



# What Happens When Internal Controls Fail



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# Your Presenters



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- > What are Internal Controls?
- > What Happens When Internal Controls Fail?
  - > Case Study #1
  - > Case Study #2
  - > Case Study #3
- > How to Monitor and Assess Internal Controls
- > How to Improve Internal Controls
- > Conclusion
- > Questions



# What are Internal Controls?

# What are Internal Controls?

## Definition of Internal Control

- > Internal control is a process, effected by an entity's *governing bodies, management and other personnel*, designed to provide **reasonable** assurance regarding the achievement of **objectives** in effectiveness and efficiency of operations, reliability of financial reporting and compliance with laws and regulations

# What are Internal Controls?

## Fraud Prevention and Detection

> Develop and implement an entity-wide approach which includes:

- Development of financial internal controls
- Development of non-financial internal controls
- Development of oversight controls



# What are Internal Controls?

## Two Types of Internal Controls

- > Preventive – designed to stop a fraud before it happens
- > Detective – designed to catch a fraud that has occurred

# What are Internal Controls?

## Examples of Preventive Controls

- > Restricting access to systems via passwords
- > Authority limits for check signing

# What are Internal Controls?

## Examples of Detective Controls

- > Bank reconciliation process
- > Variance analysis

# What are Internal Controls?

## Areas of Focus – Cash Collection

- > Handling of cash
- > On-line payments

# What are Internal Controls?

## Revenue & Cash Receipts Controls

- > Segregation of duties
- > Immediate restrictive endorsement
- > Timely bank deposits
- > Store collections in a safe until deposited
- > Use/reconcile cash receipts log
- > Dual control over receipts
- > Use of a bank lockbox service

# What are Internal Controls?

## Revenue & Cash Receipts Controls (cont.)

- > Segregate the cash collection and accounts receivable posting functions
- > Monitor the aging of accounts receivable
- > Reconcile cash receipts with accounts receivable postings
- > Monitor accounts receivable write-offs
- > Monitor the issuance of credit memos

# What are Internal Controls?

## Areas of Focus – Cash Disbursements

- > Budgets
- > Segregation
- > Check Processing/Signing
- > Wire Transfers
- > Vendors
- > Expense Reimbursement



# What are Internal Controls?

## Areas of Focus – Bank Reconciliation Process

- > Statements –who opens/reviews
- > Extent of review
- > Cancelled checks



# What are Internal Controls?

## Purchasing & Cash Disbursement Controls

- > Segregation of duties
- > Use checks in sequential order
- > Do not sign checks in advance
- > Control the use of signature stamps
- > Limit access to unused checks
- > Require two signatures on all checks over an established limit
- > Keep the authorized signers list up to date
- > Control signed checks not yet mailed
- > Properly void incorrect checks
- > Perform bank reconciliations in a timely manner

# What are Internal Controls?

## Purchasing & Cash Disbursement Controls (cont.)

- > Segregate the ordering, receiving and approval
- > Control physical access to inventories/supplies
- > Control the issuance of company credit cards
- > Establish credit limits on company credit cards
- > Promptly review credit card statements
- > Require the prompt submission of support for credit card purchases
- > Control physical access to company credit cards when not in use
- > Perform credit checks on individuals who will be issued company credit cards

# What are Internal Controls?

## Purchasing & Cash Disbursement Controls (cont.)

- > Maintain an approved vendor list
- > Segregate the responsibilities for invoice approval and the mailing of signed checks
- > Only make payments against original vendor invoices
- > Match invoices against receiving reports
- > Immediately cancel invoices once payment has been made
- > Periodically review vendor payment histories
- > Inspect canceled checks for unusual endorsements
- > Periodically confirm the amounts paid to certain vendors
- > Verify the existence of new vendors
- > Periodically purge the approved vendor list for vendors not used
- > Compare payees on cancelled checks with payees per the accounting records

# What are Internal Controls?

## Areas of Focus - Payroll

- > Remote sites
- > Time reporting
- > Pay stub distribution

# What are Internal Controls?

## Payroll Controls

- > Segregation of duties
- > Use checks in sequential order
- > Limit access to unused checks
- > Secure unclaimed payroll checks
- > Require written authorization of all pay rates
- > Review postings from the payroll register to the general ledger
- > Segregate the responsibilities for adding or deleting employees with the responsibilities for generating and distributing checks

# What are Internal Controls?

## Payroll Controls (cont.)

- > Require identification for picking up paychecks or pay stub
- > Compare employee rosters with payroll reports
- > Perform periodic payroll payouts or pay stub distribution (by someone independent of the payroll function)
- > Compare record of terminated employees with the payroll register
- > Review endorsements on canceled checks
- > Reconcile expenses per the payroll register with payroll expense per the general ledger

# What are Internal Controls?

## Payroll Controls (cont.)

- > Have supervisors review and sign off time sheets
- > Control access to approved time sheets
- > Restrict access to master payroll files
- > Segregate the responsibility for establishing pay rates from the responsibility for updating the master payroll files
- > Segregate the responsibility for updating the master payroll files from the responsibility for processing the payroll
- > Review and approval of the payroll register before distribution of checks

# What are Internal Controls?

## Controls over Non-Cash Assets

- > Establish appropriate capitalization thresholds
- > Use numbered identification tags
- > Count property and equipment inventories on a periodic basis
- > Consider using a perpetual inventory system for inventories
- > Maintain appropriate levels of insurance over theft
- > Protect against the theft of property and equipment:
  - Segregate the responsibility for custody of assets from the responsibility for record keeping
  - Establish budgets for the purchase of property and equipment
  - Provide adequate physical security over the organization's assets

# What are Internal Controls?

## Areas of Focus – Cost Allocation

- > Supervisor review
- > Budget comparison
- > Analytics



# What Happens When Internal Controls Fail?

## Case Study #1 – City Board of Education

### Overview and Background

- > Starting May 2013 Board of Education (BOE) outsources their IT Department to an Outside Consultant (OC)
  - President of OC also given the title of BOE IT Director
- > The BOE technology secretary realized that the total of the quarterly invoices from OC would amount to more than budgeted
- > BOE believed the overpayment amounted to \$115,600
  - President of OC believed \$115,600 was related to a WiFi project
- > Baker Tilly was retained by City to perform forensic audit of the BOE budget line items related to IT services provided by OC
  - City was concerned about conflicts of interest and alleged overpayment

## Case Study #1 – City Board of Education

### Work Performed / Challenges Faces

- > Examined procurement documents for IT services provided to the BOE
  - Bids, Requests for Proposals and Quotes
  - Agreements, plans and/or contracts
  - Invoices, purchase orders, and payments
- > Conducted interviews with former and current employees of the BOE and president of OC
- > Reviewed:
  - State and city regulations
  - BOE purchasing and contract policies
  - Internal control best practices

## Case Study #1 – City Board of Education

### Findings and Conclusion

- > In 113 of 236 of the invoices reviewed, the purchase order date was after the invoice date
  - No bids or sales quotes obtained prior to purchase for expenses over \$10,000.
- > There was a lack of segregation of duties
  - The OC was both the BOE's IT Department and a vendor.
  - IT Director would be driven to provide the most efficient technology environment, whereas a business owner would be driven toward increasing sales of services
- > BOE policies were unclear
  - It wasn't clear whether the City code applied to the BOE

## Case Study #1 – City Board of Education

### Recommendations

- The BOE should hire an IT director
- Review policies to prevent, detect and correct conflicts of interest, mitigate risks, and address emergency expenditure
- Put in place a policy of identifying and tracking inventory of all IT equipment



# What Happens When Internal Controls Fail?

## Case Study #1 – City Board of Education

Questions?

## Case Study #2 – County Office of Community Development

### Overview and Background

- > Forensic audit to determine whether any inappropriate or fraudulent activities were occurring within community development programs managed by County
- > The community development program oversees the administration of the County's housing programs for low and moderate income people
- > The forensic investigation focused on a review of funding transactions for several housing programs to determine:
  - If there was proper supporting documentation
  - If funding was appropriately disbursed
  - If there was any inappropriate employee activity related to transactions

## Case Study #2 – County Office of Community Development

### Work Performed / Challenges Faces

- > Reviewed program administration, record keeping, and documentation controls
  - Electronic voucher data print outs
  - Checks
  - Applications
  - Tax forms
- > Selected transactions from each program for testing, giving special attention to the following types of transactions:
  - Payee was employee
  - Transactions that were voided and reentered
  - Transactions that concerned program director
- > Discussions with County personnel

## Case Study #2 – County Office of Community Development

### Findings and Conclusion

- > Identified several instances of transactions without any supporting documentation, including:
  - Two cases where an employee of the County received funds for a loan
  - A \$100,000 grant
  - A \$400,000 grant for a housing project

## Case Study #2 – County Office of Community Development

### Recommendations

- Utilization of checklist to ensure loan files are complete
- Implement policy that discrepancies between applications and supporting documents will be investigated
- Establish and maintain loan files and records that can be easily audited
  - Many loan files were not labeled, or labeled improperly
- Utilization of individuals with accounting and legal backgrounds
  - To review documents and ensure compliance with laws and regulations



# What Happens When Internal Controls Fail?

## Case Study #2 – County Office of Community Development

Questions?

## Case Study #3 – City (Loans)

### Overview and Background

- > Engaged by City to conduct a forensic review of housing rehabilitation (rehab) mortgages.
- > BT reviewed a schedule provided by the City of the status of housing rehab mortgages as of June 15, 2016. We noted a total of 205 mortgage liens held by the City with a carrying value of \$1,943,035.
- > We selected 81 mortgages for testing. Of these 81, only 57 files were found in the City's records.
- > We reviewed these files to test for compliance with the respective housing rehab program policies, verify documentation which support the rehab applications, and to note any suspicious findings.

## Case Study #3 – City (Loans)

### Findings and Conclusion

- > Our examination revealed that of the 57 files examined, each file was missing at least one required supporting piece of documentation
- > These 57 properties received funding for 152 construction projects valued at \$1,204,166
- > Only 11 construction projects were fully documented on City construction permits, whereas 12 projects were not fully documented, and 129 projects were undocumented
- > One instance where a housing rehab application was completed twice

## Case Study #3 – City (Loans)

### Recommendations

- > Review remaining properties for lack of supporting documentation, questionable signatures, lack of permits, and to determine if owners have vacated and converted the property to a rental.
- > Examination of projects with no construction permit filed.
- > Comparison of all properties to tax assessor's database to determine if owners are receiving correspondence at other addresses and have vacated the property.
- > Further investigation of the signatures on the housing applications.

## Case Study #3 – City (Foreclosure Fees)

### Overview and Background

- > Concerns over the foreclosure fee process included incorrect application of payments and failure to send out registration renewal notices resulting in a lost fees owed to the City.
- > BT was provided a listing of foreclosures (active and inactive) as of April 13, 2016 and from here we identified 1,079 properties for testing. We selected a sample size of 216 properties. Our approach combined random selections while also focusing on duplicate property IDs (block and lot) and duplicate street addresses.

## Case Study #3 – City (Foreclosure Fees)

### Findings and Conclusion

- > We found that the City over-collected \$3,000 and under-collected \$56,000 in foreclosures fees on a mixture of active and inactive properties.
- > Of the 225 properties tested, 175 were active foreclosures, 49 were inactive foreclosures, and 1 was incorrectly designated as a foreclosure by City records.
- > BT encountered a difference in fees due versus fees collected for 128 properties – an error rate of 57 percent.

## Case Study #3 – City (Foreclosure Fees)

### Recommendations

- > Review of the entire population of active foreclosures.
- > Issuing refunds where the City has over-collected fees.
- > Pursue the collection of under-collected fees for active foreclosures.
- > For inactive foreclosures, consult with legal counsel to see if there is any legal recourse to collect under-collected fees.

## Case Study #3 – City (Liens)

### Overview and Background

- > The purpose of the lien forensic audit was to identify properties that had special assessment liens placed on them with no notice of violation provided to the property owner during the timeframe of 2012-2014.
- > Special assessment liens consist of emergency repairs, board and secures, and cut and cleans. Of these liens, all cut and cleans and non-emergency board and secures require a notice of violation be sent to the property's owner.
- > BT obtained a listing of 157 properties that went to tax sale and were assessed a lien during the years 2012-2014. We found that 172 liens were assessed against 148 of the 157 tax sales. These liens were comprised of:
  - > 66 cut and clean liens
  - > 104 board and secure liens
  - > 2 emergency repair liens
- > We then randomly selected for testing 20 tax sales which were associated with 22 liens

## Case Study #3 – City (Liens)

### Findings and Conclusion

- > Error Rate Calculation: Based on the findings, Baker Tilly calculated the following error rates:

Lien Type	Number of Liens Tested	Number of Liens Lacking Evidence of Required Notification	Error Rate
Cut and Clean	8	2	25%
Board and Secure	12	9	75%

- > The remaining two liens not listed in the error rate calculation above (to bring the total to 22) did not require notification to the property owner – one was an emergency repair and the other was a canceled lien.
- > By extrapolating over the total population of liens on properties that went to tax sale during 2012 – 2014, it is estimated that the following percentage of cut and clean liens and board and secure liens did not have the required notification sent to the property owners:

Lien Type	Total Number of Liens 2012 – 2014	Error Rate Applied	Estimated Number of Liens that did not Receive Required Notification
Cut and Clean	66	25%	16.5
Board and Secure	104	75%	78

## Case Study #3 – City (Liens)

### Recommendations

- > Review all 172 liens that were assessed against properties that went to tax sale during 2012 – 2014 to identify all instances where the property owner should have received notification of the lien and did not.
- > Assess the current lien notification process and revise as necessary to ensure compliance with the requirement that property owners receive notification if a cut and clean or board and secure (non-emergency) lien is assessed against his or her property to include, but not limited to:
  - > Document retention and file maintenance
  - > Development of and adherence to policy and procedure

## Case Study #3 – City (Liens, Foreclosure Fees and Loans)

### Recommendations

- > Our forensic audits of housing rehabilitation mortgages, foreclosure fee receipts and special assessment liens revealed weak or lack of internal controls, poor record keeping, and under collection of City revenue.
- > Although these internal control weaknesses and gaps have been, or are in the process of, being corrected, these past situations which were uncovered have had a negative impact on the revenues collected by the City.
- > Our recommendations include further inquiry into certain areas, such as the lack of construction permits for a majority of the rehab projects, the full extent to which the owners of properties receiving rehab funds have vacated the properties, recovery of missing housing rehab files and the under-collected foreclosure fee amounts.



# What Happens When Internal Controls Fail?

## Case Study #3 – City (Liens, Foreclosure Fees and Loans)

Questions?



# How to Monitor and Assess Internal Controls



# How to Monitor and Assess Internal Controls

## Things to Consider

- > Fraud Risk Assessment
- > Fraud Triangle
- > Data Analysis
- > Internal Audit Procedures

# How to Monitor and Assess Internal Controls

## Fraud Risk Assessment and the Fraud Triangle



## Fraud Risk Assessment

- > Organize and define the assessment objectives with the organizations management
- > Identify the members of the assessment team
- > Make sure senior management and the audit committee are supporting the process

# How to Monitor and Assess Internal Controls

## Fraud Risk Assessment (cont.)

- > Identify the program and accounting processes to be assessed and investigated
  - Areas of previous fraud
  - Areas that may be more prone to fraud and abuse

## Fraud Risk Assessment (cont.)

- > Identify potential fraud schemes specific to the processes to be examined and the controls that are currently in place
- > Consider:
  - The inherent risk of the process
  - The physical location of the process
  - Any known frauds or abuses

## Fraud Risk Assessment (cont.)

- > After the fraud risk for each process has been identified, documented, and ranked in relation to risk level:
  - Determine the effectiveness of each control
  - Perform tests to see if the stated controls are operating as designed
  - Group the risks in terms of their probability of occurring

## Fraud Risk Assessment (cont.)

- > Estimate the probable financial loss should the potential fraud occur
- > Also consider the loss in terms of the organization's reputation in the community
- > Present management and the audit committee with recommendations for strengthening existing controls as well as any new controls that should be established



# How to Monitor and Assess Internal Controls

## Data Analysis / Internal Audit Procedures

### > Data analysis

- particularly useful for vendor payment review

### > Internal audit procedures

- design work plan/programs for high risk areas



# How to Improve Internal Controls



# How to Improve Internal Controls

- > Tone at the top
- > Controlled access to data processing operations
- > Adequate disaster recovery / back-up in place
- > Management support for effective systems
- > Sharing issues on risks with other agencies



# How to Improve Internal Controls

- > Whistleblower policies
- > Prompt acting on reports of problems in controls (internal or external)
- > Brainstorm risk assessment
- > Independent review of monthly closing checklists and bank reconciliations
- > Dual controls on counted cash



# How to Improve Internal Controls

- > Reconciliation of donor system to accounting system
- > Bank reconciliations by an objective party (outside of recording)
- > Check signers  $\neq$  recording function
- > Positive pay, ACH confirm, approved vendors
- > Corporate card usage policies and limits



# How to Improve Internal Controls

- > Review of expense reports, including CEO
- > Timely review of journal entries
- > Total budget to actual performance for all payroll accounts
- > Start small.....don't get overwhelmed
- > Tone at the top

A hand is shown pointing upwards towards a glowing lightbulb. The lightbulb is drawn with white lines and has a bright blue glow. Overlaid on the scene is a line graph with several colored lines (green, red, yellow) and circular markers, all trending upwards and to the right. The background is a dark blue, semi-transparent image of a person in a suit.

Questions?

# Contact Information



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