



AUDIT AND ADVISORY SERVICES

Key Financial Controls Audit Project No. 13-603

October 4, 2013

Prepared by:

Chad Edwards
Auditor-in-Charge

Reviewed by:

Approved by:

Jaime Jue
Associate Director

Wanda Lynn Riley
Chief Audit Executive



AUDIT AND ADVISORY SERVICES
Tel: (510) 642-8292

611 UNIVERSITY HALL #1170
BERKELEY, CALIFORNIA 94720-1170

October 4, 2013

Delphine Regalia
Assistant Vice Chancellor and Controller
Controller's Office

Assistant Vice Chancellor and Controller Regalia:

We have completed our audit of key financial controls as per our annual audit plan in accordance with the Institute of Internal Auditors' *Standards for the Professional Practice of Internal Auditing* and the University of California Internal Audit Charter.

Our observations with management action plans are expounded upon in the accompanying report. Please destroy all copies of draft reports and related documents. Thank you to the staff of the Office of the Vice Chancellor for Research, the Office of the Vice Chancellor for Student Affairs, the Office of the Dean of the Goldman School of Public Policy, the Office of the Chief Information Officer, the School of Social Welfare, the College of Chemistry, Cal Performances, School of Law, and the College of Letters & Sciences – Biological Sciences Division for their cooperative efforts throughout the audit process. Please do not hesitate to call on Audit and Advisory Services if we can be of further assistance in this or other matters.

Respectfully reported,

Wanda Lynn Riley
Chief Audit Executive

cc: Vice Chancellor Administration & Finance John Wilton
Director Lisa Vanderfin
Senior Vice President and Chief Compliance and Audit Officer Sheryl Vacca
Associate Chancellor Linda Morris Williams

University of California, Berkeley
Audit and Advisory Services
Key Financial Controls

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OVERVIEW

Executive Summary

The audit objective was to evaluate the effectiveness and efficiency of key financial controls. The campus defines a control as a key control when, if other controls fail, it can reasonably be relied upon to detect or prevent a material misstatement of the financial statements. By design, key financial controls occur at the departmental and senior management level, and centrally within General Accounting.

The audit scope covered performance of departmental key controls over financial reporting and the process whereby deans and senior managers are required to sign annually a fiscal close certification letter.

We observed that the departmental key controls as currently outlined by the Controller's Office are neither designed nor operating effectively. While we understand the flexibility offered under the current process and that it allows for departments to employ different approaches in the practice of conducting departmental key controls, we observed in our discussions with a sample of departments as well as examination of the supporting documentation of their review that the departmental key controls, as currently designed, do not provide for a level of consistency in the performance of the control activities across campus departments.

In addition, the documentation serving as evidence of the performance of the control is not sufficient to determine whether the review was performed; for instance, the procedures performed, what was identified, what was followed-up on, and what was the final disposition of the items (i.e., the outcome).

Furthermore, oversight and monitoring controls are not currently in place at either the campus or department level to assure that department key controls are being performed completely, timely, accurately, effectively, and all while maintaining appropriate segregation of duties.

Lastly, we noted that although senior managers and deans sign the fiscal close certification letters, their understanding concerning the scope of the representations they were making could be further developed (such as those related to the awareness of potential fraud, unrecorded liabilities or expenses, or other contingencies).

Source and Purpose of the Audit

The audit was conducted pursuant to the fiscal year 2013 audit plan as approved by the campus Committee on Audit, Internal Control, and Financial Accountability and the UC Board of Regents. The audit objective was to evaluate the effectiveness and efficiency of key financial controls. The campus defines a control as a key control when, if other controls fail, it can reasonably be relied upon to detect or prevent a material misstatement of the financial statements. By design, key financial controls occur at the departmental, dean and senior management level, and centrally within General Accounting.

Scope of the Audit

Based upon our risk assessment procedures, the audit scope covered the performance of certain departmental key controls over financial reporting, which are general ledger summary review, general ledger transaction verification review, overdraft fund review, payroll expense review, and physical inventory verification.

The scope also included the process whereby deans and senior managers are required to sign a fiscal close certification letter regarding their financial responsibilities for establishing and maintaining an effective system of internal controls within their unit and the other representations related to full disclosure of transactions, potential fraud, or non-compliance.

In general, audit techniques included selecting a sample of campus departments, deans and senior managers and inquiring as to how they perform the controls, inspecting evidence of the performance of key controls, and inquiring about potential process improvements.

Background Information

In 1996, the UC Regents approved the UC Controls Initiative. Coming in the wake of high-profile control breakdowns, the Controls Initiative was designed to strengthen accountability, responsibility, and internal control across the UC system.

The Controls Initiative established the position of controller at each campus and charged them with:

- Developing and implementing campus-wide internal controls.
- Establishing, evaluating, and supporting the control environment.
- Providing financial leadership for campus operations.

A principal element of this initiative is the performance of departmental key controls and fiscal close certification letters by deans and senior managers that are carried out and relied upon to detect or prevent a material misstatement of the financial statements.

The departmental key controls involve reviewing financial and identity management reports, as well as, performing a physical inventory. Most of these controls are performed monthly, however, the identity management report review occurs quarterly and the physical inventory every two years. The Controller's Office has provided direction and guidance as to what reports may be

reviewed for each control and a checklist that departments may use to evidence performance of the controls.

As part of the fiscal close process, the Chancellor, Executive Vice Chancellor and Provost (EVCP), Vice Chancellor – Administration & Finance (VCAF) and Controller sign a campus management representation letter that is provided to the external auditors. This letter certifies that the campus information, which is incorporated into the financial statements and report, is a fair representation conforming to generally accepted accounting principles.

The decentralized nature of the University of California, Berkeley necessitates that the Chancellor, EVCP, VCAF, and Controller obtain written confirmations from deans and other campus senior managers regarding their financial responsibilities for the campus information, which is incorporated into the annual financial statements. This is accomplished through the Fiscal Close Certification Letter.

Summary Conclusion

We observed that the department key controls as currently outlined by the Controller's Office are neither designed nor operating effectively. While we understand the flexibility offered under the current process and that it allows for departments to employ different approaches in the practice of conducting departmental key controls, we observed in our discussions with a sample of departments as well as examination of the supporting documentation of their review that the departmental key controls, as currently designed, do not provide for a level of consistency in the performance of the control activities across campus departments.

In addition, the documentation serving as evidence of the performance of the control is not sufficient to determine whether the review was performed; for example, what procedures were performed, what was identified, what was followed-up on, and what was the final disposition of the items (i.e., the outcome).

Furthermore, oversight and monitoring controls are not currently in place at either the campus or department level to assure that department key controls are being performed completely, timely, accurately, effectively, and while maintaining appropriate segregation of duties.

Lastly, we noted that although senior managers and deans sign the fiscal close certification letters, their understanding concerning the scope of the representations they were making could be further developed (such as those related to the awareness of potential fraud, unrecorded liabilities or expenses, or other contingencies).

SUMMARY OF OBSERVATIONS & MANAGEMENT RESPONSE AND ACTION PLAN

Current Design of Departmental Key Controls

Observation

While we understand the flexibility offered under the current process and that it allows for departments to employ different approaches in the practice of conducting departmental key controls, we observed in our discussions with a sample of departments as well as examination of the supporting documentation of their review that the departmental key controls, as currently designed, do not provide for a level of consistency in the performance of the control activities across campus departments. In addition:

- Departments in our sample stated that training and guidance on how to properly perform the controls are currently inadequate. They said that additional guidance or information would be helpful in the following areas:
 - What are the differences among the BAIRS reports and how should they be interpreted?
 - What should be the roles within the process, positions best suited for these roles, and potential segregation of duties issues to avoid?
 - How do you review a report for “general propriety and accuracy”?
 - How do I document my review and management’s approval?

- Two out of five departments in our sample also noted that the process as currently designed does not appear to consider relative risk in prioritizing review efforts. The controls as stated imply that sufficient effort is necessary to verify “general propriety and accuracy” and to follow up on “unusual items”. As designed, departments said they follow the same process regardless of risk, such as, the materiality of the individual transaction to the department or the campus, the source of funds used (restricted or unrestricted), or the relative inherent risk associated with certain transaction types over others. As a result, they feel that they spend more time than what appears reasonable performing these controls.

Oversight and monitoring controls by the Controller’s Office are not currently in place to assure that department key controls are being performed completely, timely, accurately, and effectively across the campus.

Management Response and Action Plan

We agree that performance and documentation of departmental reviews of key financial management reports should be consistent across campus.

Guidance for both performance of the departmental reviews of key financial management reports and documentation of such reviews is provided on the Financial Controls & Accountability web pages, including:

- Definition of required organizational level (department) for review of reports.

- Identification of financial reports associated with each key control area (General Ledger Summary, General Ledger Detail, Overdraft, Payroll Expense, User System Access, and Physical Inventory) with basic instructions for review and follow-up.
- A checklist tool for documentation of reviews.

However, we will review and update the guidance based on risk analysis and consideration of minimizing existing flexibility regarding the reports, positions for performance of the reviews, and documentation of the reviews by July 1, 2014. Data analytics for devising exceptional management reports will be considered when funding is available.

In addition, in fiscal year 2014, the Financial Accounting and Controls unit in the Controller's Office will begin a project to assess and configure a monitoring process and system (UC Tracker, an IBM-developed application) for periodically monitoring and reporting on the performance of departmental reviews of key management reports. Implementation is expected by October 1, 2014.

Current Operating Effectiveness of Departmental Key Controls

Observation

In addition to the prior design observations, we have the following observations related to the operating effectiveness of department key controls from our audit fieldwork:

- Two of the five departments (40%) in our sample perform the controls at levels below the L4 level (i.e. at the L5 – discipline/group or L7 – subunit level). However, they did not assure completeness across their L4 organization and/or they did not have a process in place to detect errors that might only be discoverable at the L4 level so that an assertion could be made that the control had been consistently completed in a manner satisfying the control objective.
- When we obtained copies of the supporting documentation that would evidence the completion of the controls, we noted inconsistent practices of documentation. Some departments retained only the signed checklist whereas others retained BAIRS or internally developed reports. However, even for those that retained reports, the documentation was often inadequate for us to assess how the report was reviewed, what were the results of the review, and what was the disposition of any items identified during the review that required further research or follow-up.
- Oversight and monitoring controls are not currently in place to assure that department key controls are being performed completely, timely, accurately, and effectively. For the five departments sampled, three (60%) were out of compliance with respect to timely completion of the reviews. One department had only partially performed the required controls for selected subunits (i.e. L7 level). Two departments had largely performed the controls as required with the exception of performing physical inventories every two years.

- We also observed that personnel responsible for reviewing the BAIRS reports were also involved in recording and/or approving GL journals, purchases, vouchers, and bills in BFS and BearBuy and it was not the departments' practice for someone independent and knowledgeable to review documentation evidencing performance of the controls. This condition creates a potential segregation of duties issue in that a transaction preparer or approver may be reviewing his or her own work. Given staff reductions, for example because of Campus Shared Services, management could reduce the risk by having someone independent and knowledgeable review documentation evidencing performance of the controls.

Inadequate documentation of the performance of the process and monitoring of completion at the departmental level and campus level may result in non-compliance, errors may go undetected and corrected, and concealment of fraudulent activities could occur.

Management Response and Action Plan

As mentioned above, the Financial Accounting & Controls unit in the Controller's Office will assess, develop and configure a monitoring process and system for documenting the performance of the management review of key financial reports. This will provide a means for both campus department and central staff to identify incomplete reviews and take appropriate remedial actions, including escalation if necessary. We agree that department financial/budget management staff should perform and certify the review of the key financial reports and will take this into account in the assignment of roles in the system. Please see the response to the prior observation for more specific information and expected date.

Enhance Awareness and Understanding among Deans and Senior Management Concerning Fiscal Close Certifications

Observation

Limited to no orientation is provided to deans and senior managers regarding the assertions made and expectations of them in annually signing the fiscal close certification letters. Senior managers and deans said they placed reliance on departmental key controls, regularly meetings with their budget and finance team, and controls built into the day-to-day operation for ensuring the proper accounting of the control unit, division, and departments under their chain of command. However, some individuals we interviewed said their awareness and understanding as to the scope of some of the representations they were making could be improved, such as those related to disclosures of alleged fraud and potential unrecorded material transactions, such as off-balance sheet items, contingent liabilities, related party transactions, or other matters potentially affecting financial statement presentation and disclosures.

An approach to consider for mitigating this risk is an executive orientation to create awareness and understanding concerning the risks and the importance of this control as well as to provide guidance concerning leading practices to put in place throughout the year.

Management Response and Action Plan

Guidance for deans and senior management for the fiscal close certification process, including “frequently asked questions” pertaining to scope, materiality, accruals and deferrals, disclosures, control weaknesses and other related items, is provided on the Controller’s Office Financial Controls & Accountability web site. We will review this guidance and provide additional guidance specific to contingent liabilities and related party relationships and transactions. We will also add a reference to the web site guidance in our communication process with the deans and senior management and institute earlier communication (at the beginning of the last quarter of the fiscal year) to ensure the certifications signers are aware of the guidance. We will develop a strategy and materials for a new dean orientation by July 1, 2014.