Agenda

- Definition and internal control components
- Control activities
- Examples of control activities
- Other considerations
- Questions
Control

A mechanism used to prevent, detect or correct an undesirable outcome

Trust is not an internal control.
Deficiency in internal control

A deficiency in internal control exists when the design or operation of controls does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct, misstatements on a timely basis.

Source: AU-C Glossary of Terms
Material weakness

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

Source: AU-C Glossary of Terms
Significant deficiency

A deficiency, or combination of deficiencies, in internal control over financial reporting, that is less severe than a material weakness yet important enough to merit attention by those charged with governance.

Source: AU-C Glossary of Terms
Practical approach to controls

- Entity-wide controls (565)
- General technology controls (567/8)
- Significant cycles

Control risk assessments and control deficiencies
Monitor performance of controls and take corrective action

Policies and procedures to carry out activities

Identify potential risks (WCGW’s) and build controls

Set tone and basis for other components

Monitor

Control activities

Risk assessment

Control environment

Information and communication

Provide information to right people to perform job and controls
Internal control components

- Control environment
- Monitoring
- Risk assessment
- Information and communication
- Control activities
Control environment – “tone at the top”

> Integrity and ethical values
> Commitment to competence
> Organizational structure
> Management’s philosophy and operating style
> Human resource policies and procedures
Risk assessment
> Identification of risks
> Assess significance and likelihood of financial reporting risks

Control activities
> Design controls and procedures to address risks
Information and communication

- Accurate, timely financial information available
- Individuals understand roles and responsibilities

Monitoring

- Ongoing evaluation of new risk
- Effectiveness of control activities
- Corrective action is initiated when necessary
Types of controls
Types of controls

> Incompatible duties are segregated
> All transactions are properly authorized
> Accounting records and documentation are properly designed and maintained
> Access to assets and records is controlled
> Accounting records are periodically compared with underlying records
## Types of controls (cont.)

<table>
<thead>
<tr>
<th>Preventive controls</th>
<th>Purpose</th>
<th>Example</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>&gt; Deter process-related issues from occurring</td>
<td>&gt; Requiring for proper authorization before employee gains access into a system, general separation of duties</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Detective controls</th>
<th>Purpose</th>
<th>Example</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>&gt; Identify problems within a government's processes</td>
<td>&gt; Checking actual versus budgeted expenditures, reconciling accounts</td>
</tr>
</tbody>
</table>
Types of controls (cont.)

### Manual controls

**Definition**
- Control performed by a person without the use of automation

**Example**
- Physically counting cash in a register to match total receipts

### Automated controls

**Definition**
- Control performed by an automated system without the interference of a person

**Example**
- Departmental credit card limits
Segregation of duties

Separation of tasks in the accounting and recordkeeping process so no one individual handles an entire transaction from beginning to end

Even if you cannot fully segregate duties you can mitigate risk with certain controls or procedures.
Examples of control activities
General disbursements

New vendors

> Form to gather data for issuing 1099 requires approval
> Require a street address for all new vendors
> Produce report of new vendors for review and approval quarterly
> Approval by someone who does not order goods or process payments
General disbursements (cont.)

ACH payments/wire transfers

> Approval by someone not initiating the transaction

> Approval by governing body

> Separation of duties - person initiating the transaction should not be posting the journal entry or preparing the bank reconciliation
Payment of invoices

> Separate processing of accounts payable and ordering/receiving goods or services
> One person sets up and another releases
> Invoices are approved for payment
> Ensure compliance with purchase order policies
New employees and pay rate changes

> Separation of duties within the payroll system
> Approval of position, salary or wage, etc., by management or governing body
> Review information in system is accurate
> Documented in the employee file
Timesheets

> Approval by supervisor for all hourly employees
> Include review of where time is charged

Overall payroll approval

> Total of direct deposits and payroll checks matches payroll register
> Withholdings appear reasonable
> Completed by someone who doesn’t prepare payroll
All disbursements

> Secure all check stock
> Do not allow the signing of blank checks
> Avoid use of manual checks
> Ensure appropriate security and controls regarding signature stamps
Credit or purchase cards

> Establish clear policies regarding use
> Limit the number of cards and the maximum charged
> All charges should be supported by documentation
> Transactions should be approved
Property taxes collections

Separation of duties
> Collections, posting to general ledger and bank deposits
> Bank reconciliations

Reconciliations
> Batch collections are reconciled from general ledger to tax collection system
> Tax refund overpayments are reconciled from tax collection system to general ledger
Utility billing/receipting

Billing rates
> Entered from PSCW tariff or authorized by governing body
> Separate review of data from system after change
> Manual recalculation of sample bills

Account adjustments or write-offs
> Policy for who can authorize
> Tiered policy suggested
> Document reason and approval
New account setup

> Data provided to clerk by manager, building inspector, etc.

> System report of new accounts provided back to manager for review

Meter reading data

> High/low or other exception reports

> Follow up on exceptions

> High level analysis of sales to volume pumped or purchased
Billing versus receipting

> Separate the functions when possible
> Require use of cash register or receipt system

Reconciliations

> Monthly reconcile billing system detail to general ledger
> Investigate and resolve any differences
Reconciliation of accounts

> Performed by someone independent of processing transactions

> All balance sheet accounts should be reconciled on a routine basis (cash should always be monthly)

> Reconciliations should be reviewed and approved
Preparation of trial balances or budget reports

> Reviewed by management and governing body
> Reports should be generated by accounting system
> Variances should be investigated and resolved
Journal entries

> Approved by someone other than preparer
> Approver should see the actual entry as entered into the system
> Ensure each entry has a unique identifier and all are accounted for
IT controls

IT issues to monitor

> Passwords
> Patches
> Controls
> Laptops
> Flash drives
> Encryption
> Termination of employment – termination of IT rights
> Intrusion testing
Identity theft tips

> Make sure information requestor has valid reason
> Don’t give account information over the phone or in person to people you are not familiar with
> Don’t use cell phones, emails or wireless to send confidential information
> Check financial reports regularly
> Obtain your credit report from all 3 credit agencies
> Tear up or shred pre-approved credit applications
> Chose complex passwords and change often
What are you going to do differently?

1. ____________________________
2. ____________________________
3. ____________________________
4. ____________________________
5. ____________________________
Other considerations
Largest municipal fraud in U.S. history

The Dixon story
Dixon is 103 miles from Chicago. Population: 15,511

Budget: Total revenues and transfers for 2012/13 – $9.7M+

**Question:** How could one woman steal $53M?
Largest municipal fraud in U.S. history
*The Dixon story (cont.)*

- **1991**: $181,000 stolen
- **1990-2006**: $23M stolen
- **2006-2012**: $30M stolen
Largest municipal fraud in U.S. history
*The Dixon story* (cont.)

THEN – lavish lifestyle! 
NOW – 20 years in prison!

Municipal funds financed Rita Crundwell’s lavish lifestyle.
Dixon facts

1. People at City Hall trusted and respected Crundwell. She spent her adult life rising through City Hall’s ranks and was described as a nice person.

2. She essentially controlled all of the City’s finances and opened the mail which resulted in a lack of segregation of duties
   - a. Writing checks
   - b. Making deposits
   - c. Reconciling accounts
   - d. Wiring money (ultimately to her personal account!)

3. Crundwell created approximately 179 fake invoices

4. A tip by the City Clerk to the Mayor set things in motion i.e. FBI involvement

5. Lack of oversight
What did you take away from the movie?

1. ________________________________
2. ________________________________
3. ________________________________
4. ________________________________
5. ________________________________
Selected findings from the ACFE “Report to the Nations - 2018 Global Study on Occupational Fraud and Abuse”
What do you think is the most common detection method for occupational fraud?
How is occupational fraud initially detected?

<table>
<thead>
<tr>
<th>Detection method</th>
<th>Percent</th>
</tr>
</thead>
<tbody>
<tr>
<td>Tip</td>
<td>40%</td>
</tr>
<tr>
<td>Internal audit</td>
<td>15%</td>
</tr>
<tr>
<td>Management review</td>
<td>13%</td>
</tr>
<tr>
<td>By accident</td>
<td>7%</td>
</tr>
<tr>
<td>Other</td>
<td>6%</td>
</tr>
<tr>
<td>Account reconciliation</td>
<td>5%</td>
</tr>
<tr>
<td>Document examination</td>
<td>4%</td>
</tr>
<tr>
<td>External audit</td>
<td>4%</td>
</tr>
<tr>
<td>Surveillance/monitoring</td>
<td>3%</td>
</tr>
<tr>
<td>Notified by law enforcement</td>
<td>2%</td>
</tr>
<tr>
<td>IT controls</td>
<td>1%</td>
</tr>
<tr>
<td>Confession</td>
<td>1%</td>
</tr>
</tbody>
</table>

Source: 2018 Association of Certified Fraud Examiners, Inc.
### Who reports occupational fraud?

<table>
<thead>
<tr>
<th>Tipster</th>
<th>Percent</th>
<th>Source</th>
</tr>
</thead>
<tbody>
<tr>
<td>Employee</td>
<td>53%</td>
<td>Internal</td>
</tr>
<tr>
<td>Customer</td>
<td>21%</td>
<td>External</td>
</tr>
<tr>
<td>Anonymous</td>
<td>14%</td>
<td>Other</td>
</tr>
<tr>
<td>Vendor</td>
<td>8%</td>
<td>External</td>
</tr>
<tr>
<td>Other</td>
<td>5%</td>
<td>Other</td>
</tr>
<tr>
<td>Competitor</td>
<td>3%</td>
<td>External</td>
</tr>
<tr>
<td>Shareholder/owner</td>
<td>2%</td>
<td>Internal</td>
</tr>
</tbody>
</table>

Source: 2018 Association of Certified Fraud Examiners, Inc.
Control weaknesses that contributed to fraud

Control weaknesses

- Lack of internal controls: 30%
- Override of existing controls: 19%
- Lack of management review: 18%
- Poor tone at the top: 10%
- Lack of competent personnel in oversight roles: 8%
- Other: 4%
- Lack of independent checks/audits: 2%
- Lack of employee fraud education: 2%
- Lack of clear lines of authority: 1%
- Lack of reporting mechanism: 1%

Source: 2018 Association of Certified Fraud Examiners, Inc.
Responsibility for the prevention and detection of fraud
Who has the primary responsibility for the prevention and detection of fraud?

“The primary responsibility for the prevention and detection of fraud rests with both those charged with governance of the entity and management.”

AU-C Section 240 - .04
Management’s role

“It is important that management, with the oversight of those charged with governance, places a strong emphasis on fraud prevention, which may reduce opportunities for fraud to take place, and fraud deterrence, which could persuade individuals not to commit fraud because of the likelihood of detection and punishment. This involves a commitment to creating a culture of honesty and ethical behavior, which can be reinforced by active oversight by those charged with governance.”

AU-C Section 240 - .04
Governing body’s role

“Oversight by those charged with governance includes considering the potential for override of controls or other inappropriate influence over the financial reporting process, such as efforts by management to manage earnings in order to influence the perceptions of financial statement users regarding the entity’s performance and profitability.”

AU-C Section 240 - .04
Monitoring the risk of management override

> Understand the entity and industry including
  – Key drivers of revenue and related benchmarks
  – Factors that may threaten management’s ability to achieve budgeted results

> Brainstorm with department heads, other key members of management, external auditors and internal auditors to identify fraud risks
  – Review any material weaknesses, significant deficiencies and control deficiencies related to the financial audit
  – Review any compliance findings related to the single audit
  – Consider segregation of duties
  – Consider decentralized operations

> Assess the tone at the top and the entity’s culture

> Create a whistleblower policy
  – Consider setting up a whistleblower hotline

Responsibility for prevention and detection (cont.)

**External auditor’s role**

“An auditor conducting an audit in accordance with GAAS is responsible for obtaining reasonable assurance that the financial statements as a whole are free from material misstatement, whether caused by fraud or error. Due to the inherent limitations of an audit, an unavoidable risk exists that some material misstatements of the financial statements may not be detected, even though the audit is properly planned and performed in accordance with GAAS.”

**AU-C Section 240 - .05**
Responsibility for prevention and detection (cont.)

External auditor’s role

- Sophisticated and carefully organized schemes – concealment
- Collusion
- Relative size of individual amounts manipulated
- Seniority of those individuals involved

“Although the auditor may be able to identify potential opportunities for fraud to be perpetrated, it is difficult for the auditor to determine whether misstatements in judgment areas, such as accounting estimates, are caused by fraud or error.”

AU-C Section 240 - .06
MY COMPUTER IS TOO SLOW. I NEED TO UPGRADE IT.

I NEED A COST-BENEFIT ANALYSIS INCLUDING THE COST OF ALL ALTERNATIVES, AND VICE PRESIDENT APPROVAL.

IT WAS EASIER TO GET A SECOND JOB AND PAY FOR THE UPGRADE MYSELF.
Cross-training employees

> Can both perform functions in each area to create segregation of duties

> Flexibility
Get the board / council involved

> Perform approval and other functions
> Understand importance of controls
> Key for smaller municipalities
Red flags

> Unusual discrepancy between actual and expected results
> Disbursements to unknown vendors
> Gaps in receipt or check numbers
> Late reports or unwillingness to provide information
> Lack of scrutiny with review/approvals
> Disregarding internal control policies or procedures
Controls should provide these insights

- **Who?** Individual performing the control (can be systematic)
- **What?** Specific action being performed
- **When?** Frequency or what point in the process does this occur
- **Why?** Purpose of the action being performed

Control examples

<table>
<thead>
<tr>
<th>Poor</th>
<th>Better</th>
</tr>
</thead>
<tbody>
<tr>
<td>Employees enter their time in the Kronos application. Department managers review the employees time and submit it for processing.</td>
<td>Department managers review and approve time submitted by their employees on a weekly basis. Variances greater than 10% of the expected hours (based on a 40-hour work week) are investigated.</td>
</tr>
<tr>
<td>An account reconciliation is performed for Accounts Payable.</td>
<td>On a monthly basis, the Accounting Manager performs a reconciliation of Accounts Payable between the general ledger and the AP sub ledger report. Reconciling items greater than $1,000 are researched and resolved within 3 business days.</td>
</tr>
</tbody>
</table>
What will you do different?

“Aha!” moments

What will you do different going forward and what did you learn?

1. ______________________________
2. ______________________________
3. ______________________________
4. ______________________________
5. ______________________________
Questions?

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