Internal Controls

Agenda

- Internal controls framework
- Components of internal controls
- Internal controls by area
    - Control activities
    - Risks
    - Common issues
- Overall obstacles and guidelines

Circular Reasoning

- Effective internal controls rely on everyone to do their job
- Management and the board are responsible for setting the tone and establishing policies
- Staff are responsible for following the policies and reporting effectively
- Management relies on staff to provide accurate information
- Staff rely on management for adequate direction
- If there is a breakdown in internal controls, it is likely not due to one individual

Internal Controls

- Policies and procedures designed to protect assets, manage risk, and ensure accurate financial records and reporting.
- Prevent, detect, and/or correct errors, negligence, or fraud.
- COSO (Committee of Sponsoring Organizations of the Treadway Commission) definition:

  Internal control is a process, affected by an entity's board of directors, management, and other personnel, designed to provide reasonable assurance regarding the achievement of objectives relating to operations, reporting, and compliance.

Why do We Care?

- Public accountability
  - Governmental entities have a fiduciary responsibility to the public
  - Nonprofits receive contributions and donations from the public
- Effective controls help safeguard assets to provide assurance to the public that funds are handled appropriately.

Why do We Care?

- Compliance with external authorities
  - Governmental laws and regulations
  - Compliance requirements for federal funding
  - Debt covenants

Why do We Care?

- Prevent errors, negligence, or fraudulent activity
  - Individual level
    - Safeguards career and reputation
  - Entity level
    - Safeguards reputation and operations
    - Ensures accurate information for decision making

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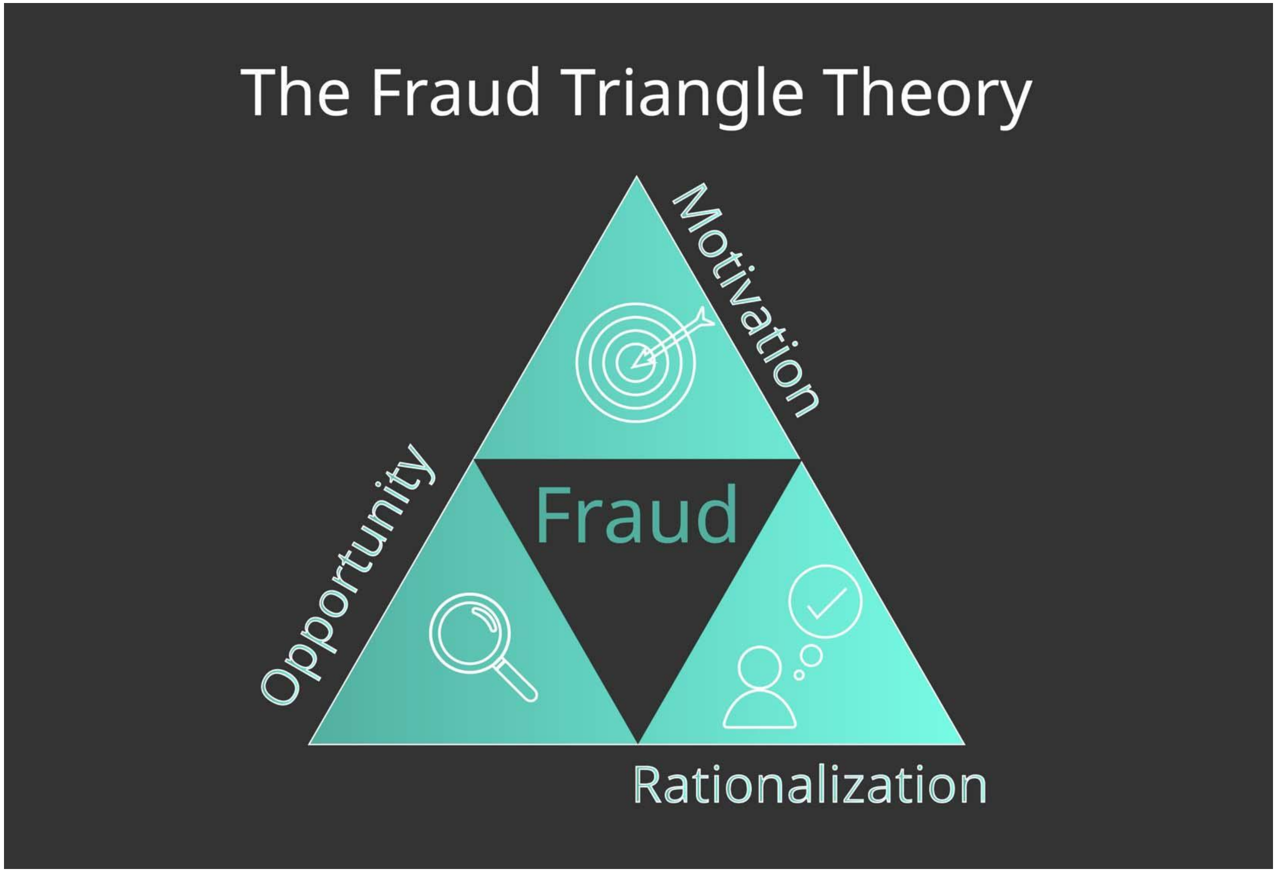
The Fraud Triangle



The Fraud Triangle

- Motivation and rationalization are mostly out of our control – things that can help are:
  - Ethics training
  - “Tone at the top” and overall workplace culture
- Opportunity is directly under our control:
  - Proper segregation of duties
  - Written policies and procedures that are consistently followed
  - Oversight of key transactional and operational areas

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Tone at the Top

- Management and the board are responsible for creating an appropriate tone at the top
- This is achieved by demonstrating a commitment to ethical behavior and cultivating the right culture
- Consider the workplace culture you want to achieve, and make personnel adjustments accordingly
  - High-stress cultures can lead to a breakdown of internal controls
  - A collaborative culture with an emphasis on open communication is more likely to have controls that are effective

Internal Controls Objectives

- Operations
  - Effectiveness and efficiency of operations
  - Safeguarding assets against loss
- Reporting
  - Internal and external reporting for decision making and/or compliance
- Compliance
  - Adherence to laws and regulations

Types of Internal Controls

1. Preventative
   - Anticipating what could go wrong
2. Detective
   - Finding what went wrong
3. Mitigating
   - Minimizing the impact of something going wrong

Internal Controls Components

- COSO framework (https://www.coso.org/)
  - Control Environment
  - Risk Assessment
  - Control Activities
  - Information and Communication
  - Monitoring Activities

Control Environment

- Control Environment
  - Commitment to integrity and ethical values
    - Tone at the top and company culture
  - Board oversight of management and appropriate management oversight of daily operations
  - Commitment to attract, develop, and retain talent
  - Hold individuals accountable

Risk Assessments

- Boards and management should regularly be discussing:
  - Identification of potential risks
  - Mitigation of potential risks
  - Response to risks

Risk Assessments

- Questions to ask:
  - What are the obstacles and potential problems that could prevent the entity from achieving its goals?
  - How could someone commit fraud within the entity?

Control Activities

- Policies and procedures are in place that prevent, detect, or correct risks
- Control activities cover the function of controls in practice
  - Entity level
  - Financial close and reporting
  - Activity level
  - Information technology (IT)

Information and Communication

- Information communicated to management and the board is timely and accurate
- Management and boards communicate policies and procedures to employees
- Management communicates with external parties on matters affecting compliance and reporting

Monitoring Activities

- Evaluation and review of internal controls
- Management and the Board are responsible for ensuring controls are effective and operating as intended
- Any deficiencies in controls are reported to and addressed by management and/or the Board in a timely manner

Focus Areas

- Entity Level
- Financial Close and Reporting
- Activity Level
- Cybersecurity/IT

Entity Level Controls

- Board oversight of management
  - Discussions and decision-making in board meetings
  - Review of financial statements in board meetings
  - Selection of CEO
- CEO and other key management personnel oversight of daily operations
- Tone at the top

Entity Level Controls Risks

- The Board does not meet regularly enough to identify and address potential issues
- Lines of communication are not sufficient to bring information to management's and the Board's attention
- Discussions center around problems without acting on solutions
- These risks are addressed by establishing regular meetings with effective agendas, and by ensuring policies and procedures and controls generally are operating
    - Management and the board set the tone at the top but rely heavily on others to perform their tasks.

Entity Level Controls

- The board reviews financial statements and relevant statistics on a monthly basis (detective)
- Management and the board actively discuss topics pertinent to operations (preventative)

Financial Close and Reporting Objectives

- Monthly financial statements and performance metrics are prepared timely
- Revenues and expenses are cut off appropriately
- Manual journal entries are prepared accurately
- Internal and external reporting for decision making and compliance
- All of the above are reviewed and/or approved by the appropriate level of management

Financial Close and Reporting Risks

- Inaccurate financial statements
  - Internal reporting – the Board relied on inaccurate information to make decisions
  - External reporting – significant adjustments needed during the audit, resulting in findings
    - The more errors there are, the more likely auditors are to miss something
- Fraudulent activity is missed or not brought to management's attention
- Inaccurate statistical reporting (third parties and internal)
  - Medicare & Medicaid cost reports

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Financial Close and Reporting Risks

- Manual journal entries
  - Unauthorized entries
  - Fraudulent activity
  - Human error

Financial Close and Reporting Controls & Safeguards

- All balance sheet accounts should be reconciled on a monthly basis (preventative, corrective)
  - Reconciliations reviewed by the appropriate person (detective)
- Manual journal entries
  - Reviewed and approved by someone other than the person preparing the entry (detective)
  - Maintain supporting documentation
- Revenue and expenses are cut off at year-end, with necessary accruals

Reviews & Approvals

- Who should perform the review?
  - Can be a significant challenge, depending on the number of personnel available
- Ideally, the next level higher should be reviewing
  - If a staff accountant prepares a reconciliation, it should be reviewed by the controller
  - Controller entries should be reviewed by the CFO
- Consider experience and qualifications
  - The person reviewing should be able to identify when something is wrong

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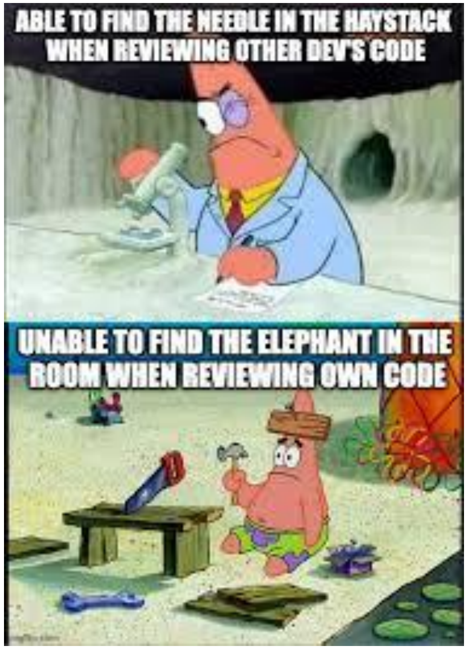
Reviews & Approvals

- Who should perform the review when there is limited personnel?
- A second set of eyes is better than none, even if they are not accountants
    - Consider training and education in these cases – what should they be looking out for?
- Avoid having employees review the work of their supervisors



Segregation of Duties

- Responsibilities and tasks should be split among available staff to ensure that no one person has too much custody or control over assets and resources.
  - Examples to follow as we look at specific activity level controls.
- Tasks should be reviewed by someone other than the individual performing the task.

Activity Level Controls

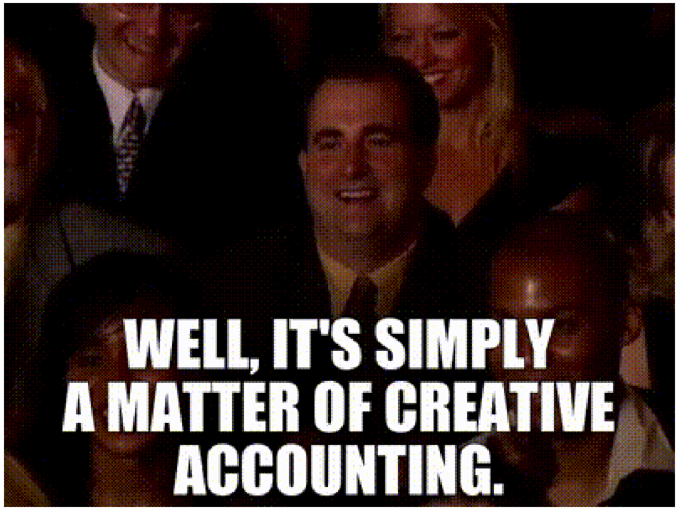
- The detailed controls surrounding significant transaction areas:
  - Accounts receivable and cash collections
  - Revenue cycle and billing
  - Cash disbursements and expenses
  - Payroll
  - Capital asset purchases and disposals

Accounts Receivable

- Risk: Inaccurate allowances result in over or understated accounts receivable.
- Controls and safeguards are focused on the calculation of the allowance for contractual adjustments and bad debt (preventative)
    - The calculation should be prepared (or at least reviewed) by someone with technical expertise and an understanding of the industry
    - Allowance rates should be regularly updated and compared to historical trends and expected collections
    - The allowance should be reviewed regularly by management (detective, corrective)

Accounts Receivable

- The allowance calculation is an estimate, creating the potential for management bias.
  - Performance-based bonuses, pressures from upper management, boards, and communities, compliance with debt covenants, and more
  - Ensure that assumptions used are supportable by data and trends



Cash Collections

- Risk: Missing cash due to theft or error.
- Cash receipts, bank deposits, posting payments controls:
  - Segregation of duties (preventative)
  - The person receiving cash from patients should not be the same person taking deposits to the bank and/or posting payments and adjustments to patient accounts
  - These tasks should be reviewed by someone not performing the task (detective, corrective)
  - Can be a rotation among available staff
    - Person A receives cash, person B prepares the deposit, person C posts payments to the account
      - All will double check each others' work

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Common Accounts Receivable and Cash Collections Issues

- Staff have access to cash and adjusting patient accounts
- Patient Account Adjustments:
  - No review of adjustments
  - No review of Business Office Manager's write-offs
  - No review of administrative adjustments
  - Batch totals of write-offs not used
    - Total must be agreed to system posting

Revenue Cycle & Billing Risks

- Inaccurate payments or adjustments made to patient accounts due to fraud or error
- Inaccurate billing, causing delays in collections
- Inaccurate coding of services provided to patients
- Unauthorized adjustments
- Lack of timely billing
- Revenue recorded in the wrong period

Revenue Cycle & Billing Controls & Safeguards

- IT controls surrounding access to EHR systems and user capabilities (preventative)
- Employee training and education on proper billing and coding (preventative)
- Written policies and procedures for the revenue cycle (preventative)
- Chart audits and chargemaster reviews (detective)
- Review of chargemaster change reports (detective)
- Reconciliations of patient statistic and department utilization data (detective)

Common Revenue Cycle Issues

- Not reconciling statistics to outside source
- Lack of documented procedures and review
- Deficient procedures for changing chargemaster:
  - Department managers not involved
  - Too many people with access to make changes
  - No review of chargemaster changes
  - Person reviewing is also making changes

Cash Disbursements and Expenses

- Purchases of goods or services
- Payments for goods or services
- Recording expenses
- Estimating and recording accruals

Cash Disbursements and Expenses Risks

- Unauthorized checks or checks altered before mailing
- Unauthorized electronic funds transfers (EFT, ACH)
- Fictitious vendors
- Duplicate invoices
- Approval and disbursement of unallowable expenditures
  - Grant/compliance requirements
- Expenses recorded in the wrong period

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Cash Disbursements & Expenses Controls & Safeguards

- Maintain an approved vendor listing (preventative)
- Segregation of duties (preventative)
  - Check stock
  - Check signors
  - Approval of purchases
- Payments matched to invoices/receipts (detective)
- Reconciliation of bank accounts, accounts payable and other accruals (detective)
- IT controls around bank account access, purchasing system, general ledger (preventative)

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Common Cash Disbursements & Expenses Issues

- Reconciliations of bank accounts and balance sheet accounts not performed timely
- The same person can write checks and post manual journal entries
- No indication of review or approval of check runs or other significant payments

Payroll Activities

- Tracking hours worked
- Calculating payroll taxes and benefits
- Payroll distributions

Me: I really need to stop buying stupid things when I get paid

Me when I get paid:

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Payroll Risks

- Inaccurate time sheets/hours tracking
- Wages paid at incorrect rates
- Fictitious employees
- Errors made by outsourced payroll vendor
- Unauthorized wage rate changes or bonuses

Payroll Controls & Safeguards

- IT controls around access to HR systems, time sheets and records, and the ability to change wage rates and benefits (preventative)
  - Review new employees added and ensure terminated employees are removed
  - Review of changes to wage rates
- Review of time sheets by direct supervisors (detective)
- Reconciliations of time entries to hours entered in payroll system (detective, corrective)
- Reconciliations of payroll expense to payroll disbursed (detective, corrective)

Payroll Controls & Safeguards

- Segregation of duties (preventative)
  - The person processing payroll is not also able to make changes to payroll
- Overtime is approved by direct supervisors (preventative)

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Common Payroll Issues

- The person processing payroll check runs has the ability to change wage rates and/or access to employee files
- System wage rate changes are not reviewed, or there is a lack of evidence of review/approval
- Lack of procedures to ensure payroll taxes and employee benefits are paid

Capital Assets Activities

- Purchasing assets
- Recording assets
- Tracking assets
- Estimating and recording depreciation

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Capital Assets Risks

- Depreciation schedules maintained in Excel
  - Manual schedules significantly increase the possibility of human error
  - Changes to formulas and hardcoded numbers are easily missed
- Expensing of assets that should be capitalized
- Capitalizing assets that should be expensed
- Unreasonable useful lives
- Misappropriation of assets

Capital Assets Controls & Safeguards

- Thorough review of Excel schedules (detective, corrective)
  - Including reconciliation to general ledger
  - Review for missing asset additions
  - Review for old assets that should be removed
- Written policies and procedures for capitalization thresholds and determination of useful lives (preventative)
- Review of supplies, minor equipment, and repairs & maintenance expenses (detective)

IT Controls

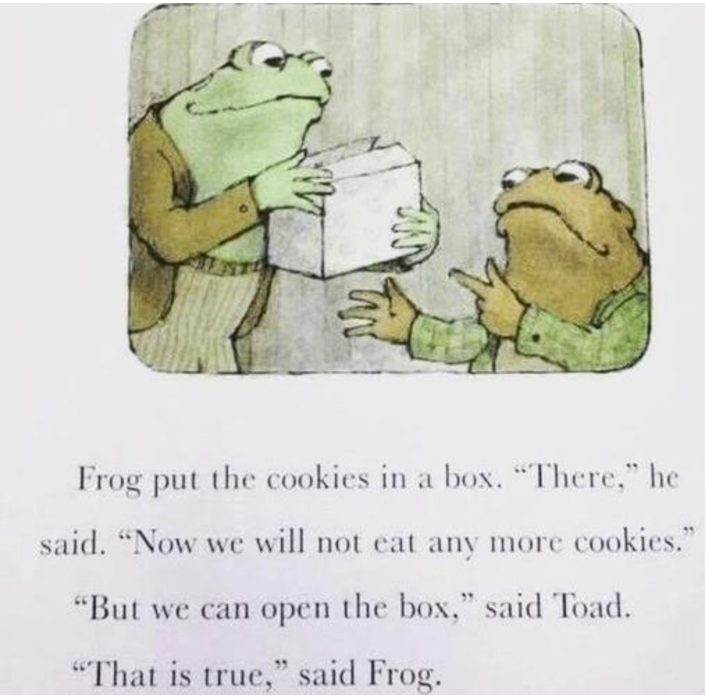
- Risks include unauthorized access and unauthorized changes to systems
- Review of user access to systems
  - Ensure that the right people have access to the right systems (and no others)
  - Terminated employees are removed timely
- Policies and procedures should be written surrounding employee access and approved systems
- Cybersecurity training

How do Internal Controls Break Down?

- Management override of controls
- Employees ignore or are not aware of policies and procedures
- One-time exceptions that turn into a slippery slope
- Misplaced trust in personnel with custody of key controls
- Policies and procedures that are not documented
  - Telephone game
- Policies and procedures that are out of date

Management Override of Controls

- An entity's internal controls are only as effective as management and employees allow them to be.
- An ethical tone at the top and a commitment to following established policies and procedures is critical
- What could go wrong? What could cause management to override controls?


Frog put the cookies in a box. "There," he said. "Now we will not eat any more cookies."
"But we can open the box," said Toad.
"That is true," said Frog.

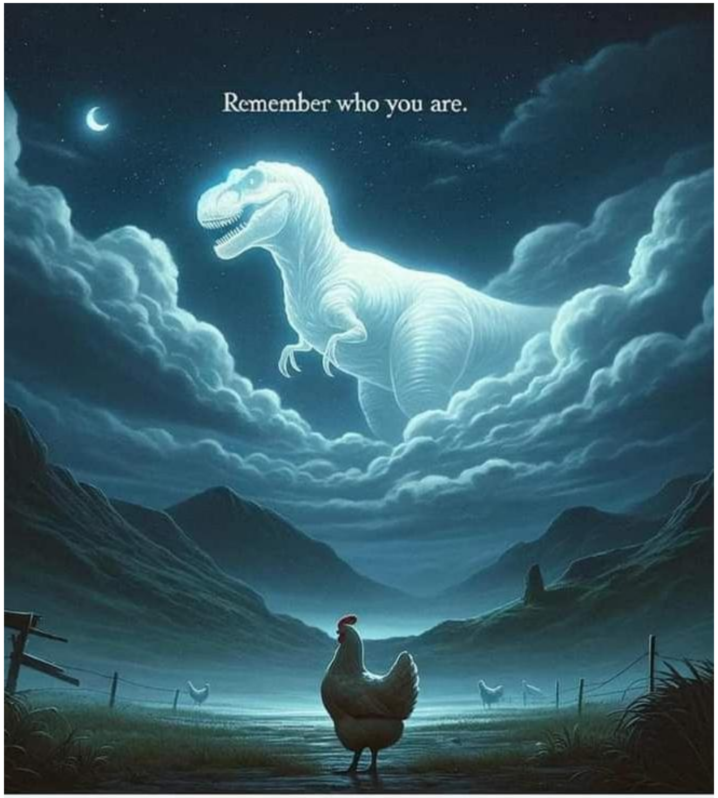
Common Obstacles

- Size of the entity/personnel available
  - Compromises can be made, as long as there are mitigating controls
- Lack of expertise or technical knowledge
  - Can be addressed through hiring decisions, as well as employee education and training
- Administrative burden of creating and maintaining written policies and procedures
  - Consider the cost-benefit analysis

Written Policies and Procedures

- Policies and procedures that are written are more likely to be followed
  - Fallback for accountability
  - A system of internal controls can survive key personnel leaving if the policies and procedures are written
- "Tribal knowledge" policies and procedures change and evolve over time, often in unexpected ways
  - Highly dependent on key personnel communicating what is expected or needed.

Accountability



- Each individual is responsible for ensuring controls are in place and operating effectively
- Self review controls
  - Less objective ("I did the work, of course I'm right")
  - Does not prevent fraud – creates the "opportunity" piece of the fraud triangle
- Leave an audit trail
  - Reviewers should leave a signature or initials
  - Don't assume controls are operating – management should be following up and reviewing

Jeremy Valdez

509.321.9486

jvaldez@dza.cpa

dza.cpa