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Internal Controls – Never an Afterthought

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Learning Objectives

At the end of this session, you will be able to:

- Recognize what internal controls could have been in place to prevent fraud from occurring or detect malfeasance earlier
- Describe the importance of the tone at the top
- Associate fraud risks to internal controls
- Identify examples of why internal controls fail
- Identify how to apply internal control best practices within your organization

Introduction

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Over 20 years experience in internal
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Agenda

- Overview of internal controls (their sources and purpose)
- The relationship between internal controls and fraud
- How governance shapes internal controls
- How we relate fraud risks in internal controls and the internal control environment
- Real world examples of internal control failures
- Leading practice of internal controls and how to apply them
- Questions and answers

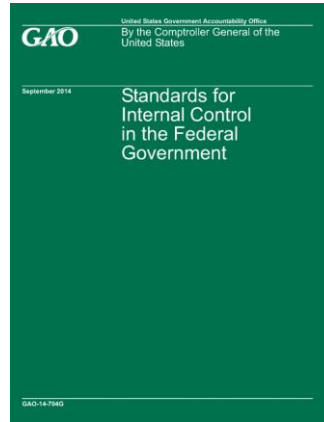


Overview of Internal Controls

Purpose

They exist for a reason (not just to inconvenience everybody).

According to the Green Book on Internal Control Standards: *Internal control is a process effected by an entity's oversight body, management, and other personnel that provides reasonable assurance that the objectives of an entity will be achieved.*



- Consists of 2 sections
 - Overview
 - Standards
- Establishes
 - Definition of internal control
 - Categories of objectives
 - Components and principles of internal control
 - Requirement for effectiveness

Source: *Standards for Internal Control in the Federal Government*, [2014] U.S. Government Accountability Office.

Overview of Internal Controls

Operations

Effectiveness and Efficiency

Is the company/area effective and efficient in its operations?

Is there any waste/idles resources, etc.?

Reporting

Reliability of reporting for internal and external use

Is our internal and external reporting (both financial AND non-financial reliable, accurate, timely?)

Compliance

Compliance with applicable rules, laws and regulations

Are we violating any rules, laws, regulations in any of the activities we are conducting or decisions that we are making?

Overview of Internal Controls



We think of internal controls as a means to manage risk, but what type of risk?



Inherent Risk: The risk that the risk event will occur absent any controls in place



Residual Risk: The risk that remains after the control has been applied



Overview of Internal Controls

- Types of controls to manage the inherent risk:
 - Preventive
 - Detective
 - Directive
 - Manual
 - Automated
- When these controls fail, the risk event will occur.
 - Examples of the impact of control failures



Overview of Internal Controls

Internal controls should be designed and operating effectively as to allow for the achievement of the organization's objectives.

Internal controls is a process that prevents an adverse risk event from happening or detects the event if it does occur.

What are some challenges in achieving cost-effective internal controls?

Overview of Internal Controls

Challenges of maintaining a cost-effective internal control environment:

- Obtaining sufficient resources to achieve adequate segregation of duties.
- Management's ability to dominate activities and override controls.
- Recruiting competent individuals to serve on audit committees and on the board of directors.
- Recruiting and retaining personnel with sufficient experience and skill in accounting and financial reporting.
- Focusing management's attention on internal controls.
- Maintaining appropriate controls over information systems with limited technical resources.
- Determining whether internal controls address significant risks.



Overview of Internal Controls

How do each of the following act/serve as an internal control?

- Policies and procedures
- Segregation of duties
- Budgeting
- Dual control
- Joint custody
- Rotation of duties
- Reconciliation

How might you test each control above to determine if they are effective?

What is an example of each?



Overview of Internal Controls

Methods to identify internal controls:

- Internal control questionnaires
- Narratives and memos
- Flow charts
- Some combination of the above

How should you document the internal control identified in the above methods?

Overview of Internal Controls

As internal auditors, what are some objectives to testing internal controls?

- Identify weaknesses in internal controls which should be corrected
- Identify weaknesses which could expose the bank to loss if not corrected
- Tailor the audit program so improperly controlled areas (risk areas) receive more attention
- Determine the reliability and integrity of information
- Determine compliance with policies, plans, procedures, laws, and regulations
- Ensure the safeguarding of assets
- Ensure economical and efficient use of resources



Overview of Internal Controls

- Sources of internal controls
 - Theoretical
 - Practical
- Theoretical
 - Frameworks, institutions, regulating bodies
- Practical
 - Internal documents, management expectations, others



Overview of Internal Controls

- Theoretical
 - COSO 2013 Internal Control Framework
 - Green Book
 - Yellow Book
 - NIST/ISO Frameworks
- Practical
 - Policies
 - Procedures
 - External/internal audit recommendations
 - Regulator input



Overview of Internal Controls

There are five components of the COSO Integrated Framework (2013):

- Controls Environment
- Risk Assessment
- Control Activities
- Information and Communication
- Monitoring Activities



Source: *COSO Integrated Framework*, © [2013] Committee of Sponsoring Organizations of the Treadway Commission (COSO). All rights reserved. Used with permission.



Overview of Internal Controls

Control Environment

- Integrity and ethical values
- Commitment to competence
- Board of Directors or Audit Committee participation
- Management's philosophy and operating style
- Organizational structure
- Assignment of authority and responsibility
- Human resource policies and practices



Overview of Internal Controls

Risk Assessment

- Dynamic, iterative process for identifying and assessing risks to the achievement of objectives
- Identify and assess changes that could significantly impact the system of internal control:
 - Changes in the institution's operating environment
 - New personnel
 - New or revised information systems
 - Rapid growth within the institution
 - New technology
 - New lines, products or activities
 - Restructuring within the institution
 - Foreign activities
 - New accounting pronouncements
 - Fraud risks



Overview of Internal Controls

Control Activities

- Actions established through policies and procedures that help ensure management's directives to mitigate risks to the achievement of objectives are carried out
- Remembering our overview of what internal controls are from earlier:
- An inherent process performed designed to accomplish management's objectives
- Accuracy of financial and nonfinancial reporting, compliance with laws and regulations
- Effectiveness and efficiency of operations



Overview of Internal Controls

Information and Communication

- Information necessary to support the achievement of objectives.
- Information must be relevant and accurate from both internal and external sources.
- Communication is continuous, disseminated throughout the organization.
- Enables a clear message from senior management that control responsibilities must be taken seriously.

Overview of Internal Controls

Monitoring Activities

- Ongoing, separate evaluations, or some combination of the two are used to ascertain whether each of the five components is present and functioning.
- The results of the evaluation are evaluated against established criteria and communicated to management and the board, as appropriate.
- The criteria can come from regulators, recognized standard-setting bodies or management and the board of directors.

Internal Controls and Fraud

Also, within the 2013 COSO Framework, the inclusion of fraud was added. The Institute of Internal Auditors requires fraud to be included as a consideration within the risk assessment process, so does the 2013 COSO framework.

It is included within the risk assessment component of the framework and is mentioned within the green book.

Internal Controls and Fraud

Fraudulent financial reporting:
Intentional misstatement or omissions of amounts or disclosures in the financial statements WITH THE INTENT to deceive.

Misappropriation of assets

Corruption (specific to the Green Book)

Internal Controls and Fraud



Internal Controls and Fraud

- Michele Rose, 61, is accused of 12 counts of wire fraud and 12 counts of forging checks, the U.S. District Attorney's office said in a news release Wednesday. Neither the release nor federal court records specify where Rose worked, only that she served as a "medical staff coordinator." According to Dubois County Herald archives, Rose served in that same position for Memorial Hospital and Healthcare Center. Older entries on the hospital's website also identify Rose as their medical staff coordinator. According to the indictment, which was unsealed Tuesday, Rose is accused of stealing more than \$153,000 between March 2011 and December 2020. Prosecutors allege Rose had access to the "medical staff checking account," which is "used to pay for flowers, employee assistance, birthday presents, scholarships, and other charitable activities." Funds usually went directly to whomever was receiving the assistance, but occasionally Rose could buy something using money from the account and reimburse herself, the indictment states. She was supposed to do so by writing a check to herself and drawing the funds from the staff checking account. Rose made it appear as if the checks were for legitimate reimbursements by writing 'reimbursement' or something similar on the check memo lines," the indictment states, "but those were false and fraudulent representations." According to the release, Rose wrote "165 fraudulent checks to herself for reimbursement of purchases that she never made."
- What control(s) should have been in place that would have either prevented this from occurring or detected much sooner rather than let it go on over the course of almost 10 years?



Internal Controls and Fraud

- The former chief financial officer of a major Pinellas County hotel is among a pair of men facing charges of stealing almost \$800,000 from the company. According to the Pinellas County Sheriff's Office, Sam Baage, 58, the TradeWinds Beach Resorts' former chief financial officer, and Harold James, 46, the resort's former director of information technology, conspired to embezzle funds from the hotel. Investigators said the duo set up dummy companies and then billed the resort for phony services. From 2007 to 2012, the pair used the fake companies to repeatedly bill the hotel for services never rendered, according to a sheriff's office release. Officials said the men stole \$782,018. An investigation initially began in 2011 after a complaint to the St. Pete Beach Police Department. Baage, who now lives and works in Miami, has been charged with money laundering, conspiracy and 14 counts of grand theft. James, arrested Wednesday near his Tarpon Springs home, is facing the same charges and being held on \$735,000 bail.

What control(s) should have been in place that would have either prevented this from occurring or detected much sooner?



Internal Controls and Fraud

- This past fall, the U.S. Department of Justice announced that two men had been charged in relation to a massive cyberattack that spanned the globe. According to a statement released by the U.S. Attorney's office in the Northern District of Georgia, the scheme involved phishing emails, the theft of employee access details, and the harvesting of credentials from computer servers. Using the stolen credentials, the fraudsters then sent out emails that contained fake invoices for hundreds of thousands of dollars in payments, which were made to the conspirators' bank account. In one specific instance, nearly U.S. \$1.5 million was stolen.

What control(s) should have been in place that would have either prevented this from occurring or detected much sooner?

Internal Controls and Fraud

2022 Global Fraud Study

- 2,110 fraud cases studied causing losses of more than \$3.6 billion
- Estimated 5% of revenue lost to fraud each year
- Average length of time from start to detection was 12 months

Internal Controls and Fraud

Understanding the methods fraudsters use to conceal their crimes can assist organizations in more effectively detecting and preventing similar schemes in the future.

TOP 4
CONCEALMENT
METHODS USED
BY FRAUDSTERS

39% created fraudulent physical documents

32% altered physical documents

25% altered electronic documents or files

28% created fraudulent electronic documents or files



Internal Controls and Fraud

Who reports occupational fraud?

Tip: 42%

Internal audit: 16%

Management review: 12%

Document examination: 6%

By accident: 5%

Account reconciliation: 5%

Automated transaction: 4%

External audit: 4%

Surveillance/monitoring: 3%

Notified by law enforcement: 2%

Confession: 1%

How is occupational fraud initially detected?

Employees: 55%

Customer: 18%

Anonymous: 16%

Vendor: 10%

Other: 5%

Competitor: 3%

Shareholder/Owner: 3%



Internal Controls and Fraud

Most Common Anti-Fraud Controls



How Governance Shapes Internal Controls

- Governance directly impacts the control environment.
- Principle 1 in the Green Book: Demonstrate Commitment to Integrity and Ethical Values.
 - One of the attributes listed is tone at the top.
 - Management demonstrates the importance of integrity and ethics through their directives, attitudes and behavior.
- What is the impact of lack of a good tone at the top on the internal control environment?

How Governance Shapes Internal Controls

Risk responses may be:

- Incomplete
- Inappropriate

Control activities may not be:

- Appropriately designed
- Appropriately implemented
- Information and communication may falter

Monitoring may not be:

- Understood or acted upon



How Governance Shapes Internal Controls

Governance defined

Per the Institute of Internal Auditors, corporate governance is the blend of processes and structures designed to help an organization achieve its objectives. The processes are not only influenced by risks but also by the organization's efforts to mitigate known risks and discover unknown risks

The Organization for Economic Co-Operations and Development states:
“Corporate governance involves a set of relationships between a company's management, its board, its shareholders, and other stakeholders. Corporate governance provides structure through which the objectives of the company are set and the means of attaining those objectives and monitoring performance are determined.”

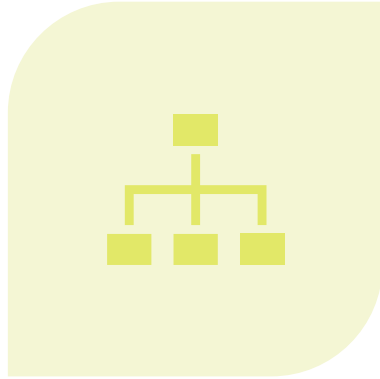


How Governance Shapes Internal Controls

The Open Compliance and Ethics Group defines corporate governance as the “culture, values, mission, structure and layers of policies, processes and measures by which organizations are directed and controlled.

How do we tie these definitions into internal controls?

How Governance Shapes Internal Controls



PER THE GREEN BOOK, THE TONE AT THE TOP IS SET BY THE BEHAVIOR OF MANAGEMENT AND THE BOARD. THE BOARD AND MANAGEMENT'S BEHAVIOR SETS THE EXAMPLE, AND THIS EXAMPLE (THEIR VALUES, PHILOSOPHY AND OPERATING STYLE) IS FUNDAMENTAL TO AN EFFECTIVE INTERNAL CONTROL SYSTEM.



ACCOUNTABILITY IS ALSO DRIVEN BY THE TONE AT THE TOP AND SUPPORTED BY THE COMMITMENT TO INTEGRITY AND ETHICAL VALUES, ORGANIZATIONAL STRUCTURE AND EXPECTATIONS OF COMPETENCE. ALL OF THIS INFLUENCES THE CONTROL CULTURE OF THE ENTITY.

How Governance Shapes Internal Controls

Control Environment

Integrity and ethical values

Commitment to competence

Board of Directors or Audit Committee participation

Management's philosophy and operating style

Organizational structure

Assignment of authority and responsibility

Human resource policies and practices



How Governance Shapes Internal Controls

- Control Environment Red Flags
 - Complex businesses process that cannot be reasonably explained by anybody in the business (or by just a very few)
 - Very aggressive goals that do not seem reasonable
 - Lack of transparency into the financial performance of an entity
 - Unusual rate of turnover in key positions of an entity
 - Complex organizational structure (difficult to understand why the entity is organized in such a way)

How Governance Shapes Internal Controls

- Controls that support and validate a strong tone at the top
 - Clear delineation of authority that rises at or near the top
 - Commitment to board and audit committee training and succession
 - Job descriptions that clearly note reporting lines and document expectations for complying with company policies.
 - Periodic personnel evaluation process that is documented



Fraud Risk in the Internal Control Environment

- Principle 8 – Assess Fraud Risk: Management should consider the potential for fraud when identifying, analyzing and responding to risks.
 - Types of fraud
 - Fraud Risk Factors
 - Response to Fraud Risks

Fraud Risk in the Internal Control Environment

What are the types of fraud that ought to be considered when assessing fraud risk?

- Fraudulent financial reporting
- Misappropriation of assets
- Corruption

How do you assess fraud risk?

- What are the primary fraud risk factors?



Fraud Risk in the Internal Control Environment

- **Incentive/Pressure** – Management or other employees may have an incentive or are under pressure.
- **Opportunity** – Absent controls, weak controls, ability to override controls
- **Attitude/Rationalization** – People will justify that it's owed to them. Brash attitude, poor ethical values.

Fraud Risk in the Internal Control Environment

- Additional sources of fraud risk
 - OIG
 - Management override of internal controls
- Fraud brainstorming
 - Can controls be circumvented? If so, how?
 - How likely are these scenarios?
 - Impact/likelihood?
- Assess internal controls and adjust audit program accordingly

Fraud Risk in the Internal Control Environment

- Fraud Impact on Risk Assessment
 - How would you change your risk assessment process in light of a fraud?
 - How did the fraud occur?
 - What controls were circumvented?
 - Did you miss something in your risk assessment?
 - Brainstorm!



Fraud Risk in the Internal Control Environment

Common controls to prevent or detect fraud

- Segregation of duties – manual controls
 - Processing transactions
 - Posting journal entries
 - Entering and approving data entries
- Information technology general controls – automated
- Account reconciliations
- Account balance confirmations

What about soft controls?



Fraud Risk in the Internal Control Environment

Examples of soft controls

- Code of ethics
- Whistleblower hotline
- Internal audit

Whistleblower hotline

- Do employees even know about this?
- Do they know its purpose?

Internal Control Failures – True Stories

From 2011 until 2014, Michael Kail, the former vice president of IT operations at Netflix approved contracts to purchase IT products and services from smaller outside vendors and authorized the corresponding payments as part of his role. However, he selected the IT contracts according to the kickbacks he would receive rather than on their merit. Netflix's internal control failures allowed Kail to employ a "pay-to-play" scheme. As part of his scheme, he approved millions of dollars in contracts for goods and services, and in exchange, he received over \$500,000 and stock options from nine tech companies. Kail was eventually sentenced to 30 months in federal prison after his conviction for fraud and money laundering.



What controls should have been in place and operating to prevent this fraud from occurring?

Internal Control Failures – True Stories

The Securities and Exchange Commission has announced that Moody's Investors Service Inc., one of the nation's largest credit ratings agencies, has agreed to pay a total of \$16.25 million in penalties to settle charges involving internal control failures and failing to clearly define and consistently apply credit rating symbols. This marks the first time the SEC has filed an enforcement action involving rating symbol deficiencies.

Moody's agreed to pay \$15 million to settle charges of internal controls failures involving models it used in rating U.S. residential mortgage-backed securities (RMBS) and will retain an independent consultant to assess and improve its internal controls. Moody's separately agreed to pay \$1.25 million and to review its policies, procedures, and internal controls regarding rating symbols. Moody's did not admit or deny the SEC's charges.

According to the SEC's order in the internal controls proceeding, Moody's failed to establish and document an effective internal control structure as to models that Moody's had outsourced from a corporate affiliate and used in rating RMBS from 2010 through 2013. Moreover, Moody's failed to maintain and enforce existing internal controls that should have been applied to the models. Ultimately, Moody's corrected more than 650 RMBS ratings with a notional value exceeding \$49 billion, due, in part, to errors in the models. Also, in 54 instances, Moody's failed to document its rationale for issuing final RMBS ratings that deviated materially from model-implied ratings.

"Rating agencies play a critical role in our capital markets and need to have effective controls over their rating processes," said Antonia Chion, Associate Director of the SEC's Division of Enforcement. "As our order notes, the SEC put Moody's on notice about its internal controls obligations yet it did not develop an effective process to ensure the accuracy of the models it relied upon when rating residential mortgage-backed securities." In the SEC's order relating to rating symbols, for 26 ratings of securities known as "combo notes" with a total notional value of about \$2 billion, Moody's assigned ratings to combo notes in a manner that was inconsistent with other types of securities that used the same rating symbols.

What controls should Moody's have been using with respect to its models?



Internal Control Failures – True Stories

A bank discovered that a senior loan officer originated fraudulent loans by entering fake loan applications into the loan system, approved the loans and issued checks made out to the fictitious company. The loan officer was also able to delete the loan account from the system to keep it off the books and showing up on past due reports.

What controls should have been in place to reduce the risks evident?



Internal Control Failures – True Stories

An e-mail went out to the company from the CEO, explaining that there was an issue with their W-2 and they needed to click on the link in the email to send them their W-2.

Nearly every employee clicked on the link, kicking off a data breach and the bad actor used the W-2s that were uploaded and filed fraudulent tax returns claiming refunds from those tax returns.

What controls should have been in place to reduce the risks this issue exposed?



Applying Internal Controls in Your Organization

Internal control is defined as a process, affected by an entity's board of directors, management, and other personnel, designed to provide reasonable assurance regarding the achievement of objectives in the following categories:

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

Applying Internal Controls in Your Organization

- Controls should be tied to objectives
 - Ask:
 - Why am I performing this process?
 - What is the goal/aim?
 - What am I trying to accomplish
- How do you get comfortable that....?

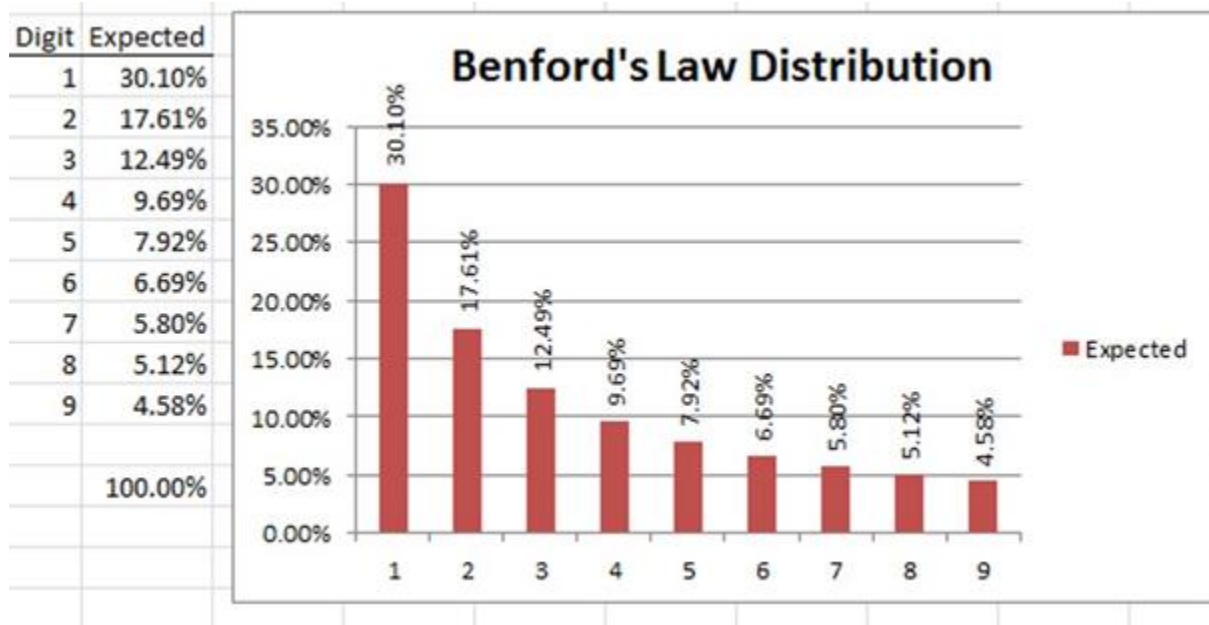
Applying Internal Controls in Your Organization

- Controls needs to be both efficient and effective
 - Can a manual control be replaced to an automated control?
 - Can technology execute the control as you expect?
 - How do you know?
- Continuous monitoring by management can be an effective way to implement controls that are timely and allow for real time action.

Applying Internal Controls in Your Organization

- Deploying data analytics as part of your control environment
 - Can detect trends
 - Isolate on potential red flags
 - Identify anomalies – including potential fraud
- Benford's Law
 - Mathematical principle that states in any large, randomly produced set of natural numbers, the leading digit of each number will occur a certain percentage of the time

Applying Internal Controls in Your Organization



Applying Internal Controls in Your Organization

- For data analytics
 - Training
 - Invest in both people and technology
- Technology
 - Leverage it to the max when it comes to controls
 - Understand its limitations
- Adopt a Framework