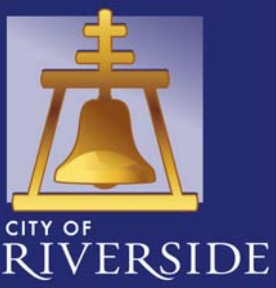




Understanding Internal Control

January 23, 2008

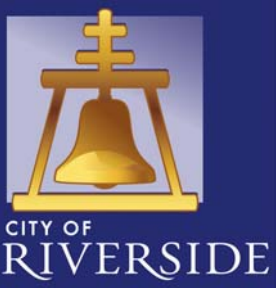
CITY OF
RIVERSIDE



Training Objectives

What You Should Know After This Class:

- 5 types of risk
- Who commits fraud and why
- Internal controls – who needs them
- 5 internal control components
- Activities for the controlling mind
- What *you* can do!



What Is Risk?

Anything that could negatively impact the City's ability to meet it's operational objectives.

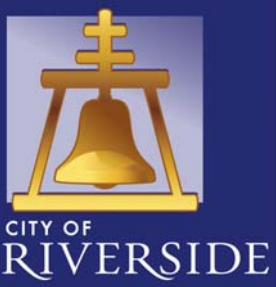




5 Types of Risk



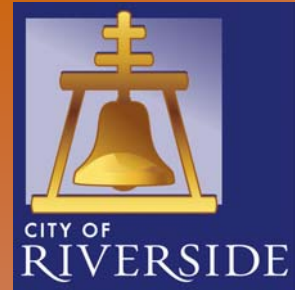
- **Strategic** – risk that would prevent a department from accomplishing it's objectives (meeting it's goals).
- **Financial** – risk that could result in a negative financial impact to the City (waste or loss of assets).
- **Regulatory (Compliance)** – risk that could expose the City to fines and penalties from a regulatory agency due to non-compliance with laws and regulations.
- **Reputational** – risk that could expose the City to negative publicity.
- **Operational** – risk that could prevent the department from operating in the most effective and efficient manner or be disruptive to other City operations.



How To Identify Risk

For each department/division objective, ask:

- What could go wrong? How could we fail?
- What must go right to succeed?
- What decisions require the most judgment?
- What activities are most complex?
- What activities are regulateded?
- On what do we spend the most money?
- How do you bill/collect related revenue?
- On what information do we most rely?
- What assets do we need to protect?
- How could someone or something disrupt our operations?

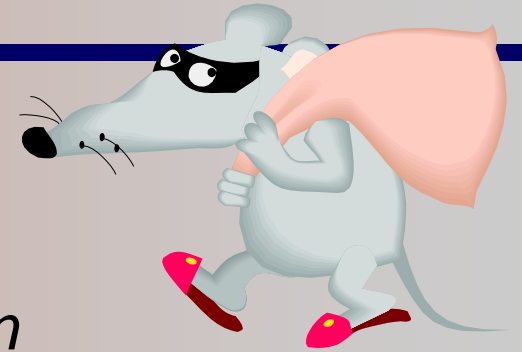


Conditions That Increase Risk

- Lack of segregation of duties
- Too much trust
 - Approval of documents without review
 - Lack of verification of transactions after they have been entered in the system
 - Lack of reconciliations
- No follow-up when things appear “questionable” or “not reasonable”
- Lack of control over cash/petty cash
- Lack of control over purchasing of materials/supplies
- Lack of knowledge of policies and procedures



What Is Fraud?

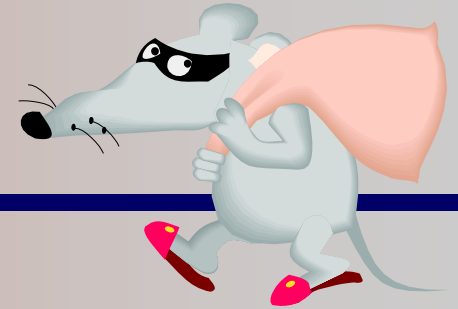


Legal Definition of Fraud

“All multifarious means which human ingenuity can devise, and which are resorted to by one individual to get an advantage over another by false suggestions or suppression of the truth. It includes all surprises, tricks, cunning or dissembling, and any unfair way which another is cheated.”



What Is Fraud?

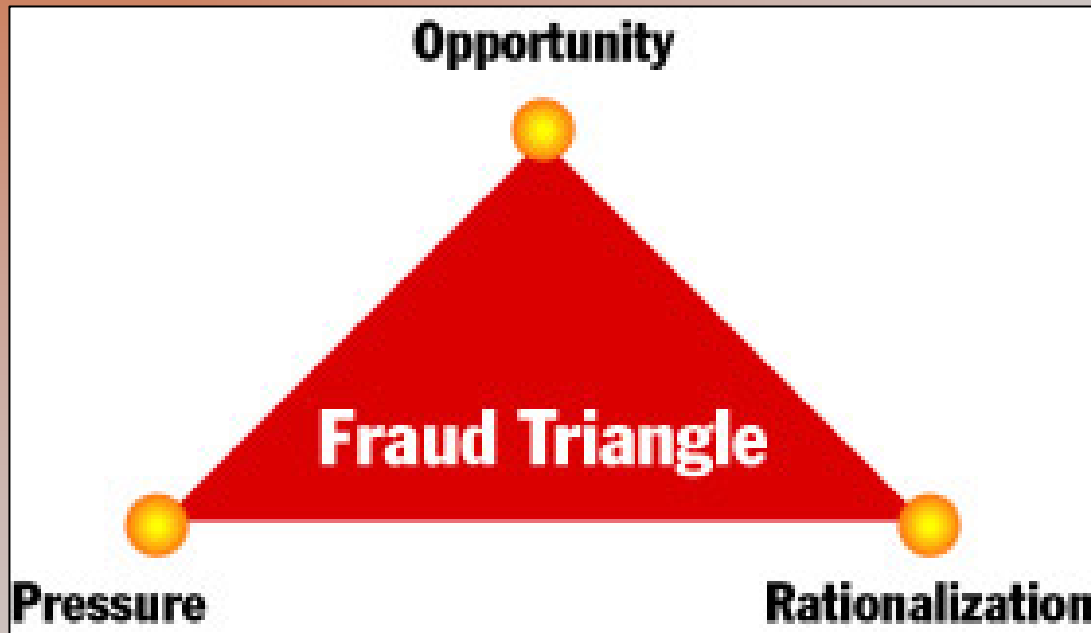


Fraud is a common risk that should not be ignored. The incidence of fraud is now so common that its occurrence is no longer remarkable, only its scale.

Any entity that fails to protect itself appropriately from fraud should expect to become a victim of fraud, or rather, should expect to discover that it is a victim of fraud.

There is no such thing as an accidental fraud. What separates error from fraud is *intent*; the accidental from the intentional.

Causes of Fraud

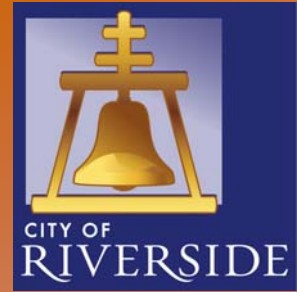


Poor internal control creates *opportunity* for fraud.



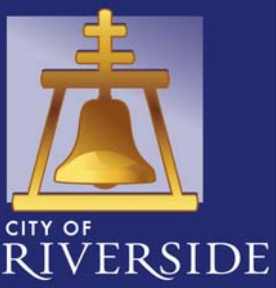
Myths About Fraud

- Most people will not commit fraud.
- Fraud is not usually material.
- Fraud goes undetected.
- Fraud is usually well concealed.



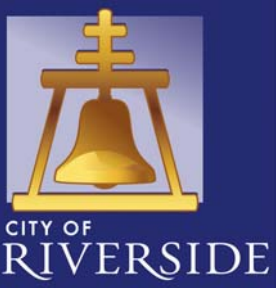
Examples of Fraudulent Behavior

- Payment to fictitious vendor
- Diversion of cash receipts
- Extra compensation to perpetrator
- Personal benefit from travel expenses
- Restricted funds manipulation



How Does Fraud Occur?

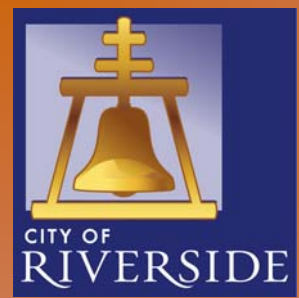
- Poor internal controls
 - Lack of proper authorization
 - No separation of authorization, custody, record keeping
 - No independent checks on performance
 - Lack of clear lines of authority
 - Inadequate documentation
- Management override of internal controls
- Collusion between employees and 3rd parties
- Collusion between employees and management
- Poor or non-existent ethics policy
- Limited, unclear or no policies and procedures to direct department/division processes



What To Do If You Suspect Fraud In Your Department/Division

- Notify Internal Audit
- Call the Fraud HOTLINE (951-826-2232)
- Report online at
www.riversideca.gov/manager/fraud-info.asp
- Refer to City Admin Manual, Policy 01.011.00 –
Fraud Prevention, Reporting and Investigation
<http://intranet2/citymanager/01.011.00.pdf>

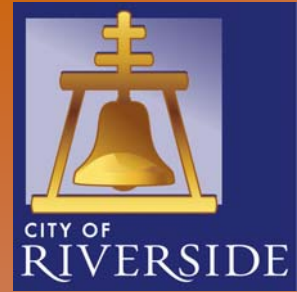




How To Mitigate Risk & Fraud

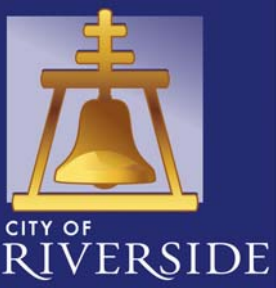
Implement Internal Control Framework





What Are Internal Controls?

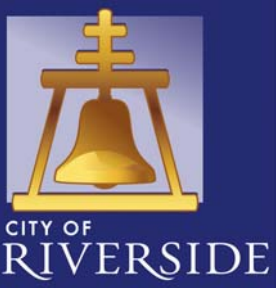
- Keeping an eye on City assets and resources.
- Finding ways to make sure people don't do bad things.
- Protecting us (the City) from being accused of doing bad things.
- Good, sound business practice.
- Common sense!



Official Definition of Internal Control

Internal control is a *process*, effected by the City Council, management, administration and individuals; designed to provide *reasonable assurance* regarding the achievement of *objectives* in the following areas:

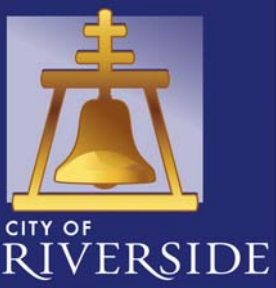
- Effectiveness and efficiency of operations
- Reliability of financial reporting
- Compliance with applicable laws and regulations
- Safeguarding assets



Examples of Internal Control

Think about what *you* do.....

- Lock your home and vehicle.
- Keep your ATM/debit card pin number separate from your card.
- Review bills and credit card statements before paying them.
- Reconcile your bank statement.
- Don't leave blank checks or cash just lying around.
- Expect your children to ask permission before they can do certain things.
- Other examples.....??



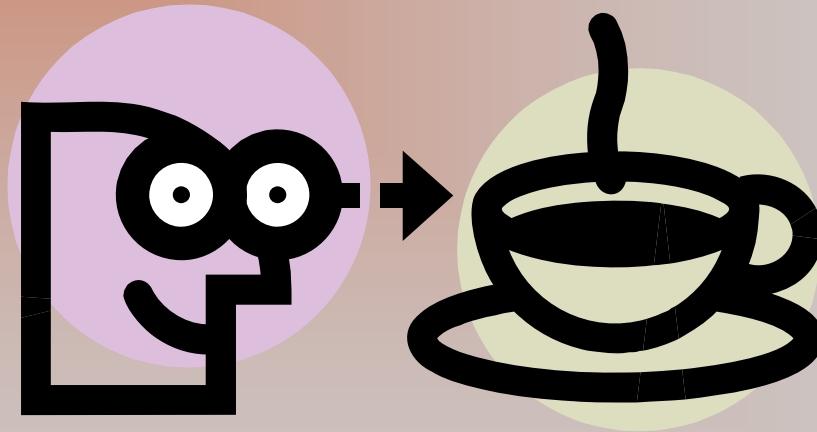
Department Internal Controls

- City vehicles are kept locked when not occupied.
- Computer passwords are periodically changed and shouldn't be written down or kept by the PC.
- Checking purchase card charges against source documents.
- Checking management reports against source documents.
- Locked cash drawers and secure storage for checks.
- Authorizations required for certain activities.
- Other examples.....??



Let's Take A Break!

10 minute break





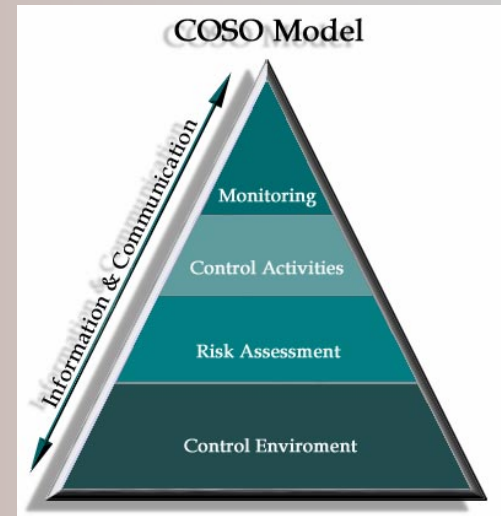
Components of Internal Control

■ Control Environment

The foundation on which everything rests.

Key factors:

- Management’s attitude: “Tone at the Top”
- Individual attributes: integrity, ethical values, competence



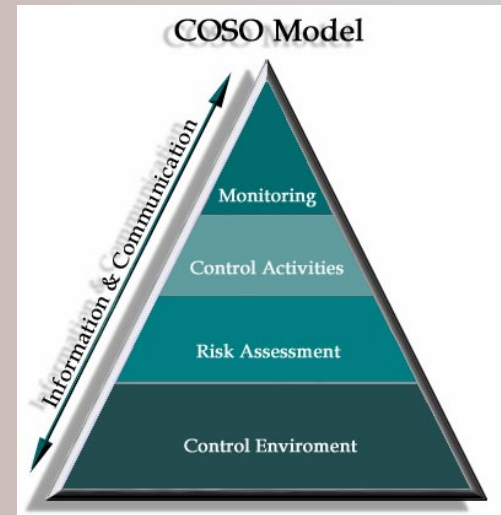


Components of Internal Control

- **Risk Assessment**

Management must be aware of, anticipate and deal with risks.

Management must establish methods and mechanisms to identify, analyze and manage risks that are likely to have an impact on service delivery and the achievement of desired outcomes.





Components of Internal Control

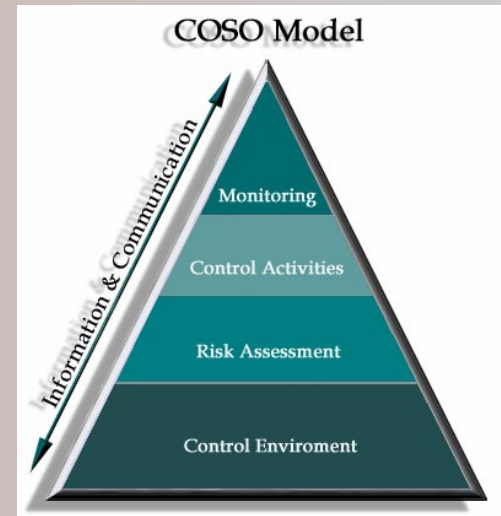
■ Risk Assessment

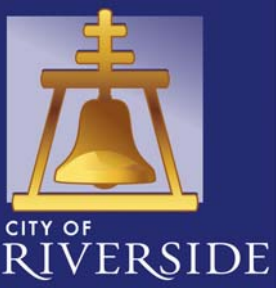
Change is an indicator of risk

- new personnel
- new information system and/or technology
- rapid growth
- new programs/services

Inherent risk

- complexity
- cash receipts

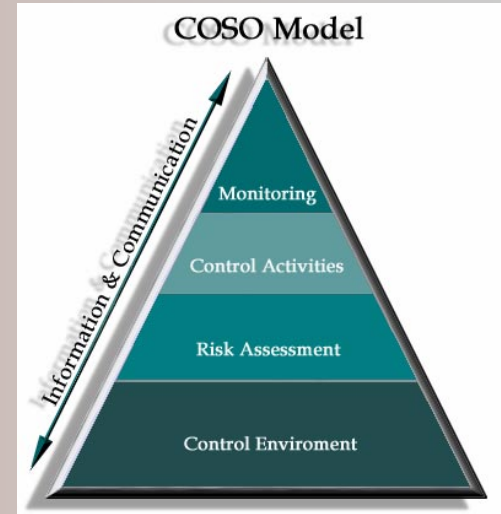




Components of Internal Control

- **Control Activities**

Control activities are the actions supported by policies and procedures that help assure management directives to address risks are carried out properly and timely.

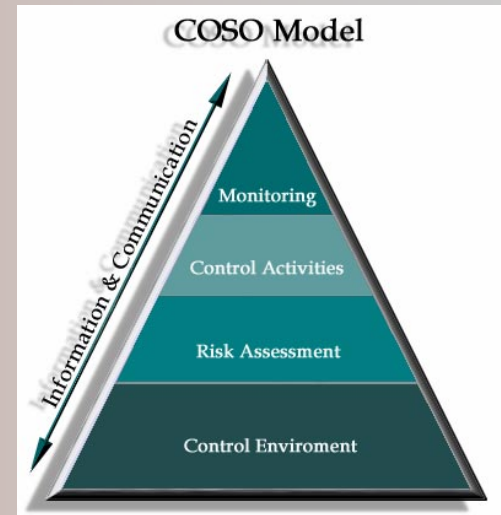


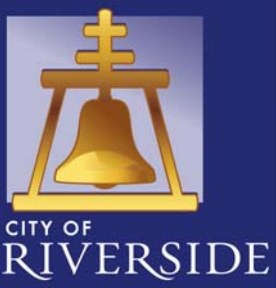


Components of Internal Control

■ Control Activities – Examples

- ✓ Authorization and approval procedures;
- ✓ Reviews of operating performances;
- ✓ Supervision (assigning, reviewing/approving, guidance, training);
- ✓ Segregation of duties (authorizing, processing, recording, reviewing);
- ✓ Controls over access to resources and records;
- ✓ Reconciliations;
- ✓ Verifications;
- ✓ Reviews of processes and activities.



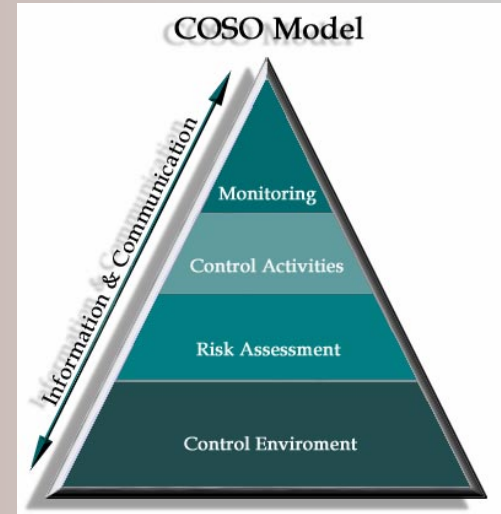


Components of Internal Control

■ Control Activities

To be effective, control activities must be:

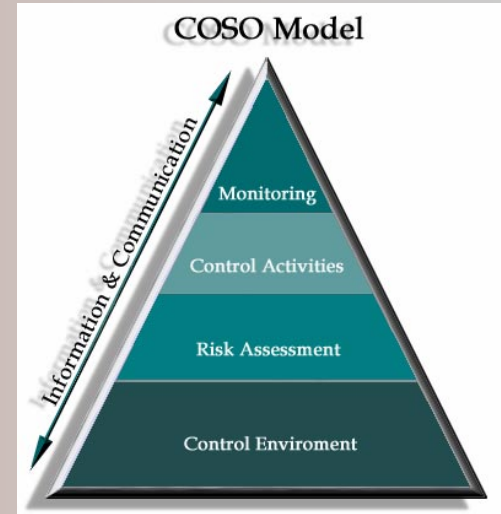
- ✓ Appropriate;
- ✓ Functioning consistently according to plan throughout the period;
- ✓ Cost effective, comprehensive, reasonable; and
- ✓ Directly related to the control objective.





Components of Internal Control

- Types of Control Activities
 - *Directive*
 - *Preventive*
 - *Detective*
 - *Corrective*
 - *Recovery*



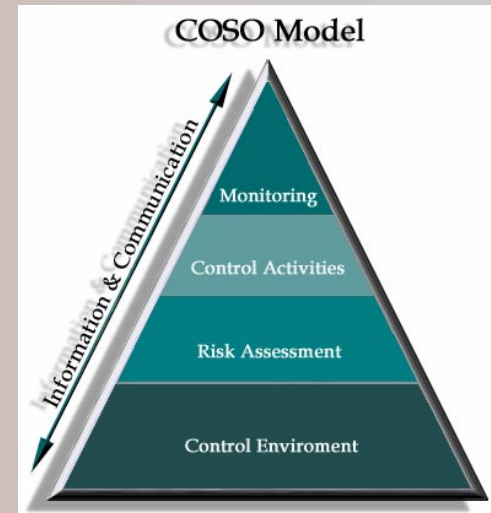


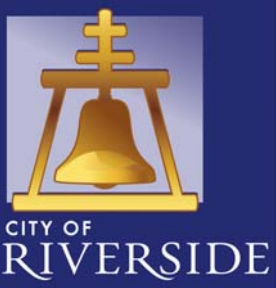
Components of Internal Control

■ Control Activities

Examples of Preventive Controls:

- ✓ Reading and understanding applicable Admin policies, department policy/procedures to learn the right way to do something;
- ✓ Review and approval process for purchase requisitions to make sure they are appropriate before the purchase;
- ✓ The use of passwords to stop unauthorized access to systems/applications;
- ✓ Other examples??



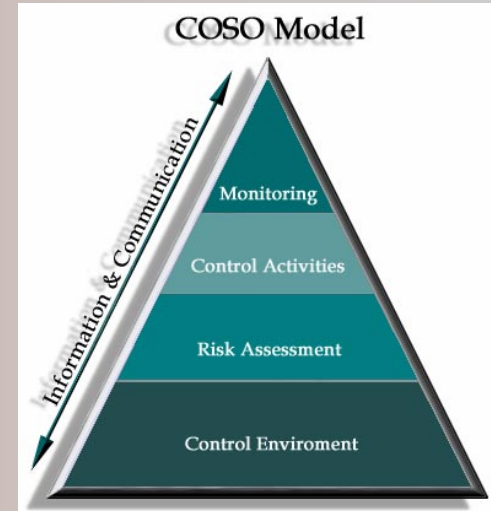


Components of Internal Control

■ Control Activities

Examples of Detective Controls:

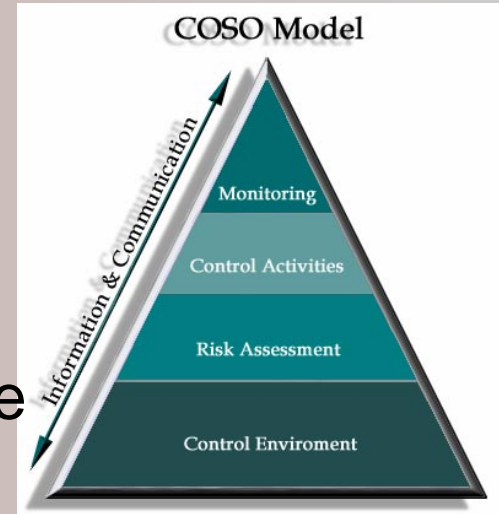
- ✓ Cash counts; bank reconciliation;
- ✓ Review payroll reports (review *your* payroll statement);
- ✓ Compare transactions on reports to source documents;
- ✓ Monitor actual expenditures against budget;
- ✓ Other examples??

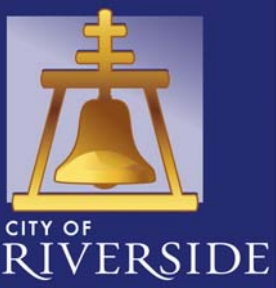




Components of Internal Control

- **Information Technology Control Activities**
 - *General Controls* are the structure, policies and procedures that apply to the information systems and help to ensure proper operation.
 - *Application Controls* are the structure, policies and procedures that apply to separate, individual computerized applications.

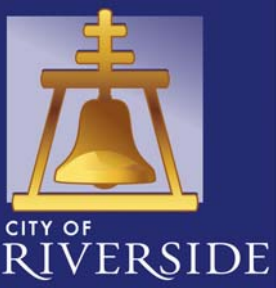




Components of Internal Control

- **Information Technology Control Activities**
- ✓ **General Controls**
 - Access security
 - Data and program security
 - Physical security
 - Software development and program change controls
 - Data center operations
 - Service continuity (disaster recovery)





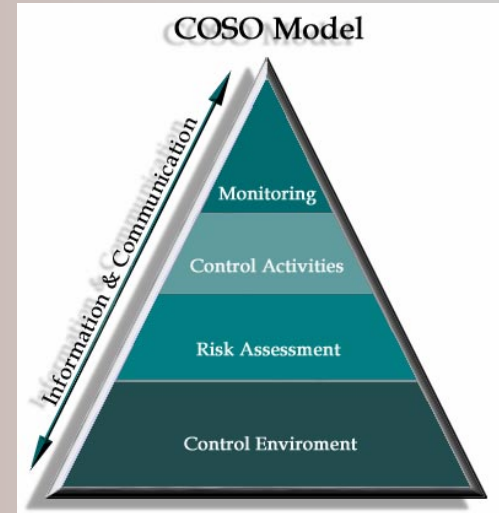
Components of Internal Control

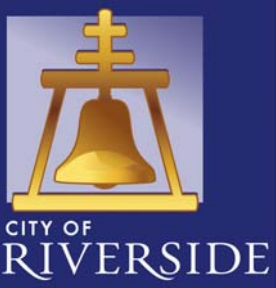
■ Information Technology Control Activities

✓ Application Controls

- Designed to prevent, detect and correct errors and irregularities as information flows through information systems:

- Input controls (data entry) – authorization; validation; error notification and correction
- Processing controls
- Output controls



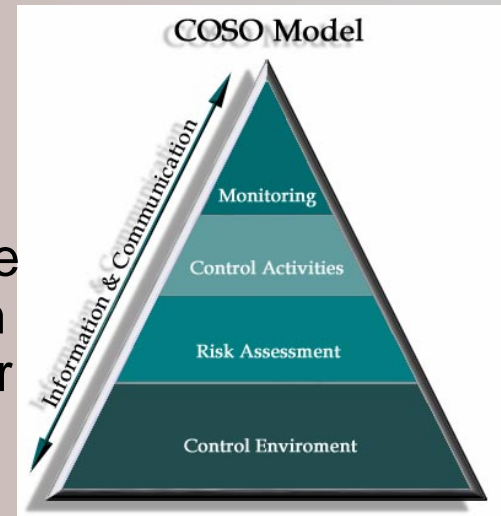


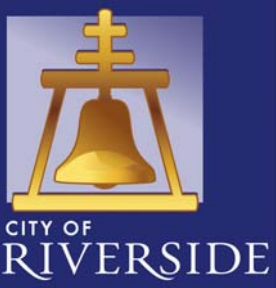
Components of Internal Control

■ Monitoring

Monitoring ensures that the internal controls operate as intended over time, and is accomplished through routine (on-going) activities, separate evaluations or a combination of both.

- ✓ *Ongoing monitoring* activities cover each of the internal control components, and involve action against irregular, unethical, uneconomical, inefficient and ineffective internal controls.
- ✓ *Separate evaluations* are conducted by internal and/or external auditors; findings/recommendations are reported to the appropriate level of management for resolution.





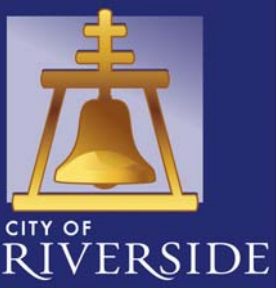
Components of Internal Control

■ Information & Communication

Pertinent and reliable information should be identified, captured and communicated in form and timeframe that enables staff to carry out their responsibilities.

- ✓ Management's ability to make appropriate decisions is affected by the quality of information; that implies that the information should be appropriate, timely, current, accurate and accessible.
- ✓ Information systems need to produce reports that contain operational, financial and non-financial, and compliance-related information.



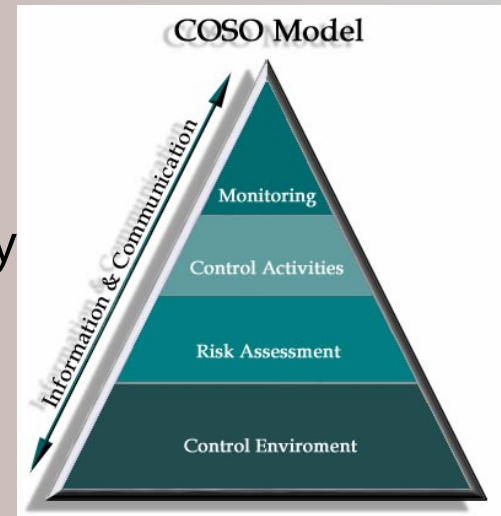


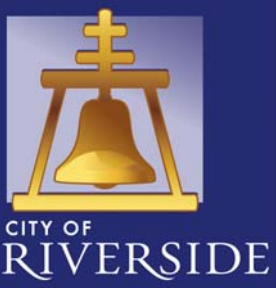
Components of Internal Control

■ Information

Transactions and events must be recorded promptly when they occur if information is to remain relevant and valuable to management in controlling operations and making decisions.

- ✓ Documentation should be updated promptly, including policies and procedures.
- ✓ Information is the basis for communication.



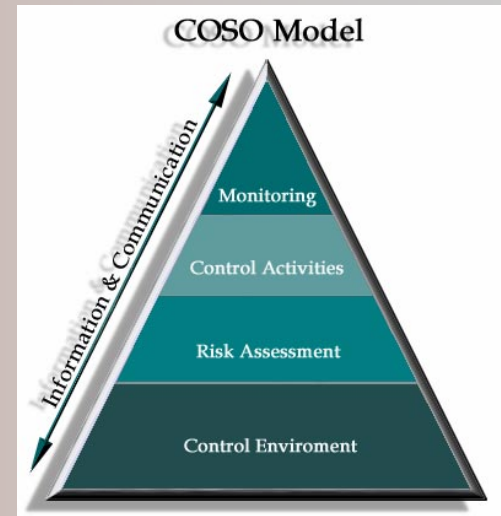


Components of Internal Control

■ Communication

Effective communication should occur in all directions – flowing down, across and up the organization, throughout all departments and divisions.

- ✓ Management should be kept up-to-date on performance, development, risks and other relevant events and issues.
- ✓ Management should communicate to its staff what information it needs to be effective; and provide feedback and direction.





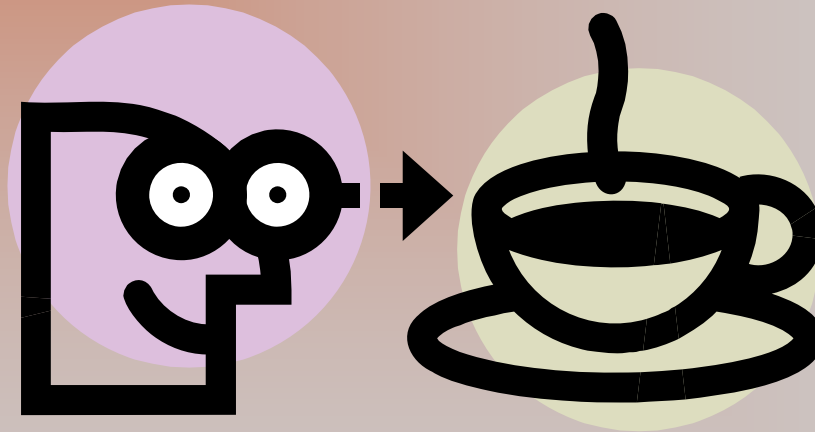
Your Internal Control Pyramid

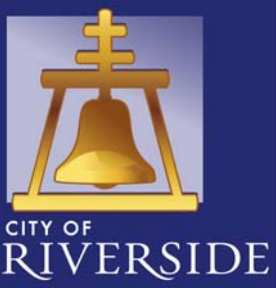




Let's Take A Break!

10 minute break

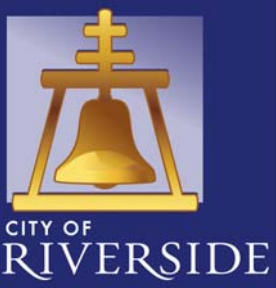




Let's Take a Quick Quiz

Which of the following best describes segregation of duties?

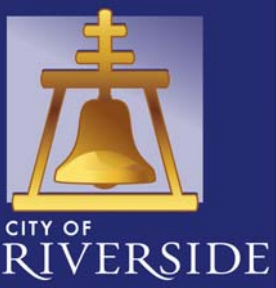
1. Split the work so that no one has to work more than anyone else.
2. When you make sure you have one person reconciling all transactions.
3. Procedures designed to ensure one individual cannot complete an entire transaction.
4. Something you can only achieve when you have at least five accounting personnel.



Let's Take a Quick Quiz

Until deposited, cash receipt should be stored:

1. In a sealed Ziploc bag.
2. In a zippered bank bag in the Department Head's desk drawer.
3. In a secured, locked location at the business unit/division.
4. By the Department Director in his/her home for safekeeping.



Let's Take a Quick Quiz

Checks should be restrictively endorsed just prior to deposit.

1. True.
2. False.



Internal Control Myths and Facts

Myths

Internal control starts with a strong set of policies/procedures.

Internal control: That's why we have internal auditors!

Internal control is a 'finance thing.'

Internal controls are essentially negative, like a list of "thou-shalt-nots."

Facts

Internal control starts with a strong control environment.

While internal auditors play a key role in the system of control, management is the primary owner.

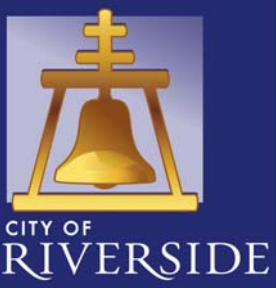
Internal control is integral to every aspect of operations.

Internal control makes the right things happen the first time!



Who Relies On the City Having a System Of Internal Controls?

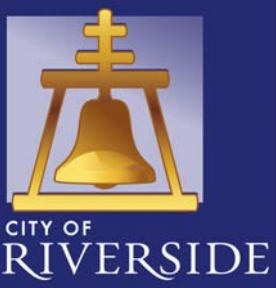
- **Residents, City Council** – Is their money being converted into the best value and used in accordance with their intentions?
- **Financial Institutions, Rating Agencies** – Is the City able to meet it's debt payments?
- **Government** – Is the City providing a value to the community, and in compliance with laws and regulations?
- **Management and Staff** – Do we work in a well controlled environment?



Who Is Responsible for Internal Controls Oversight?

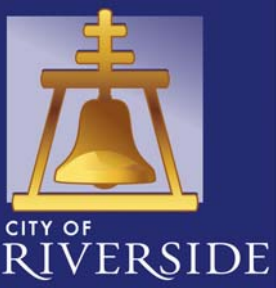
- *Managers* are directly responsible for overseeing, designing, implementing, maintaining and documenting controls;
- *Staff members* play a role in effecting control; reporting problems, etc.; and
- *Internal auditors* examine and contribute to the ongoing effectiveness of internal controls through evaluations and recommendations.





Why Controls Don't Always Work

- Inadequate knowledge of policies or governing regulations. *“I didn’t know that!”*
- Inadequate segregation of duties. *“We trust ‘A’ who does all of those things.”*
- Inappropriate access to assets. *Passwords shared, cash not secured...*
- Form over substance. *“You mean I’m supposed to do something besides initial/sign it?”*
- Control override. *“I know that’s the policy, but we do it this way.” “Just get it done; I don’t care how!”*
- Inherent limitations. *People are people and mistakes happen. You cannot foresee or eliminate all risk.*



Examples – Recent Headlines

October 4, 2007 The Californian
“Former manager sues city - for \$350”

October 16, 2007 The Californian
“Police suspect embezzlement at local company”

November 3, 2007 The Californian
“Murrieta audit notes deficiencies”

December 6, 2007 Press-Enterprise
“Redlands treasurer pleads not guilty; his attorney reports 'bombshell': two sets of books”

August 2006 GovPro.com
“P-Card Transactions Raise Control Concerns”

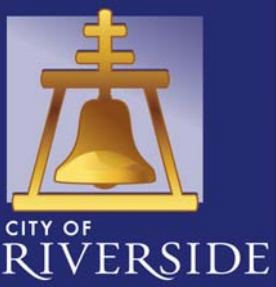




Activities for the Controlling Mind

Case Study – Missing Camera

Joe, the hard working staff assistant, is asked to process a requisition to purchase a new \$5,000 camera to be used by a project manager who is working on a federal grant project. Later, when Joe conducts the annual physical inventory for the department, as requested by the Accounting Department, he is not able to locate the camera in the department. Joe learns the project manager was given permission by the department manager to take the camera home so that he could take photos at his sister's wedding (that was 2 months ago). When Joe talks to the department director about it, he is told not to worry – since the camera wasn't purchased with City funds (i.e., the grant paid for it), it would be okay to check it off on the inventory report even though it had been removed from the premises.



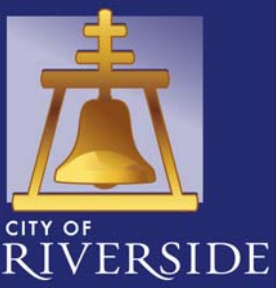
Activities for the Controlling Mind

Case Study – The New TV

Jill, a senior staff assistant, is the department's procurement card holder. Her department manager, Anna, travels extensively so Jill occasionally uses a signature stamp to approve her procurement card statements. Jill went shopping for a new TV one weekend. While checking out, Jill mistakenly used her City's procurement card. On Monday she received an email from Payme.net confirming the purchase; at that time she realized her mistake.

Jill decided to wait until Anna returned from out of town to ask her advice. Jill was certain Anna would understand and help her straighten things out. The statement arrived a week later and Jill had Jack, the office assistant, approve the statement since Anna wasn't due back for another two weeks.

Upon Anna's return, Jill had not saved enough money to repay the City for the TV. Since Anna had not seen the statement and it had already been processed by Accounting, Jill decided not to bring it up. She had been an exceptional employee for years and had seen many of her coworkers receive bonuses. She decided it was her turn. This would be her bonus. She had earned it!



What You Can Do!

- When thinking about internal controls, consider the following:
 - **Propriety of transactions...**is this legal and right? Does it feel or look wrong? Would someone else think so?
 - **Reliability and integrity of information...**is the information/form/data/report accurate and complete?
 - **Compliance with policies and government regulations...**are you following established procedures/instructions?
 - **Safeguarding assets...**could anyone take or gain access to items under your control without being observed?
 - **Economy and efficiency of operations...**is there a better way to do the job?



What You Can Do!

- Make sure you have up-to-date policies and procedures;**
- Ensure authorization limits are communicated within your department;**
- Ensure all assets (especially cash) are safeguarded at all times;**
- Establish document control (especially for spreadsheets);**
- Ensure approval signatures are visible (legible) on all required documentation;**
- Make sure data is only accessible by authorized personnel;**
- Understand your department/function's risks;**
- Ensure adherence to City policy and City code;**
- Establish objectives and measures for your department/function and for major programs; and**
- Track performance to evaluate your success!**



Questions?

