

Internal Controls

Government Financial Professional Training

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Objectives

- What is internal control?
- What are the components of internal control?
- Key controls over cash receipts, payroll, accounts payable
- Basic fraud prevention best practices
- Developing an internal control plan

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What is internal control?

Internal controls are actually a coordinated set of policies and procedures that reflect a comprehensive strategy for achieving management objectives.

The government entity's management is responsible for establishing an effective framework of internal controls.

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What is internal control?

Management is responsible for designing controls to achieve:

- Effectiveness – objectives are achieved
- Efficiency – optimal use of scarce resources
- Compliance – legal restrictions
- Financial Reporting – types of information

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Why Internal Controls?

Former TierOne Bank officials settle with FDIC

Lincoln Journal Star 3/20/14

Dixon, Illinois Comptroller Allegedly Embezzled \$30 Million To Fund Horse Breeding Business

Huffington News 4/19/2012

What Internal Control will not do:

- A solution to solve staff performance issues
- It doesn't replace the need for staff education opportunities
- Internal Control does not automatically create a culture of accountability in the department at all levels
- Eliminate all potential for internal or external fraud

Key components of internal control

A comprehensive internal control framework does all of the following:

- Provides a favorable control environment
- Continually assesses risks
- Establishes and maintains effective control related policies and procedures (control activities)
- Effectively communicates information
- Monitors the effectiveness of controls

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Who are the key internal control policy stakeholders?

- Elected official or office holder, Board of Directors/Commissioners, and Shareholders
- Internal Stakeholders
 - Other departments within your organization
 - CEO/CFO
 - Employees, supervisors, and managers
- Constituents

Segregation of duties basics

Proper segregation of duties allows the entity to:

- Demonstrate that the routine flow of financial activity contains sufficient checks and balances to catch material errors
- Reduces the possibility of employee dishonesty

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Segregation of duties basics

Three functions are considered incompatible:

- Authorization of transactions
- Recordkeeping
- Custody of assets (access to assets)

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Limitations

- Costs of controls should never exceed the benefits they provide.
- Controls are subject to management override.
- Collusion
- More is not better.

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Key controls: cash receipts / revenues

- Approval of fees / rate structure, and access to enter / change in the IT system
- Collection of receipts is segregated from posting of transactions
- Voids / adjustments are properly approved, or there are mitigating controls such as daily reports for supervisory review.

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Key controls: cash receipts / revenues

- Daily reconciliation of receipts posted per the IT system to the daily deposit
- Bank reconciliation are done timely and accurately.

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Cash Receipt Transactions

- Offer receipts for cash payments made in person
- Separate cash drawers for each person taking payments
- Assign the change fund to one person in the department for accountability
- Examine how you receive your funds
- Make sure to test new process if you are changing systems/automating more receipts
- How does you office handle cash or unidentified receipts?
- Lock up unprocessed receipts over night in a secure location

Key controls: payroll

- Master file changes (new hires, pay rates, etc.) are subject to authorization and documentation.
 - Changes are documented and approved, or IT access is restricted.
- Timecards, timesheets or other records (including overtime) are reviewed and approved by the employee's supervisor.

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Key controls: payroll

- Before disbursement is made, payroll registers are subject to review and approval.
 - Edit / exception reports are reviewed during processing.
- Adequate account coding procedures are in place to ensure proper classification of expense.

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Key controls: purchasing/accounts payable

- Purchase orders approved / purchasing policy in place and followed
- Controls over the proper approval and set-up of new vendors (including IT access to the vendor master file)
- PO, receiving documents, invoice are matched prior to payment
- Segregation of purchasing, receiving, invoicing and disbursement processes

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Key controls: purchasing/accounts payable

- Invoices properly approved
- Controls in place to prevent duplicate payments of invoices
- Controls in place over year-end cutoff

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Key controls: cash - other

- Bank reconciliations done timely and accurately
- Wire transfers require dual authorization
- Physical access to checks / check signing process and authority

For fraud prevention:

- Use of positive pay with your bank
- Use of check security features: watermarks, holograms, special ink, etc., to make it difficult to duplicate your checks

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Additional Fraud Tools

- Use bank website functionality
- Require system users to use strong passwords
- Revoke security access to bank website, bank products, accounting system, secured areas when staff leave permanently or for long periods of time
- Talk to your banker(s)
- Look at ACH options available
- Talk to IT/Information Services and other departments

Fraud prevention

An inadequate internal control framework permits and actually encourages fraud. Proper controls provide a threat of prompt detection that can function as a deterrent.

Frauds occur when there is opportunity, low likelihood of discovery, and a history / environment where punishment is not severe.

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Fraud prevention: the control environment

- Environment of high integrity / ethics
- Performance and appraisal systems
- Employee assistance programs
- Employee testing and screening
- Common sense / watchful eye

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Fraud prevention / detection

- Internal and external audits
- Fraud awareness / ethics training
 - Anonymous fraud hotlines found to catch frauds more quickly than anything else
- Conduct periodic surprise cash counts / audits.
- Perform reviews of purchasing card transactions for unusual activity or patterns of activity (and compliance with policy).
- Perform reviews of bid processes to ensure compliance with policy.

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Where to start?

- Engage your department staff, supervisors, and managers
- Develop a template to be used
- Look at the ways you process your work
- Have others review Internal Control Policies for feedback
- Include revision dates
- Require all department staff to acknowledge reading the developed policies and updates

Questions?

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