

2017 Internal Control Training

Presented by
The Office of the State Controller

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Agenda

- Welcome from the Controller
- What are Internal Controls and Why are They Important?
- The COSO Framework
- Control Environment
- Risk Assessment
- Fraud



Questions or comments are welcome!



What are internal controls? And why are they important?



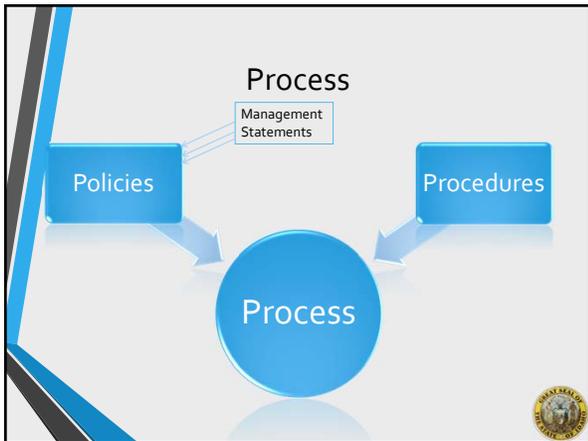
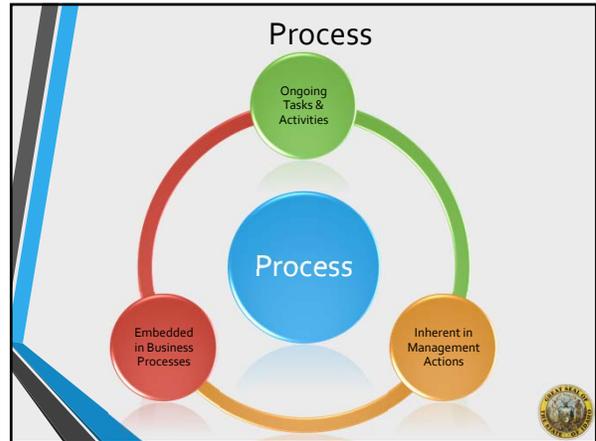
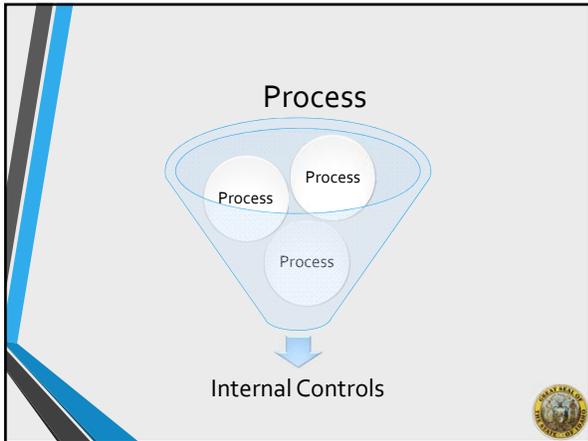
Internal Controls: Mitigate & Eliminate Threats



Internal Controls Defined

Internal controls is a *{Process}*, effected by *{People}*, designed to provide *{Reasonable}* *{Assurance}* regarding the achievement of objectives relating to *{Operations}*, *{Reporting}*, and *{Compliance}*.



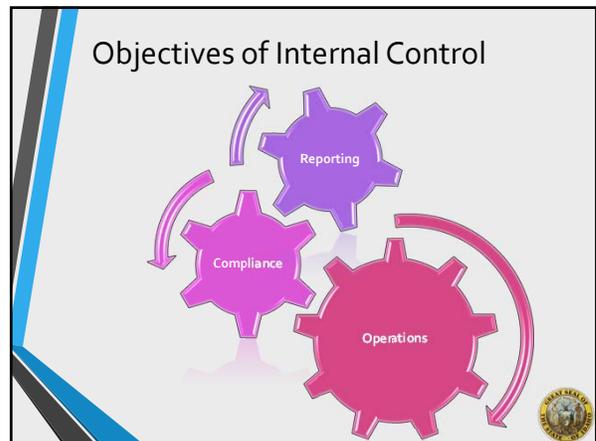


Effected by People

- Director-level
 - Provides oversight
 - Sets the tone
 - The ethical atmosphere in the workplace created by the organization's leadership
- Management implements controls
- Other personnel
 - Learn responsibilities
 - Understand limits of authority

Reasonable Assurance

- Reasonable assurance to management
- Limitations in all systems
 - Human error
 - Misjudgment
 - External events
- Circumvention
 - Collusion
 - Management overrides
- Even effective systems can fail



Relate to the achievement of an organization's basic mission and vision

Operations

Focus

- Financial Performance
- Customer/Employee Satisfaction
- Productivity
- Quality
- Environmental Practices
- Innovation
- Safeguarding of Assets



Internal and external financial and non-financial reporting

Reporting

Focus

- Reliability
- Timeliness
- Transparency



Adherence to laws and regulations

Compliance

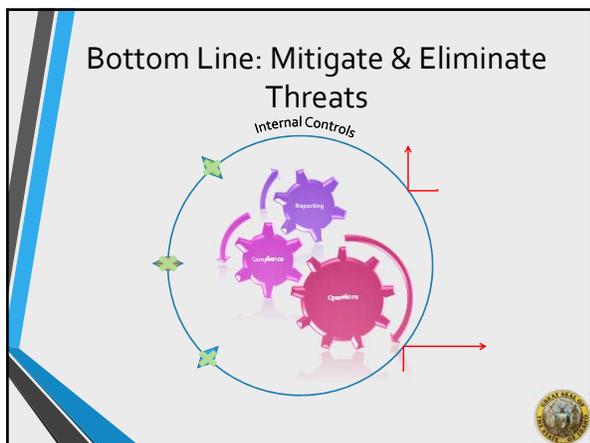
Focus

- Know the laws & regulations
- Understand what is applicable across the entity
- Laws & regulations set minimum standards

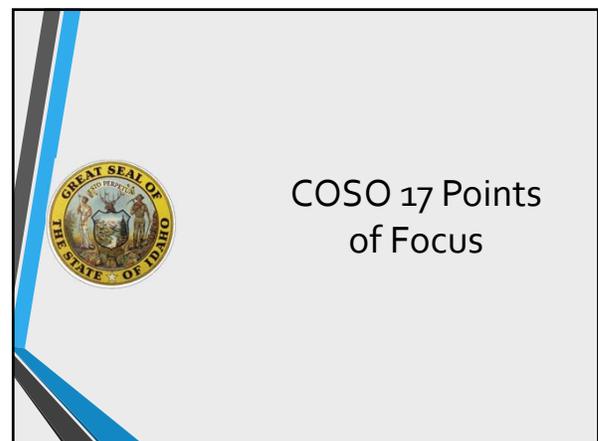
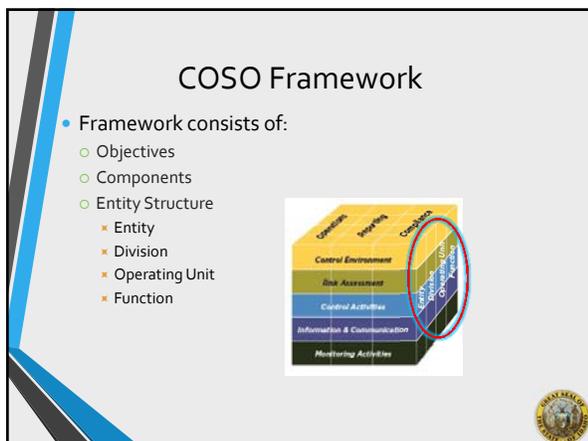
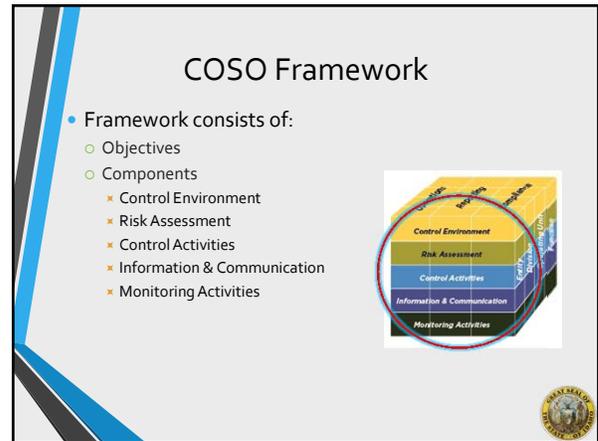
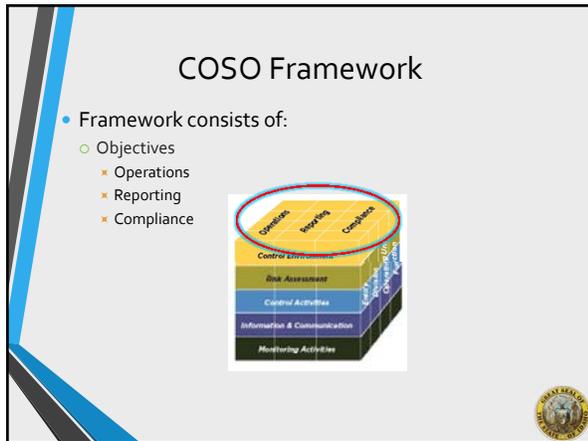
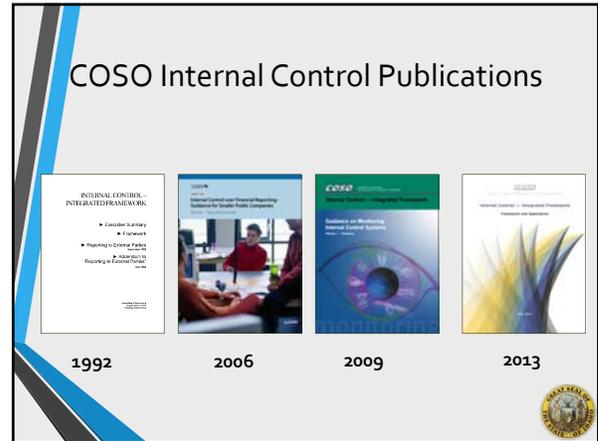


Application

- Cash or cash-like transactions
- Inventory process
- Payroll process
- Purchase requisition
- Sensitive or proprietary information
- Computers
- Grants/Federal and State funds
- Loan issuance



The COSO Framework





Control Environment

- Demonstrate Commitment to Integrity and Ethical Values
- Exercise Oversight Responsibility
- Establish Structure, Authority, and Responsibility
- Commitment to Competence
- Enforce Accountability

Risk Assessment

- Specify Suitable Objectives
- Identify and Analyze Risks
- Assess Fraud Risk
- Identify and Analyze Significant Change



Control Activities

- Select and Develop Control Activities
- Select and Develop General Controls over Technology
- Deploy through Policy and Procedures

Information and Communication

- Use Relevant Information
- Communicate Internally
- Communicate Externally

Monitoring Activities

- Conduct Ongoing and/or Separate Evaluations
- Evaluates and Communicates Deficiencies



Effective Internal Controls

- Adherence to Policies and Procedures
- Judgment
 - How much?
 - Which controls?
 - How effective are the internal controls?
- Internal control components and principles
- Risk Management
 - Need strong internal control environment



SCO Agency Review

- Meet with fiscal staff to discuss agency *processes* (e.g., receipts, payments, refunds, fixed assets, travel, p-card, grants, etc.)
- Purpose and Objective: To review the adequacy of fiscal internal controls and security over accounting transactions reported in the CAFR.
- Why? Based on Idaho Code 67-1001 (4): *"To suggest plans and provide internal control standards for the improvement and management of the public revenues, assets, expenditures and liabilities."*



SCO Agency Review

- An Agency Review is **NOT** an Audit (no findings, no responses required)
- Report: With observations, potential risks, and recommendations



Review Questions

1 - 5

Review Question #1

What is not an objective of COSO

- a) Reporting
- b) Operations
- c) Education
- d) Compliance



Review Question #2

How many Components are in the framework

- a) 3
- b) 4
- c) 5
- d) 17



Review Question #3

Judgement is included in the internal control system

- a) True
- b) False



Review Question #4

One of the reasons that strong internal controls are important is because they:

- a) Make management happy
- b) Provide a risk-free work environment
- c) Help the organization adhere to laws & regulations
- d) Prevent all fraud



Review Question #5

True or False, the COSO framework will prevent all fraud

- a) True
- b) False



Control Environment

- Is the set of standards, processes, and structures that provide the basis for carrying out internal control across the organization.



Principles for 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



Principle 1

- Demonstrates commitment to integrity and ethical values
 - Set the tone at the top
 - Establish standards of conduct
 - Evaluate adherence to the standards of conduct
 - Address deviations in a timely manner



Principle 2

- Exercises Oversight Responsibility
 - Establish oversight responsibilities
 - Apply relevant expertise
 - Operate independently
 - Provide oversight for the system of internal controls



Principle 3

- Management establishes structures, reporting lines, and appropriate authorities and responsibilities in the pursuit of an objective
 - Consider all structures of the entity
 - Establish reporting lines
 - Define, assign, and limit authorities and responsibilities



Principle 4

- The organization demonstrates a commitment to attract, develop, and retain competent individuals in alignment with objectives
 - Establish policies and practices
 - Evaluate competence and address short comings
 - Attract, develop, and retain individuals
 - Plan and prepare for succession



Principle 5

- The organization holds individuals accountable for their internal control responsibilities in the pursuit of objectives
 - Establish accountability through structures, authorities, and responsibilities
 - Establish performance measures, incentives, and rewards
 - Evaluate performance measures, incentives, and rewards for ongoing relevance





Review Questions 6 - 10

Review Question #6

The Control Environment is a set of _____ that provide the basis for carrying out internal control across the organization.

- a) Standards
- b) Processes
- c) Structures
- d) All of the above



Review Question #7

An organization should demonstrate a commitment to integrity and ethical values.

- a) True
- b) False



Review Question #8

How many principles make up the Control Environment?

- a) 6
- b) 3
- c) 5
- d) 4



Review Question #9

Who is responsible for maintaining internal controls?

- a) Management
- b) Board of Directors
- c) Accountants
- d) Every Individual has a responsibility



Review Question #10

Individuals should not be held accountable for their internal control responsibilities, since this is considered an extra task.

- a) True
- b) False



Risks & Risk Assessment

- Every entity faces risks
- Cannot eliminate all risk
- Risk assessment is the basis for determining how risks will be managed




Risk Assessment

- Four Principles:
 - 6) Specify suitable objectives
 - 7) Identify and analyzes risk
 - 8) Assess fraud risk
 - 9) Identify and analyzes significant change



Risk & Objectives

- A risk is anything that could jeopardize the achievement of your organization's objectives
- Specifies suitable objectives
 - Operate effectively and efficiently
 - Risk tolerance
 - Protect an organization's assets from loss
 - Provide reliable financial data
 - Comply with applicable laws, policies, and procedures
 - Maintain reputation & overall quality of products/services

Principle 6



Risk Assessment

- Risk Assessment is a process to:
 - Identify significant risks(Entity level vs. transaction level)
 - What can go wrong?
 - How could someone steal from us?
 - What policies affects us the most?
 - What types of transactions in our area provide the greatest risk?
 - How can someone (internally or externally) bypass the internal controls in place?
 - What potential risk areas could cause adverse publicity?
 - Assess risks
 - What is the likelihood of occurrence?
 - What is the potential impact?

Principle 7



Risk Assessment

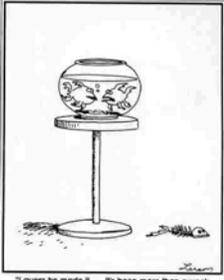



Risk Management

- Manage these risks through risk responses:
 - Acceptance
 - Avoidance
 - Reduction
 - Sharing (Insurance)
- Mitigate with Controls



Risk Assessment



"I guess he made it... it's been more than a week since he went over the wall."



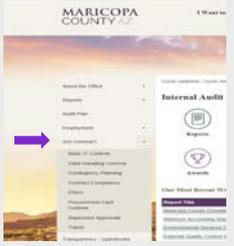
Risk Assessment Example

1. Identify risk	2. Assess the risk	3. Manage risk					
What is the Risk?	Who might be harmed and how?	Controls that could be implemented	What else can be done to manage the risk?	Who will do this?	When will it be done?	Date assessment reviewed and changes made (if necessary)	Initial
Mouse of P-Card assets	Agency—theft of	Implement a segregation of duties in the reconciliation of card activity	Supervisor review of p-card transactions/prior approval of transactions over a certain amount	Fred and George (financial technicians) will reconcile transactions and Ron (supervisor) will review all documentation	Weekly	4/7/2017, control operating effectively no changes necessary	JP
Theft of personal identifiable information	Agency employees, customers, applicants, etc.—identity theft	locked file cabinets, safe, limited access	firewalls, encryption, etc.	Ginny (HR manager)/IT Staff	Daily	4/7/2017, file cabinets were not locked at the end of the day. Arthur (Supervisor) will ensure they are locked at the end of the day	JP



Risk Assessment

- Maricopa County (AZ) Internal Audit:
 - Videos on the following topics:
 - P-card
 - Contract Compliance
 - Information Technology
 - Cash Handling
 - Ethics
 - Travel





Fraud Risk Assessment

- Assessing Fraud Risk – Points of Focus:
 - Considers Various Types of Fraud
 - Fraudulent reporting, possible loss of assets, & corruption
 - Factors impacting fraud risk
 - Incentives and Pressures
 - Opportunities
 - Attitudes and Rationalizations

Principle 8



Significant Change

- External environment
 - Regulatory (State/Federal laws)
- Business model
 - Growth, technology, new organizational components
- Leadership
 - New management's attitude & philosophies about internal control

Principle 9



Risk Assessment Summary



The... which is necessary just doing way up here in a cloud bank?



Review Questions 11-15

Review Question #11

Risk is:

- a) Living on the edge
- b) An educational gamble
- c) Anything that could jeopardize the achievement of your organization's objectives
- d) A popular board game created by Parker Brothers in 1957



Review Question #12

Specific suitable agency objectives may include:

- a) Efficient operations
- b) Eliminating all risk
- c) Reliable financial data
- d) Complying with policies and procedures



Review Question #13

Which of the following is **NOT** part of the Risk Assessment process?

- a) Identify significant risks
- b) Assess risks
- c) Mitigate risks
- d) Manage risks



Review Question #14

True or False, entity-level risks are more broad and may include internal and external factors, while transaction-level risks are more specific and apply to a specific function (i.e. procurement process)?

- a) True
- b) False

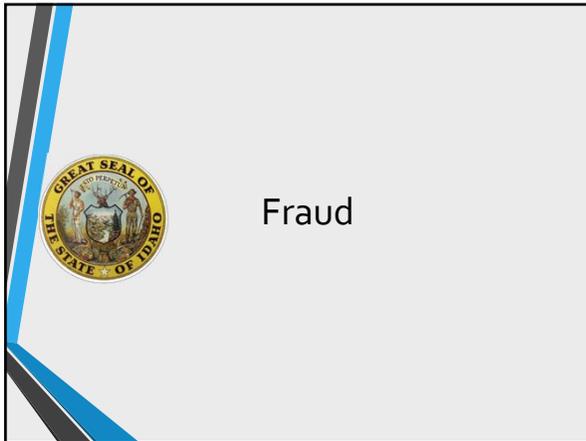


Review Question #15

It is important to have controls in place to identify and communicate change across an agency?

- a) True
- b) False





INTERESTING FRAUD FACTS

- In **94.5%** of the cases in our study, the perpetrator took some efforts to conceal the fraud. The most common concealment methods were creating and altering physical documents.
- The most common detection method in our study was tips - 39.1% of cases.
- Banking and financial services, **government and public administration**, and manufacturing industries were the most represented sectors in the fraud cases examined.

*ACFE – Association of Certified Fraud Examiners

INTERESTING FRAUD FACTS

- Fraud perpetrators tended to display behavioral warning signs when they were engaged in their crimes. The most common red flags were living beyond means, financial difficulties, unusually close association with a vendor or customer, excessive control issues, a general "wheeler-dealer" attitude involving unscrupulous behavior, and recent divorce or family problems. **At least one of these red flags was exhibited during the fraud in 78.9% of cases.**
- **More occupational frauds originated in the accounting department (16.6%) than in any other business unit.** Of the frauds we analyzed, more than three-fourths were committed by individuals working in seven key departments: accounting, operations, sales, executive/upper management, customer service, purchasing, and finance.

*ACFE – Association of Certified Fraud Examiners

- 75%** of employees have stolen at least once from their employer.
- The average organization loses **5%** of its annual revenue to fraud.
- MORE THAN **32%** of bankruptcies are caused by employee theft.
- The median amount lost is **\$175,000.**
- 77%** of fraud within companies is not publicly reported upon detection.
- Global fraud losses equate to **\$3.7 trillion.**

- The **#1 Fraud Detection Method** is a TIP.
- The median time for fraud detection is **18 months.**



Errors vs FRAUD

I know, right! It's so shocking that we have internal controls to prevent the fraud I silently think you're committing...



your cards
comparant.com

THE FRAUD TRIANGLE

MOTIVATION



OPPORTUNITY RATIONALIZATION



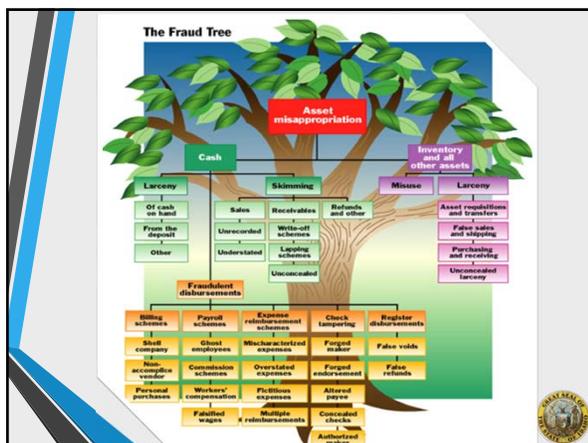
PREVENTION VS. DETECTION



ACFE* classifies occupational fraud risks into three general categories:

- Fraudulent Financial Reporting
- Misappropriation of assets
 - Corruption

*ACFE – Association of Certified Fraud Examiners

Your role in internal controls and preventing and detecting fraud?

Management & Staff






- Office of the Inspector General's independent auditor report on HUD's 2016 & 2015 consolidated financial statements and reports on internal controls over financial reporting and compliance with laws and regulations
 - 11 material weaknesses,
 - 7 significant deficiencies, and
 - 5 instances of noncompliance with applicable laws and regulations



- Per the independent auditor's report:
 - "The errors occurred because HUD failed to design and implement an adequate system of **internal controls** over financial reporting necessary to mitigate the challenges and risks in its complex financial reporting process"



- Weaknesses noted in each element of internal controls:
 - Information & communication
 - Control activities
 - Risk assessment
 - Control environment
 - Monitoring




Review Questions

16 - 20

Review Question #16

What is the distinguishing factor between errors and fraud:

- a) Incorrect data entry
- b) Intent
- c) Human judgement
- d) Management decision



Review Question #17

A deficiency or combination of deficiencies in internal control, such that there is a reasonable possibility that a material misstatement of an entity's financial statements will not be prevented or detected and corrected on a timely basis is a:

- a) Significant deficiency
- b) Misappropriation of assets
- c) Material weakness
- d) Fraudulent financial reporting



Review Question #18

Given all of the following fraud prevention methods within organizations, which one is probably the most effective?

- a) Reducing rationalization
- b) Increasing the perception of detection
- c) Having an open-door policy
- d) Screening employees



Review Question #19

The annual impact of global fraud exceeds:

- a) \$3 trillion
- b) \$1 billion
- c) \$500 million
- d) \$100 million



Review Question #20

The type of fraud that is commonly found with government benefits programs is:

- a) Falsification of medical claims
- b) Procurement fraud
- c) Auto theft rings
- d) Identity theft



Wrap-up Questions

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