Internal Controls for Governments

May 19, 2022

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About Your Presenter

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Today's Topics

Overview of Internal Controls

- Controls vs. Process

- Key Controls

- Examples of Financial Controls

- Single Audit Controls

- Detecting Fraud with Controls

  – Red Flags

- What can you do?

Internal
Controls

+

Entity
Processes

Internal Control

Definition – Internal Control (IC)

– Internal Control is a process effected by an entity's oversight body, management, and other personnel that provides reasonable assurance that the objectives of an entity will be achieved.

– IC serves as the first line of defense in safeguarding assets.

– IC serves as the first line of defense in non-compliance.

Roles in IC

Oversight Body
– Responsible for overseeing the strategic direction of the entity and obligations related to the accountability of the entity.

Management
– Responsible for all activities of an entity, including design, implementation and operating effectiveness of IC system.

Personnel
– Help management design, implement and operate an IC system and responsible for reporting issues noted in entity's operations, reporting or compliance objectives.

Roles in IC

Oversight Body

- Is your board/council actively involved in the budget process?
- Is your board/council reviewing budget to actuals on a quarterly basis?
- How does your board/council stay involved to ensure the strategic direction of the entity?

Roles in IC

Management

– Design controls – Use your resources
- Use the employees and personnel in the day-to-day processes to help design a more efficient process.

– Implement
- Once designed, put those controls into action.
- Not set in stone, you can change as you go.

– Operating Effectiveness
- Does the control provide reasonable assurance that majority of the transactions will be accurate, or will it detect an error?

Roles in IC

Personnel

- Day-to-day operations
- They know what is happening
- They can help you write down the process and procedures
- How to mitigate errors or makes things more efficient

Segregate Roles

- Segregation of Duties
  - ARC

    - Authorization

    - Recordkeeping

    - Custody (of assets)

Internal Control

Achieving objectives through internal controls

Figure 2: Achieving Objectives through Internal Control

Objective identified → Controls designed → Controls in place → Objective achieved

Source: GAO. | GAO-14-704G

Controls vs Process

- Processes are –
  - Procedures that originate, transfer, or change data

- What to <u>remember</u> about a process

A process <u>CAN</u> introduce errors into the accounting system

Controls vs Process

- Controls are –
  - Procedures designed to **prevent** or **detect** and correct errors resulting from processing of information

- What to <u>remember</u> about a control

A Control <u>CANNOT</u> introduce or generate errors into the accounting system

Key Controls

- Key Controls are –
    1. Controls that have a pervasive affect upon the **accomplishment** of the **control objectives**.
    2. Ensures the financial statement **assertions are achieved**.
    3. They should **prevent** and/or **detect** material misstatements due to error or fraud from occurring and going undetected.
    4. They should not need additional mitigating controls to achieve the control objective.
    5. Often they can be **defined** in a way in which the auditor can perform a **test of controls** from a population throughout the period tested.

- What to remember about a key control

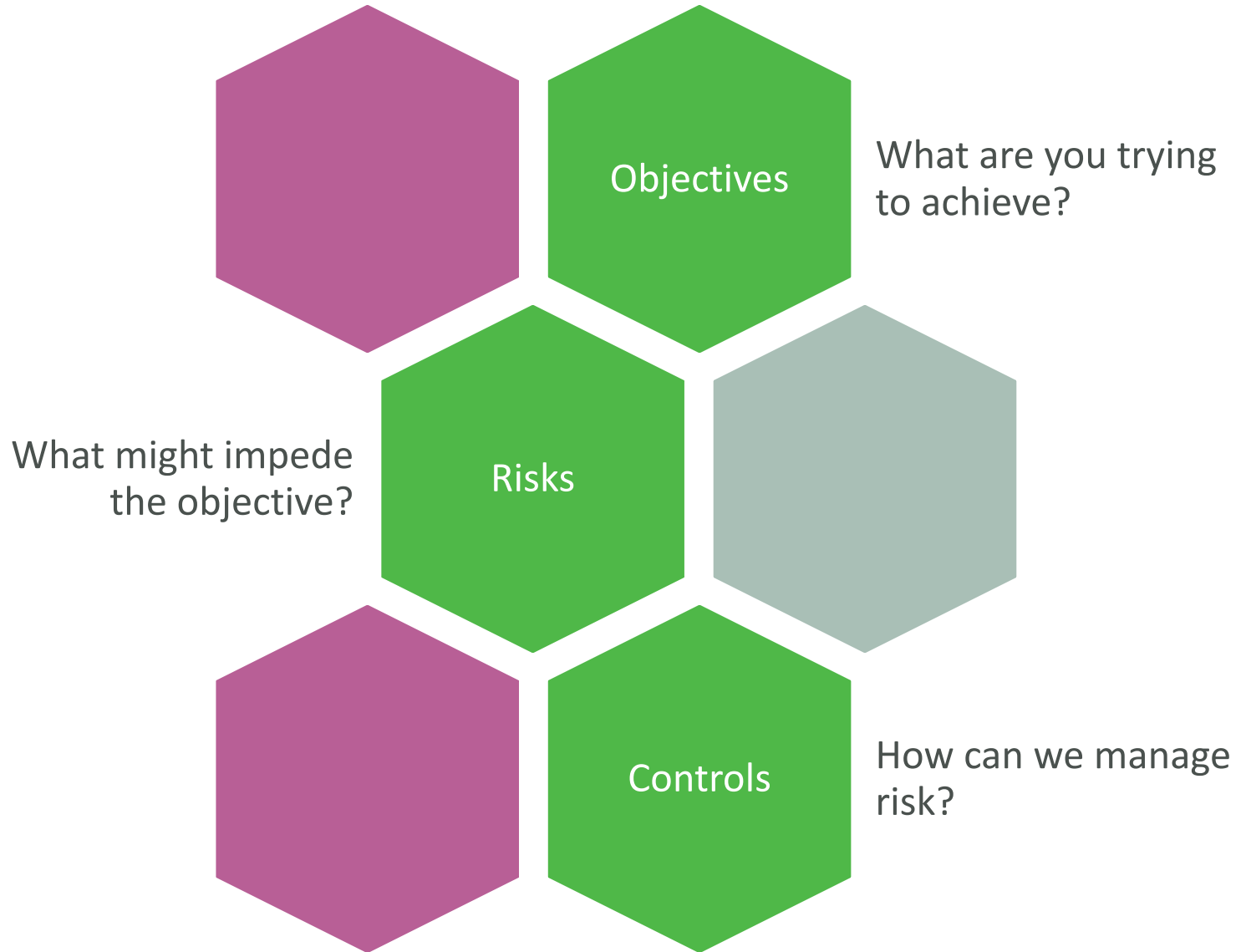# A Key Control SHOULD prevent and/or detect misstatements.

Control Deficiency

- Control deficiency –
  - A control or lack of controls that did not prevent or detect and correct misstatements in a timely basis.

- What to <u>remember</u> about a deficiency

A misstatement that was not PREVENTED or DETECTED by the key control(s).

Fundamentals of Developing Controls

Objectives

What are you trying to achieve?

What might impede the objective?

Risks

Controls

How can we manage risk?

Examples

Process or Control?

Checks received in the mail
are recorded on a check log

Process

Process or Control?

Bank reconciliations are reviewed by someone other than the preparer

Control

Process or Control?

GL system rejects duplicate entry of a vendor invoice

Control

Process or Control?

Hourly employee completes their timesheet and turns in

Process

Process or Control?

Completed timesheets are reviewed and approved by department supervisors

Control

Process or Control?

Physical inventory is compared to the GL by someone other than the individual taking inventory

Control

Process or Control?

Invoices are coded before they are entered into GL system

Process

Process or Control?

Manager approves purchase order or invoice prior to payment

Control

Process or Control?

The Controller enters the depreciable life for all fixed assets into the system

Process

Preventive Controls

- Deter the instance of errors or fraud

- Examples:
  - Segregation of duties
  - Pre-approval of purchases and coding
  - Physical control over assets
  - Passwords

Detective Controls

- Identify undesirable "occurrences" after the fact.

- Examples:
  - Physical inventory counts
  - Review & approval of reconciliations
  - Budget to Actual
  - Internal Audit

Examples

- What does your organization do?

- 5 minutes
  - Discuss with your table, where is the biggest risk in your organization?

  - Authorization or Review
  - Record keeping
  - System Access
  - Segregation of Duties
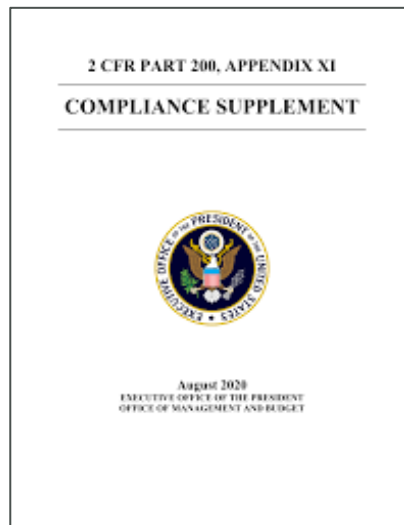
Single Audit Compliance Controls

Examples of Compliance Controls

Where to get ideas for controls?

– Part 6 of the Compliance Supplement

– https://www.whitehouse.gov/omb/office-federal-financial-management/

Examples of Compliance Controls

Part 6 – What is COSO
- Committee of Sponsoring Organization
  - Provides framework for internal controls

- 5 Main categories

- 17 Principles

Examples of Compliance Controls

Control Environment	1. Demonstrates commitment to integrity and ethical values 2. Exercises oversight responsibility 3. Establishes structure, authority and responsibility 4. Demonstrates commitment to competence 5. Enforces accountability
Risk Assessment	6. Specifies suitable objectives 7. Identifies and analyzes risk 8. Assesses fraud risk 9. Identifies and analyzes significant change
Control Activities	10. Selects and develops control activities 11. Selects and develops general controls over technology 12. Deploys through policies and procedures
Information & Communication	13. Uses relevant information 14. Communicates internally 15. Communicates externally
Monitoring Activities	16. Conducts ongoing and/or separate evaluations 17. Evaluates and communicates deficiencies

Source: COSO Outreach Deck – May 2013 (www.coso.org/documents/COSOOutreachDeckMay2013.pptx)

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Examples of Compliance Controls

Part 6

– Process owner is the doer and the Control owner is reviewer

– What could go wrong?
  - One control or multiple controls

– Put the control in a category –
  - Authorization, management review, segregation of duties, system access

Examples of Compliance Controls

11 Compliance Categories
- Allowable Costs/Allowable Activities
- Cash Management
- Eligibility
- Equipment
- Matching/Level of Effort/Earmarking
- Period of Performance
- Procurement/Suspension and Debarment
- Program Income
- Reporting
- Subrecipient Monitoring
- Special Tests

Examples of Compliance Controls

Part 6 – Activities Allowed, Cash Mgmt, etc

PART 6 – APPENDIX 2

Illustrative Specific Controls – Control Activities (excerpted from Greenbook).

Principle 10. Design Control Activities: management should design control activities to achieve objectives and respond to risks.

A. ACTIVITIES ALLOWED OR UNALLOWED B. ALLOWABLE COSTS/COST PRINCIPLES	C. CASH MANAGEMENT	E. ELIGIBILITY	F. EQUIPMENT AND REAL PROPERTY MANAGEMENT
Management identifies and puts into effect actions needed to carry out specific responses to risks identified in the risk assessment process, such as miscoding, inappropriate cost transfers, budget overages, segregation of duties concerns, unauthorized changes to system configurations, fraud, unauthorized payments, etc.	Management identifies and puts into effect actions needed to carry out specific responses to risks identified in the risk assessment process, such as time lapses between funds transfer and disbursement, fraud, liquidity pressures, inherent risks with subrecipients, etc.	Management identifies and puts into effect actions needed to carry out specific responses to risks identified in the risk assessment process, such as providing benefits to ineligible individuals, calculating amounts to be received for or on behalf of individuals incorrectly, unauthorized changes to system configurations, fraud, unauthorized payments, etc.	Management identifies and puts into effect actions needed to carry out specific responses to risks identified in the risk assessment process for equipment and real property, such as inaccurate or incomplete recordkeeping, inappropriate use, unidentified dispositions, segregation of duties concerns, fraud, loss, damage, theft, etc.
Management reviews applicable award agreements or contracts for specific allowable activities requirements, budget parameters , indirect rates, fringe benefit rates, and those activities/costs that require pre-approval by the awarding agency and documents such features into a grant approval form which is submitted to accounting personnel for review and approval before being input into the system as the profile for the grant.	Management reviews applicable award agreements or contracts to determine applicability of drawdown method (advance or reimbursement) to develop its own control activities and to inform its establishment of a method for subrecipients, as applicable.	Management reviews applicable award agreements or contracts and identifies specific eligibility requirements including benefits to be paid.	Management reviews applicable award agreements or contracts and identifies specific equipment and real property requirements.

Examples of Compliance Controls

Allowable Costs/Activities

– Creating account structure to segregate cost departments and allowability

- This would be a system control
- But who's reviewing this and when?

– Budget to actual reports reviewed monthly

- Someone other than the initial requester
- Grant Manager reviewing departments spending

Examples of Compliance Controls

Cash Management

– Management reviewing the award to understand requirements

– Request for reimbursements are reviewed prior to submission

– Drawdowns are reviewed by supervisors

- Are you comparing to budget?
- Are you looking at total project costs?

Examples of Compliance Controls

Equipment

– PPE purchases w/ grant funding are recorded and compared to source documents

- Are assets purchased w/ grant funding separately identified on your capital asset listing?

– Annually reviewing capital listing for disposals

- Does the grant require assets to be sold or donated?

– Physical inventory counts are required every 2 years

- Is this being reconciled to the accounting software?

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Examples of Compliance Controls

Program Income

– Individuals collecting cash or receipts are different than those completing the deposit and bank reconciliation

- Segregation of duties – what if your organization cannot achieve this?

- Can you get a board member involved to review the bank reconciliation?

- Do they know what they're looking for?

- Two people collecting cash and documenting the log?

Examples of Compliance Controls

Reporting

– Supervisors review and approve reports for accuracy and completeness

- Reimbursement requests
- Budget to actual reports
- Performance reporting
- This is the oversight that cannot be ignored

Pop Quiz

What attribute defines Control Activities?

1. Proper management oversight
2. Communicating to internal staff
3. Documenting Policies and Procedures

Red Flags

What can you do?

REPORT TO THE NATIONS®

2020 GLOBAL STUDY ON OCCUPATIONAL FRAUD AND ABUSE

Report to the Nations

- The information gathered for this portion of the presentation can be found at www.acfe.com.

- You can also obtain a copy of the Association of Certified Fraud Examiners Report to the Nations at this website.

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Key Finding

- Internal control weaknesses (opportunity) responsible for nearly ½ of all frauds

THE FRAUD TRIANGLE

Pressure
Motivation or Incentive
to Commit Fraud

Rationalization
Justification of
Dishonest Actions

FRAUD

Opportunity
The Knowledge and Ability
to Carry Out Fraud

The Fraud Triangle by Donald R. Cressey

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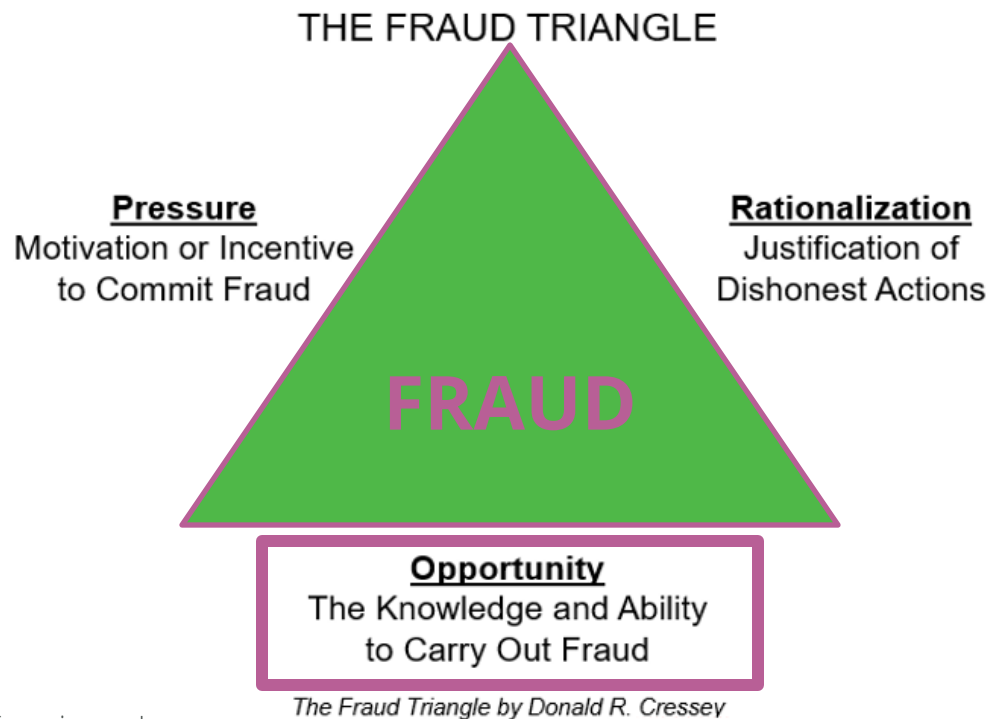
Key Findings

- Lack of internal controls – 30%

- Override of existing controls – 19%

- Lack of management review – 18%

- Poor tone at the top – 10%

- Lack of competent personnel in oversight roles – 8%

- Other – 6%

Over 50%

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Controls Detecting Fraud

Control	Percent of cases	Control in place	Control not in place	Percent Reduction
Code of conduct	80%	$110,000	$250,000	56%
Proactive data monitoring/analysis	37%	$80,000	$165,000	52%
Surprise audits	37%	$75,000	$152,000	51%
External audit of internal controls over financial reporting	67%	$100,000	$200,000	50%
Management review	66%	$100,000	$200,000	50%
Hotline	63%	$100,000	$200,000	50%
Anti-fraud policy	54%	$100,000	$190,000	47%
Internal audit department	73%	$108,000	$200,000	46%
Management certification of financial statements	72%	$109,000	$192,000	43%

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Controls Detecting Fraud

Control	Percent of cases	Control in place	Control not in place	Percent Reduction
Fraud training for employees	53%	$100,000	$169,000	41%
Formal fraud risk assessments	41%	$100,000	$162,000	38%
Employee support programs	54%	$100,000	$160,000	38%
Fraud training for managers/executives	52%	$100,000	$153,000	35%
Dedicated fraud departments, function or team	41%	$100,000	$150,000	33%
External audit of financial statements	80%	$120,000	$170,000	29%
Job rotation/mandatory vacation	19%	$100,000	$130,000	23%
Independent audit committee	61%	$120,000	$150,000	20%
Rewards for whistleblowers	12%	$110,000	$125,000	12%

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Red Flags!

- Pressure
  - Addiction problems, i.e. gambling, alcohol and drugs
  - Living beyond one's means
  - Financial difficulties
- Opportunity
  - Unwilling to share duties
  - Suspiciousness or defensiveness
  - Refusal to take vacations
- Rationalization
  - Complaints about pay and/or benefits
  - Dehumanizing the organization

Are you reactive or proactive to your internal control environment?

What can be done?

- Document your controls in:
  - A narrative or
  - Flowchart
    - Simplifies assessment of your internal control environment
    - Identify changes to strengthen controls and increase efficiencies
    - Easy to understand for everyone in the organization
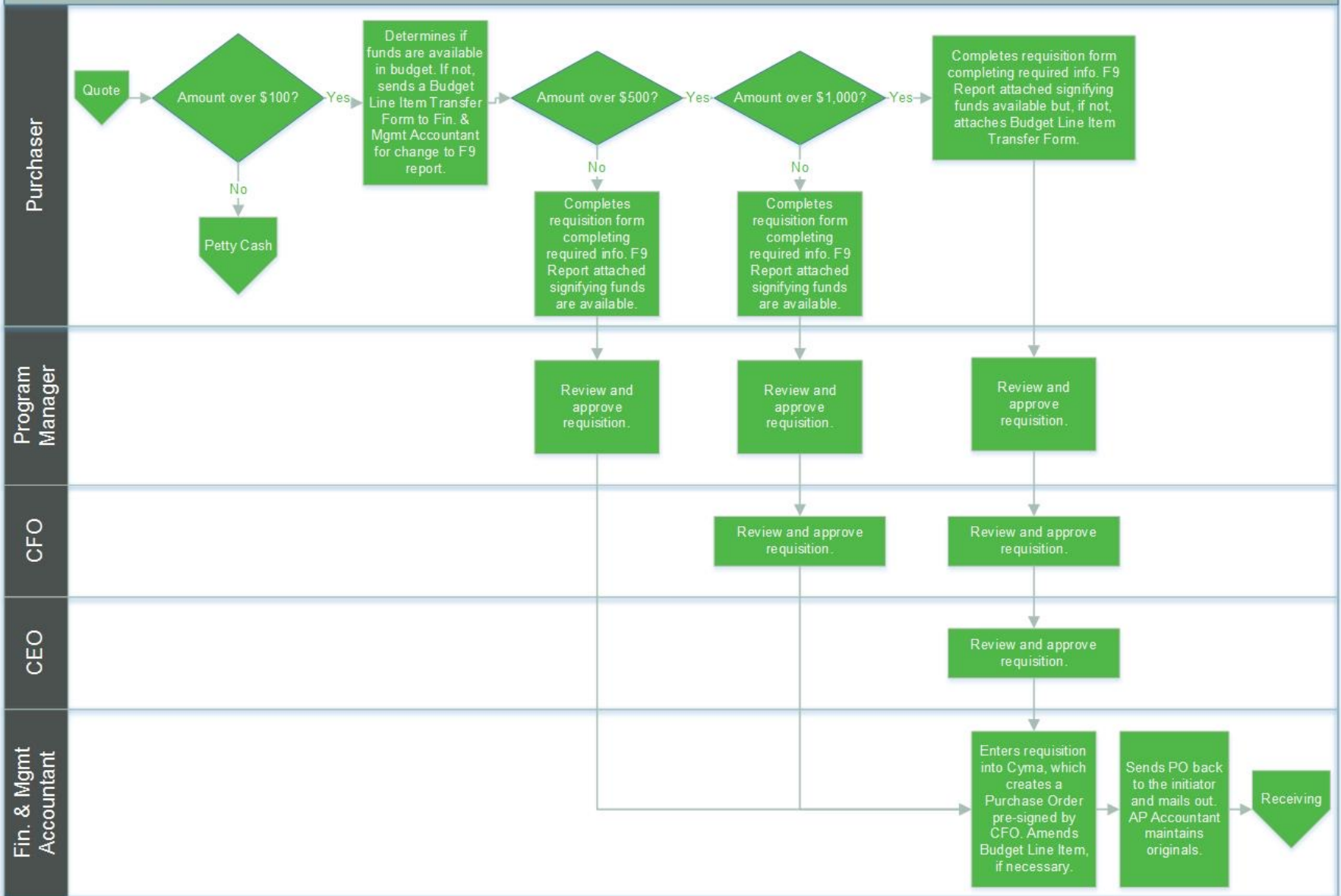   - Ensure segregation of duties

Flowcharting Process

- Discussion with each employee involved

- Documentation / flowchart

- Disburse to employees for review

- Review annually

ABC Company – Purchasing Policy

Requisition & PO

Purchaser

Quote → Amount over $100? — Yes → Determines if funds are available in budget. If not, sends a Budget Line Item Transfer Form to Fin. & Mgmt Accountant for change to F9 report. → Amount over $500? — Yes → Amount over $1,000? — Yes → Completes requisition form completing required info. F9 Report attached signifying funds available but, if not, attaches Budget Line Item Transfer Form.

- Amount over $100? — No → Petty Cash
- Amount over $500? — No → Completes requisition form completing required info. F9 Report attached signifying funds are available.
- Amount over $1,000? — No → Completes requisition form completing required info. F9 Report attached signifying funds are available.

Program Manager

- Review and approve requisition.
- Review and approve requisition.
- Review and approve requisition.

CFO

- Review and approve requisition.
- Review and approve requisition.

CEO

- Review and approve requisition.

Fin. & Mgmt Accountant

- Enters requisition into Cyma, which creates a Purchase Order pre-signed by CFO. Amends Budget Line Item, if necessary.
- Sends PO back to the initiator and mails out. AP Accountant maintains originals.
- Receiving

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What can be done?

- Segregation of duties
  - Small organizations – involving the board more, splitting responsibilities between 2 people
  - Large organizations – not enough management review
- Vacation Encouraged
  - If one person is doing everything and not taking vacation, how much control to they have?
  - Cross training
- System controls
  - Inquire with your accounting software for other features that would prevent specific entries
  - Get IT involved – password changes, user role logs reviewed

Questions?

Thank You
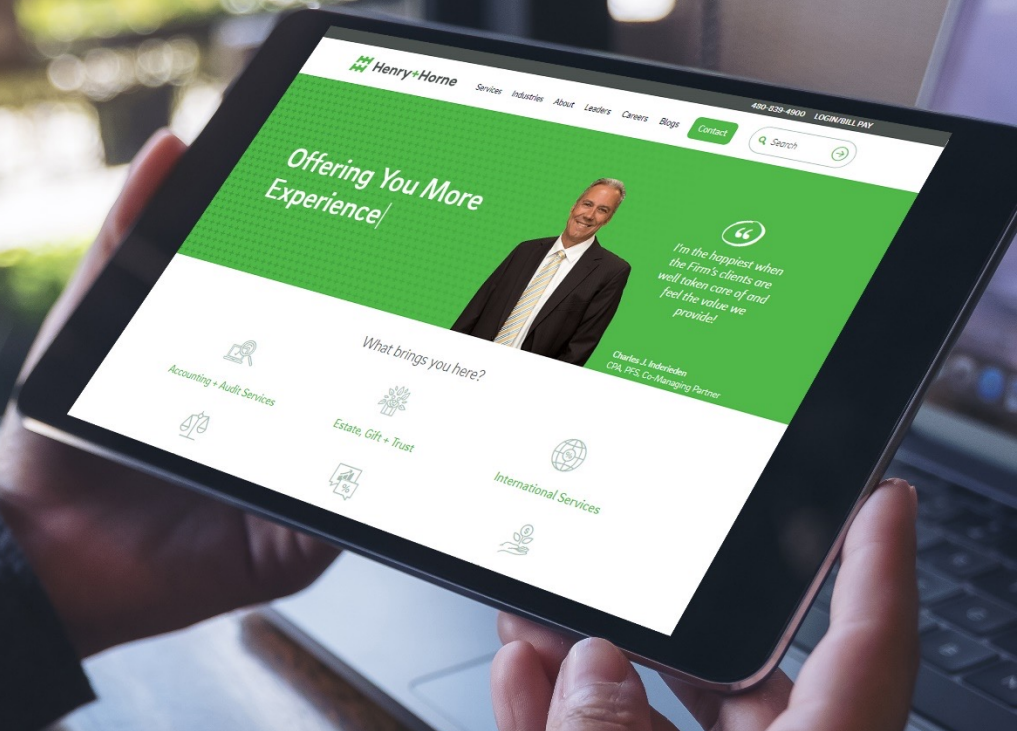
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