

Internal Controls

2023 New Officials Conference

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Kentucky Auditor of Public Accounts

23 years with the APA

- **Financial Audits & Single Audits – state agencies**
- **Financial Audits & Single Audits – county governments**
- **Special Examinations**
- **Training**
- **Research**
- **Audit Program Development**

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**Never stop
learning.
Because life never
stops teaching.**



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Objectives



- What are internal controls?
 - Why do I need them?
 - What if I don't have the budget for them?
 - What happens if I don't have them?



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What are internal controls?



Procedures that serve as the first line of defense in safeguarding assets and preventing and detecting errors and fraud.

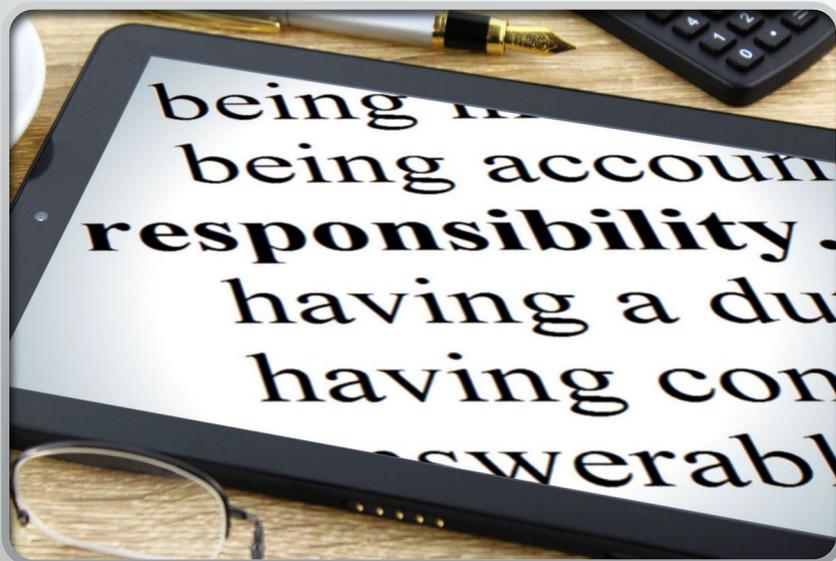


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Management's Responsibility



You are responsible for the **design**, **implementation**, and **maintenance** of internal controls relevant to the preparation and fair presentation of a financial statement that is free from material misstatement, whether due to error, fraudulent financial reporting, misappropriation of assets, or violations of laws, grant agreements or contractual agreements.



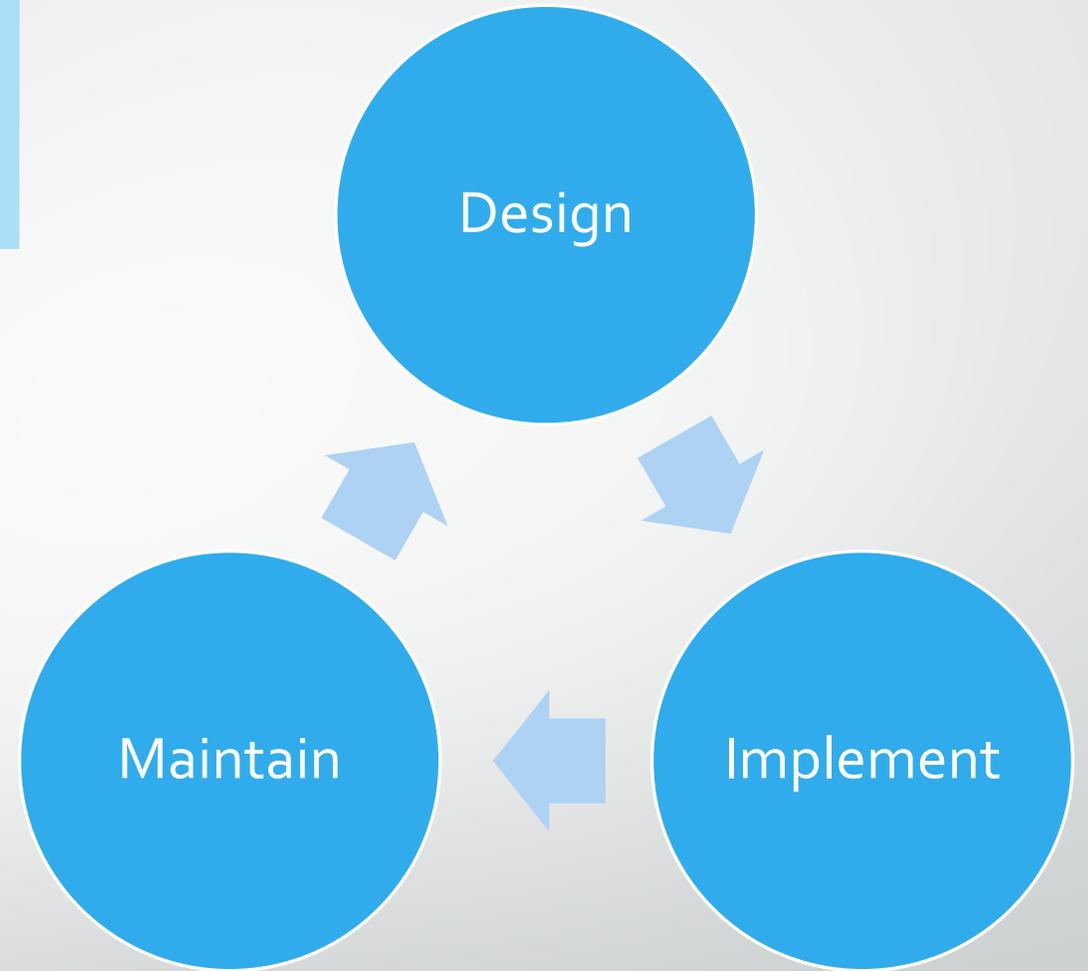
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Three Main Elements

*Ongoing
Assessment*



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Internal Controls - Key Concepts



- Segregation of Duties
- Secure Assets
- Assign/Designate/Control Level of Access
- Documentation
- Oversight/Review



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Controls: Preventive & Detective



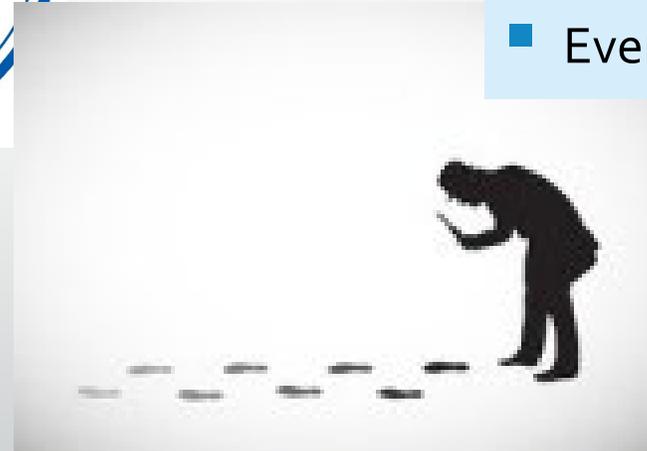
Preventive

- Require Approvals
- Segregate Duties
- Secure Assets



Detective

- Reconciliations
- Reviews
- Event Notification

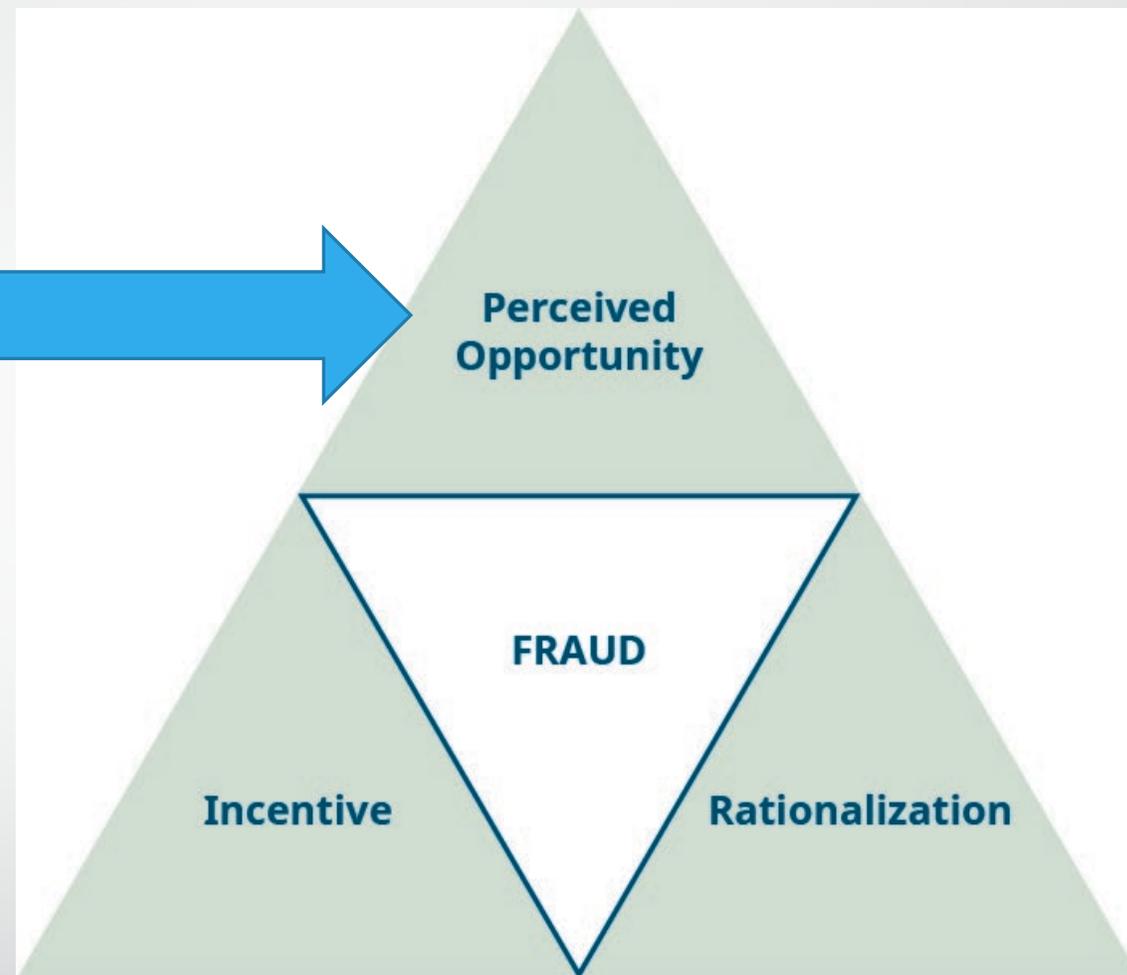


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Good preventive internal controls can remove the perceived opportunity



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Zero Cost Internal Controls

Please Pay
\$0

- Management Tone
- Written Policies and Procedures
- Surprise Cash Counts
- Employee Tips



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Management Tone

Employees feel that top management that acts ethically in these four ways are much less likely to commit fraud, versus those who feel that top management only talks about ethics without actions to support the words.

Source: National Business Ethics Survey 2005

Informs employees

Talks about the importance of ethics

Models ethical behavior

Keeps promises



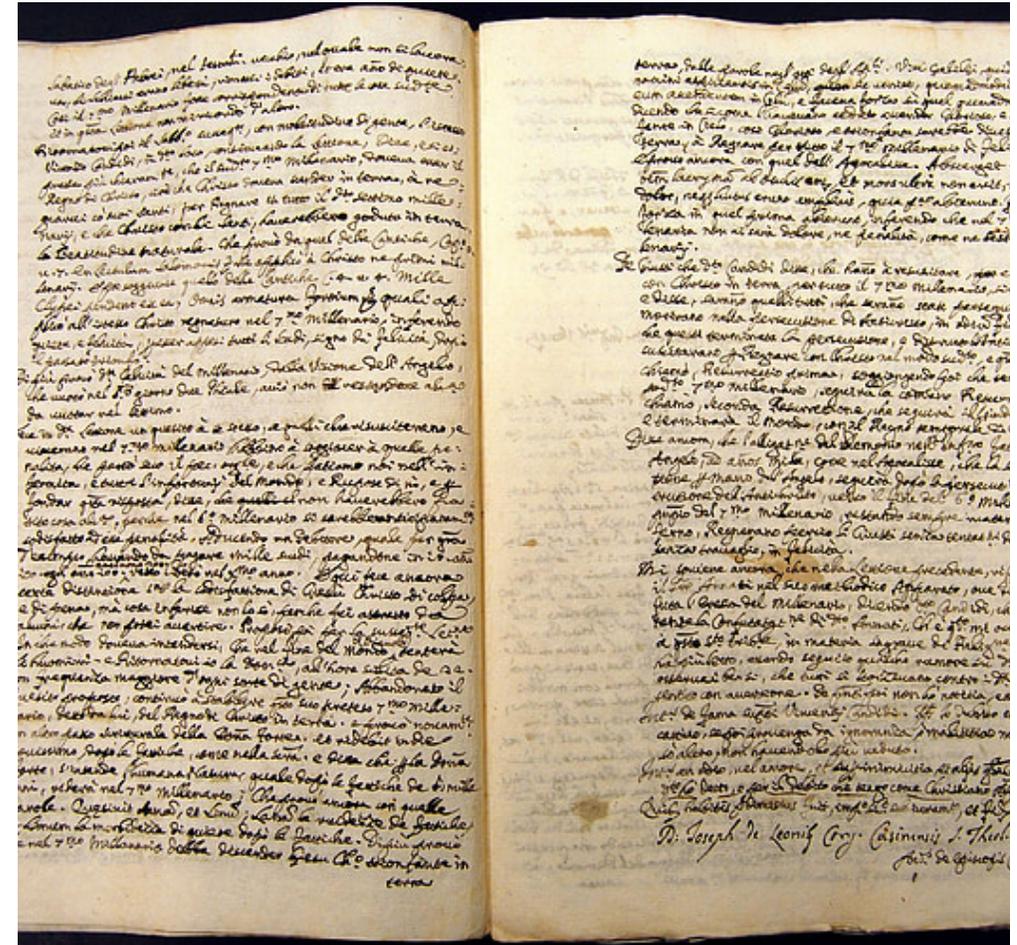
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Written Policies and Procedures

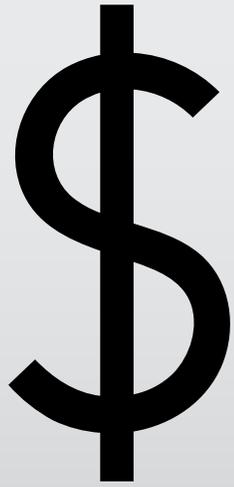
- Gives employees clear directions and guidance (no need to rely on word of mouth)
- Shows management's commitment to fraud and error prevention
- Job descriptions can clarify segregated duties
- Provides evidence for auditors



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Surprise Cash Count = Double Duty

Preventive – studies have shown that when employees know there will be surprise cash counts – they are less likely to risk coming up short.

Detective – When conducted on a surprise basis, this simple procedure can identify many cash larceny schemes.





Employee Tips

Do your employees know who to contact if they see inappropriate or fraudulent behavior?

Control Environment Risk Factors



- ✓ Too much trust in key employees
- ✓ Lack of proper procedures for authorization of transactions
- ✓ No segregation of duties between authorizing transactions and custody of assets (receiving and recording cash, for example)
- ✓ No independent review of work
- ✓ Inadequate attention to detail
- ✓ Steve Albrecht, Keith R. Howe, and Marshall B. Romney, *Deterring Fraud: The Internal Auditor's Perspective* (1984)



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Internal Controls To Prevent/Detect Most Common Types of Employee Fraud

Skimming
Cash/Cash
Larceny

Misuse of Assets

Purchase Order
Fraud

Credit Cards

Payroll

Corruption -
Bribery/Kickbacks



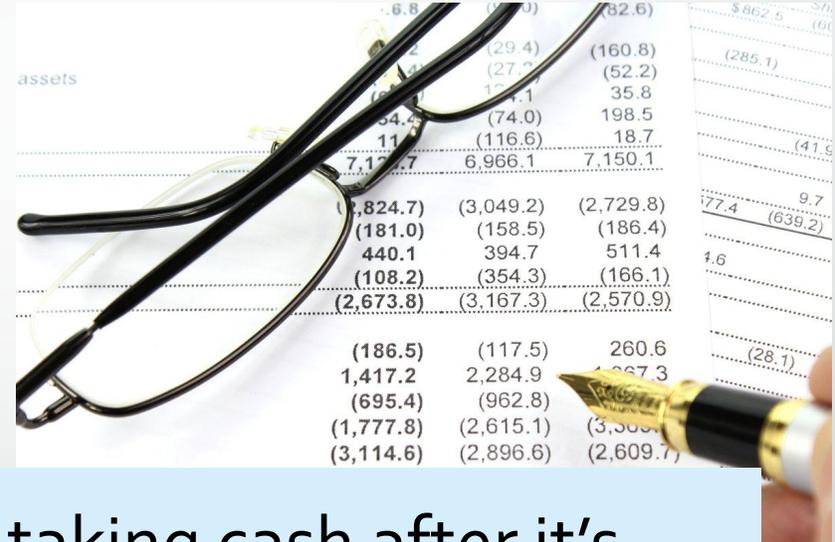
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Skimming Cash/Cash Larceny

Skimming – taking cash before it is booked



Larceny – taking cash after it's been entered into the bookkeeping system



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Internal Controls - Cash

Prevent Skimming

- Reduce Cash Transactions
- Issue Receipt for every transaction
- Proper Authorization/
Documentation for voids
- Daily Deposits
- Rotate Duties

Prevent Larceny

- Segregation of Duties
- Surprise Cash Counts

Detect Larceny

- Reconciliations by another employee
- Surprise Cash Counts



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Internal Controls - Misuse of Assets

- Using county vehicle for personal errands
- Using county equipment at home or in a side business
- Handling a side business on county computer, using printer, etc.



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Internal Controls - Misuse of Assets

Preventive

- Clear policies & procedures communicated to staff
- Tone at the top – set the example
- Secure access to vehicles/equipment/offices after hours

Detective

- Be Alert
- Hotline or Tipline

Submit questions to
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Internal Controls – Purchase Order Fraud

- Collusion with Suppliers
- Shell Companies
- Ordering Unnecessary Supplies
- Fake Invoices
- External Threats



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Internal Controls – Purchase Order Fraud

Preventive Controls

- Policies & Procedures communicated to employees
- Use the PO System
- Segregation of Duties
- Detailed Review of Purchases
- Authorized Buyers

Detective Controls

Physical Inventory of Supplies
Review Accounts for Unusual Activity
Hotline or Tipline



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Internal Controls – Credit Cards



- Personal Purchases
- Excessive/Unnecessary Purchases
- Unrelated Travel Expenses



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Internal Controls – Credit Cards

Preventive

- Written Use Policy
- Require Detailed Receipts
- Authorized Users/Control Access

Detective

- Close Review of Statements/Supporting Documentation
- Verify Purchased Items



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Internal Controls – Payroll Fraud



- Ghost Employees
- Timesheet Alterations
- Unauthorized Pay Rate Changes



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Internal Controls – Payroll Fraud

Preventive

- Policies & Procedures
- Timesheet Approvals
- Segregation of Duties
- Limit Access

Detective

- Detailed Review of Payroll Reports
- Be Alert for Changes



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Internal Controls - Corruption

- Collusion between employee & vendor or service provider
- Limiting bids
- Building permits
- Waiving fees/taxes



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Internal Controls - Corruption

Preventive

- Strong Ethics Policy
- Tone at the Top
- Segregation of Duties

Detective

- Be Alert for Red Flags
- Hotline/Tipline

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Special Considerations

- Controls at off-site locations
 - Branch Offices
 - Animal Shelter
 - Pool/Recreation Center
 - County Garbage Disposal site
 - Building Inspections/Code Enforcement



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What now?

- Risk Assessment - what are your risky areas?
- Would I know if someone wrote a check to themselves, put a family member on the payroll, or changed their own pay rate?
- Would I know if someone was misusing county property?
- Would I know if we were paying fake businesses for supplies we didn't receive?
- Would I know if all the money (cash/checks) my office receives is NOT being deposited into my official bank account?



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Consequences of Weak or Missing Internal Controls

Federal Grants

Uniform Guidance §200.303

Internal controls. The non-Federal entity must:

(a) Establish and maintain effective internal control over the Federal award that provides reasonable assurance that the non-Federal entity is managing the Federal award in compliance with Federal statutes, regulations, and the terms and conditions of the Federal award.



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Consequences of Weak or Missing Internal Controls

Audit Reports

Missing altogether in an area or materially deficient

Significantly but not materially deficient

Underlying control weakness can cause a reportable noncompliance

Material Weakness

Significant Deficiency

Reportable noncompliance – and control deficiency



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Consequences of Weak or Missing Internal Controls

Possible law enforcement investigation

Damaged staff morale

Loss of entity's reputation and possibly official's reputation

Loss of public confidence



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Resources

AICPA – Internal Control Toolkit

aicpa.org/eaq/internal-control-resources.html

AICPA Internal Control Toolkit

Obtaining an understanding of a client's internal control is a necessary step in every audit. However, a 2018 Peer Review Program survey found over 40% of audits didn't comply with AU-C 315 or AU-C 330 because auditors did not properly identify the risks of material misstatement through obtaining an understanding of their client's controls.

To help you comply with requirements associated with internal controls, we've developed resources to help. Check this page often, as new resources will be posted.



Internal control over financial reporting tool template

This tool will assist auditors with documenting their evaluation of controls relevant to the audit.



Process memo template

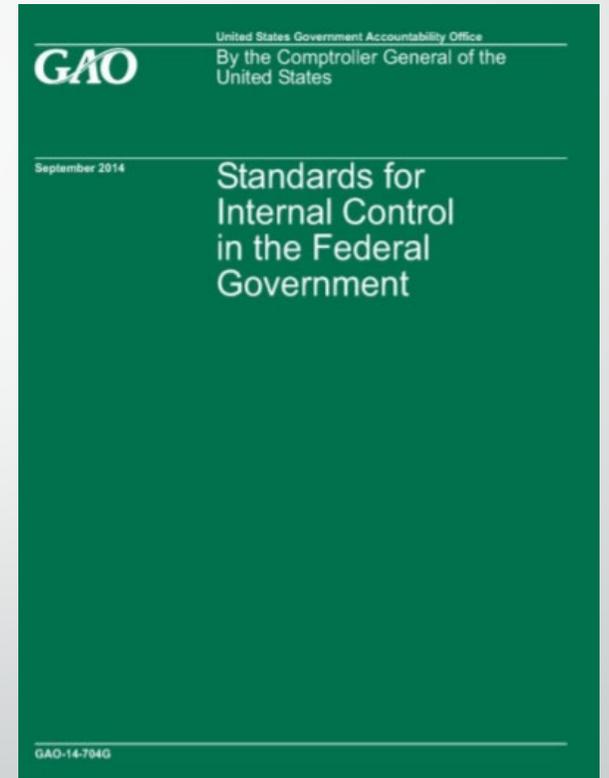
Use this process memo example as a guide when documenting your understanding of a client's processes and identification of controls relevant to the audit.



Aid for identifying controls at smaller entities

You may think a smaller client has no controls, but that's virtually never the case. Even the smallest entities have policies and procedures designed to prevent or detect and correct material misstatements. This aid will assist you in identifying controls at your smaller clients.

The Green Book
gao.gov/greenbook



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