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Internal Controls

By:

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Presentation Outline

- ▶ Defining Internal Control
- ▶ High Risk Areas for Internal Control
- ▶ Documentation of Procedures
- ▶ Enhancing Internal Control with Management Involvement
- ▶ Audit Committees
- ▶ Fraud Reporting and Internal Control
- ▶ Fraud Prevention Policies

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GFOA “Blue Book” Transmittal Letter Sample

Management assumes full responsibility for the completeness and reliability of the information contained in this report, based upon a comprehensive framework of internal control that it has established for this purpose. Because the cost of internal control should not exceed anticipated benefits, the objective is to provide reasonable, rather than absolute, assurance that the financial statements are free of any material misstatements.

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Defining Internal Control

The AICPA provided its first definition of internal control. This first study of internal control, issued in 1949, was titled Internal Control—Elements of a Coordinated System and Its Importance to Management and the Independent Public Accountant. The profession's first attempt at defining internal control was as follows: Internal control comprises the plan of organization and all of the coordinate methods and measures adopted within a business to safeguard its assets, check the accuracy and reliability of its accounting data, promote operational efficiency, and encourage adherence to prescribed managerial policies.

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Defining Internal Control–COSO

In 1992, the Committee of Sponsoring Organizations of the Treadway Commission (COSO) issued a four volume report titled Internal Control—Integrated Framework. The COSO Report defines internal control, describes the components of effective internal control, provides criteria against which internal control can be evaluated, and presents guidance that organizations can follow when reporting publicly on internal controls over financial reporting. **COSO is the most widely accepted internal control framework.** The AICPA has incorporated the COSO framework and its five components of internal control into the auditing literature. Furthermore, under SEC rules relating to the Sarbanes–Oxley Act, COSO is considered to be a suitable internal control framework for management to base its evaluation of the effectiveness of internal control over financial reporting. COSO has issued an updated framework on internal control. However, since the original COSO framework can be used until December 15, 2014.

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Defining Internal Control–COSO



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Defining Internal Control–COSO

Effective internal control:

- ▶ Achievement of three “objectives”:
 1. Effectiveness and efficiency of operations
 2. Reliability of reporting
 3. Compliance with applicable laws and regulations
- ▶ A process: recurring tasks, activities, and policies and procedures
- ▶ Effected by people: actions taken at every level within an organization
- ▶ Able to provide reasonable assurance: **not** absolute assurance

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Defining Internal Control–COSO

Comprised of the five “components” of internal control working in an integrated manner:

1. Control environment
2. Risk assessment
3. Control activities
4. Information and communication
5. Monitoring activities

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Defining Internal Control–COSO

1. Control Environment

- ▶ The organization demonstrates a commitment to integrity and ethical values. Sets the tone at the top.
- ▶ The board of directors demonstrates independence of management and exercises oversight for the development and performance of internal control.
- ▶ Management establishes, with board oversight, structures, reporting lines, and appropriate authorities and responsibilities in the pursuit of objectives.

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Defining Internal Control–COSO

2. Risk Assessment

- ▶ The organization identifies risks to the achievement of its objectives across the entity and analyzes its risks as a basis for determining how risks should be managed.
- ▶ The organization considers the potential for fraud in assessing risks to the achievement of objectives.
- ▶ The organization identifies and analyzes changes that could significantly affect the system of internal control.

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Defining Internal Control–COSO

3. Control Activities

- ▶ The organization selects and develops control activities that contribute to the mitigation of risks to acceptable levels.
- ▶ The organization selects and develops general control activities and specific controls over specific programs such as general and specific controls over IT.
- ▶ The organization deploys control activities such as physical controls over assets, performance indicators, and segregation of duties.

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Defining Internal Control–COSO

4. Information and Communication

- ▶ The organization generates and uses relevant, quality information to support the functioning components of internal control.
- ▶ The organization communicates information with internal parties, including objectives and responsibilities for internal control, necessary to support the functioning of internal control.
- ▶ The organization communicates information with external parties about matters affecting the functioning of internal control.

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Defining Internal Control–COSO

5. Monitoring Activities

- ▶ The organization selects, develops, and performs ongoing and/or separate evaluations to determine whether the components of internal control are present and functioning (typically internal auditors.)
- ▶ The organization evaluates and communicates internal control deficiencies in a timely manner to parties responsible for taking corrective action, including senior management and the board of directors, as appropriate.

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High Risk Areas for Internal Control

(partial listing)

- ▶ General Controls
- ▶ Banking
- ▶ Cash Receipts:
 - General
 - Court
 - Parks
- ▶ Payroll
- ▶ Credit Card Purchases
- ▶ Cash Disbursements
- ▶ Fuel Procedures

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General Controls

- ▶ Is there segregation of duties?
- ▶ Are employees cross trained?
- ▶ Are there documented independent approvals for everything?
- ▶ Does the Finance Director perform analytical reviews?
- ▶ Are the policies and procedures documented?
- ▶ Finance Director and City Administrator should ask questions.

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Banking

Bank Transfers

- ▶ Set limitations with the bank to only allow transfers to other City accounts or authorized vendors if doing online payments
- ▶ Have the bank require two authorizations

Bank Reconciliations

- ▶ Independent person from the check writing process should prepare the bank reconciliation or at least review
- ▶ Prepare bank reconciliations timely and investigate differences
- ▶ Investigate old outstanding checks

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Cash Receipts – General

- ▶ Centralize cash receipts if possible
- ▶ Make timely deposits
- ▶ Two people should sign off on every cash count & reconciliation with source reports
- ▶ Pre-numbered receipt books (make sure to reconcile receipt books to deposit)
- ▶ Investigate voided pre-numbered items
- ▶ Investigate adjustments of any kind
- ▶ Track over/short by employee if possible
- ▶ Account for all credit cards reversals (two people should approve all reversals)
- ▶ Follow up on old receivables

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Cash Receipts – Court

Are Court receipts being collected by non-court personnel?

Is someone reconciling?:

- Court receivables monthly
- Bonds payable monthly
- Bond cash and bonds payable
- Tickets issued by ticket number (recommended by state auditor)
- Police bond book with court deposit
- Adjustments – verify approval with judge or docket

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Cash Receipts – Parks

- ▶ Reconcile deposits to monthly reports if possible
- ▶ Monitor park usage – users vs receipts
- ▶ Monitor inventory – compare inventory decreases to receipts
- ▶ Reconcile adjustments or voids

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Payroll

- ▶ Document approval for wage increases
- ▶ Have someone independent enter new employees & restrict access for this
- ▶ Manually pass out paychecks/stubs a few times a year
- ▶ Make sure all time is approved & OT appears reasonable
- ▶ Have another person review & approve before payday

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Credit Card Purchases

- ▶ Reconcile all receipts with the monthly statement
- ▶ Document approval for all purchases
- ▶ Receipts should state valid business purpose for purchase (restaurant receipts should state who attended & what was discussed)
- ▶ Set limits with the CC company regarding credit limits, restrictions on cash advances, and what items can be purchased, if possible

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Cash Disbursements

- ▶ Document approval on all invoices
- ▶ Restrict access for entering new vendors
- ▶ Perform new vendor checks (Google or phone book)
- ▶ The check signer should be independent & they should review the invoices while signing
- ▶ Check that bidding procedures were followed

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Fuel Procedures

- ▶ Track gasoline usage by vehicle and employee
- ▶ Analyze miles per gallon
- ▶ Require employees to enter correct odometer readings
- ▶ Restrict access to fuel pumps

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Procedures Documentation



GFOA Best Practice: Documentation of Accounting Policies and Procedures:

- ▶ **Background.** Communication is an essential component of a comprehensive framework of internal controls. One method of communication that is particularly effective for controls over accounting and financial reporting is the formal documentation of accounting policies and procedures. A well-designed and properly maintained system of documenting accounting policies and procedures enhances both accountability and consistency. The resulting documentation can also serve as a useful training tool for staff.

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Procedures Documentation



Accounting procedures manual: GFOA
Recommendation–

Every government should document its accounting policies and procedures. Traditionally, such documentation has taken the form of an accounting policies and procedures manual. Thanks to advances in technology, even more effective methods are now also available for this purpose.

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Procedures Documentation



Accounting procedures manual: GFOA Recommendation–

The documentation of accounting policies and procedures should be evaluated annually and updated periodically, no less than once every three years, according to a predetermined schedule. Changes in policies and procedures that occur between these periodic reviews should be updated in the documentation promptly as they occur. A specific employee should be assigned the duty of overseeing this process. Management is responsible for ensuring that this duty is performed consistently.

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Procedures Documentation



Accounting procedures manual: GFOA Recommendation-

The documentation of accounting policies and procedures should be readily available to all employees who need it. It should delineate the authority and responsibility of all employees, especially the authority to authorize transactions and the responsibility for the safekeeping of assets and records. Likewise, the documentation of accounting policies and procedures should indicate which employees are to perform which procedures. Procedures should be described as they are actually intended to be performed rather than in some idealized form. Also, the documentation of accounting policies and procedures should explain the design and purpose of control related procedures to increase employee understanding of and support for controls.

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Procedures Documentation

Accounting procedures manual - What to Include:

- ▶ List of functions (AKA - table of contents)
- ▶ Introduction
- ▶ Date last updated
- ▶ Responsible position (person)
- ▶ How to do the functions (procedures)
- ▶ Policies
- ▶ Sample forms and screen shots

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Procedures Documentation

Accounting procedures manual – general:

- ▶ Not too detailed but detailed enough:
 - Many times don't need individual key strokes, etc.
 - Depending on the function, it is a good idea to make sure you “error on the side” of too detailed.
- ▶ The procedures should be detailed enough to allow someone with knowledge of the software and the organization in general to be able to perform the function.
- ▶ Thus, a good procedures manual is in the eye of the beholder.

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Management Involvement



GFOA Best Practice – Enhancing Management Involvement with Internal Control: Background–

GFOA's *Code of Professional Ethics* requires:

1. finance officers, as part of their responsibility as public officials, to “exercise prudence and integrity in the management of funds in their custody and in all financial transactions.”
2. finance officers in connection with the issuance and management of information that they “not knowingly sign, subscribe to, or permit the issuance of any statement or report which contains any misstatement or which omits any material fact.”

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Management Involvement



GFOA Best Practice–Enhancing Management Involvement with Internal Control: Background (cont.)

Both provisions presume the existence of a sound framework of internal control:

1. Prudence in the management of public funds requires that there be adequate control procedures in place to protect those funds.
2. A sound framework of internal control is necessary to afford a reasonable basis for finance officers to assert that the information they provide can be relied upon.

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Management Involvement



GFOA Best Practice–Enhancing Management Involvement with Internal Control: Background (cont.)

- ▶ While a government's independent auditors and similar outside parties often can provide valuable assistance to management in meeting its internal-control-related responsibilities, their contribution can never be a substitute for management's direct and informed involvement with internal control.
- ▶ Ultimately, it is the responsibility of appropriate elected officials to ensure that the managers who report to them fulfill their responsibilities in implementing and maintaining a sound and comprehensive framework of internal control.

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Management Involvement



GFOA Best Practice–Enhancing Management Involvement with Internal Control: Recommendation–

- ▶ Financial managers obtain the information and training needed to meaningfully take responsibility for internal control. In particular, they should obtain a sound understanding of the essential components of a comprehensive framework of internal control as set forth by the Council of Sponsoring Organizations (COSO)...
- ▶ Ensure that all employees responsible in any way for internal control receive the information and training they need to fulfill their particular responsibilities.

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Management Involvement



GFOA Best Practice–Enhancing Management Involvement with Internal Control: Recommendation–

- ▶ Internal control procedures over financial management be documented. Documented internal control procedures should include some practical means for lower level employees to report instances of management override of controls that could be indicative of fraud.
- ▶ Financial managers, with the assistance of internal auditors or equivalent personnel as needed, periodically evaluate relevant internal control procedures to satisfy themselves that those procedures 1) are adequately designed to achieve their intended purpose, 2) have actually been implemented, and 3) continue to function as designed.

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Management Involvement



GFOA Best Practice–Enhancing Management Involvement with Internal Control: Recommendation–

- ▶ Upon completion of any evaluation of internal control procedures financial managers determine what specific actions are necessary to remedy the root cause of any disclosed weaknesses. A corrective action plan with an appropriate timetable should be adopted. There should be follow-up on the corrective action plan to ensure that it has been fully implemented on a timely basis.

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City Administrator/Manager Involvement with **Internal Control**

Get Upper Level Management Involvement & Buy-In:

- ▶ Approve wire transfers
- ▶ Co-signer on bank accounts
- ▶ Promote fraud policy
- ▶ Sign personnel forms
- ▶ Review bill listings
- ▶ Approve issuance of credit cards
- ▶ Approve new bank accounts
- ▶ Approve all PO's in excess of a certain amount

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City Administrator/Manager Involvement with **Financial Reports**

- ▶ Quarterly meetings with department heads to discuss budget variances
- ▶ Heavily involved in budget process
- ▶ Involved in 5-year capital plan
- ▶ Quarterly meetings to discuss revenue projections
- ▶ Involvement with audit process
- ▶ Review monthly reports in detail
- ▶ Require long term projections (5 years)

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Audit Committees



GFOA Best Practice – Recommendation:

- ▶ The governing body of every state and local government should establish an audit committee or its equivalent.
- ▶ The audit committee should... oversight of the work of any independent accountants engaged for the purpose of preparing or issuing an independent audit report...
- ▶ Ideally, all members of the audit committee should possess or obtain a basic understanding of governmental financial reporting and auditing...
- ▶ All members of the audit committee should be members of the governing body...
- ▶ ...provide independent review and oversight of a government's financial reporting processes, internal controls and independent auditors.

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Fraud Reporting



GFOA Best Practice – Encouraging and Facilitating the Reporting of Fraud and Questionable Accounting and Auditing Practices: Recommendation–

- ▶ The Government Finance Officers Association recommends that every government establish policies and procedures to encourage and facilitate the reporting of fraud or abuse and questionable accounting or auditing practices. At a minimum, a government should do all of the following: Formally approve, and widely distribute and publicize an ethics policy that can serve as a practical basis for identifying potential instances of fraud or abuse and questionable accounting or auditing practices.

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Fraud Reporting



GFOA Best Practice – Encouraging and Facilitating the Reporting of Fraud and Questionable Accounting and Auditing Practices: Recommendation (cont.)–

- ▶ Establish practical mechanisms (e.g., hot line) to permit the *confidential, anonymous reporting* of concerns about fraud or abuse and questionable accounting or auditing practices to the appropriate responsible parties.
- ▶ A government should regularly publicize the availability of these mechanisms and encourage individuals who may have relevant information to provide it to the government.

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Behavioral Red Flags of Perpetrators (Is someone stealing?)

- ▶ Living beyond means
- ▶ Financial difficulties
- ▶ Control issues, unwillingness to share duties
- ▶ Unusually close association with vendor/customer
- ▶ Divorce/family problems
- ▶ Irritability, suspiciousness, or defensiveness
- ▶ Addiction problems

(continued)

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Behavioral Red Flags of Perpetrators (Is someone stealing?)

- ▶ Refusal to take vacations
- ▶ Past employment-related problems
- ▶ Complaints about inadequate pay
- ▶ Excessive pressure from within organization
- ▶ Past legal problems
- ▶ Instability in life circumstances
- ▶ Excessive family/peer pressure for success
- ▶ Complaints about lack of authority

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Implementing an Anti-Fraud Program

- ▶ It is important to involve many departments in the implementation of the anti-fraud program, such as:

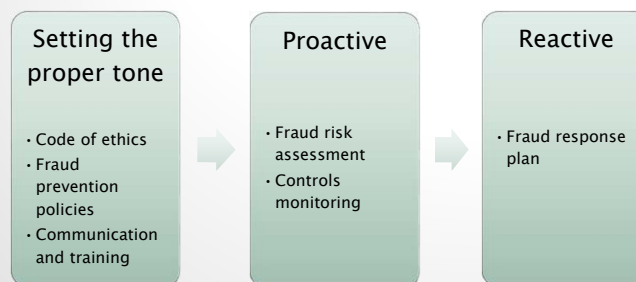


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Implementing an Anti-Fraud Program

- ▶ Anti-fraud programs should consist of three categories:



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Implementing an Anti-Fraud Program

▶ Setting the Proper Tone: Fraud Prevention Policies

Be specific to the individual organization and its operations

Guide employees through complex issues

Provide a channel for employees or third parties to report fraud

Establish procedures to govern the escalation of fraud allegations, guiding important resources decisions

Provide support and protection for whistleblowers

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Implementing an Anti-Fraud Program

▶ Proactive: Fraud Risk Assessment

Identify common types of fraud schemes that could occur within any organization

Specify fraud schemes that are industry, and sector, specific as well as geographic

Create a road map for future areas to analyze with analytical procedures and determine if controls are sufficient to mitigate

Provide annual and real-time updates to fraud risk assessment work plan to address change in business environment, acquisitions, current issues, etc.

Consider all areas of the organization to identify areas of weakness

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Implementing an Anti-Fraud Program

▶ Proactive: Controls Monitoring

Rank fraud schemes identified within the risk assessment

Develop action plans to assess, improve, and/or monitor the controls associated with the risks identified

Report the results of the action plans to executive management and/or the audit committee

Challenge prior year controls and analytics protocols to update with current issues and effective use of technology

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Implementing an Anti-Fraud Program

▶ Reactive: Fraud Response Plan

Establish investigation protocols

Coordinate remediation action steps across business units

Maintain consistent disciplinary procedures

Help "set the tone" within the government with respect to fraud

Develop investigation protocols for internal and external resources

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Fraud Prevention Policies

- ▶ To increase employees' perception of detection, are the following proactive measures taken and publicized to employees?

Is possible fraudulent conduct aggressively sought out, rather than dealt with passively?

Does the organization send the message that it actively seeks out fraudulent conduct through fraud assessment questioning by auditors?

Are surprise fraud audits performed in addition to regularly scheduled fraud audits?

Is continuous auditing software used to detect fraud and, if so, has the use of such software been made known throughout the organization?

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Fraud Prevention Policies

- ▶ Is the management climate/tone at the top one of honesty and integrity?

Are employees surveyed to determine the extent to which they believe management acts with honesty and integrity?

Are performance goals realistic?

Have fraud prevention goals been incorporated into the performance measures against which managers are evaluated and that are used to determine performance-related compensation?

Has the organization established, implemented, and tested a process for oversight of fraud risks by the board of directors or others charged with governance (for example, the audit committee)?

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Fraud Prevention Policies

- ▶ Are fraud risk assessments performed to proactively identify and mitigate the organization's vulnerabilities to internal and external fraud?
- ▶ Are strong anti-fraud controls in place and operating effectively, including the following?

Proper segregation of duties

Use of authorizations

Physical safeguards

Job rotation

Mandatory vacations

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Fraud Prevention Policies

- ▶ Are employee support programs in place to assist employees struggling with addiction, mental/emotional health, family, or financial problems?
- ▶ Is an open-door policy in place that allows employees to speak freely about pressures, providing management the opportunity to alleviate such pressures before they become acute?
- ▶ Are anonymous surveys conducted to assess employee morale?

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Why are Internal Controls Important?

Dixon, Ill., comptroller Rita Crundwell to face charges she embezzled more than \$53 million.



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The Fraud Problem

- ▶ Small organizations are most commonly victimized due to lack of anti-fraud controls
- ▶ Anti-fraud controls appear to reduce the cost & duration of fraud schemes
- ▶ The average fraud lasted an average of 18 months before being detected.
- ▶ Frauds are most likely to be detected by tip
- ▶ One of the industries most commonly victimized is government/public administration

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Questions and Discussion

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