizational value**
- Procedures do not address the **identified risks**
- **Constraints** placed on auditor by management



Timing of Deliverables

- **Too slow** to add value
 - Usually too much in the scope
 - Auditee delays the process
- Audit period **too old**
 - Changes have already been made without the audit results



Contracting for Internal Audit

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Why Contract?

- Flexibility in staffing resources
 - Able to get medical, environmental, information technology expertise
- Increased objectivity and independence
 - Sometime internal audit can be seen as less objective and not independent by constituents and others
- Variable in cost
 - Contracts are not a fixed cost



Best Practices in Contracting Internal Audit

- Request for Qualifications (RFQ)
 - Select more than one vendor (concurrent work, specialties, cost control)
- Issue scopes of work/task orders
- Work with the vendor to control the scope and related cost before committing to the project
 - Objective-based
 - Cost-based
- Be part of the process to ensure the project meeting the stated objectives.





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