Internal Controls – What are they and why should I care?

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I’LL MAKE YOUR LIFE MISERABLE! I’LL THWART YOUR EVERY MOVE!

HI. I’M THE NEW SADIST. WHAT HAPPENED TO THE OLD ONE?

HE WENT TO SADIST PARADISE. THE AUDITING DEPARTMENT?
Course objectives

- Understand what internal control is and define the various types of internal controls
- Gain an understanding of the “control environment”
- Understand the types of controls you should have in place in your department and how we audit for those controls
- Analyze case studies to understand the correlation between fraud and internal controls and what can happen when controls fail
- Where to go for help
- Have some fun
What is Internal Control?

- Internal control is a process, effected by an entity’s board of directors (regents), management and other personnel, designed to provide reasonable assurance regarding the achievement of the following objectives:
  - Effectiveness and efficiency of operations
  - Reliability of financial reporting
  - Compliance with applicable laws and regulations
  - Safeguard assets
Internal Control Key Concepts

- Internal control is a "process". It’s a means to an end, not an end in itself.
- Internal control is affected by "people". It’s not merely policy manuals and forms, but people at every level of the organization.
- Internal control can be expected to provide only "reasonable assurance", not absolute assurance, to an entity’s management and board.
- Internal control is geared to the achievement of the entity’s "objectives".
**Internal Control Key Concepts (cont.)**

- Management, not auditors, must establish and maintain the entity’s controls.
- No system can be regarded as completely effective.
- Should be applied to both manual and computerized systems.
- Are implemented to protect the employee.
1. Which of the following is NOT a true statement?

a. Putting controls in place will always cost more money
b. Controls help to ensure compliance with policies
c. Controls will help the organization achieve its mission
d. Controls will help protect the organization’s assets
3 Reasons for Internal Controls

- Protect the weak from temptation
- Protect the strong from opportunity
- Protect the innocent from suspicion
Types of Internal Controls

1. Directive Controls
2. Preventative Controls
3. Detective Controls
4. Mitigating Controls
Directive Controls – encourage good behavior, it’s the right thing to do

- Incentive plans
- Laws and regulations
- Recognition awards
- Training
- Policies and procedures
- Promotions
- Job descriptions
Preventative Controls - prevent undesirable events from occurring

- Knowledge that someone is reviewing your work
- Segregation of duties
- Limited access
- Levels of authorization
- Security badges
- Business rule set-up in automated systems
Detective Controls – detect and correct undesirable events after they occur.

- Reconciliations
- Auditing
- Confirmations
- Exception reports
- Reviews done on a regular basis
Mitigating Controls – Mitigate for the lack of an expected control.

- Cash handling – lack of adequate staff for proper segregation of duties – sharing with another area
- Software security/access – regular monitoring of access for certain employees when software security is not adequate because of functional constraints
Internal Controls can fail because:

- Employees can make mistakes or exercise poor judgment
- There can be collusion – where two or more individuals work together to misappropriate assets
- Management may inappropriately override established policies or procedures
- Employees are not held accountable
  - No consequences for noncompliance
2. The most important component of internal control is:

a. Segregation of duties
b. Following policies
c. The integrity, ethical values, and competence of an organization’s employees
d. Theft prevention
Implementing Internal Controls

The cost of a control vs. the benefit derived is always a balancing act. It’s all part of the risk assessment. Remember though, not all controls will cost more money.
Risk Assessment – What is it?

It’s a process to:

- Identify significant risks
  - Compliance/Financial/Operational
- Assess risks
  - What is the likelihood of occurrence?
  - What is the potential impact?
- Manage these risks through:
  - Avoidance
  - Acceptance and sharing (insurance)
  - Mitigate with internal controls
What are Risks?

A risk is anything that could jeopardize the achievement of your organization’s objective to:

- Achieve your goals
- Operate effectively and efficiently
- Protect the University’s assets (including employees) from loss
- Provide reliable financial data
- Comply with applicable laws, policies, and procedures
Identifying your Risks

Questions to ask yourself:

- What can go wrong?
- What laws or regulations would be violated?
- What policies most affect us?
- What types of transactions/activities in our area expose us to the greatest risk?
- How can someone bypass the internal controls? (How could someone misappropriate assets?)
- What potential risks could cause adverse publicity?
What are control activities?

Control activities are the policies and procedures that help ensure that actions identified as necessary to manage risks are carried out properly and in a timely manner.

- Policies should be implemented thoughtfully, conscientiously, and consistently.
- Procedures are not useful without a focus on policies.
Control Environment

- Ethical “tone at the top” communicated in words and deeds
- Ethics program, including meaningful code of conduct
- Active, independent, well-informed Board of Regents
- Organization structure appropriate to entity’s activities and which promotes the flow of information
- Clear definition of responsibilities and accountabilities
Control Environment (cont.)

- Analysis of knowledge and skills needed to perform each job; formal or informal job descriptions; qualified and well-trained personnel
- Frequent interaction between senior and operating management. Appropriate policies and procedures for hiring, training, promoting and compensating employees
- Background checks for new hires, especially those in sensitive positions
What do we mean by “Tone at the Top”? 

It’s Management’s behavior, control consciousness and commitment to competence by:

- Promoting integrity, ethical values & conduct
- Walking the walk
- Leading by example
- Being approachable
- Complying with policy
- Not circumventing policies & procedures
- Providing full disclosure
- Fixing problems
- Implementing equal treatment for equal offenses
- Rewarding things that are done right
Control Environment at the University of Iowa

- Implementation of a ‘Code of Business and Fiduciary Conduct’ which includes a specific section for senior management
- Composition of a ‘Resource Handbook for Business and Fiduciary Conduct’
  http://www.uiowa.edu/president/ethics-conduct/handbook.htm
- ICON Course on Ethics and Responsibilities – go to your Portal page and then “My Training” and look for ICON courses
- This Business Process Series Training Opportunity
Control Environment at the University of Iowa (Cont.)

- Implementation of a confidential reporting mechanism for questionable financial behavior
  - EthicsPoint is an independent third party contracted to receive reports of questionable financial activity
  - Reports can be made by telephone or through the web
  - Reports can be made anonymously
  - All reports are forwarded to Internal Audit for triage and follow up
Control Environment at the University of Iowa (Cont.)

- The reporter is assigned an ID and password to sign into the system to track progress and answer questions.
- Links are at the bottom of President’s Welcome page and on the Internal Audit home page:
  - [http://www.uiowa.edu/president/ethics-conduct/index.htm](http://www.uiowa.edu/president/ethics-conduct/index.htm)
  - [http://www.uiowa.edu/~intaudit/](http://www.uiowa.edu/~intaudit/)
Segregation of Duties

- Functions are divided so that no one person has control over all parts of a transaction. This reduces the risk of error or inappropriate action.

- Normally, the responsibilities of the following should be separated:
  - Custody
  - Recording
  - Authorization
  - Reconciliation

- Example: University cash handling policy
Internal Control Quiz

3. Who has the primary responsibility for internal controls in your college/department?

a. The college dean/department chair
b. The college/department fiscal officer
c. The Internal Audit Department
d. The Controller
Rating yourself

- Do you provide management training for those who oversee others?
- What message do you send your personnel who travel regarding meal limits, conference meals that are included in the registration?
- What policies and procedures do you have in place for reporting vacation and sick leave?
Rating yourself (cont.)

- How well do you enforce annual employee evaluations?
- Do you have signature authority assignments or delegations in place that reflect a proper segregation of duties?
- What approval process do you have in place for transfers between accounts, for budgeting?
Limit authorization authority
  - ‘Delegation of Signature Authority’
- “Rubber Stamping”
  - ‘Responsibility of an Approver’
- Secure access to passwords, electronic signatures or other signatory devices
- Develop written procedures outlining delegation guidelines
Security of All Assets

- Even though this is a financially oriented presentation, please remember as you do your risk assessments, not all assets are financially focused.
  - Children in PICU/NICU
  - Academic & Research Data
  - Human & Animal Research Subjects
Security of All Assets

- Periodic asset counts
- Periodic comparisons
- Investigation of discrepancies
- Regular data file backups
- Secure document retention (both hard copy & electronic)
- Physical safeguards against theft and fire
Monitoring

- Ongoing monitoring activities are Management’s responsibility
  - Compares information about current performance to:
    - Budgets
    - Prior periods
    - Other benchmarks (i.e. other peer universities)
  - Measures against achievement of goals and objectives
Monitoring

- Identifies unexpected results or conditions which require follow-up.
- The entire process must be constantly monitored, and make changes as conditions warrant.
- Separate evaluations are conducted by Internal Audit
4. Segregating duties is most important because:

a. An employee should not be put in a position where they are able to “steal & conceal”
b. Having too many duties overburdens an employee
c. The auditors may write you up if you don’t do it
d. All of the above
Who is accountable for assurance that appropriate internal controls are in place?

Management!
Who’s responsible for the performance of internal control activities?

Everyone!
Audit tests, how well will your department do?

- Will your employees verify a strong tone of control (governance) when interviewed?
- Will your capitalized asset inventory be accurate?
- Will your budget controls and fund transfers have independent oversight and are they aligned with the purpose of the account charged?
How well will you do?

- Are your purchases and disbursements properly approved and screened for university related purpose?
- How well are grants monitored for compliance? What is the involvement between the department and the PI?
- What best practices for IT controls are shared with employees?
How well will you do?

- Are HR and Payroll on-line reports utilized to monitor the correct payroll?
- Are annual reviews performed?
- Are personnel files maintained? Are health related documents kept in a separate file? Are they secure?
- How is vacation and sick leave monitored?
How well will you do?

- Does your IT area have good physical controls and is there a disaster/business continuation plan?
- Are employees’ access rights removed when they transfer or terminate?
- Are cash handling policies in place and are they followed?
IT Access Limitation Controls

- To create a record
- To change a record
- To approve a transaction
- By allowing read-only
- By requiring unique passwords
- Requiring time out limits
- By installing firewalls
- ITS desktop best practices
Internal Control Tools

- Formal compliance programs
- Checklists
- Inspections
- Exception reports (i.e. Performance appraisals not completed, excessive overtime, duplicate payments etc.)
- Forms control (pre-numbered documents, filing by and verifying integrity of numerical sequence)
- Performance standards
- Physical safeguards (safes, locks, access cards, dual control over sensitive assets, cameras, alarms, guards, ID badges etc.)
- Simulated disaster recovery drills
What happens when internal controls fail?

- Loss of revenue
- Non-compliance
- Loss of reputation
- Negative impact on students/patients/staff
- OR
Iona College Fires 2 Employees After Discovering $800,000 Fraud

By Andrea Fuller

A former employee of Iona College defrauded it of hundreds of thousands of dollars over nearly a decade, The Chronicle has learned.

The Roman Catholic college reported on its 2008-9 Internal Revenue Service tax forms that an unnamed employee fraudulently misappropriated $80,000 per year for approximately 10 years. The employee obtained the money though a series of small-dollar transactions, approving a college credit card for personal use and fraudulently signing checks.

The main campus of Iona College is located in New Rochelle, N.Y.

Enlarge Image
Columbia U. Will Pay $995,000 to Settle Medicare-Fraud Case

Columbia University has agreed to pay $995,000 to settle a lawsuit alleging that a doctor at an affiliated hospital defrauded the Medicare program by overbilling and by billing for unneeded tests, according to a news release issued by the U.S. Department of Justice. The lawsuit, filed under the False Claims Act, alleged that the doctor at New York Presbyterian Hospital, Erik Goluboff, an oncologist and former associate professor of clinical urology at Columbia, overbilled Medicare for urological procedures and billed for medically unnecessary tests. The lawsuit alleged that Columbia and Presbyterian were aware of the fraud and failed to stop it.
Let’s Take a 10 Minute Break!
What happens when internal controls fail?

- Loss of revenue
- Non-compliance
- Loss of reputation
- Negative impact on students/patients/staff
- OR
Audit finds $11M UIHC billing error

Regents also approve a 6% rate increase at meeting

By B.A. Morell
Iowa City Press-Citizen

An Iowa state Board of Regents internal audit found $11 million worth of charges that weren’t billed to patients in the University of Iowa Heart and Vascular Center.

UI officials still are working to determine the root of the billing error, which has been traced back to November 2009. UI Vice President for Medical Affairs Jean Robillard said. All of the bills have since been paid, he said.

"We don't like when we find this — no one does — but because of things like this, we can have a university of this quality," he said.

Regents were presented with the audit at a meeting Wednesday in Iowa City. Also at the meeting, regents approved a 6 percent rate hike for patient services at UIHC and for UI to enter into an agreement for a $73 million outpatient clinic in Coralville that could be completed by May 2012.

The audit report examined the EPIC Cardiary systems and Heart and Vascular systems for proper safeguards and controls; Cath Lab procedures for appropriate documentation; and the billing system for consistent, timely and accurate processing. The audit identified a number of billing errors and inadequate documentation of patient vitals according to hospital policy.

"We take these charges very seriously. We are trying to determine why these failures occurred," said Ken Kates, UIHC chief executive.

Follow- ing hospital procedures, some charges were never posted, so patients weren't billed, Kates said. The problems were not because of a new $60 million computer system called Epic, which has caused problems for some staff, but Kates declined to say it was a human error.

"We are still working to determine the root causes," he said.

UIHC has $235 million in gross monthly charges, said Ken Fisher, chief financial officer for UI Health Care, which oversees UIHC. The hospital has been checking other departments for billing problems as well.

Regent President pro

See REGENTS, 6A
Any Ideas What Might Have Went Wrong?
**Facts of the case**

- Numerous controls were lacking (or were ignored) that allowed this to occur.
- Occurred following a change in business processes due to a software implementation.
- Billing Clerk fell behind and failed to enter charges into the billing system.
- Supervisory oversight was lacking which should have identified a substantial variance in revenues.
- No fraudulent intent was noted.
5. Which is NOT an example of an internal control?
   a. Maintain adequate records
   b. Combine recordkeeping and custody of assets
   c. Apply IT controls to your work environment
   d. Make deposits daily or per policy
Executive Summary

Summary of Findings

• Survey participants estimated that the typical organization loses 5% of its annual revenue to fraud. Applied to the estimated 2009 Gross World Product, this figure translates to a potential total fraud loss of more than $2.9 trillion.

• The median loss caused by the occupational fraud cases in our study was $160,000. Nearly one-quarter of the frauds involved losses of at least $1 million.

• The frauds lasted a median of 18 months before being detected.
Executive Summary

• Asset misappropriation schemes were the most common form of fraud in our study by a wide margin, representing 90% of cases — though they were also the least costly, causing a median loss of $135,000.

• Financial statement fraud schemes were on the opposite end of the spectrum in both regards: These cases made up less than 5% of the frauds in our study, but caused a median loss of more than $4 million — by far the most costly category.

• Corruption schemes fell in the middle, comprising just under one-third of cases and causing a median loss of $250,000.
Executive Summary

- High-level perpetrators cause the greatest damage to their organizations. Frauds committed by owners/executives were more than three times as costly as frauds committed by managers, and more than nine times as costly as employee frauds. **Executive-level frauds also took much longer to detect.**

- More than 80% of the frauds in our study were committed by individuals in one of **six departments**: accounting, operations, sales, executive/upper management, customer service or purchasing.
Executive Summary

• More than 85% of fraudsters in our study had never been previously charged or convicted for a fraud-related offense. This finding is consistent with our prior studies.

• Fraud perpetrators often display warning signs that they are engaging in illicit activity. The most common behavioral red flags displayed by the perpetrators in our study were living beyond their means (43% of cases) and experiencing financial difficulties (36% of cases).
Executive Summary

Conclusions and Recommendations

• Occupational fraud is a global problem. Though some of our findings differ slightly, most of the trends in fraud schemes, perpetrator characteristics and anti-fraud controls are similar regardless of where the fraud occurred.

• Fraud reporting mechanisms are a critical component of an effective fraud prevention and detection system. Organizations should implement hotlines to receive tips from both internal and external sources. Such reporting mechanisms should allow anonymity and confidentiality, and employees should be encouraged to report suspicious activity without fear of reprisal.
Executive Summary

• Surprise audits are an effective, yet underutilized, tool in the fight against fraud. Less than 30% of victim organizations in our study conducted surprise audits; however, those organizations tended to have lower fraud losses and to detect frauds more quickly.

• While surprise audits can be useful in detecting fraud, their most important benefit is in preventing fraud by creating a perception of detection. Generally speaking, occupational fraud perpetrators only commit fraud if they believe they will not be caught. The threat of surprise audits increases employees’ perception that fraud will be detected and thus has a strong deterrent effect on potential fraudsters.
Executive Summary

• Organizations tend to over-rely on audits. External audits were the control mechanism most widely used by the victims in our survey, but they ranked comparatively poorly in both detecting fraud and limiting losses due to fraud.

• Audits are clearly important and can have a strong preventative effect on fraudulent behavior, but they should not be relied upon exclusively for fraud detection.

• Our data show not only that most frauds are detected by tips, but also that organizations that have anti-fraud training for employees and managers experience lower fraud losses.
Executive Summary

• Internal controls alone are insufficient to fully prevent occupational fraud. Though it is important for organizations to have strategic and effective anti-fraud controls in place, internal controls will not prevent all fraud from occurring, nor will they detect most fraud once it begins.

• Fraudsters exhibit behavioral warning signs of their misdeeds. These red flags — such as living beyond one’s means or exhibiting control issues — will not be identified by traditional controls.
Fraud Triangle

Opportunity (or perceived opportunity)

Need (Financial Problems)  Rationalization
Red Flags for Fraud

No vacation
Voluntary overtime
Unexplained variances
Complaints
No reconciliation
One employee “does it all”
Documentation is not original
“Rush” requests
Detection of Fraud Schemes

Initial Detection of Occupational Frauds

Detection Method:
- Tip: 40.2%
- Management Review: 15.4%
- Internal Audit: 13.9%
- By Accident: 8.3%
- Account Reconciliation: 6.1%
- Document Examination: 5.2%
- External Audit: 4.6%
- Surveillance/Monitoring: 2.6%
- Notified by Police: 1.8%
- Confession: 1.0%
- IT Controls: 0.8%

Percent of Cases
If you suspect fraud....

- **Do Not** confront the person
- **Do Not** talk about it with co-workers
- **Do Not** try to verify fraud has taken place or catch them on your own.

- **DO** call Departmental or College Administrators, Internal Audit, University Counsel, or University Police –
  - Experts in objective verification of the facts
  - Work closely with University Counsel and Safety/Security to document the issues with possibility of testifying in court.
Internal Control Quiz

6. Which of the following is true regarding internal controls?

a. Are only needed to keep dishonest people from stealing
b. Are not needed in a small office where everyone knows each other
c. Are not needed if the staff is honest
d. Are always necessary regardless of the staff involved
February 2, 2009

Audit: A University official improperly spent money

- A state audit report has identified more than $19,400 in apparent improper disbursements and unrecorded personal leave taken by an University official.
Facts of the case

- Assistant Director, Campus Program
- Personal purchases on PCard for travel for herself and a friend - $9,373
- 21 days of unrecorded personal leave - $4,686
- Travel advance not repaid - $1,788
- January 1, 06 to March 31, 2008
Facts of the case (cont.)

- Administration person left - was behind on reconciling PCard statements
- Reported to her Director that she had inadvertently used University Card and started making repayments
- Over 7,000 minutes of personal calls on University cell phone
What controls failed.....

- Late PCard Vouchers
- No independent review of PCard
- No review of leave records by supervisor
- Cell phone policy
- Travel advance policy not followed
June 13, 2006

Audit: University is Over Billed for Services

- A state audit report has identified more than $431,373 in a billing scheme by an approved contractor hired to perform maintenance on campus.
Facts of the case

- Some contractor employees were billing out up to 34 hours in a single day on multiple projects.
- Contractor billed all types of employees at the highest approved rate, rather than by employee classification as require in the contract.
- Over 15,700 hours of labor were billed and paid for work that was not performed.
What controls failed.....

- Not adequate oversight of contracted workers to determine what would be reasonable number of hours
- Invoices paid without adequate review
- Invoices were not compared to contract to determine that hourly rates should have varied by worker type
Facts of the case

- Suspected fraud was discovered by the Accounts Payable Department when they reviewed several invoices at once and noticed lapping.
- Internal Audit was contacted and we performed a full audit of the claims
- Case turned over to State Auditor
7. The fiscal officer of the School of DeArts wants to make sure the controls that were implemented are still effective. The fiscal officer should:

a. Ask all of the other school fiscal officers if they have had any money stolen
b. Change the locks on the doors
c. Spot-check transactions, records, and reconciliations to ensure they meet expectations
d. Ask for an Internal Audit of the school’s internal controls
What can Internal Audit do for you?

- Give you free expert advice
- Benchmark with your peers
- Assist with specific issues within the area
- Provide training on internal controls
- Provide a confidential sounding board for your ideas or concerns
- Help identify risks in your areas.
Fraud Reporting Methods

look at the Bruce [redacted] grants that Marlea [redacted] oversees

Nepotism?

daughter is Sarah [redacted]

husband is Patrick [redacted]

Look closely at expenses & travel submitted
8. No matter how well designed and executed, internal controls can fail because:

a. Employees can make mistakes or exercise poor judgment
b. There can be collusion – where two or more individuals work together to steal
c. Management may override established policies or procedures
d. All of the above
Financial fraud is defined as a deliberate act or deliberate failure to act with the intent to obtain unauthorized financial benefit from the University for oneself, one's family, or one's associates. Financial fraud includes, but is not limited to, misappropriation of university funds or property, authorizing or receiving compensation or reimbursement for goods not received or services not performed, falsification of work/employment records, or unauthorized alteration of financial records.
U of I Fraud Policy - Examples

- Embezzlement or other financial irregularity
- Misappropriation, misapplication, removal, or concealment of University property
- Falsification of work/employment records
- Misuse of University facilities
- Violation of University purchasing procedures
All University employees have a stewardship responsibility for University funds and other assets, consistent with the Board of Regents, State of Iowa, Code of Business and Fiduciary Conduct (http://www.regents.iowa.gov/Policies/Chapter%207/chapter7.02.htm).
University employees are responsible for safeguarding University resources under their control and for ensuring that those resources are used only for authorized purposes and in accordance with University rules, policies, and applicable federal and state laws.
Each manager should be familiar with the types of improprieties which might occur in her/his area of responsibility and assure that all reasonable internal controls are in place and effective to prevent and detect occurrence of fraud.
Any member of the University community or the public may use the University's confidential reporting line, Ethics Point, to report any suspected financial fraud: Phone: 1-866-294-9350 or anonymously via the web at: http://www.uiowa.edu/president/ethics-conduct/ethics-point.htm
If a supervisor or senior manager, or a financial or human resource representative has received a report or has reason to believe that financial fraud may have occurred, they are expected promptly to contact one or more of the University resources listed below:
U of I Fraud Policy – Reporting

- University Controller
- Human Resources
- General Counsel
- Office of Internal Audit
- Joint Office for Compliance
- Department of Public Safety
Fraud cases are usually complex requiring special expertise to investigate the underlying issues. Therefore it is important to notify one of these University offices immediately to minimize loss to the University. These offices will consult with one another to determine if further investigation is needed. **Departmental personnel should not attempt to independently investigate instances of suspected fraud.**
The University relies upon the Chief Audit Executive reporting directly to the Board of Regents to report suspected financial fraud to the State Auditor's Office in accordance with state law (Chapter 11.6(7) of the Code of Iowa).
Thank you for your time today. Questions?

- University Internal Audit
  - W512 Seashore Hall
  - E613 General Hospital

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