

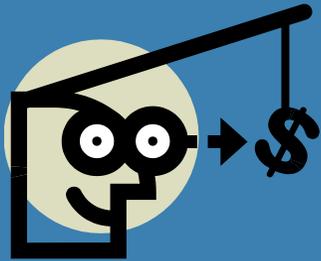
Internal Controls

Presented by:
Patrick Cowen, CPA, CIA, CISA

Why Internal Controls?

Prevent and Detect Fraud, Waste and Abuse

Motive + Opportunity + Justification = Fraud

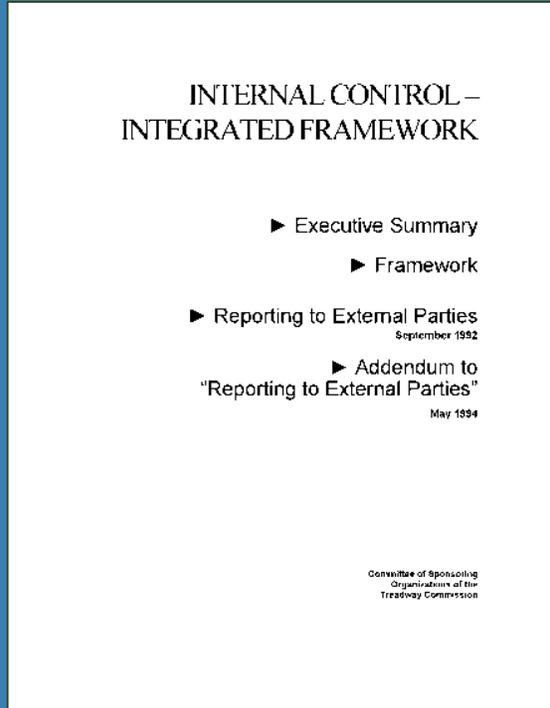


What Are Internal Controls?

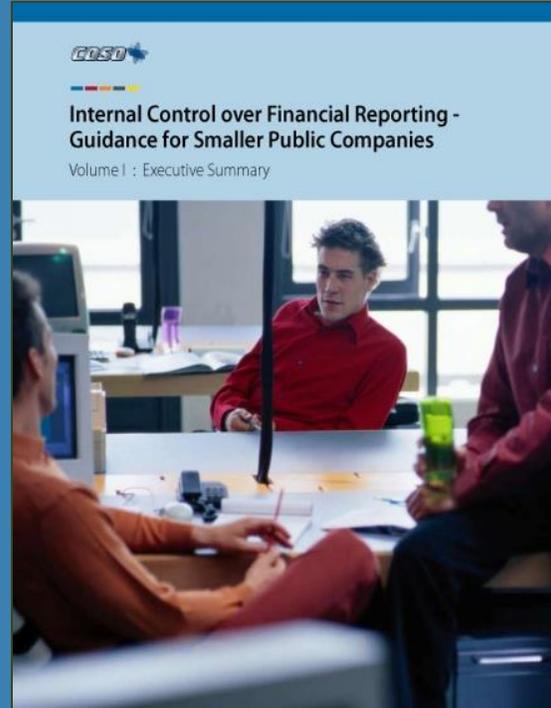
Internal Control is a process set by management, designed to provide **reasonable assurance** regarding the achievement of objectives in three categories:

- Effectiveness and efficiency of operations
- Reliability of financial reporting
- Compliance with applicable laws/regulations

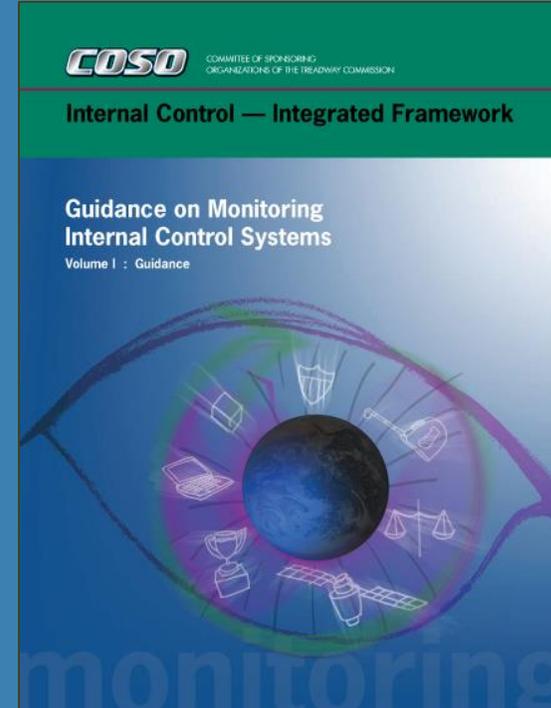
Committee of Sponsoring Organizations



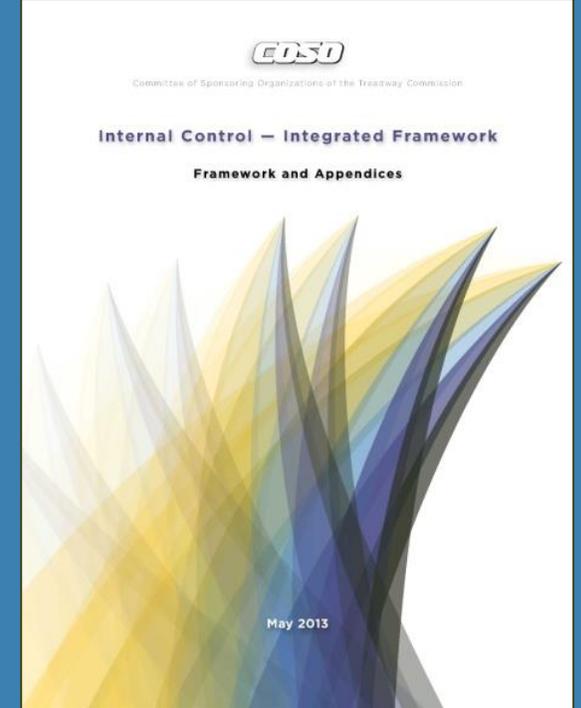
1992



2006



2009



2013

Components & Principles

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

COSO - Internal Control Components

1- Control Environment

2- Risk Assessment

3- Control Activities

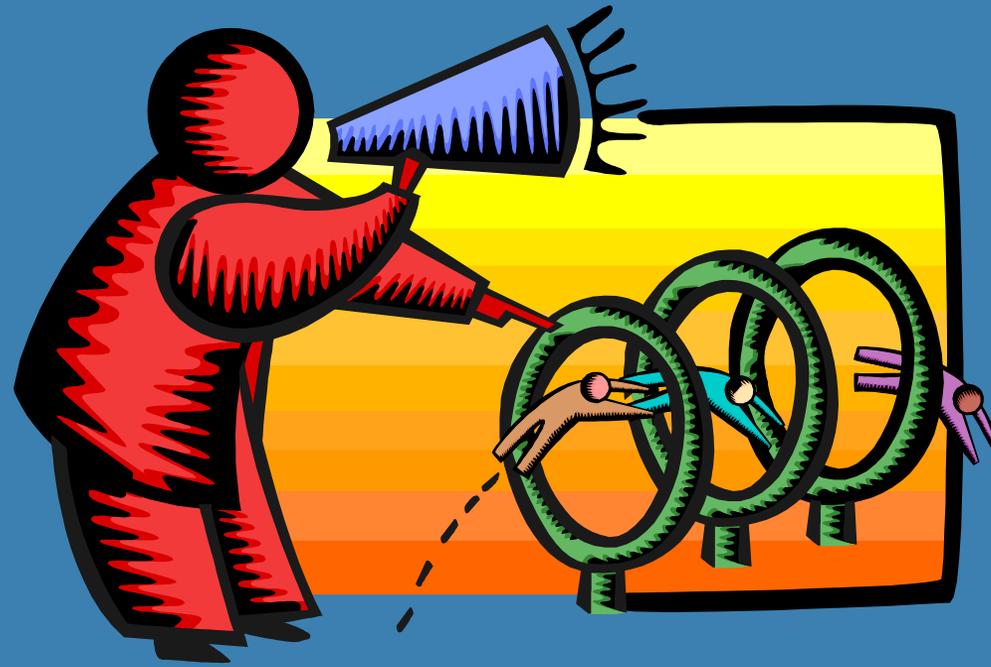
4- Information & Communication

5- Monitoring Activities

1. Control Environment

- Organizational Culture
- Management Attitude
- Management Philosophy
- General Atmosphere

Most Effective Control: Management Attitude



Management must set the tone. Staff will not use internal controls if management does not take internal controls seriously. *“Code of Conduct”*

City of Opa Locka

- 7 individuals charged in public corruption scheme
- 51 month prison sentence for one Commissioner
- 38 month prison sentence for the City Manager
- City's Public Works Director & several local business owners have been charged

2. Risk Assessment

Changes... Changes... Changes...

New

Technology . Vendor . Manager

Employee . Laws and Regulations . Standards

Transactions

3. Control Activities

Segregation of Duties

Safeguarding Assets

Proper Authorization of Transactions

Proper Documentation

Internal Control Activities

- Authorization and approval
- Review of operating performances
- Supervision (assigning, reviewing/approving, direction, training)
- Controls over access to resources and records, separation of duties
- Reconciliations & Verifications

Types of Control Activities

Directive

- Policies and procedures
- Laws and regulations
- Training seminars
- Job descriptions
- Meetings



Types of Control Activities

Preventive

- Segregation of duties
- Physical control over assets
- Locking office door to discourage theft
- Using passwords to restrict computer access
- Shredding documents with confidential information



Types of Control Activities

Detective

- Exception reports which list incorrect or invalid entries or transactions
- Reviews and comparisons
- Reconciliations
- Physical counts of inventories



Components of Internal Control

To be effective, control activities must be:

- Appropriate
- Functioning consistently
- Cost effective, comprehensive, reasonable
- Directly related to the control objective

4. Information & Communication

Effective communication methods
for policies and procedures

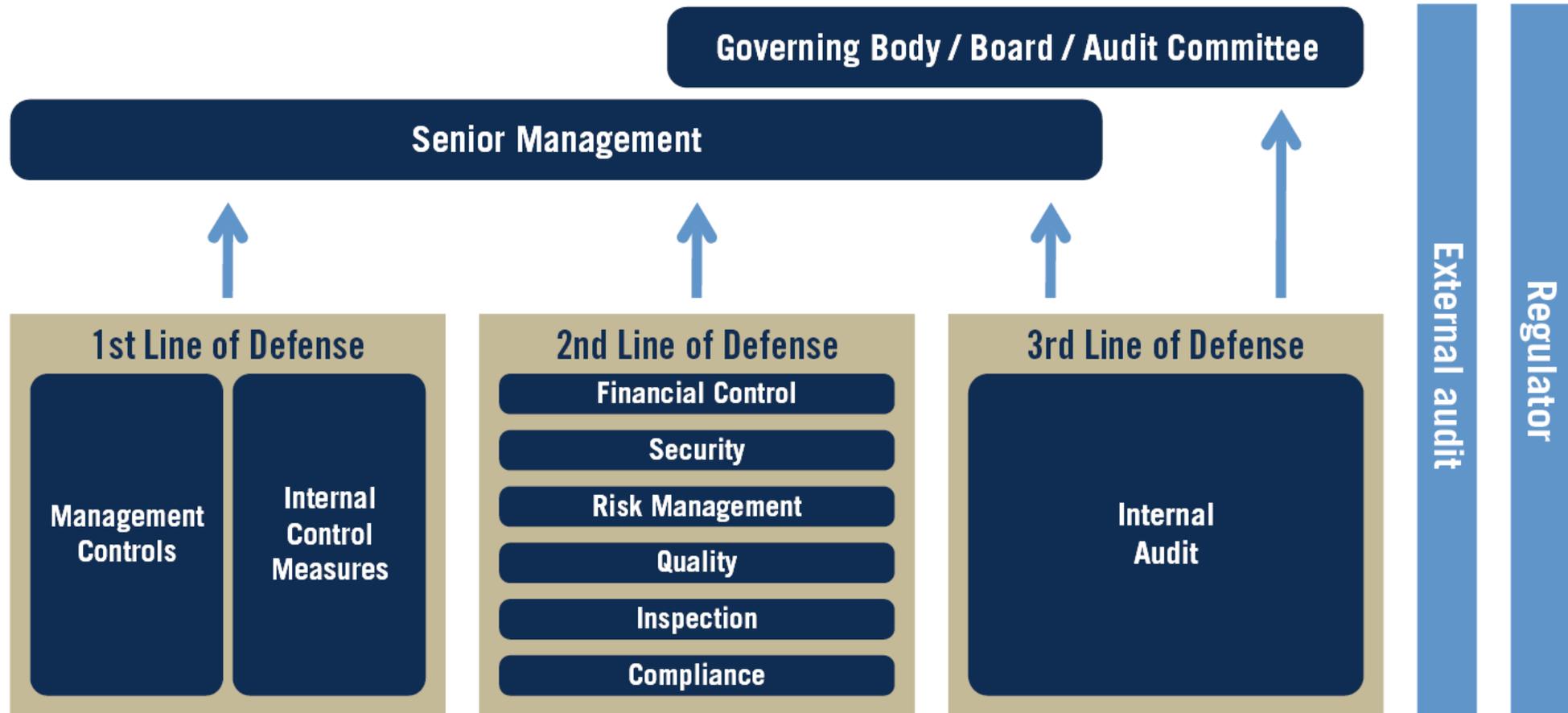
Accounting Information System

5. Monitoring Activities

Assess the internal control effectiveness

Update the internal control system
continuously

The Three Lines of Defense Model



Fraud

Definition:

Act or course of deception, an intentional concealment, omission, or perversion of truth, to:

- (1) gain unlawful or unfair advantage
- (2) induce another to part with some valuable item or surrender a legal right
- (3) inflict injury in some manner.

It is a criminal offense.

Examples of Fraud

- Stealing cash, equipment, supplies, materials
- Creating a fictitious vendor and then submitting fictitious invoices to get paid
- Giving City business to friends or others and getting a kickback
- Receiving compensation for time not worked
- Falsifying travel reimbursement requests and expense forms
- Falsifying personnel records for the purpose of gaining a job promotion
- Recording your time as if you worked when you didn't

ACFE Report to the Nations

- Internal control weaknesses were responsible for nearly half of frauds.
- Most common fraud detection:
 - Tips 40%
 - Employees provide over ½ of the tips
 - 46% for organizations with hotlines
 - Internal audit 15%
 - Management review 13%
- Median durations for a fraud scheme is 16 months
- Median Fraud Loss - \$140,000

ACFE Report to the Nations Cont.

- Most victimized industries – banking, financial services, manufacturing and **government**
- Only 4% of fraudsters had a prior conviction

Fraud Statistics

Demographics:

Men 58%

Women 42%

How Does Fraud Occur?

- Poor or lack of internal controls
- Management overrides controls
- Collusion
- No Ethics policy or related education
- Lack of policies and procedures

Example #1

Day Labor Time Card Billings

- City contracts with local day labor company to provide 2 day laborers for tree maintenance
- Staff questioned suspicious timesheets
- \$5,000 in billings; \$20,000 additional questionable timesheets
- Improper supervisor signature

Example #2

Segregation of Duties

No one **employee** should control all pieces of the pie!



Example #2 - Continued



First Audit

Duties were not adequately segregated as a supervisor:

- Received all animal adoption fees from each cashier at the end of each workday
- Had capability to record those fees in the system or change what had been recorded by someone else
- Prepared the deposit

Example #2 - Continued

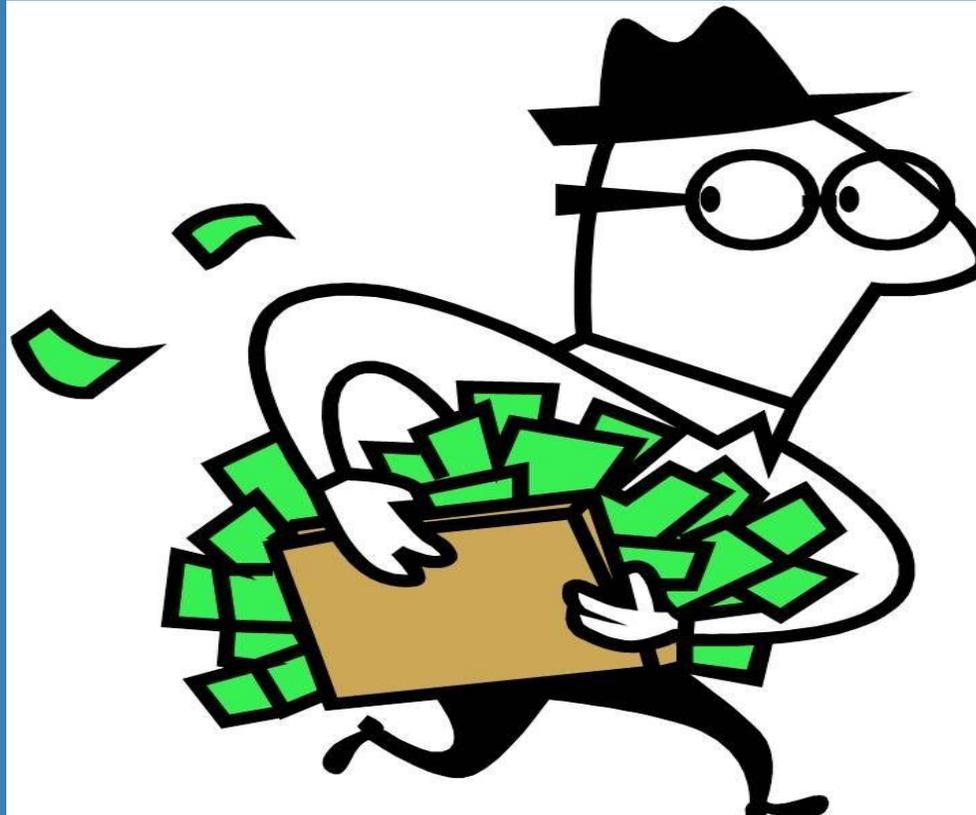


Second Audit

- Showed that someone was reversing several individual \$50 fee collections recorded in the system each day – they showed as “refunds”
- Amount deposited equaled only the fee totals that had not been refunded in the system!
- Called individuals that adopted the animals - they had not been returned!

Example #2 - Continued

Estimated \$80,000 diverted



Example #2 - Continued

WHY? Duties were not adequately segregated – office manager had access to both cash and related records; with no compensating controls!

What Could Have Been Done?

1. Not allow the supervisor to have system permission to record refunds
2. Management should have been generating reports and reviewing activity for anomalies
3. Someone could have reconciled the animals in the Center to the adoption records in the system

Example #3

Overbilling by Vendor Not Detected

- City and Contractor split services by geographical region
- One neighborhood jointly served by both City and Contractor
- City later took over that neighborhood
- Contractor continued to bill for that neighborhood for 30 months
- Overpayments totaled \$65,000



Example #3 Continued

- Contractor subsequently resumed providing services in that neighborhood
- Double billed the City for those services – Additional \$25,000 overpayments resulted
- Contractor billed the City for those resumed services a month before they started providing them

Example #3 Continued

WHY? Because the **contract manager was not reviewing the invoices**; relied on administrative staff that were not knowledgeable of the contract details and related amendments.

RESULT: Total overpayments of \$88,000 and unhappy management!



Example #4

Overbilling by Vendor Not Detected

- Contractor hired to replace two software systems with newer products (systems)
- Contractor delays resulted in a change order whereby contractor agreed to provide free maintenance on old system for an extended period
- Free services were to commence June 1st
- However, contractor continued to bill for those services through October 31st
- City overbilled and overpaid \$21,000 (Not detected!)

Example #4 Continued

- The City prepaid annual maintenance for one of the systems being replaced, with understanding the City would be credited for any unused months after the City cutover to the new system
- When the City cutover to the new system, no credit was provided for the unused portion of prepaid costs for the old system
- Resulted in another overpayment of \$28,000

Example #4 Continued

WHY? Because the contract manager was not reviewing the invoices; instead the contract manager relied on administrative staff that were not knowledgeable of the contract details and related amendments

RESULT: Total overpayments of \$50,000



Duplicate Payments



Audit #1:

- Overall project manager hired for design and construction of major projects
- Subcontractors paid directly by the project manager. Project manager then reimbursed
- Project manager reimbursed for the same subcontractors twice, in September and then again in subsequent May
- Overpayment \$20,000.
- Not detected!

Duplicate Payments Cont.

Audit #2:

- Nonprofit awarded City loan of \$250,000
- Loan proceeds paid by City after nonprofit provided evidence project costs incurred
- Nonprofit entity reimbursed \$45,000 after submitted evidence of vendor invoices totaling that amount
- Nonprofit submitted subsequent request that included \$20,000 for vendor invoices that were part of initial \$45,000
- Result: Nonprofit received same \$20,000 twice!
- Not detected!

Duplicate Payments Cont.

Audit #3:

- Nonprofit awarded City grant of \$60,000
- Strictly cost-reimbursement with required evidence of costs incurred
- Supplemental pay request submitted end of grant year for “additional costs” to “get to the \$60,000”
- Included same costs claimed in prior months
- Result: Nonprofit overpaid \$2,200
- Not detected!

Duplicate Payments Cont.

WHY? Contract managers were not reviewing invoices in sufficient detail

What Could Have Been Done?

- Know and understand the contractual provisions
- Review invoices in sufficient detail
- Don't assume vendors are right
- Educate staff responsible for processing and reviewing invoices

"KEEP LOOKING UP ...
THAT'S THE SECRET OF
LIFE ... "

Snoopy



Thank You

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