

Internal Controls: Safeguarding your Company

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Agenda

- COSO Framework – Foundation of present day Internal Control Activities
- Internal Control Activities by major transaction processing cycle
- Impact of Information Technology in the Internal Control environment
- Fraud
- Sarbanes-Oxley Act – Will it impact me ?
- Questions

COSO Framework

- The COSO (*Committee of Sponsoring Organizations of the Treadway Commission*) was originally issued in 1992 in 4 volumes (Framework, Evaluation Tools, Reporting to External Parties and Executive Summary)
- The Sponsoring Organizations were:
 - American Accounting Association (AAA)
 - American Institute of Certified Public Accountants (AICPA)
 - Financial Executives International (FEI)
 - Institute of Internal Auditors (IIA)
 - Institute of Management Accountants (IMA)
- The Treadway Commission stated that the definition of internal control must be overhauled in order to discourage fraudulent financial reports
- The Treadway Commission instructed the COSO to “work together to integrate internal control concepts and definitions, and to develop a common reference point”

COSO Definition of Internal Control

COSO defines internal control as:

A process, effected by an entity's board of directors, management and other personnel, designed to provide reasonable assurance regarding the achievement of objectives in the following categories:

- Effectiveness and efficiency of operations;
 - *Effectiveness* is doing the right thing, *Efficiency* is doing the right thing the right way
- Reliability of financial reporting;
 - Management representing that financial statement components have certain characteristics (Existence or Occurrence, Completeness, Rights and Obligations, Valuation or Allocation, Presentation and Disclosure)
 - More than just published financial statements and;
- Compliance with applicable laws and regulations
 - Potential cost of non-compliance can be significant in financial terms and in loss of reputation.

COSO Components of Internal Control

- COSO states that internal control consists of 5 interrelated components that are derived from the way management runs the entity and that are integrated with the management process:
 - Control Environment
 - Risk Assessment
 - Control Activities
 - Monitoring
 - Information and communication

COSO Components of Internal Control

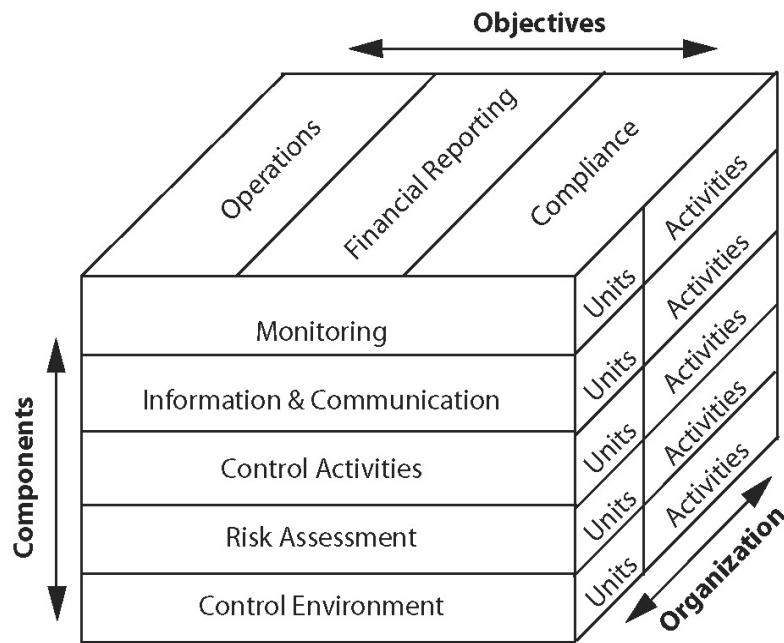
- **Control Environment:**
 - Foundation for the internal control system
 - Integrity, ethical values and competence are part of the control environment
- **Risk Assessment**
 - Any condition, event, or factor that might prevent the organization from achieving its objectives
- **Control Activities**
 - Once the risks are known, control activities are established to prevent or detect the risks
 - The policies and procedures that people perform that management's directives related to risk are carried out
- **Monitoring**
 - Monitoring mechanisms receive and evaluate the output of control activities
 - Monitoring also encompasses the ongoing appraisal of the performance and capabilities of the control system itself
- **Information and Communication**
 - Information is disseminated through channels of communication through every level of the internal control structure
 - Quality of the information is only as good as the ability of the communication channel and the communication channel is only as good as the quality of information it delivers

COSO Components of Internal Control - Examples

- Control Environment:
 - Management's philosophy and operating style
 - Competency of individuals (education, training, skills)
 - Hiring policies
- Risk Assessment
 - Market conditions
 - Government regulations, external events
- Control Activities
 - Authorizations and approvals
 - Verifications and reconciliations
 - Performance review
 - Security of assets
 - Segregation of Duties, Information Technology controls
 - ***Focus of this presentation***
- Monitoring
 - Comparison of system data to physical assets (i.e. inventory records to physical counts)
 - Regular managerial reviews
 - External feedback from customers, suppliers, other interested parties
- Information and Communication
 - Information systems (internal and external) must be of high quality
 - Internal communication (two-way, both planes)
 - Sales must communicate with production; engineering with marketing
 - Senior Management must list to lower level management
 - External communication (customers, suppliers, regulators, etc.)

COSO Components of Internal Control

Graphically, the integrated COSO framework is depicted below



Internal Control Activities by Major Transaction Cycle

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Internal Control Activities by major transaction processing cycle

- For a manufacturer & distributor, the major processing cycles can be summarized as:
 - Purchasing
 - Receiving
 - Accounts Payable Invoicing
 - Cash Disbursements
 - Inventory Management
 - Order Entry
 - Shipping
 - Customer Invoicing/Accounts Receivable
 - Cash Receipts
 - Payroll
 - Financial and Operational Reporting (internal/external)

Internal Control Activities by major transaction processing cycle - Purchasing

- Vendor Selection – segregation of duties
 - Purchasing responsible for identifying and collecting business information about potential vendor
 - Finance responsible for assessing financial capabilities of vendor
 - Quality (or equivalent) responsible for monitoring vendor performance
 - Independent entry into ERP system
- Purchasing
 - Segregation of duties between purchasing, receiving and accounts payable functions
 - Use of purchase order for all purchases (not just products)
 - There will be exceptions but these should be kept at a minimum
 - Use of tolerance limits for price and quantity (ERP system feature)
 - Only pre-authorized (via vendor selection process) vendors should be used (data validation by ERP system)

Internal Control Activities by major transaction processing cycle – Receiving

- Segregation of duties from Purchasing and Accounts Payable
- Only receive on an open purchase order
- Centralized or controlled receiving area
- Blind receiving if possible at the receiving area
- Use of bar coding
- Daily receiving log prepared (generated by ERP system)
 - Used for proper cutoff and accruals
- Immediate update of perpetual inventory (ERP System) and accounts payable (un-vouchered payables)
- Ideally segregated into a quality area for inspection prior to release to inventory
- RMAs for customer returns

Internal Control Activities by major transaction processing cycle – Accounts Payable

- Segregation of duties from Purchasing and Receiving
- Three way match between purchase order, receiver and vendor invoice
- Escalation to source where three way match fails
- If tolerance limits have been implemented, override must be captured by the ERP system
- Segregation between invoice entry and posting (if possible)
- Only enter invoices for valid vendors
- Daily roll-forward of accounts payable
- Monthly reconciliations of accounts payable to general ledger
- Annual review of vendor activity
- Periodic cross referencing of vendor file to payroll file

Internal Control Activities by major transaction processing cycle – Cash Disbursements

- Segregation of duties from Accounts payable invoice entry and check writing
- Segregation of duties between cash receipts, cash disbursements and bank reconciliations
- Mailing of bank reconciliations to owner or other non-financial representative address
- Physical security over checks and check signing mechanisms (stamps, printer device, etc.)
- Pre-numbered checks
- Payment based upon terms
- Review of agings and cash requirement reports
- Dual signature of checks based upon dollar value
- Positive pay if offered by financial institution
- Limited use of check requests
- Call back on electronic fund transfers

Internal Control Activities by major transaction processing cycle – Inventory Management

- Segregation of duties from Purchasing and Accounts Payable
- Physical security over inventory area (use of locked areas, security cameras (inside and outside), restricted access)
- Regular cycle counting (daily, if possible)
- Neat and organized warehouse layouts
- Use of bar coding or paper to track all movement of inventory
- Perpetual records for all inventory (including parts in trucks)
- Authorized returns only (RMA's)
- Periodic review of activity to assess obsolescence (based on sales activity)

Internal Control Activities by major transaction processing cycle – Order Entry

- Customer Selection – segregation of duties
 - Marketing/Sales responsible for identifying and collecting business information about potential customer
 - Finance/Credit Department responsible for assessing financial capabilities of customer (credit check)
 - Independent entry into ERP system
- Order Management
 - Segregation of duties between order entry, shipping and accounts receivable functions
 - Supported by purchase order or other evidence of customer authorization
 - Use of RMAs for customer returns

Internal Control Activities by major transaction processing cycle – Shipping

- Segregation from Order Management
- Use of bar coding
- Shipping log for cut-off
- Shipping manifests, bills of lading, etc to match with order management
- Cycle counting
- Prevention of Bill and Holds

Internal Control Activities by major transaction processing cycle – Customer Invoicing/Accounts Receivable

- Ideally automated based upon shipping application;
- If not, matching of ordering with shipping documentation prior to invoice generation
- Segregation of duties between accounts receivable and cash receipts
- Daily accounts receivable roll-forward
- Reconciliations between general ledger and accounts receivable
- Controlled credit memo process (RMA and customer write-offs) including independent approval of credit
- Annual review of customer master file
- Segregation between invoice entry and posting (if possible)

Internal Control Activities by major transaction processing cycle – Cash Receipts

- Use of lockbox
- Segregation of duties between cash receipts and reconciliation function
- For credit card transactions, daily reconciliations between revenue system and merchant bank receipts
- Segregation of duties between receipt and posting of cash
- Reconciliations between general ledger and accounts receivable

Internal Control Activities by major transaction processing cycle – Payroll

- Segregation of duties between Hiring and Payroll processing
- Background checks
- Senior approval for all new hires
- Periodic review of Payroll files with vendor files
- Periodic physical distribution of checks to employees
- Use of time sheets with appropriate authorizations and signoffs
- Review employee social security numbers against valid lists published by the Social Security Administration
- Periodic review of payroll costs for reasonableness
- Direct Deposits
- Pre-numbered checks, Security over check stock
- If outsourced (i.e. ADP), obtain and review SAS 70 report
- Expense reimbursement – original receipt policy over a pre-defined dollar amount
- For major expenses – consider direct bill to company versus reimbursement to employees

Internal Control Activities by major transaction processing cycle – Financial Reporting

- Monthly reconciliation of general ledger accounts on a rotation basis
- Review key benchmarks/ratios weekly and monthly
- Use of budget vs. actual (and/or prior year vs. actual) reporting with investigation of significant variances
- Authorization of journal entries
- Use of “soft” and “hard” closes
- Reconciliation of financial statements to trial balances (especially if you are utilizing a 3rd party report writer)
- Leverage third party involvement (independent auditors, outsourced internal audit function)

Impact of Information Technology in the Internal Control Environment

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Impact of Information Technology in the Internal Control Environment

- COSO Framework – Monitoring, Information and Communication
- 2 Components of the IT internal control environment
 - Application Controls
 - General Controls (Physical and Logical Access)
- Application Controls
 - Input
 - Processing
 - Output
- General Controls
 - Physical access to equipment
 - Logical Access to programs, data and operating system
 - Remote Access
 - Preservation of data (backups, Disaster Recovery)

Impact of Information Technology in the Internal Control Environment

- Do I have a custom system ?
 - If so, what are the controls over the development process ?
- Segregation of duties
 - Between programming and data entry
- Are there shadow systems ?
 - Are they backed up regularly ?
- Do I have a username and password policy ?
- How is remote access controlled ?
- Do I have a mandatory vacation policy ?
- Does my insurance cover loss of data ?
- Contingency plan/hot sites ?
- Documented policies, procedures, topology
- What do I do to monitor activity
 - System (access logs, etc.)
 - Application (presence of system audit trails)
- Do I conduct transactions over the web ?
 - Systrust or other seals of approval
- Are information technology operations regularly monitored ?

Fraud

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Fraud – Wells Report

- Wells Report (study of 508 fraud cases – total value of fraud value reviewed: \$761 million)
- Fraud defined as “the use of one’s occupation for personal enrichment through the deliberate misuse or misapplication of an organization’s resources or assets”
- Report Conclusions
 - Smaller organizations = greater risk (41.8% of fraud cases were in privately held organizations at an average loss of \$123,000)
 - Direct correlation between position and amount of loss
 - Most offenders are first-time
 - Most fraud not discovered in a routine audit
 - Most cases exposed by whistleblowers
 - Prevention is most cost-effective device
- Offender characteristics:
 - 53% of offenses committed by college-educated white males
 - Median losses by Men - \$160,000; Women - \$60,000

3 types of Fraud

- Asset Misappropriation (92%) – the theft or misuse of an organization’s assets such as payroll and cash disbursements. Some examples:
 - Fraudulent Disbursements
 - Billing Schemes
 - Payroll Schemes
 - Expense Reimbursement Schemes
 - Check Tampering
 - Register Disbursements
 - Skimming Cash
 - Unrecorded Sales
 - Lapping Schemes
 - Unauthorized credits or refunds
 - Larceny
 - Theft of cash on hand
 - Theft of deposits

3 types of Fraud - continued

- Corruption (30%) - the wrongful use of influence in a business transaction in order to procure some benefit for themselves or another person, contrary to their duty to the organization or the rights of another person. Some examples:
 - Conflicts of interest involving sales or purchases
 - Bribery in bid rigging or invoice kickbacks
 - Illegal gratuities
 - Economic extortion
- Fraudulent Financial Statements (8%) - Involve falsification of an organization's financial statements. Some examples:
 - Improper timing differences
 - Fictitious revenues
 - Improper asset valuations or measurement
 - Concealed or misclassification of liabilities and expenses

Fraud – Some Common Methods

- Shell companies used by employees for improper disbursements
- Personal purchases from a common vendor (gas, building supplies, etc.)
- Fictitious Employee checks
- Continued payment of departed employees by altering bank routing numbers
- Modifying withholding amounts such as 401k between employees (increase one/take away from another)
- Theft of Inventory
- Falsified employee expenses
- Bill and Hold transactions
- Unauthorized customer credits
- Modification of a variety of documents based upon technology advances

Fraud – Prevention Techniques

- Create a strong internal control environment (see previous discussion by transaction area)
- Establish and enforce a formal fraud and embezzlement policy that includes:
 - Sign-offs by all employees
 - Whistleblower hotline with rewards
 - Prosecution
- Know your key financial metrics, trends and indicators
- Independent Reviews

Fraud – Prevention Techniques - continued

- Watch for key warning signs for employees
 - Gambling, expensive habits
 - Unusual work schedules
 - Financial difficulties
 - Hesitancy to delegate tasks
 - Uncooperative
 - Resistance to taking vacation time
 - Living beyond one's means
 - Turn down of promotions/transfers
 - Un-reconciled general ledger accounts
- Establish a counseling mechanism, as necessary

Sarbanes Oxley

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Sarbanes Oxley – Will it Impact Me ?

- The Sarbanes-Oxley Act of 2002 was passed due to the accounting scandals at Enron, WorldCom, Global Crossing, Tyco;
- Consists of 11 sections; most notably:
 - Requires a company to issue an internal control report that states that management is responsible for establishing an adequate internal control structure for financial reporting and also contains management's assessment of its effectiveness (November 2006);
 - Certification of financial reports by CEOs and CFOs
 - Established the Public Company Accounting and Oversight Board
 - Eliminated certain types of non audit work that public accountants can perform for their clients
 - Others
- Applicable to all publicly traded companies in the United States, including all wholly-owned subsidiaries, and all publicly-traded non-US companies doing business in the United States

Sarbanes Oxley – Will it impact Me ?

- If you are publicly traded – obviously, yes
- If your organization is contemplating an IPO, you may need to comply with certain provisions
- Some privately held organizations are adopting Sarbanes Oxley because of the sense of inevitability
 - Primarily in the tax exempt arena
- Bottom line:
 - Sarbanes Oxley will most likely impact all organizations directly or indirectly to some extent
 - For example, customers who are publicly traded may impose new requirements upon privately held organizations that can be linked back to the Act
 - Financial institutions may impose internal control reporting requirements as part of lending covenants
 - Non public investors may demand adoption of certain provisions
 - Privately held organizations should adopt the “spirit” of the Sarbanes Oxley Act if not all of its provisions

Questions ?

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