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Internal Controls Workshop

Financial and Business Services
2009

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Agenda

- Course Objectives
- Ethics
- Introduction to internal control
- What happens when internal control is weak
- Fraud
- Internal control theory
- Case study
- Additional Resources

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Course Objectives

After the course, participants will be prepared to:

- List the five components of internal control and why each is important
- Describe the roles of central administration vs. colleges/units in effective internal controls
- Understand their role in effective internal controls
- Understand other, related, concepts

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CAN ETHICS BE TAUGHT?

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Three stages of moral development (Kohlberg)

- Preconventional
 - Defines right and wrong by what authority figures say ("mommy said so")
- Conventional
 - Based on group loyalties ("my friends think so")
- Postconventional
 - Universal point of view ("what would a reasonable person think?")

Source: Markula Center for Applied Ethics, Santa Clara University, <http://www.scu.edu/ethics/practicing/decision/canethicsbetaught.html> (originally published in *Issues in Ethics*, V1 N1 1987)

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Why have internal controls?



- Promote operational efficiency and effectiveness
- Provide reliable financial information
- Safeguard assets and records
- Encourage adherence to prescribed policies
- Comply with regulatory agencies

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Internal Control Objectives

- Recorded transactions are valid
- Transactions are properly authorized
- Existing transactions are recorded
- Transactions are properly valued

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Internal Control System


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:

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

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Let's look at some examples where internal controls broke down




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Fund scandals erode coffers, Utahns' Trust (Deseret Morning News, 2/6/05)

- Draper code enforcement officer charged with diverting anti-littering money to her own bank account - \$43,000
 - “Even long-time employees with clean track records can be tempted by the easy access to public funds...It's all about ensuring there are adequate controls so they don't become complacent when they handle cash” (City Manager Eric Keck)


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Ex-secretary who stole \$1.1M ordered to prison (The Salt Lake Tribune, 6/8/07)

- Sentenced to up to 30 years for 45 counts of theft, money laundering and fraud
- KSL News, 6/29/07 – “Denise Aughney says she got away with it for seven years because auditors didn't do their jobs.”



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Bank collapse sparks anger in Ephraim (Deseret Morning News, 11/27/04)

- Insiders fraud was “24 years in the making and involved cash filled suitcases and Las Vegas gambling sprees”
- Report on the Failure of the Bank of Ephraim, Office of the Inspector General BOE “failed because the institution's cashier exploited a weak corporate governance environment and inadequate internal control structure to embezzle funds and conceal the fraud...”



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...but it doesn't happen here at the University of Utah...right?


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Wrong!

- Bookstore (2002) - \$142,700. Employee manipulated accounting records to allow theft of cash. Convicted of 2nd degree felony.
- University Student Apartments (2002) - \$42,647. Employee used pcard to buy unauthorized items. Convicted of 2nd degree felony.
- College of Business (2003) - \$12,081.88. Employee used university funds to buy personal items. Accounts used were not reviewed by the PI.


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Wrong! (cont'd)

- Dermatology (2003) - \$73,128.55. Employee manipulated records allowing misappropriation of patient refunds. Convicted of 2nd degree felony.
- Hospital Cashier (2003) - \$32,065.00. Employee kited checks. Convicted of 2nd and 3rd degree felonies.
- Neonatology (2004) - \$240,000. Employee used approximately 8 different fraud schemes. Convicted of 2nd degree felony.


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What went wrong?

- In each of these cases, poor or missing internal controls enabled the fraud to occur
- In each of these cases, all three elements of the fraud triangle (discussed later) were present

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Question – it's the auditors' fault, right?



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Answer

False. While auditors play an important role, management is the owner of internal control.

...so how can this be prevented?

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Let's Learn about Fraud

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What is fraud?

Fraud encompasses an array of **irregularities and illegal acts** characterized by **intentional deception**. The elements of fraud are:

- A representation about a **material fact** – which is **false**
- Made **intentionally, knowingly, or recklessly** – which is **believed**
- **Acted upon** by the victim
- To the victim's **damage**

Source: Wayne State University, Internal Audit, Audit Alerts – The Red Flags of Fraud

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2008 Report to the Nation on Occupational Fraud and Abuse. Copyright 2008 by the Association of Certified Fraud Examiners, Inc.

- **Occupational fraudsters are generally first-time offenders.** Only 7% of fraud perpetrators had prior convictions and only 12% had been previously terminated by an employer for fraud-related conduct.

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2008 Report to the Nation on Occupational Fraud and Abuse

Fraud perpetrators often display behavioral traits that serve as indicators of possible illegal behavior. **The most commonly cited behavioral red flags were perpetrators living beyond their apparent means (39% of cases) or experiencing financial difficulties at the time of the frauds (34%).**

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2008 Report to the Nation on Occupational Fraud and Abuse


Median Duration of Fraud Based on Victim Organization Type

Organization Type	Median Months to Detection
Government Agency	24
Not-for-Profit	24
Private Company	24
Publicly Traded Company	18

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2008 Report to the Nation on Occupational Fraud and Abuse - How Fraud is Detected

Type of Detection	2008 (%)	2006 (%)
Tip	46.2%	34.2%
By Accident	28.0%	25.4%
Internal Audit	19.4%	20.2%
Internal Controls	23.3%	19.2%
External Audit	9.1%	12.0%
Notified by Police	3.2%	3.8%



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2008 Report to the Nation on Occupational Fraud and Abuse

By far, the greatest percentage of tips came from employees of the victim organization. The fact that over half of all fraud detection tips came from employees suggests that organizations should focus on employee education as a key component of their fraud detection strategies.

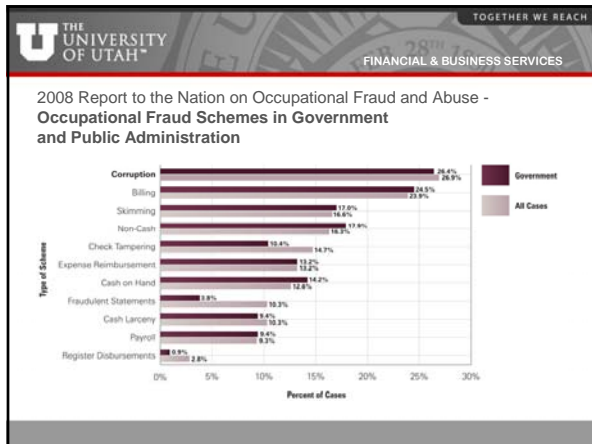

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Employees should be trained to understand what constitutes fraud and how it harms the organization. They should be encouraged to report illegal or suspicious behavior, and they should be reassured that reports may be made confidentially and that the organization prohibits retaliation against whistleblowers.


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Industry of Victim Organizations
(Sorted by Frequency)

Industry	# of Cases	% of Cases	Median Loss
Banking / Financial Services	152	14.0%	\$70,000
Government and Public Administration	106	11.7%	\$93,000
Healthcare	76	8.4%	\$70,000
Manufacturing	65	7.2%	\$41,000
Retail	63	7.0%	\$70,000
Education	58	6.1%	\$60,000
Insurance	51	5.6%	\$78,000
Construction	42	4.6%	\$30,000
Religious, Charitable, or Social Services	38	4.2%	\$28,000
Services - Other	28	3.0%	\$10,000
Services - Professional	24	2.6%	\$100,000
Transportation and Warehousing	21	2.3%	\$70,000
Real Estate	20	2.2%	\$184,000
Technology	20	2.1%	\$400,000
Utilities	22	2.4%	\$80,000
Oil and Gas	17	1.9%	\$70,000
Wholesale Trade	17	1.9%	\$70,000
Auto, Transportation, and Recreation	16	1.8%	\$70,000
Telecommunications	16	1.8%	\$60,000
Communications / Publishing	14	1.5%	\$70,000
Agriculture, Forestry, Fishing and Hunting	13	1.4%	\$60,000

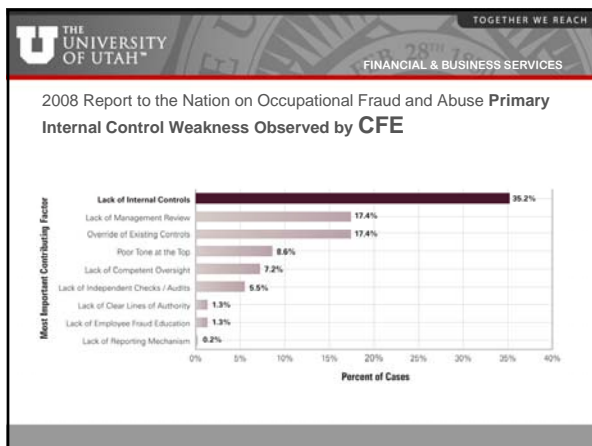


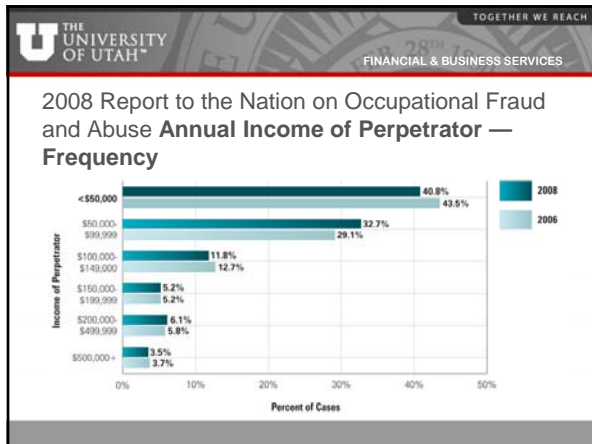
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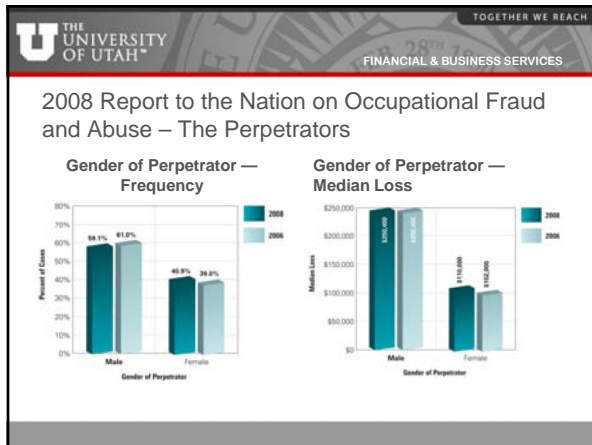
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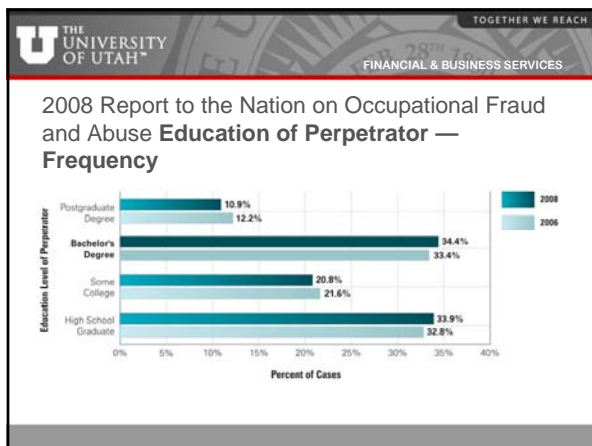
2008 Report to the Nation on Occupational Fraud and Abuse

- **Lack of adequate internal controls was most commonly cited as the factor that allowed fraud to occur.**









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Myth: Fraud is committed by “bad” people

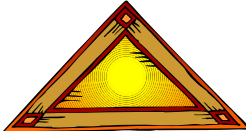
- Most people who commit fraud against their employers are not career criminals. The vast majority are trusted employees who have no criminal history and who do not consider themselves to be lawbreakers. So the question is, what factors cause these otherwise normal, law-abiding persons, to commit fraud?

Source: AICPA, Antifraud and Corporate Responsibility Center, Understanding Why Employees Commit Fraud

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The fraud triangle


Opportunity



Pressure Rationalization

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Like a three legged stool, generally all three parts of the triangle must be in place for fraud to occur.


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Who is likely to commit fraud?

- 1 in 10 people will not commit fraud regardless of the circumstances
- 8 in 10 will commit fraud if the fraud triangle is in place
- 1 in 10 people seeks a particular job in order to commit fraud (predatory employee)


Source: State of Utah Risk Management Workshop


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Opportunity

Opportunity is generally provided through weaknesses in internal controls. Some examples include inadequate or no:

- **Supervision and review**
- **Separation of duties**
- Management approval
- System controls


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Pressure can be imposed due to:

- Personal financial problems
- Personal vices such as gambling, drugs, extensive debt, etc.
- Unrealistic deadlines and performance goals

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Rationalization occurs when the individual develops a justification for their fraudulent activities. The rationalization varies by case and individual. Some examples include:

- "I really need this money and I'll put it back when I get my paycheck"
- "I'd rather have the company on my back than the IRS"
- "I just can't afford to lose everything - my home, car, everything"



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What are the red flags of fraud?

- Ineffective internal controls such as:
 - Not separating functional responsibilities of authorization, custodianship, and record keeping. No one should be responsible for all aspects of a function from the beginning to the end of the process.
 - Unrestricted access to assets or sensitive data
 - Not recording transactions resulting in lack of accountability
 - Not reconciling assets with the appropriate records
 - Unauthorized transactions
 - Unimplemented controls because of the lack of or unqualified personnel
- Collusion among employees over whom there is little to no supervision

Source - Wayne State University, Internal Audit

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Money Issues

Frequency of various employee fraud schemes at companies with fewer than 100 workers

Billing	28.7%	Cash larceny	15.2%
Check tampering	25.4	Noncash ²	14.9
Corruption	23.1	Payroll	14.0
Skimming ¹	20.8	Fraudulent financial statements	12.3
Expense reimbursement	15.5	Register disbursements	3.5
Physical theft of cash	15.5		

¹Theft of cash before it's recorded in the books ²Theft of equipment, merchandise, inventory or data

Note: From a survey based on data compiled from 959 cases of occupational fraud investigated between January 2006 and February 2008. The survey included 342 companies with fewer than 100 employees.

Source: Association of Certified Fraud Examiners

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SEGREGATION OF DUTIES

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Segregation of duties

- Segregation (or separation) of duties is a basic, key internal control and one of the most difficult to achieve. It 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:
 - 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. At the most basic level, it means that no single individual should have control over two or more phases of a transaction or operation.

Source: University of Utah, Internal Audit

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Segregation of Duties (cont'd)

- In an ideal world, no one employee would have more than two of the key duty types
- If duties can't be properly segregated, then compensating or mitigating controls must be implemented
- Supervision and review are an important compensating control
- Proper segregation of duties is important at all times – consider this when assigning backup responsibility or coverage when someone is out of the office

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Categories of Duties

- **Authorization** - the process of reviewing and approving transactions or operations
- **Custody** - having access to or control over any physical asset such as cash, checks, equipment, supplies, or materials.
- **Recordkeeping** - the process of creating and maintaining records of revenues, expenditures, inventories, and personnel transactions. These may be manual records or records maintained in automated computer systems
- **Reconciliation** - verifying the processing or recording of transactions to ensure that all transactions are valid, properly authorized and properly recorded on a timely basis. **This includes following up on any differences or discrepancies identified.**

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Question – If controls are strong, we can be assured employees will be prevented from committing fraud. True or false?

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Answer

False. Internal control provides reasonable, but not absolute assurance.

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Internal Controls Don't Always Work


- Control override. "I know that's the policy, but we do it this way." "Just get it done, I don't care how."
- Inherent limitations. People are people and mistakes happen. You can't foresee or eliminate all risk.
- Collusion. Two or more employees work together to circumvent controls and commit fraud.

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But there's more to internal control than segregation of duties...

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Internal Control Components




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


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Control Environment

- Sets the tone on an organization
- Influences the control consciousness of its people
- The foundation of all other components
- Includes such things as
 - Integrity
 - Ethical values and competence
 - Management's philosophy and operating style
 - The way management assigns authority and responsibility
 - The way management organizes and develops its people
 - The attention and direction provided by the Board of Trustees


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Control Activities

- Policies and procedures
- Occur at all levels and in all functions
- Includes such things as
 - approvals
 - authorizations
 - verifications
 - reconciliations
 - reviews of operating performance
 - security of assets
 - segregation of duties


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Information & Communication

- Pertinent information must be identified, captured and communicated
- Information systems provide a large portion of the reports and other data required for decision-makers
- Effective communication must flow down, across, and up the organization – as well as to external parties, such as customers, suppliers, regulators, and stakeholders
- Staff & faculty need to understand their own role in the internal control system, as well as how individual activities relate to the work of others

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Monitoring

- Assessing the quality of the internal control system's performance over time
- Ongoing monitoring activities
 - Management and supervision
 - Reviewing work of subordinates
 - Cross training, job sharing
- Separate evaluations
 - Periodic reviews of each process/procedure
 - Employee surveys
 - Performance appraisals

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Expectations...Tone at the Top

"Acting responsibly and doing the right thing are central to our future success at the University of Utah; and I look forward to working together, and demonstrating to each other and our many partners, our shared commitment to making collective stewardship and ethical behavior part of our everyday activity".




Pres. Michael K. Young

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EVERYONE has a role in internal controls

- Read and understand the policies and procedures which affect your job
- Comply with the controls established to protect both the employee and the University
- Design and implement controls within your area of responsibility
- Identify control weaknesses to supervisors or managers
- Ask questions to understand
- With greater responsibility comes accountability to the next higher level
- "Walk the Talk" and lead by example



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Internal Control Questions

- **Propriety of transactions** - is this legal and right? Does it look or feel wrong? Would someone else think so?
- **Reliability and integrity of information** - is the information/form/data accurate and complete?
- **Compliance with University policies and government regulations** - are you following established instructions or procedures?
- **Safeguarding assets** - could anyone take or gain access to items under your control without being observed?
- **Economy and efficiency of operations** - is there a better way to do the job?


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Question – Internal controls take time away from core activities, such as serving faculty and students. They’re more of a “nice to have”. True or false?


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Answer

False. Internal control should be built “into,” not “onto” business processes.


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INTERNAL CONTROLS IN ACTION

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Examples of Internal Controls


- Offices, buildings, labs and state vehicles are kept locked when unoccupied.
- Checking management reports and purchase card charges against source documents.



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Examples of Internal Controls (cont'd)


- Locked cash drawers and secure storage for checks.
- Authorizations required for certain activities.
- Reading and understanding applicable University Policy to learn the right way to do something.



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Examples of Internal Controls (cont'd)


- The review and approval process for purchase orders or requisitions to make sure they're appropriate before the purchase.
- The use of computer passwords to stop unauthorized access.



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Examples of Internal Controls (cont'd)


- Cash counts and bank reconciliations
- Review of payroll reports
- Comparing transactions on monthly management reports to departmental source documents



Date	Amount
10/20	\$ 738.97
10/21	506.82
10/22	586.53
10/23	534.21
10/24	563.04
10/27	508.42

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Your Internal Control System



- Identify risks in your environment
- Identify control points
- Analyze potential exposures
- Design system to mitigate risk

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Case Study – Sally Smith




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Reference Material

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Additional Resources

- Ethical Standards and Code of Conduct
<http://www.hr.utah.edu/ethicalstandards/index.php>
- Utah Public Officers' and Employees' Ethics Act
http://www.le.state.ut.us/~code/TITLE67/67_OD.htm
- Ethics and Compliance
http://www.utah.edu/Internal_Audit/ethics.htm
- Ethics and Compliance Hotline
(801) 585-1593


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Additional Resources

- Policies & Procedures Manual
<http://www.admin.utah.edu/ppmanual/>
- Conflicts of Commitment
<http://www.admin.utah.edu/ppmanual/2/2-26.html>
- Code of Conduct for Staff
<http://www.admin.utah.edu/ppmanual/2/2-27.html>
- Conflicts of Interest
<http://www.admin.utah.edu/ppmanual/2/2-30.html>


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Professional Organizations

- Committee of Sponsoring Organizations (COSO)
- American Institute of Certified Public Accountants (AICPA)
- American Accounting Association (AAA)
- Financial Executives Institute (FEI)
- The Institute of Internal Auditors (IIA)
- Institute of Management Accountants (IMA)


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Questions? Contact...

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