Internal Auditing 101 with Panel Discussion

VGFOA – Virginia Beach
May 2013
Introduction of Our Panel

Mike Garber – Partner, PBMares
Jon Munch – Financial Services Division Chief - Fauquier County Government
Bill Brunke – School Board of the City of Virginia Beach
Terrie L. Pyeatt – Director of Internal Audit for Virginia Beach City Public Schools
What is Internal Auditing?

Internal auditing is an independent, objective assurance and consulting activity designed to add value and improve an organization’s operations. It helps an organization accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control, and governance processes.

- Institute of Internal Auditors
Agenda

Governance

Risk Assessment

Working Annual Audit Plan

Internal Audits and Methodology

Audit Reports

Follow-up
Governance Breakdowns
Governance Breakdowns
Governance

- Development of a Charter
- Independent Reporting Structure
- Audit Committee
- Methodology
- Resources
Governance

Develop an internal audit charter.

- Purpose, authority, responsibility
- Unrestricted access
- Independence
- Review and ‘by-in’ by senior management
- Approval by board
 Governance

Independent Reporting Structure

- Board or Council
- Superintendent
  County Executive
  City Manager
- Internal Audit Function
- Management
Governance

Audit Committee

5 to 7 members
From outside
A financial professional
Audit Committee Responsibilities

- Oversight
- Guidance
- Independence
- Reporting
Governance

Adopt a widely accepted methodology.

For Example: “COSO” Framework

Committee of Sponsoring Organizations
## Internal Control Principles

### Codification of 17 Principles embedded in the 1992 Framework

| Control Environment | 1. Demonstrates commitment to integrity and ethical values  
|                     | 2. Exercises oversight responsibility  
|                     | 3. Establishes structure, authority and responsibility  
|                     | 4. Demonstrates commitment to competence  
|                     | 5. Enforces accountability  

| Risk Assessment     | 6. Specifies relevant objectives  
|                     | 7. Identifies and analyzes risk  
|                     | 8. Assesses fraud risk  
|                     | 9. Identifies and analyzes significant change  

| Control Activities  | 10. Selects and develops control activities  
|                     | 11. Selects and develops general controls over technology  
|                     | 12. Deploys through policies and procedures  

| Information & Communication | 13. Uses relevant information  
|                             | 14. Communicates internally  
|                             | 15. Communicates externally  

| Monitoring Activities    | 16. Conducts ongoing and/or separate evaluations  
|                         | 17. Evaluates and communicates deficiencies  

Slide Source: COSO IC-IF Outreach Deck_12 29 11 (http://www.ic.coso.org/pages/about-the-project.aspx)
Governance

Resources
- Employee Full Staff
- Out-source
- Co-source
- Budget Allocation

Competencies
- CPA’s
- CISA’s
- CIA’s
- CFE’s
- Actuary
Whether you...
1. Outsource 100%
2. Co-Source
3. Employee a Full Staff

Chief Auditor must...
1. Assist audit committee to assure its charter, activities, and processes achieve its responsibilities
2. Ensure internal audit’s charter is responsive to the needs of the committee
3. Maintain open, direct and effective communications with the committee
4. Be viewed as a trusted advisor
Panel Discussion
Risk Assessment

The *objective* of the risk assessment is to ensure that the entity has sufficient and continuous internal audit coverage of those areas judged as having a relatively high risk profile considering both impact and likelihood.
Institute of Internal Audit standards require risk assessments be conducted every 3 years with updates conducted on the off years.
A Risk Assessment should be conducted by applying a broad-based, business view on risk, keeping in mind and identifying opportunities and vulnerabilities. Interviews should be conducted at all levels within the organization to obtain a high-level understanding of -

“What keeps them up at night?”

It is critical to drill down into department and/or functional areas to understand risk from the perspective of the individuals responsible for controlling such risks.
Risk Assessment

When we talk about risk we mean:

- Financial Risk
- Performance Risk
- Compliance Risk
- Public Perception
Risk Assessment

Risk Components or Factors

- **Control Environment** -- describes the overall tone and control consciousness of the sub-entity/function. It involves the integrity, ethical values and competence of personnel as well as management philosophy and operating style.

- **Change** -- addresses the extent to which change has impacted or is expected (in the near term) to impact the sub-entity/function, including changes in key personnel, the organization, its products, services, systems or processes.

- **Process Risk** -- addresses the inherent risk of the activities performed by the sub-entity/function, including the assets managed or in the custody of the sub-entity/function. Process risk addresses the extent of support the sub-entity/function provides to vital business functions, including the threat to continuity of the business caused by failures or errors; the probability of failure due to the amount of judgment, academic or technical skill required to manage the unit or perform key activities.

- **External Factors** -- describes the environment in which the sub-entity operates, and the type and amount of external interaction in which the sub-entity engages. Factors to consider include overall County and regulatory environment, the level of interaction with users and success in satisfying user requirements, the financial reporting environment and results of regulatory compliance audits.

- **Revenue Source** -- describes resources available to the sub-entity/function. Factors to consider include maximizing revenues, obtaining additional revenue sources and producing revenues outside of the standardized tax base.
Utilization of COSO - Internal Control Principles

*Codification of 17 Principles embedded in the 1992 Framework*

**Control Environment**
- 1. Demonstrates commitment to integrity and ethical values
- 2. Exercises oversight responsibility
- 3. Establishes structure, authority and responsibility
- 4. Demonstrates commitment to competence
- 5. Enforces accountability

**Risk Assessment**
- 6. Specifies relevant objectives
- 7. Identifies and analyzes risk
- 8. Assesses fraud risk
- 9. Identifies and analyzes significant change

**Control Activities**
- 10. Selects and develops control activities
- 11. Selects and develops general controls over technology
- 12. Deploys through policies and procedures

**Information & Communication**
- 13. Uses relevant information
- 14. Communicates internally
- 15. Communicates externally

**Monitoring Activities**
- 16. Conducts ongoing and/or separate evaluations
- 17. Evaluates and communicates deficiencies

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Risk Assessment

- Risk-Based Planning
- Focus on Key Areas
- Matrix based
- Optimal Allocation of Resources
- Qualitative Analysis
- Quantitative Analysis
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Panel Discussion
The Internal Audit Plan is compiled based on the results of the Risk Assessment.

It is a working draft that should continually be updated and refreshed.
Internal Audit Plan

- **Ongoing Audit Functions:**
- **Cycle Audits:**
- **Entity-Wide Audits:**
- **Individual Function Audits:**
- **Special Audits or Requests**
Internal Audit Plan

- **Ongoing Audit Functions:**
  - Risk Assessment and Updates
  - Quality Control
  - Fraud Awareness and/or other Seminars
  - Follow-up
Internal Audit Plan

Cycle audits are typically performed in functions that are inherently high risk, they are narrower in scope and occur more often than full audits.
Internal Audit Plan

- **Entity-Wide Audits** – these audits are of areas or functions that cross over functions and departments and often have multiple responsible parties. Examples include:

  - Timekeeping
  - Human Resources
  - Asset Management
  - Purchasing
  - Contract Management
Individual Function Audits are narrower in focus that entity-wide audits with more specific ownership tied to the Department or Function.
Internal Audit Plan

- **Special Audits and Requests include:**
  - Forensic Investigations
  - Financial Condition Reviews
  - Whistle Blower Investigations / Allegations
  - Board Requests
Panel Discussion
Internal Audits

Entity-level Assessment and Brainstorming

Planning and Scoping

Execution of Audits / Reviews

Communicate Results

On-Going Monitoring and Follow-Up

Internal Control Assessment

Process Analysis

Process Assurance

Process Improvement

Understand and Document the Process

Assess Design Effectiveness

Document Existing Controls

Assess Operating Effectiveness

Analyze Deficiencies

Individual Audits / Reviews

Assess Effectiveness
Facilitated Sessions/Process Documentation

- Trained Facilitators
- Efficient and effective
- Common Language
- Encourages discussion and enhanced process
- Identification of Risk
- Key Control Points

### Functional Bands

<table>
<thead>
<tr>
<th>Process Step</th>
<th>Control</th>
<th>Gap</th>
</tr>
</thead>
<tbody>
<tr>
<td>Start</td>
<td>Accounts Payable Department</td>
<td></td>
</tr>
<tr>
<td>A</td>
<td>Contractors Check Request Utilities Expense Reports</td>
<td></td>
</tr>
<tr>
<td>A</td>
<td>Manually opens Mail And restrictively Date stamps each document</td>
<td></td>
</tr>
<tr>
<td>A</td>
<td>Sorts by payment terms: Immediate Pay Net 10 &amp; 45 days</td>
<td></td>
</tr>
<tr>
<td>A</td>
<td>Contractors Check Request Utilities Expense Reports</td>
<td></td>
</tr>
<tr>
<td>A</td>
<td>Is vendor a new Vendor?</td>
<td>Yes</td>
</tr>
<tr>
<td>A</td>
<td>Obtain approval of dept. mgr. and Add G/L Coding to Invoice &amp; travel Expense reports</td>
<td></td>
</tr>
<tr>
<td>A</td>
<td>Invoices</td>
<td>Files Alphabetical</td>
</tr>
<tr>
<td>A</td>
<td>Accounting Manager</td>
<td>Reviews the Vendor Master File Annually to verify Integrity and pertinence</td>
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</tbody>
</table>

### Process Documentation

- **Start**
  - Contractors Check Request Utilities Expense Reports
  - Manually opens Mail And restrictively Date stamps each document
  - Sorts by payment terms: Immediate Pay Net 10 & 45 days
  - Contractors Check Request Utilities Expense Reports
  - Is vendor a new Vendor? Yes
  - Obtain approval of dept. mgr. and Add G/L Coding to Invoice & travel Expense reports
  - Invoices
  - Files Alphabetical

- **A**
  - Accounting Manager
  - Reviews the Vendor Master File Annually to verify Integrity and pertinence

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**Legend:**
- Process
- Step
- Control
- Gap
**Internal Audits**

Our Risk and Control Matrix captures risks, our preliminary assessment as to the effectiveness with which they are managed, specific control objectives, related control descriptions, and testing strategies to be used for future audit purposes.

<table>
<thead>
<tr>
<th>Risk Level</th>
<th>Control Objectives</th>
<th>“As Is” Control Description</th>
<th>Testing Reference</th>
<th>Type of Control</th>
<th>Anti-Fraud Control?</th>
<th>Level of Control</th>
<th>Assessment of Design Effectiveness in Meeting Control Objective</th>
<th>Control Owner</th>
<th>Frequency of Control Operation</th>
</tr>
</thead>
<tbody>
<tr>
<td>E, C, V</td>
<td>Review of the A/R aging schedule is performed consistently in accordance with the credit management policy.</td>
<td>Manual detective</td>
<td>Yes</td>
<td>Secondary</td>
<td>Needs Improvement</td>
<td>A/R Clerk</td>
<td>Monthly</td>
<td></td>
<td></td>
</tr>
<tr>
<td>E, C, V</td>
<td>Contract is not paid on timely basis then customer is changed to COD ONLY for the occurrence of non-payment.</td>
<td>Manual preventive</td>
<td>No</td>
<td>Secondary</td>
<td>Needs Improvement</td>
<td>Contracts Manager</td>
<td>Per Occurrence</td>
<td></td>
<td></td>
</tr>
<tr>
<td>E, C, V</td>
<td>Controller reviews A/R schedule for outstanding overdue balances, she then notifies A/R Rep to follow up on any other customers that have not been previously identified.</td>
<td>Manual detective</td>
<td>Yes</td>
<td>Secondary</td>
<td>Needs Improvement</td>
<td>Contracts Manager</td>
<td>Monthly</td>
<td></td>
<td></td>
</tr>
<tr>
<td>E, C, V</td>
<td>Contracts are reviewed for terms and pricing and are validated by V.P. of Operations to make sure proper conditions have been met for the sale. Contracts Employee enters contract information into Wide Area Work Flow (WAWF), which applies to Government contracts only. Information is obtained from the Contract folders which hold the most updated contract terms and conditions.</td>
<td>Manual preventive</td>
<td>Yes</td>
<td>Pay/Primary</td>
<td>Needs Objective</td>
<td>V.P. of Operations</td>
<td>Per Occurrence</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
Internal Audits

- **Entity-level Assessment and Brainstorming**
- **Planning and Scoping**
- **Execution of Audits / Reviews**
- **Communicate Results**
- **On-Going Monitoring and Follow-Up**

**Internal Control Assessment**

- **Process Analysis**
- **Process Assurance**
- **Process Improvement**

**Individual Audits / Reviews**

- **Understand and Document the Process**
- **Assess Design Effectiveness**
- **Document Existing Controls**
- **Assess Operating Effectiveness**
- **Analyze Deficiencies**
Internal Audits

Keys to a Successful Audit

- Communication – Communication
- Kick off Meeting and Setting Expectations
- Set the Right Timeline – Timing is Key
- Discussions throughout the Audit
- Leave behind the ‘Got-Cha’ Factor
- No Surprises
- Exit Conference
Audit Reports

- Executive Summary
- Objectives & Scope
- Background
- Issues Matrix
Audit Reports

Issues Matrix:

• Risk Rating of the Issue
  • High, Moderate, Low
• Full detailed Write-up of the Issue
  • Include the ‘So-What’ Factor
  • Include the specifics What did we find
• Recommendation
• Managements Response
  • Action, Estimated Completion Date and Responsible Party
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Follow-up

- Included within Management Response in issued internal audit reports should be the targeted implementation date for remediation and the responsible party. Routinely, procedures for those issues where the target dates have been reached are performed to verify and report the implementation status of the recommendations to all the previously reported findings.

- Objectives of the overall follow-up procedures are to determine if open issues from previous audit reports have been properly remediated.

- Follow-up is meant to validate, on a sample basis, the effectiveness of the remediated controls of the previously reported open issues.
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Panel Discussion
Foster a strong, ongoing relationship with your internal auditor.

- Mutual trust
- Mutual benefit
- Open communications
- Defined expectations
- Performance feedback
- Innovation and change
Questions
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