Internal Controls

Presentation Outline

- What are internal controls
- Benefits of internal controls
- Types of internal controls
- Segregation of duties
- Components of internal control
- Fraud risk

What are Internal Controls

- ***Internal control*** is 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*) <u>reliability of financial reporting</u>**,** (*b*) <u>effectiveness and efficiency of operations</u>, and (*c*) <u>compliance with applicable laws and regulations</u>.

Benefits of Internal Controls

- Establish protocols
- Protect employees
- Provide more accurate financial statements
- Compliance with laws and regulations
- Safeguard assets

Types of Internal Controls

- Preventive Controls – are designed to keep errors or irregularities from occurring in the first place.
- Detective Controls – are to uncover existing errors or irregularities.
- Corrective Controls – with preventive and detective controls, corrective controls help mitigate damage once a risk has materialized.

Components of Internal Control

- Control environment
- Risk assessment
- Control activities
- Information and communication
- Monitoring

Control Environment

Sets the tone of an organization, influencing the control consciousness of its people. It is the foundation for all other components of internal control, providing discipline and structure.

Control Environment

- The entity demonstrates a commitment to integrity and ethical values.
- The governing body demonstrates independence from management in exercising oversight of the development and performance of internal control over financial reporting.
- With governing body oversight, management establishes structures, reporting lines, and appropriate authorities and responsibilities to achieve financial reporting objectives.
- The entity demonstrates a commitment to attract, develop, and retain competent individuals in alignment with financial reporting objectives.
- The entity holds individuals accountable for their internal control responsibilities.

Risk Assessment

Is the entity’s identification and analysis of relevant risks to achievement of its objectives, forming a basis for determining how the risks should be managed.

Risk Assessment

- The entity specifies objectives to enable the identification and assessment of risks relating to financial reporting objectives.
- The entity identifies risks to achieving its objectives and analyzes risks to determine how the risks should be managed.
- The entity considers the potential for fraud in assessing risks to the achievement of financial reporting objectives.
- The entity identifies and assesses changes that could significantly impact the system of internal control.

Control Activities

Are the policies, procedures, techniques, and mechanisms that help ensure that management's response to reduce risks identified during the risk assessment process is carried out. In other words, control activities are actions taken to minimize risk.

Control Activities

What controls are in place for:

- Cash Receipting
- Cash Disbursements
- Payroll
- Financial Close and Reporting
- State Compliance
- Grant Compliance

Information and Communication

Are systems that support the identification, capture, and exchange of information in a form and time frame that enable people to carry out their responsibilities.

Information and Communication

- The entity obtains or generates and uses relevant, quality information to support the functioning of internal control over financial reporting.
- The entity internally communicates information, including objectives and responsibilities for internal control, to support the functioning of internal control over financial reporting
- The entity communicates with external parties regarding matters affecting the functioning of internal control.

Monitoring

Is a process that assesses the quality of internal control performance over time.

Monitoring

- The entity selects, develops, and performs ongoing and/or separate evaluations to determine whether the components of internal control are present and functioning.
- The entity evaluates and communicates internal control deficiencies in a timely manner to those parties responsible for taking corrective action, including senior management and the governing body, as appropriate.

Segregation of Duties

- Segregation of duties is one of the key concepts of internal controls. It is also one of the most effective internal controls in combating employee fraud.
- Segregation of duties contributes to an organization's system of checks and balances. The concept of segregation of duties is to separate the following responsibilities in each business process:
  - Custody of assets
  - Record keeping
  - Authorization
  - Reconciliation

Segregation of Duties

- Ideally, no individual employee should handle more than one of the above-noted functions in a process. When an organization separates these functions among its employees, it has implemented a strong internal control, which may deter and prevent employee fraud.
- When duties cannot be segregated, compensating controls should be considered. Compensating controls can be preventative, detective or monitoring controls that are executed by an independent, supervisory-level employee who does not have custody, record-keeping, authorization or reconciliation responsibilities for the process.

Information Technology

- The entity has an IT strategic planning and risk management process in place to support its financial reporting requirements.
- The entity maintains reliable systems that include appropriate data backup and recovery processes.
- Physical security and access to programs and data are appropriately controlled to prevent unauthorized use, disclosure, modification, damage, or loss of data.
- Program changes (including report development) and systems acquisition and development are appropriately managed to ensure that the application software and reports adequately support internal control and financial reporting objectives.

Fraud Risk Factors

Fraudulent Financial Reporting

Misappropriation of Assets

Noncompliance

Fraud Triangle

The Fraud triangle is a framework designed to explain the reasoning behind a worker's decision to commit workplace fraud. The three stages, categorized by the effect on the individual, can be summarized as pressure, opportunity and rationalization

Fraudulent Financial Reporting

Incentives/Pressures

- Financial stability of the government may be threatened
- A high degree of competition for federal and state awards
- Complex or frequently changing compliance requirements
- Unusually aggressive financial and performance expectations for employees
- Unrealistically aggressive budget or program goals
- Unusually significant pressures on meeting performance targets
- Financing agreements with debt covenants that are difficult to achieve or maintain
- The credit rating for the governmental unit's securities recently has been downgraded by an independent agency
- Opinion shopping by management

Fraudulent Financial Reporting

Opportunities

- Conditions related to the nature of the government’s operations that provide opportunities to engage in fraudulent financial reporting
- There is ineffective monitoring of management
- Conditions that indicate a complex or unstable organizational structure
- There are deficiencies in internal control components as a result of circumstances
- A related party has dominant influence over the entity or its management

Fraudulent Financial Reporting

Attitudes/Rationalizations

- Conditions that indicate attitudes/rationalizations on the part of management to engage in or justify fraudulent financial reporting
- Situations indicating a strained relationship between management or the governing body and the current or predecessor auditor

Misappropriation of Assets

Incentives/Pressures

Personal financial obligations create pressure on management or employees with access to assets susceptible to theft to misappropriate those assets

Conditions or circumstances that indicate adverse relationships between the government and its employees with access to assets susceptible to misappropriation

Misappropriation of Assets

Opportunities

The government maintains or processes large amounts of cash

The government’s inventory/capital assets are easily susceptible to misappropriation

The government is susceptible to fraudulent, unauthorized disbursements

Credit cards

Conditions that indicate possible deficiencies in the government’s internal controls over assets susceptible to misappropriation

There is a lack of adequate oversight of expenditures, such as travel and other reimbursements

Misappropriation of Assets

Attitudes/Rationalizations

Employees with access to assets susceptible to misappropriation disregard internal controls designed to prevent or detect misappropriation, for example, by overriding controls or failing to correct known deficiencies in controls

Employees with access to assets susceptible to misappropriation are dissatisfied with the government

Known or observable personal financial pressures affecting employees with access to assets susceptible to misappropriation

Evidence of employees with access to assets susceptible to misappropriation who are “living beyond their means.

Noncompliance

Incentives/Pressures

Conditions that indicate the financial stability of the entity or its federal award programs may be threatened by economic and operating conditions

Conditions that indicate excessive pressure on management to meet the requirements or expectations

Other conditions that indicate risk factors that could provide motivation to intentionally not comply with major program compliance requirements

Noncompliance

Opportunities

Inappropriate segregation of duties or independent checks, especially in areas such as eligibility determination and benefit awards

Inadequate monitoring by management of compliance with policies, laws, and regulations

Inadequate oversight by those charged with governance over management's activities and the financial reporting process

High employee turnover; employment of accounting, internal audit, or IT staff who are not effective

Noncompliance

Attitudes/Rationalizations

Management demonstrates disinterest toward strict adherence to federal award rules and regulations such as those for participant eligibility or benefit determinations

An attitude among program personnel that given their position they, or parties related to them, are due benefits from the program (such as expenses reimbursed by the federal award or participation in the program), to which they would otherwise not be entitled, resulting in questioned costs

Ineffective (or no) means of communicating and supporting the entity’s values or ethics, especially in matters such as acceptable business practices, conflicts of interests, and codes of conduct