

Overview of Internal Controls



MARCH 18, 2025

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Learning Objectives

This course is designed to:

- ❖ Introduce participants to internal control concepts, components, and processes
- ❖ Present internal control best practices to help local government officials/staff enhance fiscal and programmatic operations
- ❖ Provide **practical** guidance you can quickly employ to affect change and improvement

Internal Control - What is it?

A process effected by those charged with governance, 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

COSO: Committee of Sponsoring Organizations of the Treadway Commission's *Internal Control: Integrated Framework*



Internal Controls – Simply Defined

Internal controls are nothing more (or less) than **the combination of people, policies, and procedures** that managers rely upon to be able to provide positive answers to these questions:

- ❖ *How do I know* that my organization is **operating effectively and efficiently** and is safeguarding its assets?
- ❖ *How do I know* that financial statements and other reports **can be relied upon**?
- ❖ *How do I know* that my organization is **complying** with applicable laws, regulations and policies?

Stephen J. Gauthier, former Director of Technical Services, Government Finance Officers Association (GFOA)



I like this definition.....

Internal Controls help to “make sure things happen the way you want them to happen and bad or unexpected things don’t happen.”

Deane Hennett,
Director of Internal Audit
Old Dominion University



Why are internal controls important to Local Governments?

- ❖ **Safeguard** against fraud and the misuse of assets
- ❖ Serve as management tool to achieve objectives efficiently and effectively (**Operations**)
- ❖ Ensure accuracy and reliability of **financial reporting**/other information used for decision-making
- ❖ Ensure **compliance** with laws and regulations

Managing the People's Business is not easy, but Controls will help!

The Process of Internal Control is geared to the achievement of objectives!

- ❖ **Objectives** = things you want/need to happen (e.g., Provide utility services to paying customers)
- ❖ **Risks** = what could occur to keep objectives from happening (e.g., Customers don't pay, but receive services)
- ❖ **Controls** = actions to make sure objectives happen (e.g., review past-due accounts and apply cut-off policy....**do we have a cut-off policy?**)

Very Important Concepts of Internal Control

- ❖ A process involving people at all levels
- ❖ Provides reasonable assurance, not absolute:
 - ✓ No matter how well designed and operated, can't protect you from everything
 - ✓ Absolute assurance would be really expensive
 - ✓ Errors in judgment, human error, **collusion** among employees, and **management override** of controls

Very Important Concepts

Internal Control is affected by people!

- ❖ Not just policy manuals and forms
 - ❖ It's **people** performing assigned functions at **every level**
 - ❖ Board Member to Agency Head to Accounting Clerk – **all have a role in successful operation** of Internal Controls
- ✓ **Teamwork: Cooperation, Coordination, Respect.....don't have it, won't work!!!!**

What happens if controls are weak?

Does it just happen in Government?

- ❖ Rock band *Cold Kingdom* has \$33,000 in equipment stolen
- ❖ New Jersey Doctor has 40,000 patient files stolen
- ❖ Employee steals \$500,000 from Doctor's office (According to police, doctors were aware of financial issues, but thought they were related to the pandemic)
- ❖ Crazy Eddie's Electronics Business defrauds government and investors of millions
 - ✓ Inflating inventory assets to increase reported profits
 - ✓ Sam Antar said that nobody looked behind the boxes

Internal Control Process



Components of Internal Control – Control Environment

- ❖ Tone at the top – influences behavior and filters down/up to all in the organization
- ❖ Bedrock on which all other elements based
- ❖ Influences the risk assessment process; the control activities established; communication systems; and monitoring activities
- ❖ Association of Certified Fraud examiners reported that poor tone at the top was one of the top five control weaknesses contributing to fraud (study of over 2,500 fraud cases)
- ❖ **When all in the organization know (and actually see) that the Board and Management take Internal Control seriously, change will take place.**

Components of Internal Control – Control Environment

The Board/Management:

- ❖ Communicate and enforce **integrity/ethical values** through codes of conduct
- ❖ Display **effective attitudes and actions** when objectives are being jeopardized (e.g. address policy violations immediately and consistently)
- ❖ Set the skills, knowledge, and experience needed by staff (e.g., job descriptions)
- ❖ Assign right number of staff with right skill sets for the job
- ❖ Consistently hire, train, evaluate, compensate, promote, and discipline based on solid policies and procedures

Components of Internal Control – Risk Assessment

What could go wrong?

Identifying and analyzing risks that threaten objectives

- ❖ Estimating likelihood of occurrence and impact on achievement of objectives
- ❖ Helps Board and Management determine what controls should be implemented to manage the identified risks

Components of Internal Control – Information and Communication

- ❖ Supports the functioning of all components of internal control
- ❖ Information must be identified, captured, and communicated so that people can carry out their responsibilities
- ❖ Information can be operational, financial, and compliance-related (makes it possible to manage the organization)
- ❖ Should be internal as well as external (e.g., info conveyed to or received from customers, consultants, auditors)

More Information and Communication

Information must be:

- ❖ Accessible – easy to obtain
- ❖ Timely – available when needed
- ❖ Current – up-to-date data
- ❖ Accurate – Free from errors and complete (validation checks)
- ❖ Sufficient – enough information to make informed decisions
- ❖ Valid – represents activities that actually occurred

Can't manage what you don't understand!

Components of Internal Control - Monitoring

Monitoring Activities

❖ **Self-assess:**

- ✓ What is working?
- ✓ What is not?
- ✓ When we didn't meet objectives, why didn't we?
- ✓ Which controls would move us towards achievement of objectives?

❖ Internal Control System should be monitored continuously

❖ Deficiencies should be discussed and resolved

Control Activities

Components of Internal Control – Control Activities

- ❖ Strategies and activities that management designs to mitigate risks and help to ensure that objectives are achieved
- ❖ Can be **Preventative** (avoid) or **Detective** (discover and correct)
- ❖ **Formal/Written Policies and Procedures** (your blueprint)
- ❖ ACFE reported that lack of internal controls was primary weakness contributing to fraud in 32% of cases studied

Control Activities – Segregation of Duties

- ❖ No single person should control all steps of a transaction
- ❖ Separate incompatible duties (initiating, authorizing, recording, custody of assets, and reconciliation)
- ❖ Mitigating controls may be necessary for smaller entities
- ✓ **No employee should be in a position to both commit an abuse/fraud and conceal it!**
- ✓ **Undetected errors could cause big problems!**

More Control Activities

- ❖ Physical Access Controls (equipment, inventories, cash, etc. are locked up and access is restricted)
- ❖ Reconciliation of financial documents/records (sub-ledger to general ledger to bank statements)
- ❖ Remember – look behind the boxes!!!!
- ❖ ACFE reported that lack of management review is major control weakness contributing to fraud
- ❖ **Surprise review of entire process and follow-up on discrepancies**

Policies & Procedures

- ❖ No formal, written policies and procedures – **Very common problem that we see.**
- ❖ Necessary to provide a clear understanding of:
 - ✓ **What** should be done?
 - ✓ **How** it should be done?
 - ✓ **Who** should do it?
 - ✓ **When** it should be done?

Policies & Procedures

Why are they important?

- ❖ It's your **blueprint** for current administration and those that follow
- ❖ Lessens the risk of violating state law and local ordinances
- ❖ Establishes controls that can deter theft and other losses
- ❖ Ensures consistency and continuity of operations (all on the same page)
- ❖ A "go-to" during disputes
- ❖ Helps to cross-train staff
- ❖ Helps hold staff accountable

Policies & Procedures

Should address:

- ❖ Preparing, adopting, monitoring, and amending the **budget**
- ❖ **Financial Statement preparation**, reporting, and related council discussion of financial information
- ❖ Procurement and **purchasing** (e.g., Bid Law; purchase initiation; vendor listing)
- ❖ Use of **credit cards** (e.g., allowable purchases and supporting documentation requirements)
- ❖ Dispensing **fuel** and reviewing usage
- ❖ Recording, tagging, and safeguarding of **assets** (conducting physical inventories)

Policies & Procedures

- ❖ Receipts and Collections
- ❖ Payroll and Personnel
- ❖ Contracting
- ❖ Travel and Expense
- ❖ Debt Service Requirements (fund debt reserve accounts and don't miss debt payments – Fiscal Admin.)
- ❖ IT Disaster Recovery and Business Continuity
- ❖ Ethics (e.g., prohibitions, responses to violations, monitoring system for potential violations)
- ❖ Sexual Harassment Prevention (La. R.S. 42:341-345 require education/training, certain records, reporting)
- ❖ Fraud and Abuse Reporting (La. R.S. 24:523)

Ethics

- ❖ Emphasize the importance of the Code of Ethics

(R.S. 42:1101 et. seq.)

- ❖ Require Board members, officials, and staff to sign annual certification letters attesting to compliance with the Code and other internal ethics policies
- ❖ Make sure all are receiving yearly ethics training per state law

Financial Management

- ❖ Accurate and complete financial statements should be prepared each month
- ❖ Statements should include a comparison of actual results to budget amounts with variances
- ❖ Statements and other financial information should be provided to the Board and discussed in detail at regular Board meetings (at least monthly)!!!

Financial Management

Financial Information to Present and Discuss at Board Meetings:

- ❖ Income Statement (should include a comparison of actual and projected revenues and expenditures compared to the budget)
- ❖ Balance Sheet
- ❖ Accounts payable and receivable aging schedules
- ❖ Analysis of budget variances and recommendations for corrective action
- ❖ Formal plans to eliminate deficits!
- ❖ Use your audits: identify problems and recommend solutions and the “Notes” tell a story!

Financial Management – The Budget is an Internal Control Tool

Board/Management should ensure that:

- ❖ Budget calendar is used to make sure you are appropriately managing the budget process and meeting all deadlines
- ❖ Budget is developed and adopted annually
- ❖ Budget is balanced, realistic, and based on sound estimates
- ❖ Budget contains required elements as presented in law

[R.S. 39:1305 (C)(2)(a)]

- ❖ Monitor revenues and expenditures monthly
- ❖ Amend the budget when there's an unfavorable variance of at least 5%
- ❖ **Budget is used to drive decisions and plans and to effectively manage the People's Business!!!**

Credit Cards

- ❖ If you must use them, limit the number and control usage
- ❖ Always know how many cards you have and who has them at all times; maintain a master listing of cards
- ❖ Require all cardholders to sign a written agreement before a card is issued to them
- ❖ Cardholders should immediately notify management if a card is **lost or stolen**. The card should be immediately cancelled. If the card is stolen, law enforcement should be notified.
- ❖ Cards **should not be used for overriding regular established purchasing processes.**

Credit Cards

- ❖ Define allowed/prohibited purchases and communicate this information to all employees and officials (P&Ps)
- ❖ Itemized/detailed receipts should be required as support and business purpose should be documented for all charges (persons making and participating in expenditure should be identified); “How is this expenditure benefitting the people we are serving?”
- ❖ Someone other than the cardholder should review the monthly statement and compare it to the attached support and follow up on irregular purchases; **there are no stupid questions...ask until resolved!!!**
- ❖ Someone should also review fuel card statements and monthly summary reports for reasonableness
- ❖ For cards used in employee travel, the approver should review any travel-related reimbursements to verify that the employee did not have card charges for which the employee was also reimbursed

Credit Cards

- ❖ Regularly review bank statements and look for suspicious charges that may indicate that an employee is using a credit card that was opened without Town approval.
- ❖ **Make it clear to all that there will be regular reviews of credit card usage with related documentation. Stress that all fraud, waste, and abuse will be dealt with very seriously! Also, surprise reviews by independent staff.**
- ❖ **“Tone at the Top”** ACFE reports that lack of management review is major weakness contributing to fraud!!!
- ❖ If your review finds that purchases **do not support the purposes of the Town and the business of the People**, hold employees accountable for reimbursement. If fraud is occurring, act swiftly, consistently, and with protection of Town assets as a priority.

Closing Thoughts

- ❖ **Internal controls** help to protect assets; prevent fraud, abuse, and waste; prevent, detect, and resolve errors; ensure compliance; and help you achieve objectives and serve the Public well!!!
- ❖ Success depends on **everyone's** active participation!!!
- ❖ **Continuous** evaluation and improvement is key!!!
- ❖ Managing the People's Business requires **critical thinking and attention!!!**
- ❖ And remember, if you are not working as a **TEAM**, controls are likely to fail!!!

Resources and Contacts

- ❖ Center for Local Government Excellence at <https://lla.la.gov/resources/center-for-local-government-excellence>
- ❖ LLA's Legal Assistance at <https://lla.la.gov/resources/legal-assistance>
- ❖ Association of Certified Fraud Examiners at <https://Acfe.com>
- ❖ Institute of Internal Auditors at <https://theiia.org>
- ❖ Government Finance Officers Association at <https://www.gfoa.org/best-practices--resources>

Resources and Contacts



www.coso.org

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