FEATURE

ORGANIZING A FINANCIAL REPORTING CONTROLS REVIEW

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Background

Though not legally required to follow the Sarbanes-Oxley Act, many non-public not-for-profit healthcare systems intend to comply with all or part of the Act as a demonstration of good governance. Annual certifications of financial reporting internal controls by the CEO and CFO (Section 404) are likely to become best practice. This article outlines the first segment of the approach adopted by one healthcare system and its internal audit department to document, evaluate the design, and test the effectiveness of financial reporting controls in preparation for annual certifications.

Part of this article was extracted from Legacy Health System's "Financial Reporting Controls Project Management Plan". The plan, in addition to documenting authority, responsibilities and approach, presented several perspectives on internal control to further educate the Audit Committee, management and internal audit staff. While many resources were consulted when developing the Project Management Plan, Protiviti Inc.'s "Guide to the Sarbanes-Oxley Act: Internal Control Reporting Requirements" was a key source and certain material was extracted directly from that document.

Critical to the success of the Financial Reporting Controls Project is the use of "control assurance software" to link processes, accounts, and financial statement elements; to assign ownership of processes and the effectiveness of controls; to document risks, controls, and test results; and to facilitate management of the project. Control assurance software is available from many vendors.

Introduction and Scope

The Audit Committee of the Legacy Health System's Board of Directors requested that management initiate an annual CEO/CFO certification of financial reporting internal controls, in compliance with Section 404 of the Sarbanes Oxley Act of 2002, by the end of FY 2006.

Management asked Internal Audit (IA) to evaluate the design and operating effectiveness of financial reporting internal controls, and develop and manage the annual certification process. Accordingly, the scope of this project is financial reporting controls, except in those cases where operating and/or compliance controls are integrated with financial reporting. We intend to perform similar reviews of operating and compliance controls at the conclusion of the Financial Reporting Controls (FRC) Project.

This plan documents IA's responsibilities, as well as the organization and control of the FRC Project. As detail of the work plan is formulated, changes will be documented and discussed with the Project Sponsor being adopted and then reported to the Audit Committee at their quarterly meetings.

Objectives

The primary objectives for the FRC Project are:

- As outlined in The Institute of Internal Auditors' Practice Advisory 2120.A1-1, "Assessing and Reporting of Control Processes", perform sufficient audit work and gather other information to form a judgment about and report on the adequacy and effectiveness of financial reporting controls by December 31, 2005. Implicit in this objective is that work in key areas will be completed in time for management to have sufficient opportunity to remedy control weaknesses, if any, before the reporting date. This work will be referred to as the FRC Review.

- Design and implement a certification process that complies with Section 404 of the Sarbanes Oxley Act for the fiscal year ending March 31, 2006. This work will be called the FRC Certification. Detail planning for this work will be done at a later date.

An overview of the project is presented in Table 1. The first three phases are the FRC Review and the fourth phase is the FY 2006 Certification.

IA's objective is also to educate managers on risks and controls through training, and support managers in the documentation and assessment of financial reporting controls in their respective areas.

Project Organization

IA's assessment of financial reporting internal controls will be based on the following definitions and evaluation standards:

- The organization has adopted COSO as the framework for internal control evaluation. Accordingly, all five components (i.e., control environment, risk assessment, control activities, information and communication, and monitoring) of financial reporting internal controls will be evaluated.

- Financial reporting risks will be drawn from the series of assertions (i.e., existence or occurrence, completeness, rights and obligations, valuation or allocation, and presentation and disclosure) that underlie the financial statements.

Specialized software will be used by IA to manage the project, the documentation of financial reporting risks and internal controls, and the annual certifications.

The FRC Review will be conducted on three levels:

- ***Entity.*** IA will perform a system-wide review of the control environment (including the Human Resources function), risk assessment, information (including IT general controls) and communication, and monitoring components of internal control.

- ***Process.*** The primary focus of IA's work will be the control activities component of internal control. The design and effectiveness of the control activities will be evaluated through a scope that is based on the level of financial reporting risk. The majority of this work will occur in the Corporate Financial and Patient Business Services functions.

- ***Department.*** Certain control activities (e.g., charge capture reconciliations, controls that safeguard cash receipts and equipment, approval of labor hours) occur in departments. IA will perform a survey of controls that occur at the department level and do limited testing in selected departments.

When process owners and other key individuals have been identified, the Project Sponsor and Project Leader will launch the FRC Project by communicating the objectives, briefly describing the work plan, and outlining management's responsibilities for participation in surveys, preparation of control documentation, and annual self-assessments of the operational effectiveness of controls.

Project Responsibilities

- ***Project Sponsor (CFO).*** Responsible for ensuring that the organization understands the value and importance of the project. Approves the project plan and authorizes changes to the approach and/or schedule, if needed.

- ***Project Leader (Director, Internal Audit).*** Overall project responsibility. Accountable for achieving the project objectives within the time and resources allocated. With input from the Project Team and Advisors, designs the approach and makes decisions on control design and effectiveness. Monitors project execution and reports status to the Project Sponsor and the Audit Committee.

- ***Project Team (Internal Auditors).*** Responsible for building the project's support tools (e.g., software, surveys, templates) and executing the work plan. Assess risks and controls and conclude on the adequacy and effectiveness of financial reporting internal controls.

- ***Process Owners.*** Ensure that processes and controls are completely and accurately documented. Remedy control deficiencies. Oversee periodic control testing and annual certifications.

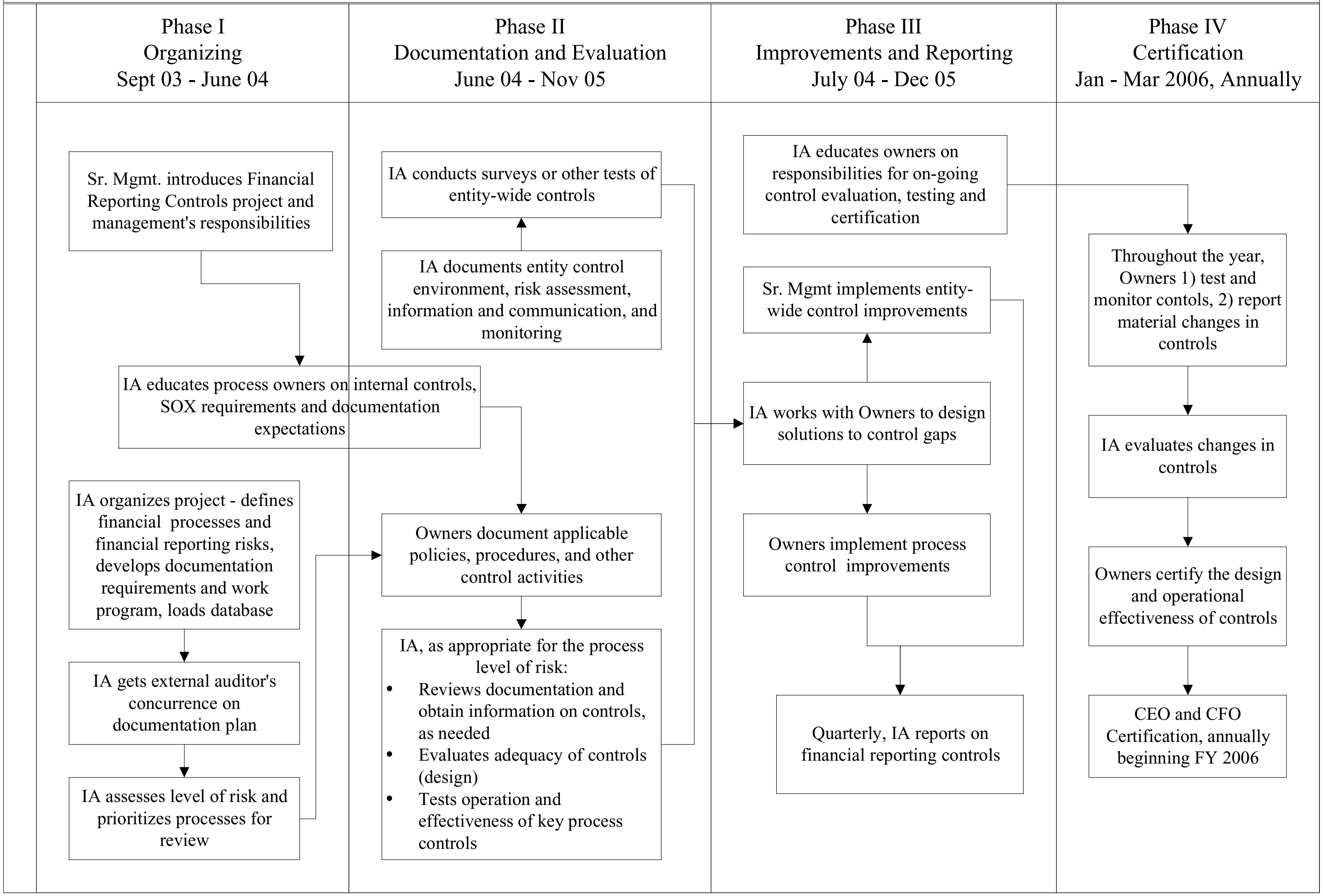
- ***Advisors.*** Key management personnel and the organization's independent auditors will be consulted as needed.

Internal Controls and Internal Control Weaknesses

Internal controls occur throughout the organization. There are varieties of ways to classify internal controls. For example:

- Some controls evidence the organizational philosophy; these pervasive controls (e.g., assign key tasks to quality people, establish accountability for results, facilitate

Table 1 - Financial Reporting Controls Project Overview



Phase I
Organizing
Sept 03 - June 04

Sr. Mgmt. introduces Financial Reporting Controls project and management's responsibilities

IA educates process owners on internal controls, SOX requirements and documentation expectations

IA organizes project - defines financial processes and financial reporting risks, develops documentation requirements and work program, loads database

IA gets external auditor's concurrence on documentation plan

IA assesses level of risk and prioritizes processes for review

Phase II
Documentation and Evaluation
June 04 - Nov 05

IA conducts surveys or other tests of entity-wide controls

IA documents entity control environment, risk assessment, information and communication, and monitoring

Owners document applicable policies, procedures, and other control activities

IA, as appropriate for the process level of risk:

- Reviews documentation and obtain information on controls, as needed
- Evaluates adequacy of controls (design)
- Tests operation and effectiveness of key process controls

Phase III
Improvements and Reporting
July 04 - Dec 05

IA educates owners on responsibilities for on-going control evaluation, testing and certification

Sr. Mgmt implements entity-wide control improvements

IA works with Owners to design solutions to control gaps

Owners implement process control improvements

Quarterly, IA reports on financial reporting controls

Phase IV
Certification
Jan - Mar 2006, Annually

Throughout the year, Owners 1) test and monitor contols, 2) report material changes in controls

IA evaluates changes in controls

Owners certify the design and operational effectiveness of controls

CEO and CFO Certification, annually beginning FY 2006 continuous learning, segregate incompatible duties) apply to all objectives – financial reporting, operational, and compliance.

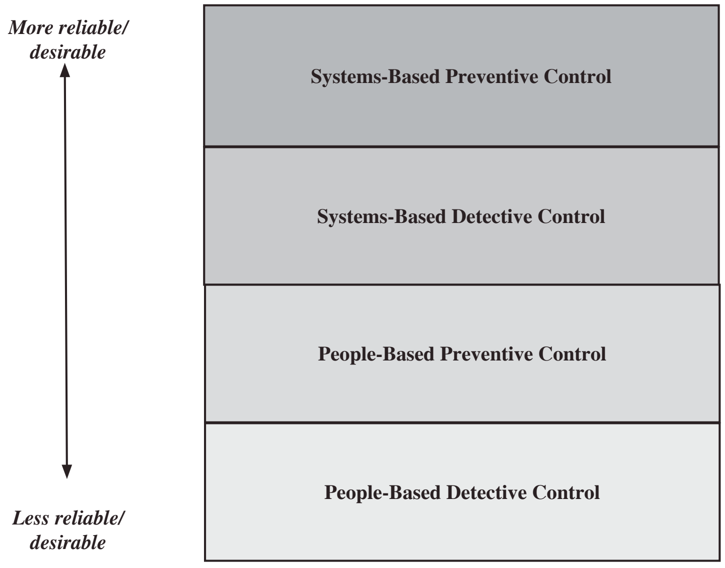
- Information controls (e.g., obtain prescribed approvals, test samples/verify process performance, perform reconciliations, independently verify existence) apply to processes generating financial and/or operating information, and provide assurance that the information is reliable.

At the process level, pervasive controls and information controls are either preventive (positioned at the source of the risk) or detective (placed down the process flow). Controls are also system-based or people-based. As depicted by the Hierarchy of Controls (Table 2) an anticipatory, proactive approach to controlling risk requires greater use of preventive controls than the reactive "find and fix" approach embodied in detective controls. The greater the volume and velocity of transaction processing, the more desirable it is to increase the emphasis on preventive and systems-based controls; effectively designed control processes aim to prevent errors and omissions at the source.

When assessing the "design effectiveness" of process-level controls, Internal Audit will also consider whether all levels of control (i.e. operating, supervisory and monitoring levels) are present. Controls at the operating level define what is done, by whom and how (e.g., policies, procedures, training, system passwords, input controls). Supervisory controls verify that the operating controls are functioning (e.g. reconciliations, exception reports, physical inventories, work reviews). Monitoring controls are the analytics and other review mechanisms used, primarily by management, to assess the integrity of information and control compliance.

When formulating a conclusion regarding the effectiveness of financial reporting internal controls, "reasonable assurance" is the standard to be met. Inherent limitations (e.g. human judgments, breakdowns due to human error and simple mistakes, collusion by two or more people, management override) in any control system make absolute assurance an impossible and/or cost-prohibitive standard. The concept of reasonable assurance implies consideration by management of the cost of a control and its resulting benefits in terms of reducing risk.

Table 2 - Hierarchy of Controls


More reliable/ desirable
Less reliable/ desirable
Systems-Based Preventive Control
Systems-Based Detective Control
People-Based Preventive Control
People-Based Detective Control

As control weaknesses are identified, IA will evaluate the severity of the weakness and determine whether it is a minor deficiency, a significant deficiency, or a material weakness. Definitions include:

- ***Significant Deficiency.*** A deficiency in internal control is significant if it could adversely affect a company's financial reporting processes and the critical processes that feed data and information to the financial reporting processes.

- ***Material Weakness.*** A material weakness is a condition in internal controls in which there is a high probability that errors or irregularities in amounts material to the financial statements could occur and not be detected by employees and processes the company has in place.

Deficiencies that could be considered significant or a material weakness will be reported immediately to the Project Sponsor and promptly discussed with the independent auditor and the Audit Committee.

Preliminary Assessment

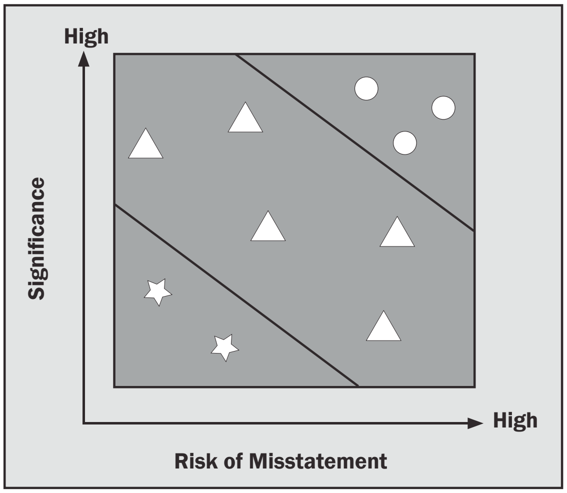
To prepare for the FRC Review, we updated our understanding of the financial reporting environment and developed an assessment strategy by completing the following:

- Assess significance and risk of misstatement for financial statement lines. Significance was determined by ranking the absolute dollar values of the amounts reflected in the year end financial statements. Risk of misstatement was independently rated by six members of financial leadership. Factors considered were:

- ► Volatility of balance, GAAP, disclosure requirements;
- ► Subjectivity in determining the account balance;
- ► Susceptibility to loss, fraud, errors; and
- ► Complexity of information systems, calculation, disclosures.

IA scored and plotted these assessments. In two-dimensions (Table 3), boundaries that create high (circle), medium (triangle) and low (star) risk levels can be visualized. IA will correlate the scope of the evaluations of control design and effectiveness with risk levels. The risk levels assigned to financial statement lines will also be used to validate our process risk assessments.

Table 3 - Documentation, Assessment and Validation Approach



	Documentation, Assessment, and Validation Legend
High ○	Determine sub-process risks based on walkthroughs and information obtained from sub-process management.
	Identify controls expected to mitigate risks.
	Obtain actual control information and supporting documentation from sub-process management.
	Compare expected and actual controls. Evaluate adequacy of control design. If gaps, make recommendations for improvement.
	Validate, through additional walkthrough procedures and comprehensive tests, that controls are operating effectively.
Medium △	Determine sub-process risks based on walkthroughs and information obtained from sub-process management.
	Obtain control information and supporting documentation from sub-process management.
	Evaluate control design. If weaknesses are noted in key controls, make recommendations for improvement.
	Perform limited testing to validate that key controls are operating effectively.
Low ☆	Based on walkthroughs and information obtained from sub-process management, identify major risks and key controls.
	If significant weaknesses noted in key controls, make recommendations for improvement

- ■ Assign financial statement elements to processes. Based on analysis of the accounts that make up the financial statement elements, we identified seven core financial processes:

1. Revenue & Receivables
2. Productive Assets
3. Treasury
4. Compensation & Benefits
5. Supply Chain
6. Risk Management
7. Other Assets & Liabilities

To facilitate IA's work, core processes will be segregated into sub-processes. Sub-processes will be IA's work units (i.e., a sub-process will be assigned to an auditor for internal control evaluation and validation). Our approach to each sub-process will be guided by whether it is routine or non-routine.

- ■ ***Routine.*** Processes that initiate, record, and report frequently recurring transactions. Internal controls for these processes should be more formal because of the recurring nature of the transactions, the objectivity of the transaction data, and the volume of data processed. Risk of error lies within the process. Accordingly, these sub-processes will be segments of the core process so we can fully evaluate the flow of financial data.

- ■ ***Non-routine Processes and Estimate Transactions.*** Processes where transactions occur irregularly or account balances are derived from calculations or estimates of the effects of future events. Controls often vary in terms of formality. Because transactions involve more subjectivity and/or occur less frequently and processing is often ad hoc, the risk of error is greater than with routine transactions. To ensure a comprehensive evaluation of risks and controls, sub-processes will be major accounts and/or groups of similar accounts.

- ***Establish Guidelines*** for documentation and assessment of control design and operating effectiveness.

  The extent to which controls are documented and evaluated should correspond to the level of risk in the sub-process. As shown in Table 3, we defined our approach based on level of risk; the higher the risk, the more substantial the documentation, evaluation and testing.

Entity-Level Work Plan

Early in the FRC Review, IA will review controls with system-wide application. This review will include the following:

- IA will evaluate the pervasive controls related to Information Technology and Human Resources, as described below in the Process Level work.

- IA will assess the control environment, management's risk assessment processes, communication and other information functions and monitoring. The assessment method has not been determined; it could include the development and use of a survey tool, and/or interviews of the CEO, CFO and management at each control unit. We intend to obtain and validate support for the existence and effectiveness of controls.

Process-Level Work Plan

The process-level work focuses on the sub-processes in the seven core financial processes and the components of Financial Reporting, Information Technology General Controls, and Human Resources (i.e., the ten core processes).

The work plan for each of the ten core processes has six major steps:

1. Define sub-processes and identify contact
2. Understand sub-processes
3. Identify and document risks
4. Identify and document controls
5. Evaluate internal controls
6. Test the effectiveness of controls

Details of the process-level work plan are included at Table 4 (page 28).

Department-Level Work Plan

IA's preliminary plan for the department-level FRC Review is to survey managers on the control activities that occur in departments. Key elements of the plan would be:

- Define the population by identifying departments with petty cash, equipment, charge capture, cash receipts, requisitioning, etc., and determine the selection methodology.

- Develop an electronic survey tool that can serve as the documentation of department controls.

- Conduct the survey and evaluate results.

- Review procedures at any department with clearly inadequate controls.

- Select a limited number of departments and validate control documentation and application.

If the work in the three levels outlined above discloses gaps in control design or operating effectiveness, IA will work closely with department managers and process owners to design and implement a solution before December 31, 2005.

Project Schedule, Resources, and Reporting

Internal Audit's current staff has the capabilities to complete the work outlined for all levels of the plan. However, we cannot yet determine that our resources are sufficient to complete the Project in the timeframe depicted in Table 1. Until the number of sub-processes and the risk levels of each, with the associated documentation and validation expectations, are determined (i.e., Phase I) and the several reviews are completed, there is insufficient information on which to base an estimate of resource needs or to create a project schedule. An assessment of resource needs and a schedule will be completed by July 2004.

Accordingly, in Phase I Internal Audit will report accomplishments and open items. Beginning with Phase II, progress will be monitored against the schedule and status reported to the Project Sponsor monthly and to the Audit Committee at each quarterly meeting.

The software has substantial reporting capabilities. Except for Internal Audit's final conclusion on the adequacy and effectiveness of financial reporting internal controls, we intend to rely on the software for all reporting (e.g., risk assessment results, issues identified, recommendation and action plans, and action plan status). ■

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Table 4 – Process-Level Work Program

Step 1: Define Sub-processes and Identify Contacts

- Assign the financial statement lines to the core processes.
- Identify the general ledger accounts that compromise the financial statement lines.
- Meet with core process owner(s) to identify the key activities or groups of process steps (i.e., sub-processes) and determine person responsible (contact) for each sub-process.
- Enter the sub-process information into the software.

Step 2: Assess Sub-process Risk Level

- Meet with the contact and accountant to walkthrough the sub-process, gather information for risk assessment, identify existing control documentation, and verify general ledger accounts impacted by the sub-process.
- In the software, link accounts and sub-process.
- In the software, complete risk assessment by rating factors such as materiality, complexity, history of errors or adjustments, extent of estimates or judgment, and propensity for change. The conclusion on overall risk level defines the "review level" and the work to be performed. In the following steps, the scope of work is differentiated by review level designations of high, medium and low.
- As appropriate for the review level, work with contact to obtain documentation of sub-process transaction flow, key decision points and criteria, and control activities.

Step 3: Identify and Document Risks

- Review sub-process documentation to determine the activities (i.e., initiation, processing, closing, reporting) taking place in the sub-process.
- Select applicable risks from the software's risk model and link to the sub-process.
- High and medium: Record each risk on a separate "Risk-Control Documentation Template".
- Low: Identify the major risks and record in the software.

Step 4: Identify and Document Controls

- High: Determine the controls that should be in place (expected control) based on sub-process documentation and knowledge or risks and controls. Consider the preferred hierarchy of controls and levels of controls. Select these controls from the software's control model or create new controls in the model and link to the risk.
- High and medium: Deliver the Risk-Control Documentation Templates to the contact/accountant and provide controls education and Template instructions. When completed Templates and supporting documents are returned, document the control (documented control) in the software's control model and link to the risk.
- Low: Review the sub-process documentation to identify control activities for major risks, document the control in the software's control model and link to the risk.

Step 5: Evaluate Internal Control Design

- High: Compare documented controls to expected controls. If an expected control does not have a corresponding documented control, identify this as a gap and record in the software as an issue. Evaluate documented controls without corresponding expected controls to identify opportunities to efficiency and effectiveness.
- Medium: Evaluate documented controls in relation to preferred hierarchy of controls and levels of control. Identify gaps in the control design and record in the software as an issue. Categorize the controls that provide the greatest mitigation to significant risks as key controls.
- Low" Categorize the controls that provide the greatest mitigation to significant risks as key controls and evaluate in relation to the preferred hierarchy of controls and levels of control. Identify gaps or excessive controls and record in the software as an issue.
- Use the software to report issues. Discuss issues with sub-process contact, accountant and owner, as appropriate; obtain action plans and document in software.

Step 6: Test Control Effectiveness

- High: Design tests that provide assurance that controls (i.e. ,documented and recommended controls) are functioning as intended. Perform tests on documented controls and schedule tests on recommended controls several months after implementation.
- Medium: Design and perform tests on key controls to determine whether control is functioning as intended.
- Low: For key controls, design and perform limited testing (e.g. walk through procedures, observation of control activity, tracing a couple to transactions through process).
- Use the software to report issues. Discuss issues with sub-process contact, accountant and owner, as appropriate; obtain action plans and document in software.