




**INTERNAL CONTROLS**



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AGA National President-Elect  
December 8, 2016



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**INTERNAL CONTROLS**

**“Don’t Sweat the Small Stuff!”**





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**INTERNAL CONTROLS**



- “Fraud just couldn’t happen here because all our employees are honest.”
- “Our government’s small... We don’t have any fraud risks.”
- “Implementing internal controls is too costly.”
- “Internal controls? That’s why we have insurance.”
- “Utilizing internal control procedures takes too much time.”
- “If we get audited every year, why do we need controls?”



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INTERNAL CONTROLS



FRAUD IN TENNESSEE

- Over 800 hotline contacts (via phone and website)
- Approximately 130 fraud reporting forms
- \$1,814,029 in cash shortages




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INTERNAL CONTROLS



WHAT ARE INTERNAL CONTROLS?

- Internal controls are methods put in place to provide reasonable assurance that the objectives of the governments will be achieved in operations, reporting, and compliance...
- Checks and balances that are in place to detect and to help prevent fraud...
- They keep things under control...




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INTERNAL CONTROLS



HISTORY OF INTERNAL CONTROLS

- 1981 - GAO's first revision of the Yellow Book
- 1982 – Federal Managers Financial Integrity Act
- 1983 – GAO establishes Standards for Internal Controls in the Federal Government – This was the Green Book...




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**INTERNAL CONTROLS**



**HISTORY OF INTERNAL CONTROLS**

- 1984 – Single Audit Act
- 1992 – COSO releases the Internal Control Framework
- 2004 – COSO Releases ERM – Enterprise risk management 
- 2006 - SAS 112 - Communicating Internal Control Matters Identified in an Audit




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**INTERNAL CONTROLS**



**HISTORY OF INTERNAL CONTROLS**

- 2013 – COSO Updates the Internal Control Integrated Framework
- 2014 – GAO Updates the Standards for Internal Controls in the Federal Government (Green Book)
- 2014 – OMB Uniform Grant Guidance




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**INTERNAL CONTROLS**



**WHY DO WE NEED INTERNAL CONTROLS?**

- Reduce opportunities for fraud and waste
- Help management make better informed decisions
- Establish performance standards
- Help ensure compliance with applicable laws, regulations, policies, and procedures
- Eliminate adverse public trust
- Protect government assets
- Promote effectiveness and efficiency of operations
- Ensure reliability of financial reporting
- Promote transparency and accountability




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**INTERNAL CONTROLS**  
**WHO'S RESPONSIBLE FOR INTERNAL CONTROLS?**

- Management
- Governing Board
- Audit Committees
- Internal Audit Function



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**INTERNAL CONTROLS**  
**HOW DO INTERNAL CONTROLS RELATE TO AUDIT?**

- AU-C Section 315 – Understanding the Entity and its Environment and Assessing the Risks of Material Misstatement
- Support audit opinions
- Reduce audit or test work
- Identify material weaknesses
- Reliance vs. responsibility



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**INTERNAL CONTROLS**



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## INTERNAL CONTROLS CONTROL ENVIRONMENT



- “Tone at the Top”
- The most important component
- Management must set an example of professional integrity and ethical values
- Management has got to be knowledgeable about internal controls
- Management must be committed to establishing and maintaining internal controls
- Management must communicate their support for internal controls to their staff




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## INTERNAL CONTROLS RISK ASSESSMENTS



- Inherent Risk - Some things are just inherently more risky than others...Most of the time an organization has no control over these types of risks...(Example: handling cash)
- Control Risk – The risks that an organization’s internal controls won’t detect or prevent errors or fraud
- Detection Risk – This is the measurement of how likely and how quickly a fraud or error will go undetected




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### Comptroller of the Treasury Risk Assessment Worksheet

Division: Local Government Audit  
Year: 2016

(1) Determine potential impact to agency assuming the risk occurs  
(2) Assess the likelihood of the risk occurring (probability), reasonable possibility (R) or remote (L)

Category	Risk Description	Inherent Risk	Control	Control	Control	Residual Risk
		HS High	MS Medium	LS Low	Y Yes	N No
Operational Compliance 11.1.2	Having an unapproved or unrecorded expense or financial statement	H	MS	LS	Y	Y
Operational Compliance 11.1.2	Not performing the audit in accordance with relevant standards	MS	MS	LS	Y	Y
Operational Compliance 11.1.2	Having a report not in compliance with the standards	H	MS	LS	Y	Y
Operational Compliance 11.1.2	Change in accounting handling practices that could impact CPA's ability to conduct timely, quality, independent audits	H	L	L	N	N




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## INTERNAL CONTROLS

### CONTROL ACTIVITIES



- Nuts and bolts of internal control
- The day to day activities staff carry out in the course of their duties
- Actions an agency takes to respond to risks that are identified during the risk assessment
- Reduce a risk to an acceptable level
- Examples would be: issuing pre-numbered receipts and checks, reconciling bank statements, controlling access to credit cards, separate cash drawers for those responsible for collecting cash
- Not costly or difficult to implement



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September 2016

### COMMON INTERNAL CONTROL DEFICIENCIES IN LOCAL GOVERNMENTS

The following are terms where internal control deficiencies are commonly identified in local governments by Local Government Audit staff.

**What are internal controls?**  
Internal controls are defined as policies and procedures designed to assist management in achieving its goals such as: (1) a favorable control environment (tone at the top); (2) controlling risk assessment; (3) policies to ensure management directives are carried out; (4) effective communication of information; and (5) ongoing monitoring of policies and procedures.

**How are internal control deficiencies identified?**  
The Comptroller of the Treasury Division of Local Government Audit staff perform audits annually in 80 counties, several municipal units, and non-incorporated. In addition, staff reviews the audits performed by independent accounting firms for six counties, municipalities, public interest school funds, charter schools, utility districts, housing authorities, local government special districts, quasi-governmental organizations, and other government-related entities. Through these audits, a number of internal control deficiencies are noted, evaluated, and communicated to management. The Division continues to evaluate a local government's efforts to address these deficiencies through the audit and review processes.

Many of these deficiencies are considered to be significant due to their potential to lead to fraud, waste, abuse, and mismanagement.

For more information, contact Stan Aronette at 615.463.7944 or [Stan.Aronette@dnr.tn.gov](mailto:Stan.Aronette@dnr.tn.gov)

1. **Segregation of Duties**  
Duties relating to accounting functions are often not adequately segregated.
2. **Misclassification of Information of Audit Logs**  
Misclassification of information provides employees with the ability to access accounting or information systems. For those applications that record those manipulations in an audit log, management is not reviewing these logs.
3. **Cash Drawer Operations**  
Multiple employees operate from the same cash drawer within the office.
4. **Logical Access to Accounting Software**  
Logical access controls are inadequate. In some instances, passwords are not assigned to operating systems or application user logins. Also, application logins are shared among users.
5. **Performance of Reconciliations**  
Management fails to perform reconciliations of its various general ledger accounts with supporting documentation and reports monthly.
6. **Timely Maintenance of Accounting Records**  
Some county offices do not maintain their accounting records on a current basis. Records may be maintained as early as several months behind throughout the fiscal year and may not be closed and available for audit timely.
7. **Unexplained Expenditures**  
Many counties have internal control weaknesses related to their purchasing process. Examples include not establishing a formal purchase order system, issuing purchase orders after the purchases have been made, and paying invoices without confirmation that goods or services are received.
8. **Annual Disbursements**  
Checks documenting payroll are often not maintained adequately. Some counties lack supporting documentation for time worked and no evidence of supervisory approval of time worked.
9. **Data Backup and Disaster Recovery**  
Deficiencies in computer system backup procedures exist, and disaster recovery plans have not been developed.
10. **Lack of Management Oversight**  
Management does not always properly oversee the operations of the office.

Division of Local Government Audit

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## INTERNAL CONTROLS

### INFORMATION AND COMMUNICATION



- Refers to the ability of an agency to produce and communicate accurate information (Example: Issuing financial statements that comply with GAAP)
- Requires hiring competent, trained staff who understand accounting and are knowledgeable of the accounting standards



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INTERNAL CONTROLS

MONITORING



- Activity management performs to assess how effective their internal control system is functioning
- Can detect weaknesses and prompt corrective actions (Examples: surprise cash counts, examination of purchases to be sure all purchasing controls have been followed)
- Helps prevent the override of internal controls




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INTERNAL CONTROLS

FRAUD TRIANGLE




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INTERNAL CONTROLS

TYPES OF CONTROLS



Preventive Controls – Steps you take before a fraud occurs (Examples: Segregation of duties, passwords to prevent unauthorized access to networks or applications, locks on doors, alarms)

Detective Controls – Controls designed to find problems if a problem exists. They provide assurance that preventive controls are working (Examples: An inventory of assets, reconciliation of bank statements, an external audit)

Corrective Controls – Controls designed to correct errors or the results of fraudulent activity once they've been detected (Example: Corrective journal entries)




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**INTERNAL CONTROLS**

**EXAMPLES OF INTERNAL CONTROLS**



- Set the tone at the top
- Establish a code of professional conduct
- Segregation of duties
- Establish an audit committee
- Account reconciliation
- 3-day deposit law
- Separate cash drawers
- Establish a fraud hotline
- Offer fraud training for officials
- Hire and promote qualified employees
- Perform background checks for new hires
- Use data analytics
- Do annual risk assessments
- Institute job rotation or mandatory vacations
- Provide rewards for whistleblowers
- Make discussions about internal control and ethics part of all staff meetings
- Perform surprise audits
- Purchasing and payroll controls




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**INTERNAL CONTROLS**

**WHY INTERNAL CONTROLS DON'T WORK**



- No internal control system will provide absolute assurance whether they will allow an organization to meet their objectives without issues
- Internal control is implemented by humans and requires the use of their judgement in decision making...Humans are prone to mistakes and moral and ethical lapses
- Some internal controls just don't work
- Management blindly trusts their employees
- Staff might not be up to speed on internal control policies
- There's a cost vs. benefit - No organization has unlimited resources
- Sometimes internal controls are subject to management override
- There's the possibility of collusion




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**INTERNAL CONTROLS**






*"Never trust the people you cheat with. They'll throw you under the bus."*

Marianne Jennings, Ethics Professor, Arizona State University, Author

*"Three people can keep a secret if two are dead."*

Ben Franklin, Founding Father


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**INTERNAL CONTROLS**

**KEY POINTS TO REMEMBER**

- Internal control is the combination of people, policies, and procedures that organizations rely upon to obtain reasonable assurance that their government's operating effectively
- The primary responsibility for internal control lies with management...But the governing body has the ultimate responsibility to be sure management is doing what they're supposed to do
- External auditors rely on internal controls to support their audit opinions regarding the financial statements
- Audit committees and internal auditors support management and the governing body regarding internal control
- Reasonable assurance requires an internal control system that addresses the 5 components of internal control: control environment, risk assessment, control activities, information and communication, and monitoring
- Even the best system of internal control will fail in an unfavorable environment
- Risk assessment is not a one-time event...It's an on-going process


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**INTERNAL CONTROLS**






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**INTERNAL CONTROLS**

**“Making government work better...”**

*Jim Arnette*  
 AGA National President-Elect

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