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# Internal Controls

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# **Designing and Implementing Strong Internal Controls**

**Presented by  
Paul Kelsey, CPA  
Audit Manager  
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# Introducing HLB – the Numbers

■ Founded	1986
■ Number of Offices	2
■ Number of Partners	11
■ Number of Employees	88
■ Number of Certified Public Accountants	36
■ Size of Firm in Tarrant County*	6 <sup>th</sup>
■ Size of Firm in Metroplex**	13 <sup>th</sup>

\* Source: Fort Worth Star Telegram

\*\* Source: Dallas Business Journal

# Introducing HLB – Services Provided

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- Auditing and Accounting
- Payroll Tax
- Due Diligence
- Sales Tax
- Corporate Finance
- Consulting
- Federal Tax
- Litigation Consulting
- State and Local Tax
- Business Valuations
- International Tax

# Introducing HLB – Core Values

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- Family life is foundational
- Integrity and independence are cornerstones
- Teamwork is the infrastructure
- Committed to exceptional service
- Aggressive investors in our people
- Embrace change

# Introducing Paul A. Kelsey, CPA

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- Position in the Firm – Audit Manager
- Areas of Expertise and Experience
  - Not-For-Profit, Manufacturing, and Wholesale industries.
  - More than 9 years in the accounting industry, including managing, consulting and auditing Not-For-Profit organizations.

# Introducing Paul A. Kelsey, CPA

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## ■ Education

- 2001-2003 University of Arlington
  - Masters of Professional Accounting
  - Masters of Business Administration
- 1993-1997 Abilene Christian University

# Introducing Paul A. Kelsey, CPA

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## ■ Professional Affiliations

- Texas Society of Certified Public Accountants
- American Institute of Certified Public Accountants
- Association of Certified Fraud Examiners

# Why Am I Here?

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- As a service to PPAI
- Serving the community at large
- Demonstrating a commitment to financial literacy and strong internal controls



# Today's Topic

“Designing and Implementing Strong Internal Controls, Including Effective Financial Reporting to Governing Bodies”

# Today's Agenda

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- Define Internal Control
- Identify Key Components of Strong Internal Controls
- Identify Fraud Considerations
- Discuss Segregation of Duties and Mitigating Controls
- Discuss Financial Reporting to Governing Bodies
- Acknowledge Management Override Risk
- Wrap Up and Questions

# Defining Internal Control

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- The Committee of Sponsoring Organizations (COSO) consists of the American Institute of CPAs, the Institute of Management Accountants, the Institute of Internal Auditors, Financial Executives International, and the American Accounting Association.
- COSO defines internal control as “a process, effected by an entity’s board of directors, management and other personnel, designed to provide reasonable assurance regarding the achievement of objectives” in three categories:
  - Effectiveness and efficiency of operations
  - Reliability of financial reporting
  - Compliance with applicable laws and regulations

# Defining Internal Control

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- Internal control can be judged as effective if the board of directors and management have reasonable assurance that
  - They understand the extent to which the entity's operations objectives are being achieved.
  - Published (internal and external) financial statements are being prepared reliably.
  - Applicable laws and regulations are being complied with.

# Defining Internal Control

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Also from the COSO definition:

- Internal control is a process. It is a means to an end, not an end in itself.
- Internal control is not merely documented by policy manuals and forms. Rather, it is put in by people at every level of an organization.
- Internal control can provide only reasonable assurance, not absolute assurance, to an entity's management and board.

# What Internal Control can do.

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- Keep the right people informed about the organization's progress (or lack of progress) in achieving its objectives
- Provide **reasonable** assurance within inherent limitations

# What Internal Control cannot do.

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- Guarantee success, or even survival, of an organization
- Turn a poor manager into a good one
- Provide absolute assurance that objectives were met

# Key Components of Internal Control

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## 1. Control Environment – “Tone at the Top”

- Integrity, ethical values, competence of the people.
- Management’s philosophy and style
- Management’s method of assigning authority
- Management’s method of organizing and developing people
- Management’s attention to direction

# Key Components of Internal Control

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## **2. Risk Assessment**

- Identification and analysis of relevant risks
- Decide how risks should be managed

# Key Components of Internal Control

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## **3. Control Activities**

- Help ensure management directives are carried out
- Occur throughout the organization at all levels and all functions
  - Approvals
  - Authorizations
  - Verifications
  - Reconciliations
  - Reviews of operating performance
  - Security of assets
  - Segregation of duties

# Key Components of Internal Control

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## 4. Information and communication

- Identify, capture and communicate information to enable the right person to carry out their responsibilities
- Information systems are key
- For management's decisions and for external reporting
  - Internal information
  - External events
  - Activities
  - Conditions

# Key Components of Internal Control

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## 5. Monitoring

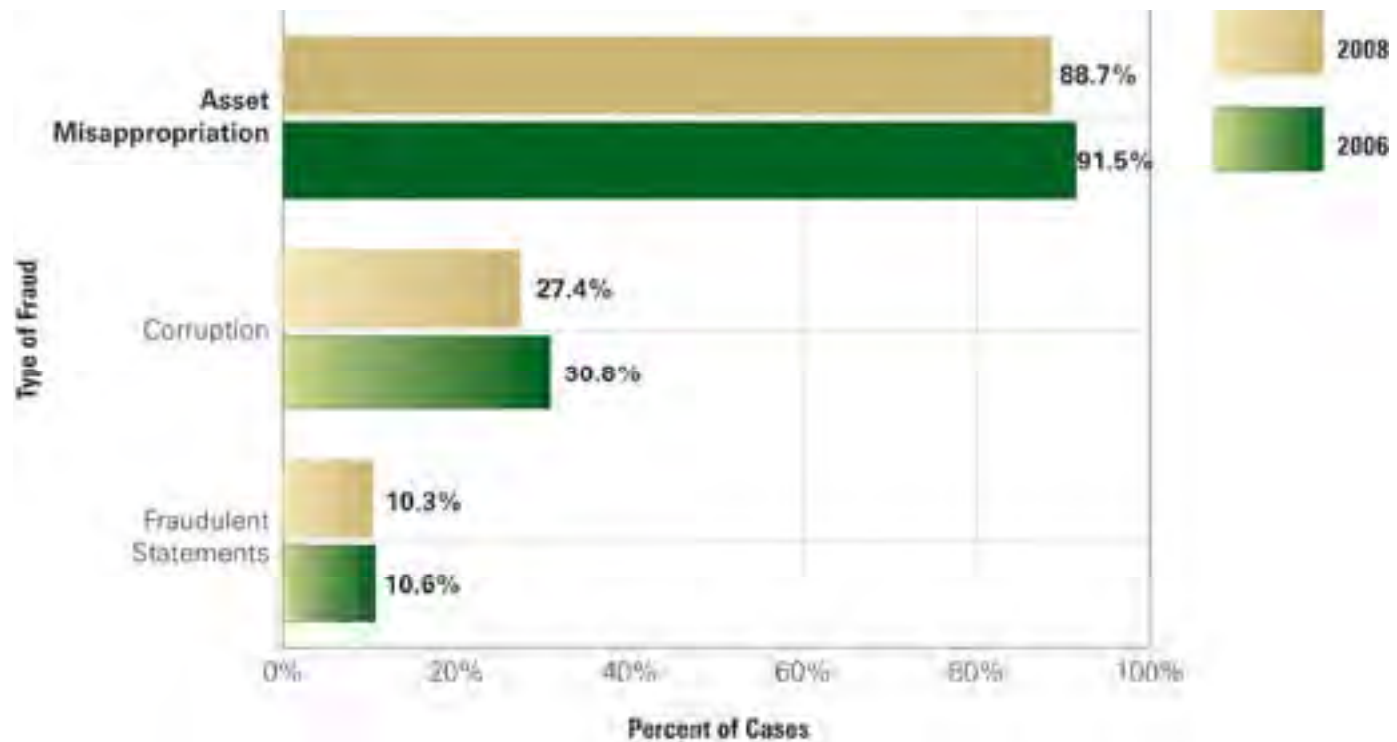
- Internal control system must be monitored by management and others in the organization
- Control deficiencies must be reported upstream
- Restarts the internal control cycle

# Why Consideration of Fraud is crucial.

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- Fraud must be considered to provide reasonable assurance that an intentional misstatement would be detected.
- In most instances, if internal controls are designed to prevent and detect fraud, the controls will detect all other errors.

# Fraud Type Frequency



# Fraud Type Medial Losses



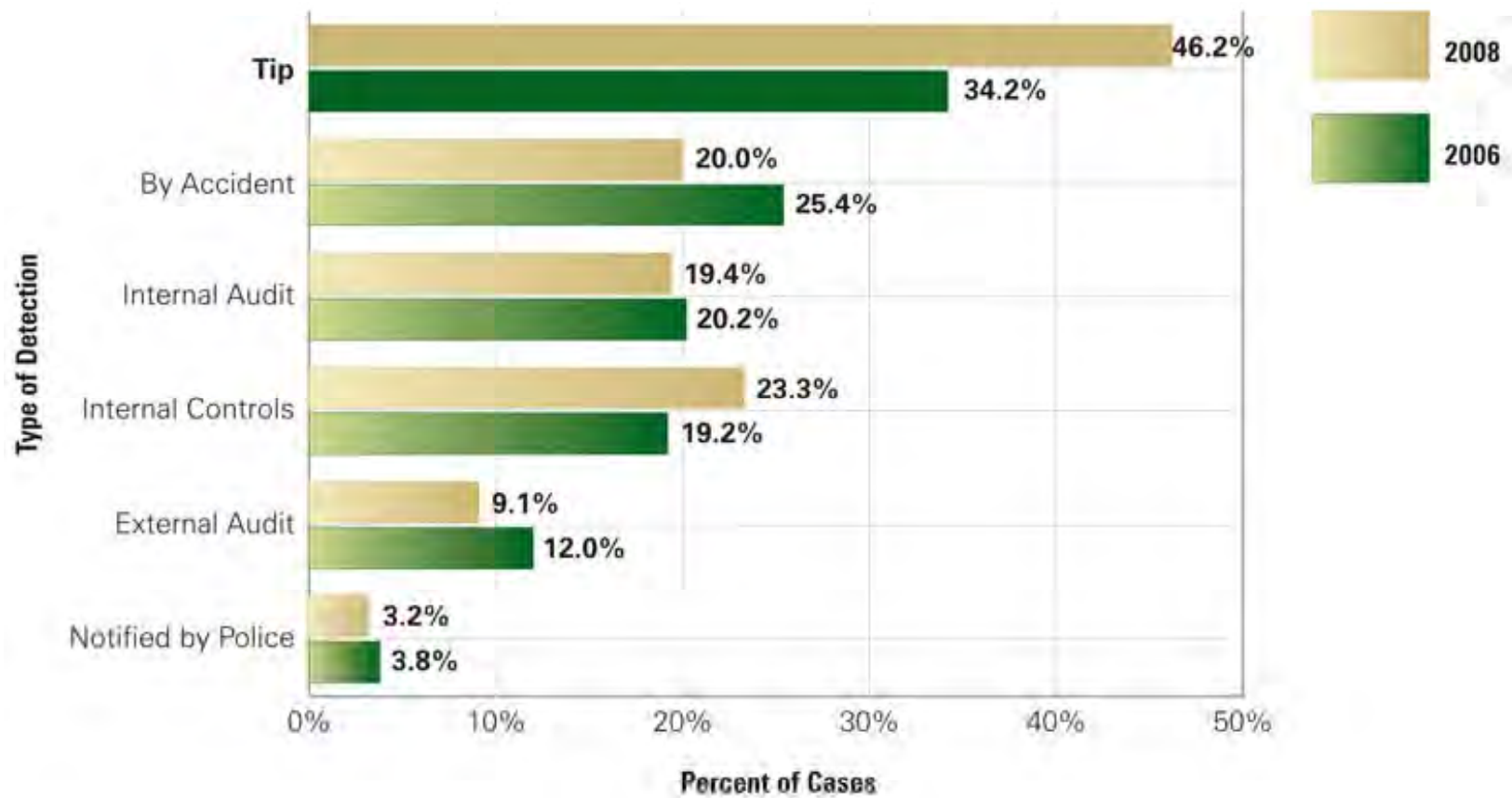
# Types of Misappropriation Frauds

Asset Misappropriation Sub-Categories					
Category	Description	Examples	Cases Reported	Percent of all cases <sup>2</sup>	Median Loss
<b>Schemes Involving Cash Receipts</b>					
Skimming	Any scheme in which cash is stolen from an organization <i>before</i> it is recorded on the organization's books and records.	<ul style="list-style-type: none"> <li>Employee accepts payment from a customer but does not record the sale</li> </ul>	159	16.6%	\$80,000
Cash Larceny	Any scheme in which cash receipts are stolen from an organization <i>after</i> they been recorded on the organization's books and records.	<ul style="list-style-type: none"> <li>Employee steals cash and checks from daily receipts before they can be deposited in the bank</li> </ul>	99	10.3%	\$75,000

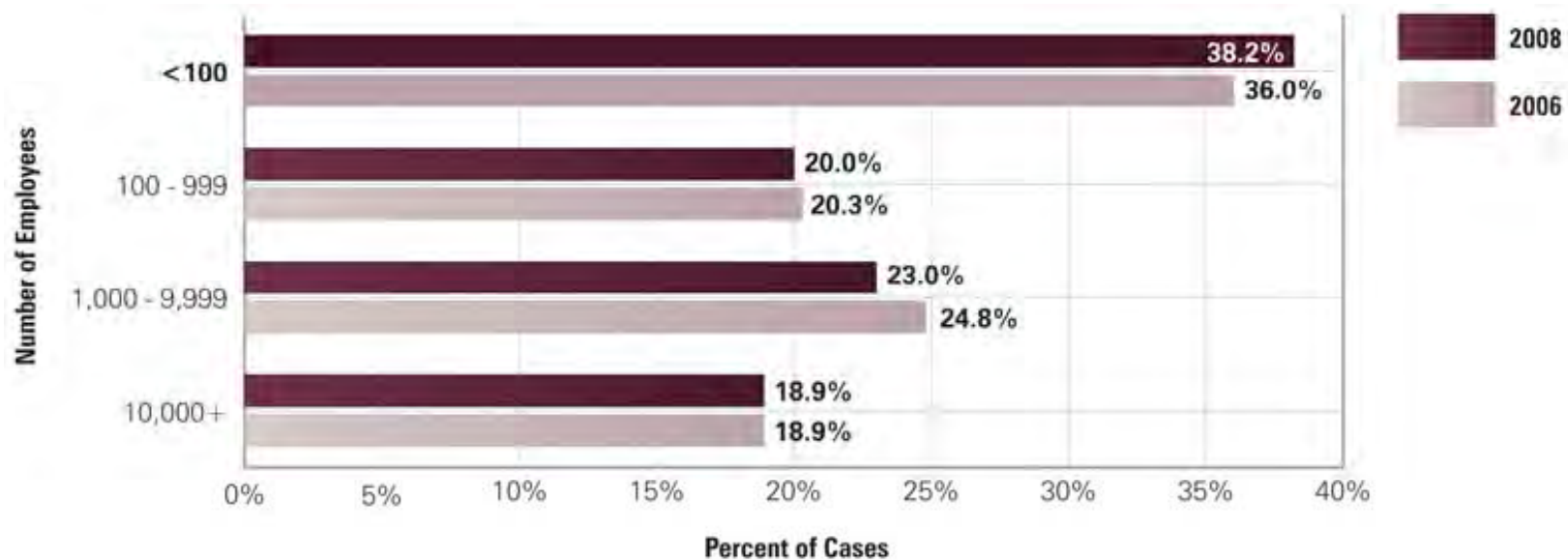
# Types of Misappropriation Frauds

Schemes Involving Fraudulent Disbursements of Cash					
Billing	Any scheme in which a person causes his or her employer to issue a payment by submitting invoices for fictitious goods or services, inflated invoices, or invoices for personal purchases.	<ul style="list-style-type: none"> <li>Employee creates a shell company and bills employer for nonexistent services</li> <li>Employee purchases personal items, submits invoice to employer for payment</li> </ul>	229	23.9%	\$100,000
Check Tampering	Any scheme in which a person steals his or her employer's funds by forging or altering a check on one of the organization's bank accounts, or steals a check the organization has legitimately issued to another payee.	<ul style="list-style-type: none"> <li>Employee steals blank company checks, makes them out to himself or an accomplice</li> <li>Employee steals outgoing check to a vendor, deposits it into his own bank account</li> </ul>	141	14.7%	\$138,000
Expense Reimbursements	Any scheme in which an employee makes a claim for reimbursement of fictitious or inflated business expenses.	<ul style="list-style-type: none"> <li>Employee files fraudulent expense report, claiming personal travel, nonexistent meals, etc.</li> </ul>	127	13.2%	\$25,000
Payroll	Any scheme in which an employee causes his or her employer to issue a payment by making false claims for compensation.	<ul style="list-style-type: none"> <li>Employee claims overtime for hours not worked</li> <li>Employee adds ghost employees to the payroll</li> </ul>	89	9.3%	\$49,000
Cash Register Disbursements	Any scheme in which an employee makes false entries on a cash register to conceal the fraudulent removal of cash.	<ul style="list-style-type: none"> <li>Employee fraudulently voids a sale on his cash register and steals the cash</li> </ul>	27	2.8%	\$25,000
Cash on Hand Misappropriations	Any scheme in which the perpetrator misappropriates cash kept on hand at the victim organization's premises.	<ul style="list-style-type: none"> <li>Employee steals cash from a company vault</li> </ul>	121	12.6%	\$35,000
Non-Cash Misappropriations	Any scheme in which an employee steals or misuses non-cash assets of the victim organization.	<ul style="list-style-type: none"> <li>Employee steals inventory from a warehouse or storeroom</li> <li>Employee steals or misuses confidential customer financial information</li> </ul>	156	16.3%	\$100,000

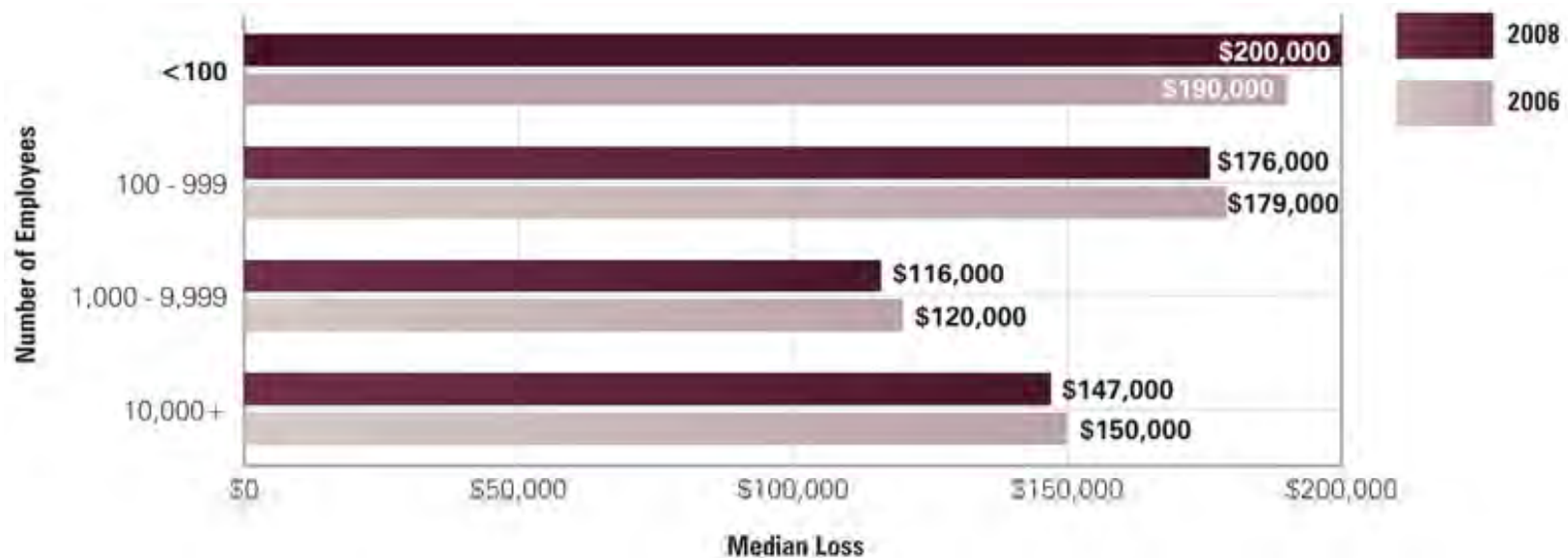
# Initial Detection of Fraud



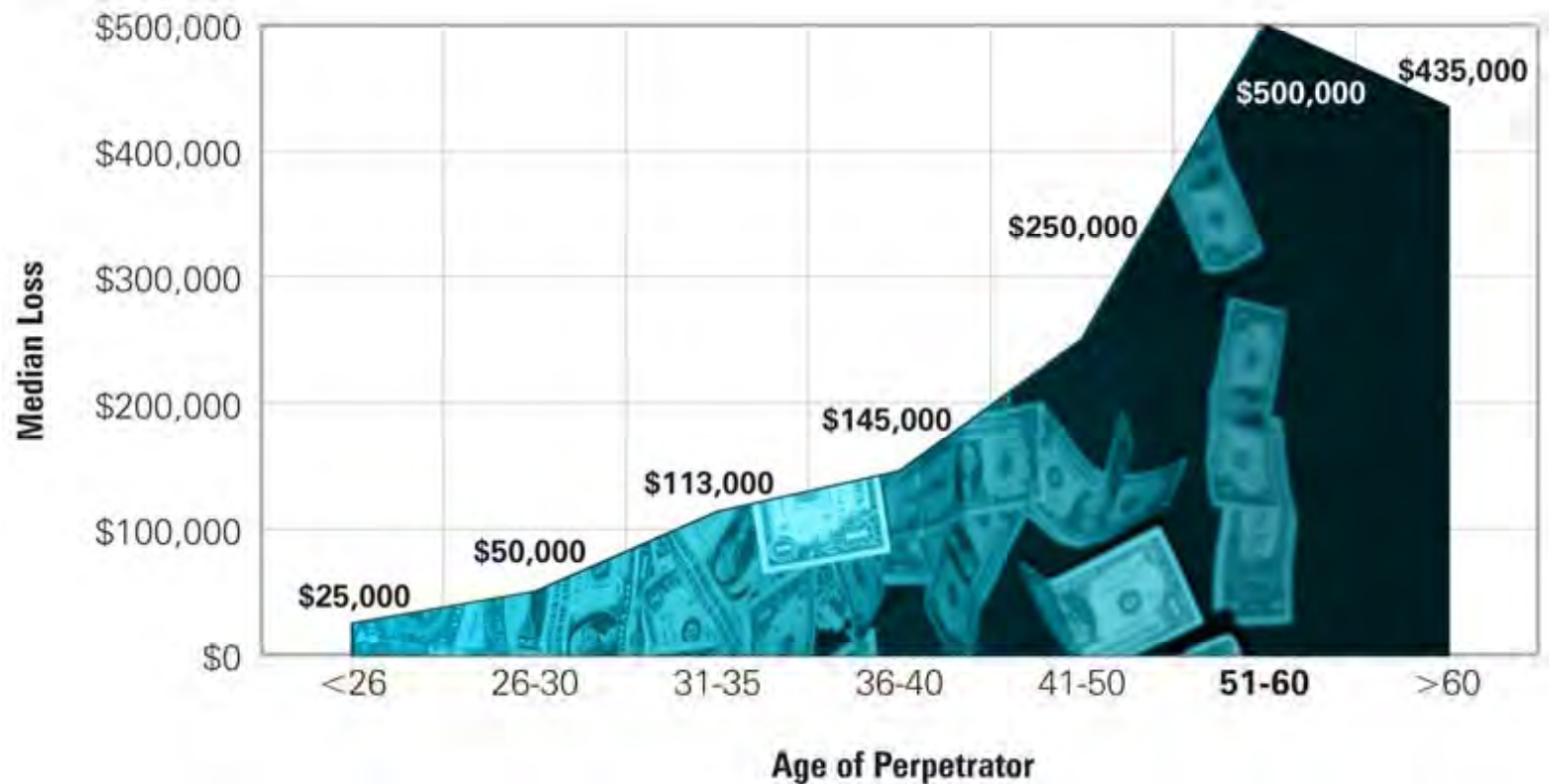
# Size of Victim Organizations – Frequency



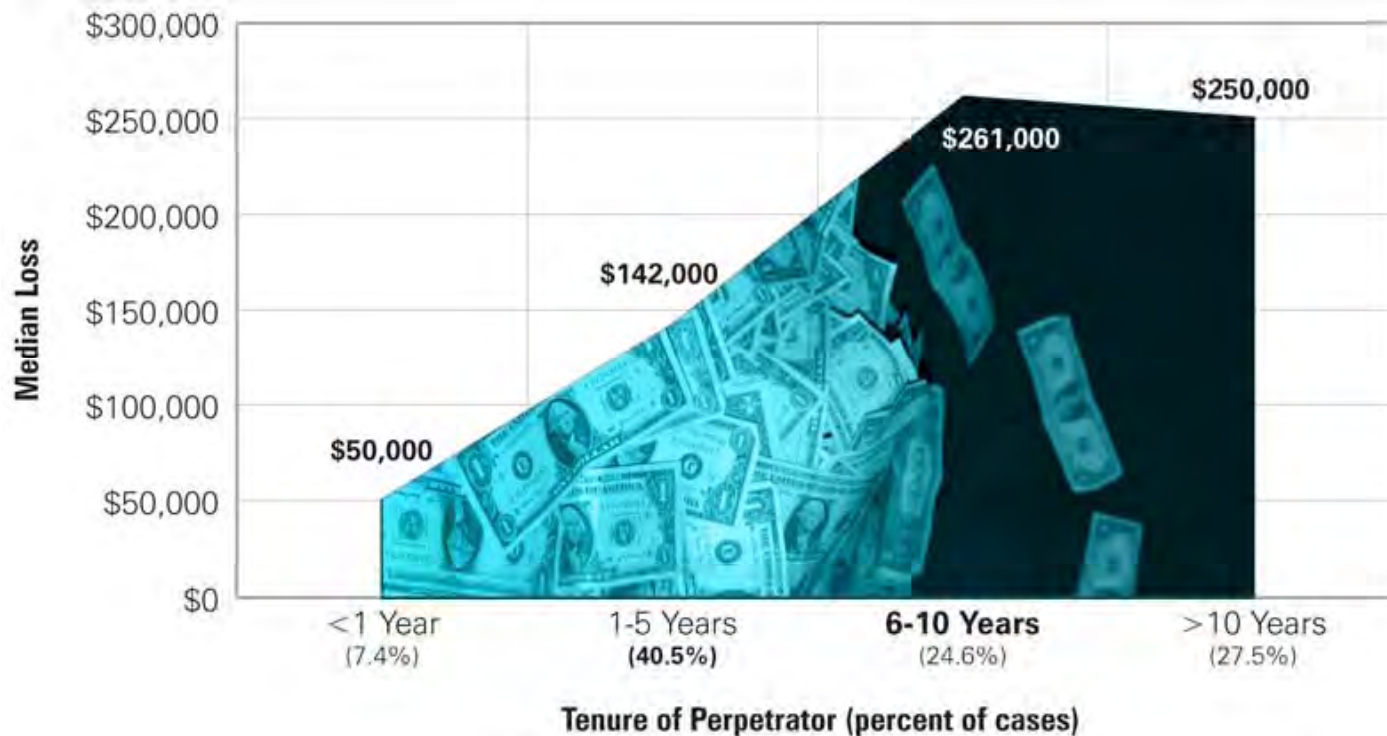
# Size of Victim Organizations – Median Loss



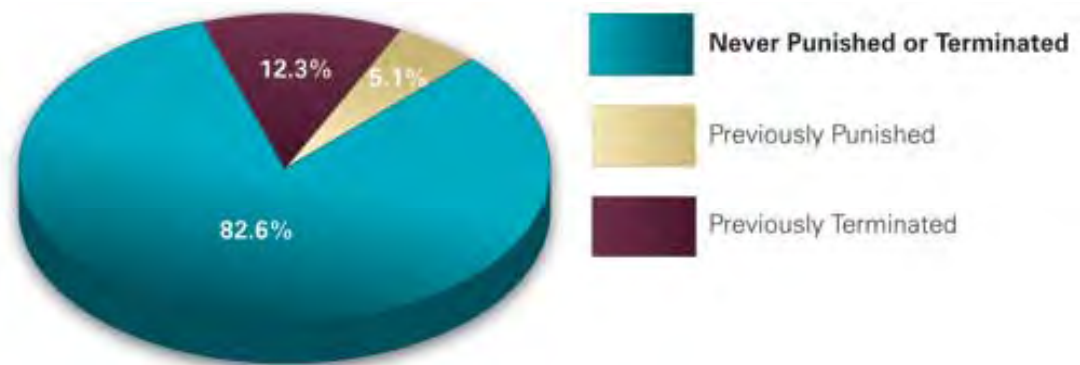
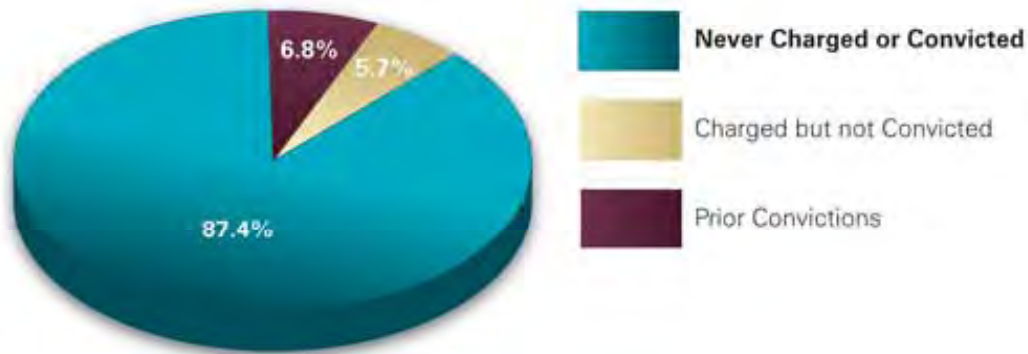
# Median Loss by Age of Perpetrator



# Median Loss by Tenure of Perpetrator



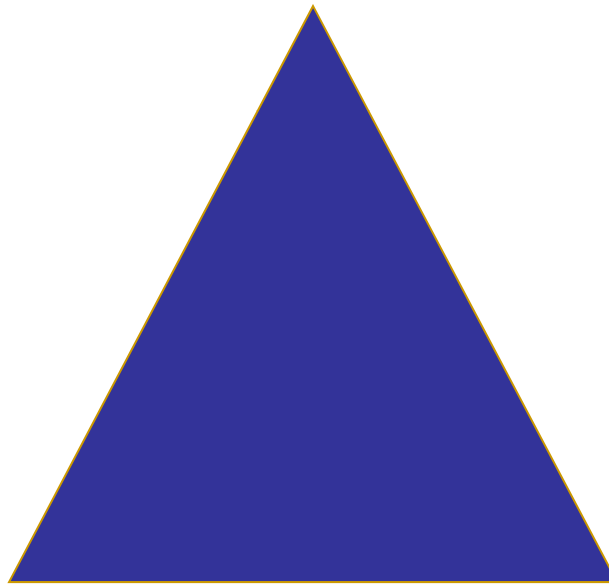
# Perpetrator's Criminal History / Employment History



# Fraud Triangle

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**Opportunity**



**Pressure /  
Incentive**

**Rationalization**

# Fundamental Control Activity: Segregation of Duties

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- Prevent one person from having both access to assets and responsibility for maintaining the accountability of those assets.
- Prohibit the ability of one employee to perpetrate and then conceal errors or fraud.

# Segregation of Duties

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- In general, three roles that must be separated for asset processes:
  - Custody of assets.
  - Authorization/approval of transactions
  - Recording/reporting of transactions and asset balances

# Segregation of Duties

## Example: Receivables and Cash Receipts

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- Custody of assets = anyone who touches the cash
- Authorization = anyone who approves writeoffs, credits, reclassifications
- Record keeping = anyone who posts activity to accounting system and generates reports, bills, statements
- Examples

# Segregation of Duties

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- Other cycles?

# Solution for Small Organizations: Mitigating Controls

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- A type of control designed to compensate for known control weakness
- Generally can only detect, not prevent errors/fraud
- Still requires action from at least one individual independent of the asset process (ideally a board member)
- Examples

# Fundamental Control Activity: Financial Reporting

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- Probably Needed Regularly:
  - Internal financial statements
  - Budget / Actual / Projection
  - Cash flow (if needed)
  - Nonfinancial indicators

# Financial Reporting Expectations

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- Understandability
- Relevance
- Reliability
- Comparability

# Financial Reporting Pitfalls

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- Overly detailed or complex
- Not provided in advance of meetings or significantly altered by time of meeting
- Inaccuracy or inconsistency
- Lots of “what” but no “why”
- Untimely
- No projection

# Financial Reporting – Budget Tips

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- Budget at an account level, report at higher levels
- Make sure “ownership” exists at the account level
- Identify drivers for each account and make sure the related nonfinancial data is tracked
- Report upstream and downstream about budget/actual and related causes
- Always project year-end based on latest knowledge

# Management Override of Controls

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- No matter how strong internal controls are, there is a risk of management override.
- Solution
  - Attention to “tone at the top” by board
  - Communication throughout organization about what to do when override occurs
  - Whistleblower policy
- Also consider minimizing pressure and incentive for fraud by using reasonable expectations and consequences

# Recap

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- Define Internal Control
- Identify Key Components of Strong Internal Controls
- Identify Fraud Considerations
- Discuss Segregation of Duties and Mitigating Controls
- Discuss Financial Reporting to Governing Bodies
- Acknowledge Management Override Risk



Questions?

# Contact Info

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