INTRODUCTION AND LEARNING OBJECTIVES

Often when reading about fraudulent acts you will see a common theme. One employee has sole responsibility for a process. The employee usually is a long-time, trusted part of the department. The fraudulent activity is discovered when the employee is unexpectedly absent from work and cannot perpetuate established schemes. A division of responsibilities between several employees could have lessened the likelihood of the event occurring; and the possible loss of public confidence avoided. In this chapter we will discuss the importance of segregating duties.

After completing this chapter, you should be able to

- Define segregation of duties
- Review what duties should be segregated for payroll
- Complete a segregation of duties evaluator for a sample government

WHAT IS SEGREGATION OF DUTIES?

Segregation of duties (SoD) means separating the record-keeping function from the operational responsibility of that activity and from those who exercise physical control over the records. Segregation of duties is one of the key concepts of internal control and is the most difficult and sometimes the most costly one to achieve. The term SoD is common in financial accounting systems. Companies of all sizes understand not to combine roles such as printing payroll checks and signing those same checks.

SoD is used to ensure that errors or irregularities are prevented or detected on a timely basis by employees in the normal course of business. Segregation of duties provides two benefits:

1) a deliberate fraud is more difficult because it requires collusion of two or more persons

2) it is much more likely that innocent errors will be found. At the most basic level, it means that no single individual should have control over two or more phases of a transaction or operation

With continuing restraints on revenues, governments are being forced to do more with less. Often this means that a job previously performed by two employees is now performed by one. Typically the duties of the job are not reduced increasing the likelihood of error or fraud. Good financial management requires the finance officer
review remaining positions to identify those who can provide the appropriate segregation of duties. We will discuss how duties may be segregated below.

**CATEGORIES OF DUTIES TO BE SEGREGATED**

There are four general categories of duties or responsibilities which are examined when segregation of duties are discussed:

- authorization
- custody or access to asset
- record-keeping
- reconciliation or accountability

In an ideal system, different employees would perform each of these four major functions. In other words, no one person should have control of two or more of these responsibilities. The following chart reflects the common processes that fall under each of the four general categories:

<table>
<thead>
<tr>
<th>Authorization</th>
<th>Custody (Access to Asset)</th>
<th>Record Keeping</th>
<th>Reconciliations (Accountability)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Approval of new hires</td>
<td>Access to payroll checks/bank accounts (EFT)</td>
<td>Preparing source documents</td>
<td>Preparing bank reconciliations</td>
</tr>
<tr>
<td>Approval of pay rates</td>
<td>Mailing or delivering checks</td>
<td>Maintaining journals, ledgers, or other files</td>
<td>Preparing payroll liability reconciliations</td>
</tr>
<tr>
<td>Signing of checks</td>
<td></td>
<td>Preparing performance reports</td>
<td></td>
</tr>
</tbody>
</table>

The more liquid the asset, the greater the need for proper segregation of duties - especially when dealing with cash and negotiable checks. In those instances where duties cannot be fully segregated, mitigating or compensating controls must be established.
EVALUATING SEGREGATION OF DUTIES

One of the most difficult management tasks is to evaluate segregation of duties and then to make employee assignments appropriately, especially if the number of employees is limited. A simple challenge question to evaluating segregation of duties is this:

If I make an error in my work, will someone else in the process detect it before it becomes a major issue for management and the taxpayers to read about?

By breaking apart tasks (approvals, access, recording, and reconciling results), governments increase the likelihood that they can detect unintentional errors in their results before it's too late. A person with multiple functional roles has the opportunity to abuse those powers. The pattern to minimize risk is:

A. Start with a function that is indispensable, but potentially subject to abuse.
B. Divide the function into separate steps, each necessary for the function to work or for the power that enables abuse to occur.
C. Assign each step to a different person or to a different department.

Optimally, different employees should perform the duties within the four categories of authorization, custody, record-keeping, and reconciliation. However, if the optimum degree of segregation cannot be achieved, a minimum degree of segregation must be maintained. At a minimum, no person should be able to perform more than two of the functions. The matrix illustration below presents various ways to assign responsibilities that are less than the optimum.

<table>
<thead>
<tr>
<th>RESPONSIBILITY/SCENARIO</th>
<th>Authorization</th>
<th>Custody</th>
<th>Recording</th>
<th>Reconciliation</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Emp1</td>
<td>Emp2</td>
<td>Emp2</td>
<td>Emp1</td>
</tr>
<tr>
<td>2</td>
<td>Emp2</td>
<td>Emp1</td>
<td>Emp2</td>
<td>Emp1</td>
</tr>
<tr>
<td>3</td>
<td>Emp2</td>
<td>Emp2</td>
<td>Emp1</td>
<td>Emp1</td>
</tr>
<tr>
<td>4</td>
<td>Emp1</td>
<td>Emp1</td>
<td>Emp2</td>
<td>Emp2</td>
</tr>
</tbody>
</table>

The process of recording (record-keeping) and reconciliation should be performed by two different employees to maximize the opportunity to identify errors in the ordinary course of business. This is illustrated in scenario 1 and 2 in the above matrix. In scenarios 3 and 4, there must be more reliance on mitigating or compensating controls since employees are assigned incompatible functions.

MITIGATING OR COMPENSATING CONTROLS

A mitigating or compensating control is one that reduces the risk of an existing or potential control weakness resulting in errors and omissions. Compensating controls are less desirable than the segregation of duties because compensating controls generally occur after the
transaction is complete. Also, more resources are required to investigate and correct errors and to recover losses than it does to prevent the errors in the first place. However, in some instances governments do not have the staff resources to establish adequate segregation of duties. In these instances, it is important for management to implement internal controls that compensate for this increased risk.

Following are some types of compensating controls to implement in the payroll function:

- **Review reports of detail transactions** – Managers review on a regular and timely basis system the payroll register report including reconciliations.

- **Review selected transactions**– Managers select transactions for review of supporting documents.

- **Take periodic asset counts**– Managers periodically hand delivers payroll checks or direct deposit remittance advices to ensure all employees paid actually exist.

- **Check reconciliations** – Managers from time to time review reconciliations of account balances such as payroll deductions payable or perform them independently.

Notice that in each of the above compensating controls that management is the one performing the procedure. Compensating controls cannot be delegated. They must be performed by a supervisory or management level employee that is knowledgeable about the process. Delegating the controls would defeat the purpose of the compensating control and render it ineffective. In addition, management should take compensating controls into consideration in the risk assessment phase of internal control evaluation.
CHAPTER 5 SUMMARY

1. Segregation of duties means separating the record-keeping function from the operational responsibility of that activity and from those who exercise physical control over the records.

2. Segregation of duties provides two benefits:
   • A deliberate fraud is more difficult because it requires collusion of two or more persons; and
   • It is much more likely that innocent errors will be found.

3. Categories of duties that need to be segregated include:
   • Authorization—authorization of transactions such as new employee hires;
   • Custody—access to payroll checks and EFTs;
   • Record-keeping—preparing source documents, such as timesheets; maintaining journals and ledgers; preparing performance reports;
   • Reconciliations—preparing bank reconciliations.

4. A simple challenge question to evaluating segregation of duties is this: If I make an error in my work, will someone downstream of me detect it before it becomes a major issue for management and the taxpayers to read about?

5. The process of record-keeping and reconciliation should be performed by two different employees to maximize the opportunity to identify errors in the ordinary course of business.

6. If employees are assigned incompatible duties, then mitigating or compensating controls must be established.

7. A mitigating or compensating control is one that reduces the risk of an existing or potential control weakness resulting in errors and omissions.

8. Types of compensating controls that can be implemented include:
   • Review reports of detail transactions – Managers review on a regular and timely basis system the payroll register report including reconciliations.
   • Review selected transactions – Managers select transactions for review of supporting documents.
   • Take periodic asset counts – Managers periodically hand delivers payroll checks or direct deposit remittance advices to ensure all employees paid actually exist.
   • Check reconciliations – Managers from time to time review reconciliations of account balances such as payroll deductions payable or perform them independently.
CHAPTER 5 EXERCISES

1. Below is a listing of responsibilities within the payroll function. Determine which category of duties to be segregated each would belong to. The categories of duties to be segregated include:

   • Authorization
   • Custody or access to asset
   • Record-keeping
   • Reconciliation or accountability

A. Receipt of returned paycheck

B. Approval of new hire

C. Posting of payroll

D. Signing of payroll checks

E. Bank reconciliation

F. Approval of pay changes

G. Access to bank accounts/online banking

H. Mailing of payroll checks

I. Posting of payroll adjustments

J. Sub-ledger and account reconciliation

K. Payroll register approval
2. Complete the following segregation of duties matrix for a payroll area that has two employees, Nora and Sam, along with the payroll supervisor, Laura.

<table>
<thead>
<tr>
<th>Task</th>
<th>Authorization</th>
<th>Custody</th>
<th>Record-keeping</th>
<th>Reconciliation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Entry of time worked</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Approval of preliminary payroll register</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Printing of Payroll Checks</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Posting of Payroll Adjustments</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Bank Reconciliation</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Reconciliation of payroll withholding accounts</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
3. List 4 compensating controls that utilized in the absence of proper segregation of duties.

A. 

B. 

C. 

D. 