Session Overview

This session will explore the basic fundamentals of internal auditing and internal controls, as they relate to an organization’s control environment and risk management. Best practices of internal audit are explored to contribute to the attendee’s growth in becoming more effective and successful in their role as an internal auditor. The topics are essentials for individuals new to the internal audit profession or for non-auditors eager to gain an understanding of the core concepts which drive the audit function.
Agenda – Today’s Session

1. Internal Auditing - Defined
2. Internal Controls - Defined
3. The Control Environment
4. Enterprise Risk Management
5. Keys to Success
Internal Auditing - Defined

- An independent, objective assurance and consulting activity adding value and improving operations.

- Brings a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control, and governance.

- the Institute of Internal Auditors
Internal Auditing - Defined

WHY IS IT NECESSARY?

- Audit required for publicly held companies and entities held publically accountable
- External audit lends credibility to financial statements
- Internal audit lends credibility to business processes
Internal Auditing - Defined

Is the cornerstone of strong governance;

- IAS bridges the gap between management and the board,

- IAS assesses the ethical climate and the effectiveness and efficiency of operations, and

- IAS serves as an organization’s safety net for compliance with rules, regulations, and overall best business practices.
Internal Auditing - Defined

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- IAS serves as an organization’s safety net for compliance with rules, regulations, and overall best business practices.
Assurance that:

- Internal controls are sufficient to mitigate risks
- Governance processes are adequate
- Organizational goals and objectives are met
Internal Auditing - Defined

- **External Audit**
  - Confirms the validity of the financial position expressed by an organization
  - Investigation may be supported by internal audit function

- **Internal Audit**
  - Confirms the effectiveness of business process controls in reducing financial risk
  - Assures compliance with the law
  - Indicates areas where business processes may be improved upon
Internal Controls

Controls are things that we create and experience in our personal lives every day. In a business environment controls are the culmination of processes and actions which are intended to achieve a desired result.
Internal Controls – What’s for Dinner?

- Refrigerator – prevents food from spoiling
Internal Controls – What’s for Dinner?

- Locking your door when you leave your home, car, apartment or office
Prepare a shopping list or plan your trip to avoid forgetting something or wasting time.
Internal Controls – What’s for Dinner?

- Using a unique PIN number for your ATM card
Balancing your bank statements each month to ensure the accuracy and validity of the transactions on your account.
Internal Controls – What’s for Dinner?

- Cookbook—provide step by step instructions to create a desired result
Internal Controls – What’s for Dinner?

- Taste the soup before you serve it
Methods of assigning authority and responsibility
Effectiveness of specific policies & procedures
Organizational Structure
Audit Committee
Management philosophy
System development methods
Management reaction to external influences
Internal Controls – The Purposes

• Ensure Reliability

• Promote Compliance

• Prevent & Detect Fraud

• Safeguard Assets

• Optimize Resources
<table>
<thead>
<tr>
<th><strong>Internal Controls</strong></th>
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<tbody>
<tr>
<td><strong>Preventive</strong></td>
</tr>
<tr>
<td>• Intended to avoid an unwanted event from occurring</td>
</tr>
<tr>
<td><strong>Detective</strong></td>
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<tr>
<td>• Designed to monitor operations identify errors and abnormalities</td>
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<tr>
<td><strong>Corrective</strong></td>
</tr>
<tr>
<td>• Designed to correct errors and abnormalities that have occurred</td>
</tr>
<tr>
<td><strong>Application</strong></td>
</tr>
<tr>
<td>• Processes intended to create desired outcomes, consistently</td>
</tr>
<tr>
<td><strong>Manual</strong></td>
</tr>
<tr>
<td>• Performed by individuals outside of a system.</td>
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</table>
Internal Controls - Defined

In a business environment...

- Policies and procedures,

- Established and maintained by management,

- To assist in achieving the orderly and efficient conduct of the entity’s business.
Internal Controls - Objectives

- Internal Control objectives are desired goals or conditions for a specific event cycle which, if achieved, minimize the potential that waste, loss, unauthorized use or misappropriation will occur.

- For a control objective to be effective, compliance with it must be measurable and observable.
Internal Controls - Objectives

Internal Control objectives include:

- Authorization
- Completeness
- Accuracy
- Validity
- Physical Safeguards
- Security
- Error Handling
- Segregation of Duties.
Internal Controls - Objectives

- **Authorization** - The objective is to ensure that all transactions are approved by responsible personnel in accordance with specific or general authority before the transaction is recorded.

- **Completeness** - The objective is to ensure that no valid transactions have been omitted from the accounting records.

- **Accuracy** - The objective is to ensure that all valid transactions are accurate, consistent with the originating transaction data and information is recorded in a timely manner.

- **Validity** - The objective is to ensure that all recorded transactions fairly represent the economic events that actually occurred, are lawful in nature, and have been executed in accordance with management's general authorization.
Internal Controls - Objectives

- **Physical Safeguards & Security** - The objective is to ensure that access to physical assets and information systems are controlled and properly restricted to authorized personnel.

- **Error handling** - The objective is to ensure that errors detected at any stage of processing receive prompt corrective action and are reported to the appropriate level of management.

- **Segregation of Duties** - The objective is to ensure that duties are assigned to individuals in a manner that ensures that no one individual can control both the recording function and the procedures relative to processing the transaction.
Definition of Internal Controls

- It is a process
- It is effected by an entity’s board of directors, management, and other personnel
- It is effected by people. It’s not merely policy manuals and forms, but people at every level of an organization
- The ultimate responsibility of functioning internal control lies on the top management and board of the organization
- It is designed to provide reasonable assurance regarding the achievement of objectives in the following categories:
  - Effectiveness and efficiency of operations
  - Reliability of financial reporting
  - Compliance with applicable laws and regulations

Definition by COSO, 1994, 13.
(Committee of Sponsoring Organizations of the Treadway Commission)
## Internal Controls – Defined

<table>
<thead>
<tr>
<th>Category</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>segregation of duties</td>
<td>separate people raising a sales invoice and recording the receipt of funds</td>
</tr>
<tr>
<td>organization</td>
<td>giving people a job description and ensuring they know what they should be doing</td>
</tr>
<tr>
<td>authorization</td>
<td>transactions require an authorized signatory to be approved</td>
</tr>
<tr>
<td>physical</td>
<td>a locked safe to store cash before being banked</td>
</tr>
<tr>
<td>supervision</td>
<td>a superior to review work and ensure quality and completeness</td>
</tr>
<tr>
<td>personnel</td>
<td>appraising staff regularly to ensure performance is satisfactory</td>
</tr>
<tr>
<td>arithmetic accuracy</td>
<td>a procedure to validate accuracy of calculations</td>
</tr>
<tr>
<td>management</td>
<td>a hierarchy of responsibility to ensure individuals and organizations are accountable</td>
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</tbody>
</table>
Preventive Controls - Examples

In a motor vehicle...

- Guardrails
- Traffic Lights
- Center lane dividers
- Turn Signals
- Brakes
- Child Safety Locks
- Cruise Control
- Speed Limits
- Auto-pilot
- Seat Belts
- Air-Bags
- Radar Detector
Preventive Controls - Examples

In a business environment...

- Segregation of duties
- Proper authorization
- Adequate documentation
- Physical control over assets
Internal Controls – The Types

Preventative  Vs.  Detective
Preventive Controls - Defined

- They are designed to discourage errors or prevent irregularities from occurring.
- They are proactive controls that help prevent a loss.
- They are most desirable as it stops problems and incorrect processing from occurring.
Detective Controls - Defined

- Designed to identify a problem after it has occurred
- They will not prevent problems from occurring
Detective Controls

- Reviews and monitoring
- Reconciliations
- Physical inventories
- Variance analyses
- Batch control documents
- Batch serial numbers
- Clearing accounts
- Exception reporting
- Audits
Detective Controls

- A security guard watches monitors for crimes or safety risks (physical environment)
- Programmers and system administrators use file integrity tests to detect unauthorized changes to system files (electronic environment)
Control Environment - Attributes

- Management philosophy and operating style
- Methods of assigning authority and responsibility
- Management control methods
- Effectiveness of specific policies and procedures
- Organizational Structure
- Personnel policies and practices
- System development methods
- Board of Director and Audit Committee
- Control Systems
- Management reaction to external influences

Control Environment
Internal Controls — Limitations

- **Judgment** - The effectiveness of controls will be limited by decisions made with human judgment under pressures to conduct business based on the information at hand.

- **Breakdowns** - Even well designed internal controls can break down. Employees sometimes misunderstand instructions or simply make mistakes. Errors may also result from new technology and the complexity of computerized information systems.

- **Management Override** – personnel may be able to override prescribed policies and procedures. This is distinct from management intervention, which represents management actions to depart from prescribed policies and procedures for legitimate purposes.

- **Collusion** - Control systems can be circumvented by employee collusion. Individuals acting collectively can alter financial data or other management information in a manner that cannot be identified by control systems.
Internal Controls – The Environment

- It is a means to an end, not an end in itself, a tool to give a reasonable assurance that:
  - Laws and other regulations are followed in the organization
  - Assets of the organization, both physical and immaterial, are safe
  - Reporting of finances and activities is actual, useful, sufficient and reliable
  - Operations are efficient and effective.
Management is responsible for establishing and maintaining a system of internal controls within an organization “Tone from the top”

Internal controls help mitigate the risks

Internal audit assists both management and the oversight with an objective assessment of internal controls
Internal Controls – The Environment

Control objectives

Control components

Organizational levels of responsibility
Best Practices of the Internal Audit

- Organizational independence and reporting structure
- Unrestricted access
- Audit charter
- Professional audit standards
- Training and quality assessment
- Prioritization, a risk-based approach
- Audit reports and follow-up
- Advisory services and investigations
The purpose of the Audit Committee is to assist the Board of Directors to:

- Provide oversight of:
  - Financial statement integrity
  - Legal and regulatory compliance
  - Auditor’s qualifications
  - The performance of the Internal Audit Function
Internal Audit Services follow professional standards; examples
Enterprise Risk Assessment

- **RISK**
  - What can go wrong?

- **IMPACT**
  - How bad? How often? How likely?

- **ACTION**
  - What can be done to prevent or minimize it?
## Assessing Risk

<table>
<thead>
<tr>
<th>Impact</th>
<th>Likelihood</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bad but not likely</td>
<td>Bad and likely</td>
</tr>
<tr>
<td>Not bad not likely</td>
<td>Not bad but likely</td>
</tr>
</tbody>
</table>
Assessing Risk

Impact

Likelihood

Financial / Compliance

LOW MODERATE

LOW

LOW

MODERATE

MODERATE

HIGH

HIGH

HIGH MODERATE
How much control is enough?

- Cost of securing an asset should not exceed the asset’s value
- Value of tangible assets easily calculated
  - E.g., improperly documented charges
- Intangible assets value difficult to assess
  - What is the damage if patients lose confidence in the hospital?
  - How does one measure the extent and value of such lost confidence?
Assessing Cost of Controls

Impact

High

Low

Cost of Control

Low  ←  High
Risk Scoring

- Extreme Risk – Requires urgent action
- High Risk – Action implemented ASAP
- Moderate Risk – Action required current year
- Low Risk – Quick easy matters resolved immediately and further action planned to sustain control
Audit Risk Assessment Process
Types of Audits

- Operational: 22%
- Financial: 26%
- Fraud: 16%
- Information Technology: 6%
- Clinical: 2%
- Continuous Controls Monitoring: 15%
- Compliance: 13%
Technology and the Audit Function
The way it used to be . . .

- Data analysis was a manual, ad hoc process, often re-inventing the ‘wheel’
- Data acquisition usually the result of cut-and-paste methods prone to error
- Could only examine a small portion of all the data available
- Results distributed manually
Advantages of Audit Automation

- Build customized analytics to test key controls automatically on a timely basis
- Exceptions and anomalies quickly identified and quantified; a proactive and efficient approach
- Test 100% of the data, improved reliability
- Promotes management confidence in process controls
Quality Assurance Review (QAR)

- Designed to assess conformance with Standards and effectiveness of consulting
- Documents commitment to quality and grounding in professionalism
- Provides evidence to stakeholders of concern about internal controls, activities, governance, ethics and risk management
Internal Audit Capability Model

- Framework of fundamentals for effective internal auditing
- Illustrates 5 stages through which IA activities can evolve
- Covers 6 areas of internal audit
Six areas of capability

1. Services and role of Internal Audit
2. People management
3. Professional practices
4. Performance management and accountability
5. Organizational relationships and culture
6. Governance structure
Keys for Success

- The Audit Plan is a dynamic instrument; immersing issues, and process changes need to be considered which may take precedence over established plans
- Make objective assessments
- Provide advice for improving controls, processes, procedures and outcomes
- Evaluate alternatives reducing costs and enhancing revenues and efficiencies
- Encourage audit requests
Keys for Success

- Staying in tune with the organization’s risk priorities
- Taking a risk-based approach to internal audit planning
- Continuously monitoring organizational changes
- Making informed and educated recommendations to management and the Board
- Partner with management and auditees
- Obtain honest feedback and make improvements
- Become an reliable and invaluable team member
Save the Date:

32nd Annual Conference
Chicago, IL

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Assoc. of Healthcare Internal Auditors