



A plan's management should view an effective system of internal controls as one of the mechanisms for meeting its fiduciary responsibilities. Accounting internal controls do not usually come up for discussion among trustees and those charged with the day-to-day administration of an employee benefit plan, unless fraud against the plan is discovered. While trustees and plan professionals get involved in reviewing audited financial statements and other financial reports, very little attention is usually paid to internal control matters. This article will discuss, among other topics, the nature, purposes and limitations of internal controls; who is responsible for implementing and maintaining internal controls; the impact of third parties processing transactions; and how the auditor can assist the plan's management with respect to internal controls. It is meant to provide an overview for non-accountants involved in the administration and servicing of Taft-Hartley employee benefit plans.

An Overview of Internal Controls

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Internal control is defined in the auditing literature (AU Section 319, *Consideration of Internal Control in a Financial Statement Audit*) 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: (a) reliability of financial reporting, (b) effectiveness and efficiency of operations, and (c) compliance with applicable laws and regulations.”

The Auditor’s Responsibility vs. Management’s Responsibility

Inherent in the above definition is plan management’s responsibility to implement and maintain effective internal controls to ensure financial statements are free of material misstatements and the assets of the plan are adequately safeguarded from misappropriation. Management should implement and maintain ef-

fective internal controls that provide reasonable assurance that adequate controls exist over the plan's books and records, and its assets. An example of a basic internal control is the proper authorization of transactions.

The auditor's role with respect to internal controls is to gain an understanding so as to plan the audit of the entity's financial statements. Ensuring effective internal controls are in place is one of the day-to-day functions of management, and the auditor cannot take on that responsibility. To do so would breach the independence rules, which are at the core of the auditing profession.

It is important to note the auditor is not required to test internal controls in the course of performing an audit of financial statements. Generally accepted auditing standards require only that the auditor obtains an understanding of internal controls. So how does an auditor conclude whether or not the financial statements are fairly stated if, in certain cases, there will be no testing of internal controls? The answer is simply the auditor has other tools at his or her disposal.

Some elaboration of the preceding discussion would be helpful. It would be virtually impossible to perform an effective audit of a relatively large entity (for instance, General Motors or a multibillion-dollar employee benefit plan) without performing tests of its internal controls. The complexity of the organization and the volume of transactions would be such that the auditor would have to evaluate the way processing takes place through the system of internal controls, to determine the degree of reliability to be placed on the accounting information produced by the entity. The auditor would, therefore, test internal controls to determine their effectiveness and thus be assured the system of internal controls facilitates reliable processing of data, which is then summarized to produce financial statements that are free of material misstatements.

On the flip side of this are numerous situations in which an entity is considered small or not complex. In these situations, it is usually not economically feasible for the auditor to test internal controls. This can be appropriately bypassed and compensated for by the performance of other procedures. This does not mean the auditor ignores internal controls in the case of

a relatively small entity. As previously mentioned, an audit would be substandard if the auditor did not obtain an understanding of the entity's internal controls. This understanding is obtained so the auditor can plan what types of procedures to perform and choose the extent to which they're needed and when to perform them.

The Engagement Letter

The auditor's standard *engagement letter*, which is the contract between the auditor and the plan for the performance of the audit, makes clear the responsibilities of the auditor and those of plan management. It specifically states that, among other things, management is responsible for:

- The establishment and maintenance of adequate records and effective internal controls over financial reporting
- The design and implementation of programs and controls to prevent and detect fraud.

The standard letter also states the auditor will obtain an understanding of the internal controls only as is necessary to plan the audit of the financial statements. It goes on to say the audit is not designed to provide assurance on internal controls or to identify significant shortcomings in their design or operation.

The Management Letter

While only limited procedures on internal controls are performed in the course of a financial statement audit, the plan's management can still derive benefits from those procedures. By obtaining an understanding of the plan's internal controls, the auditor can identify weaknesses that can be remedied in a cost-effective way, even in a relatively small plan.

These findings, together with recommendations, should be communicated to the client, either in writing or informally. When disseminated in writing, such correspondence is called a *management letter*. It is important to note this communication is not meant to be a comprehensive report on internal controls. It is only meant to bring to management's attention matters encountered as a consequence of obtain-

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Michelle V. Rafter,
Workforce Management,
January 2005, pp. 60-61.
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ing an understanding of the internal controls to plan the audit of the financial statements. An accountant would have to perform a special audit in order to opine on the state of an entity's internal controls. The procedures performed for this type of engagement are broader in scope and will include testing of the internal controls to evaluate their effectiveness.

The Objectives of Internal Controls

Reliability of Financial Reporting

Generating reliable financial data is a must for the smooth operation of a plan (internal use) as well as to ensure the numbers included in regulatory filings (e.g., Form 5500) are fairly stated (external use).

Safeguarding Assets

This is an objective most can relate to; it has to do with preventing and detecting the misappropriation of the plan's assets. Adequate internal controls should be in place to safeguard the plan's assets against unauthorized use and disposition. Examples of such controls are requiring the use of two signatures on checks and board of trustees' authorization of payroll increases, conference expenses, capital expenditures and the write-off of uncollectible receivables.

The Effectiveness and Efficiency of Operations

In the course of performing the financial statement audit, the auditor may bring to management's attention matters which, while not affecting the maintenance of reliable books and records, impact the operations of the entity. These could be duplicate operations or operations that are not needed, for instance, maintaining detailed investment records at the plan office. This may not be necessary if the information is, or could be, provided by a benefit plan's investment custodian. Duplicate operations could come about where a plan grows in size and complexity due to mergers, for example, and little or no attention is paid to combining or coordinating operations. Suggestions for improvement in the efficiency of operations of the entity are usually included in the management letter. A comprehensive review of operations, whether done internally or by the plan's independent CPA, could be beneficial in

identifying areas where some streamlining and cost savings could be accomplished.

Compliance With Applicable Laws and Regulations

A plan should have systems, policies and procedures in place to prevent prohibited transactions. Think ERISA and HIPAA. Written policies on the sharing of common administrative expenses, collection and delinquency, and reimbursement of trustees' expenses should be in place. Of course, these policies should meet the pertinent legal requirements and be followed.

Similarly, checks and balances should be in place to ensure there is compliance with the requirements of HIPAA.

Inherent Limitations of Internal Controls

Regardless of how well designed and smoothly operated a system of internal controls is, it can only provide reasonable—not absolute—assurance that the objectives of the plan will be attained. Surveys have indicated two of the main reasons why frauds occur are management override of internal controls and collusion. So it is no coincidence two key inherent limitations of a system of internal controls are:

- **Management override.** Internal controls can be circumvented by management pressuring a subordinate to record improper accounting entries. This may be done to conceal the misappropriation of assets, or to misrepresent the information reported in the financial statements, i.e., “fudging the numbers.” For example, in order to show a better bottom line, management directs expenses for repairs and maintenance be recorded as additions to fixed assets, thus delaying the recognition of a portion of the expense.
- **Collusion.** In smaller organizations, for instance, where a bookkeeper who is inadequately supervised and monitored does the banking, maintenance of the books and records, etc., there is susceptibility for the perpetration of fraud by that person because of the lack of segregation of duties. However, this vulnerability does not necessarily disappear in larger organizations,

where there may be layers of supervision, and checking and cross-checking taking place. It is extremely difficult, despite the segregation of duties that may exist in a larger entity, to prevent and uncover fraud, if there is collusion between two or more individuals. This collusion may be internal, involving employees only, or a combination of internal and external, involving an employee and a vendor.

Cost/Benefit

The cost/benefit factor in the design and implementation of internal controls should always be kept in mind. Every procedure that is put into place comes with a cost. It is important to keep in mind what the plan hopes to achieve. To an extent, this is a subjective process and the facts and risks of errors or fraud must be carefully considered. This is an area where management can consult with the plan's professionals.

Service Organizations

It is quite common for plans to outsource some of their transaction processing and recordkeeping. For example, a custodian bank is given physical custody of the investments and maintains the records of transactions affecting those investments. Other examples of service organizations are a pharmacy benefit manager (PBM); an insurance company that provides administrative services only (ASO) in the area of health claims processing; a recordkeeper (a financial institution such as a mutual fund company, bank or insurance company that maintains participant account balances) of a participant-directed defined contribution retirement plan; and a dental claims processor. In some cases, a third-party administrator (TPA) is hired to assume all or substantially all the administrative functions, sometimes including the bookkeeping.

Whenever services are outsourced, the internal controls in operation at the service organization are considered a part of the plan's internal controls. For this reason, the plan auditor is required to obtain an understanding of those internal controls to plan the financial statement audit. It would be helpful for plan management, in the course of hiring a service organization or anytime thereafter, to ask

about the internal controls in place at the service organization. Many of the larger service organizations hire a CPA to perform a special audit on the internal controls. The CPA issues an SAS 70 report, so named after the auditing standard that provides guidance on the performance of such an audit. It is normal for the plan's auditor to request this report, as it provides useful information for planning and performing an audit of the plan's financial statements. When a service organization or TPA lacks an SAS 70 report, the plan's auditor should perform procedures for obtaining an understanding of its internal controls. Plan management sometimes obtains and reads this report, since it gives them a sense of how their plan's business is conducted by the service organization.

The Tone Is Set at the Top

The plan's management (board of trustees, plan administrator, controller, etc.) has an impact on the environment that serves as the backdrop for the internal controls. It is imperative that managers show the same respect for policies and procedures expected from employees. The ethical values and integrity of management, and the attitude of management toward internal controls, filters down to employees. There is no better deterrent to the perpetration of harmful acts against a plan than a management—including the board of trustees—that is proactive and involved. The fact and perception that management pays attention to what is going on increases the likelihood of efficient and effective plan functioning and reduces the risk of fraud.

Policies and Procedures

While a detailed discussion of the various internal control policies and procedures is outside the scope of this article, there is one area that should be discussed and that is the segregation of duties. As far as is feasible, certain incompatible duties should not be combined in one person's job. Duties are incompatible when they provide an opportunity for someone to commit an error or fraud and then be able to conceal it. An example is where the employee who collects revenue (cash and checks) does the banking and also maintains the accounting records. Such

an individual can commit fraud and then cover it up by "doctoring" the books. In this situation, the employee has custody of assets and maintains the records. Whenever possible, the functions of and responsibility for executing a transaction, recording a transaction and maintaining custody of the assets should be assigned to different employees.

In smaller organizations, it is not possible to have the degree of segregation of duties previously described. In such cases, the procedures below, some of which could also benefit larger plans, should be implemented.

- Plan management should increase its familiarity with operations and thus be better able to spot any anomalies.
- Increase supervision of employees.
- Ensure the accounting software leaves a trail of any bookkeeping entries that are changed or deleted. Once a transaction is recorded, it should only be removed or modified by posting another entry into the accounting records to reflect the deletion or change.
- Promptly prepare monthly bank reconciliations. After preparation, a second plan employee should independently review the bank reconciliations.
- The plan administrator or someone in a comparable position should directly receive and review all correspondence from the bank, including bank statements. That individual should count the canceled checks against the checks listed as cleared on the bank statement and examine canceled

checks for any unusual payees and endorsements. Much fraud has been committed by employees writing checks to themselves or to dummy vendors.

- Eliminate or minimize the use of signature stamps. If signature stamps are used, implement adequate safeguards to prevent unauthorized use. Keep signature stamps securely locked with limited access.
- Adequately safeguard unused checks.
- Cancel paid invoices to prevent them from being used again for disbursing cash.
- Make employee vacations mandatory. While one employee is on vacation, have another employee perform the duties of the absent employee.

The above is not an exhaustive list—Your plan's professionals should be able to assist in the identification and implementation of additional procedures and policies.

Conclusion

Two other points should be noted: Internal control policies and procedures are only as good as the people carrying them out, and internal controls could become obsolete over time as conditions evolve. Therefore, continuous monitoring should take place to ensure that the entity's objectives are being met. **B&C**

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