Segregation of Duties/Internal Controls
2017 WASBO Accounting Conference

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Objectives

▶ Discuss failures of internal controls to detect or prevent fraud and learn how to implement controls and practices to reduce the likelihood of fraudulent activities
▶ Understand how Segregation of Duties (SoD) affects your internal controls
▶ Examine the cost-benefit analysis that takes place at a school district with respect to designing an internal control structure considering SoD
▶ Demonstrate how to implement effective SoD
   – Districts should identify their SoD risks and controls
   – A process is needed to correct ineffective SoD
   – Maintaining effective SoD requires processes and tools

Agenda

▶ Discuss fraud and risks of fraud
▶ Examples of Segregation of Duties (SoD) violations
▶ Demonstrate a method for evaluating SoD
▶ Considerations for maintaining proper SoD
"The Fraud Triangle" - Dr. Donald Cressey

Opportunity
- No Separation of Duties
- Close relationships with third parties
- Understanding of accounting functions

Rationalization
- I will pay it back
- I deserve this
- They won’t miss it

Unshareable Need
- Personal financial problems
- Addictions
- Unrealistic goals

Fraud Characteristics
- Fraud always starts small
- There are always fraud warning signals
  - Collection agency calling
- You can’t be too trusting. Fraud always involves confidence.
- Tone at the top is most important
- Establishing controls always good! Ensuring controls established are working always better!
  - Internal controls will fail if not monitored.

Real Life Examples
- Credit card purchases and monitoring
  - Purchasing supervisor responsible for monitoring credit card purchases
  - Accounts payable: Invoice documentation reviewed by purchasing supervisor/not forwarded to accounts payable
  - No review of purchasing supervisor’s detailed invoices; statement documents illustrated diverse purchases
- Credit card purchasing and monitoring
  - Library administrative assistant purchased textbooks for child
  - Credit card statement approved by director/remit to finance without detail
Real Life Examples

- Unauthorized disbursements
  - Grant program assistant requisitioned more hotel rooms at conference
  - Canceled/requested gift cards in lieu of cash refunds
  - Purchased computers for grandchildren through grant budget

- Capital projects expenditures
  - Large dollar invoices
  - Not part of operating budget
  - Generally, lack of segregation of duties – one key employee in monitoring projects

Real Life Examples

- Unauthorized payroll disbursements
  - Payroll checks issued duplicated direct deposit
  - Reoccurring payroll entry to book unauthorized disbursements
  - Fraud built into budget
  - Caused by payroll system glitch and lack of segregation of duties

- Cash receipts schemes
  - Parking ticket revenues
  - Pupil activity funds diverted to pay costs directly
  - Generally, lack of segregation of duties – one key employee

Fraud Schemes

- Methods of Committing Fraud have Changed 30 Years Ago:
  - Stealing cash receipts
  - Stealing supplies and equipment
  - Checks for cash
Fraud Schemes (continued)

- Methods of Committing Fraud have Changed
  Now:
  - Electronic transfers to personal accounts
  - Unauthorized payments – fake vendors
  - Payroll schemes – fake employees, unauthorized payments
  - Credit card purchases for personal use

Why are Governments Susceptible?

- Management and governing boards are more trusting.
  - Lack of "owner" role
- Cost restrictions and size limitations
  - Segregation of duties (budget constraints)
  - Limited anti-fraud programs or controls
  - Limited ratio analysis

Fraud: Our Role as Auditors

- School District
  - What are your roles and responsibilities?
- Auditors
  - What red flags should we be aware of?
    - Personal situations of employees are difficult for auditors to know or detect.
  - What are our professional responsibilities?
Auditors’ Responsibilities

“...risk assessments, the auditors consider internal control relevant to the School District’s preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the District’s internal control. Accordingly, we express no such opinion.”

Internal Control Assessments
- Deficiency (management letter comment)
- Significant deficiency (finding)
- Material weakness (finding) – “reasonable possibility that a material misstatement of the entity's financial statements will not be prevented, or detected and corrected timely.”

Internal Controls

Internal control is broadly defined as an integral process, affected by a municipality’s governing body, management and other personnel, designed to provide reasonable assurance regarding the achievement of objectives in the following categories:

- Reliability of financial reporting.
- Compliance with applicable laws and regulations.
- Effectiveness and efficiency of operations.

Internal controls are dependent upon people and will succeed or fail depending on people.

Committee of Sponsoring Organizations of the Treadway Commission (“COSO”)

- Control Environment - board, committees, policies
- Risk Assessments - identification of risks the government is facing
- Control activities - segregation of duties, reconciliations
- Information and communication - financial reporting
- Monitoring - are policies/controls still current/relevant
Communication/Awareness

- Control environment – Board Governance
  - Asking the right questions (oversight role)
    - Are controls in place?
    - Are we following best practices?
    - How have we assessed internal controls?
  - Authorization (budget, purchases, debt financing, disbursements)
  - Address noncompliance with policies, procedures and internal controls.

Communication/Awareness

- Control environment - management oversight
  - Establishment of strong policies and procedures
  - Awareness of fraud red flags
    - It is most common for employees who steal to use the proceeds for lifestyle improvements (i.e. more expensive cars, extravagant vacations, expensive clothing, new or remodeled homes, expensive recreational property, and outside investments).
    - Addicted to gambling

Internal Controls

- Controlling the opportunity
  - There are two sets of controls that school districts can implement depending on their environment:
    - Preventative controls - such as segregation of duties and access controls can be implemented in the beginning of a process to not allow fraud to happen.
    - Detective controls such as monitoring or reconciliations can be implemented on the back-end which will help to identify the occurrence of fraud after the fact.
Internal Controls

- How do you define where there should be internal controls?
  - Understand your processes
    - Segregation of duties
    - Multiple layers of authorization
  - Define key control points in those processes by asking yourself where there could be a breakdown in the process
  - Ensure or recommend controls for where controls could breakdown during those processes

What is Segregation of Duties?

- How do you define it?
  - COSO: “Dividing or allocating tasks among various individuals making it possible to reduce the risks of error and fraud.”
  - Contains four functions
    - Authorizes transaction
    - Custody of asset, whether directly or indirectly, e.g., receiving checks in mail or implementing source code or database changes
    - Records, e.g., preparing source documents, code or reports
    - Reconciles in general ledger
  - Ideally, a single individual would have responsibility for only a single function

What is Segregation of Duties?

- What is the goal of segregation of duties?
  - Benefits of implementing and maintaining SoD include:
    - Safeguarding of assets
    - Accurate financial reporting
    - Reduced risk of non-compliance
  - SoD conflicts are not equally important and can be overcome by proper design of compensating controls
Evaluating Your Segregation of Duties

- Management is responsible for enforcing and maintaining proper SoD
- Create listing of incompatible duties
  - Consider "sensitive" duties such as posting of journal entries, performing reconciliations and Vendor Master
  - Identify level of risk accepted (cost-benefit)
- Develop SoD matrix
  - Correlates procedure with internal control function, and identifies the level of risk
  - Can be used to evaluate your ability to segregate duties and documents to your board/auditors your risk assessment considerations

Example SoD Matrix

- Correlates procedure/function with risk
- Design compensating/detective controls to offset risk

Evaluating Your Segregation of Duties

- Translate SoD requirements into applications
  - Define how you grant user access
  - Roles should not contain "built-in" conflicts
  - Identify the "sensitive" objects associated with conflicting duties
    - Example: Restricted finance director's ability to enter journal entry
- Additional issues and complexity
  - Users assigned to multiple roles
  - Users assigned access rights by User ID
  - Users accessing multiple systems
Maintaining Segregation of Duties

- **Prevention**
  - Tools for granting user access rights
    - IT becomes a gatekeeper
  - Maintain strong userid and password requirements

- **Detection**
  - Internal audit
  - Periodic evaluation and monitoring
  - Exception reporting

- **Automated Methods**
  - Automated monitoring
  - ERP system tools and workflow

Prevention and Detection Strategies

- **How can you reduce the risk of fraud:**
  - Communication/Awareness
    - Discuss with the Board their role in monitoring financial activities
  - Risk Assessment - internal control enhancements to control employee's opportunity to commit fraud
  - Strong internal control system
    - Even at small districts with limited employees, controls should be implemented to minimize opportunities

- **Strategies to reduce your risk:**
  - Professional skepticism
  - Understand red flags

Why Do Internal Controls Fail?

- **Heavily reliant on people**
  - “Going through the motions”
    - Process driven versus understanding role
  - “See no evil, hear no evil”
    - Conflict avoidance; not my job, not my business
  - “Management override”
  - “Employee turnover”
    - Lack of documentation (who, why, how)
  - “Where’s all the time gone?”
Sample Risk Assessments

Handouts
- Accounts payable and disbursement process
- Receipting, invoice and revenue recognition process
- Payroll, human resources process

Strengthening Controls with Limited Resources

Controls that help you get the biggest bang for your buck!
- Integration of board member (smaller organizations) in processes
- Positive Pay - a feature offered by banks that can identify potential fraud
- Pay attention to check sequencing - an out of sequence check can tip you off to fraud
- Surprise procedural reviews
- Encryption
- Password protection

Lessons Learned

Do you have Internal Controls in Place to Prevent/Minimize Fraud?
- Is financial information presented timely and accurately and generated from the general ledger system, not spreadsheets?
- Is there a fraud risk management process - identification by board/management of areas of potential risk on an ongoing basis?
- Make sure employees understand their role in your internal control structure.
- Keep documents (bank recs, blank checks, invoices, personnel files, etc.) in appropriate areas with appropriate controls
- If employee goes on vacation, does someone else perform their job? Mandatory vacations?
- Conflict-of-interest policy is critical!
Lessons Learned (continued)

▶ SoD helps prevent fraud and errors
▶ Districts should identify their SoD risks and controls
▶ Detective controls can be effective
▶ A process is needed to correct ineffective SoD
▶ Maintaining effective SoD requires processes and tools
▶ Management is always surprised about current access
▶ Without performing an analysis, SoD issues are apparent after something bad occurs

THANK YOU!

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