





## A BEGINNER'S GUIDE TO

# Internal Controls



BY JAMES SEAMAN

Proper internal controls keep your organization and its employees safe from fraud and its repercussions. Often, the key to success is prevention. This article looks at the different types of internal controls and why they are important—and provides simple but effective tips to establish them.

**W**e have all heard about the fraud triangle: rationalization, opportunity, and incentives/pressures. But what we don't always do is to consider what that means in our organizations. In many fraud cases we read about, basic preventive controls were found to have been ignored, or were often completely missing from the organization. At the most basic level, these included access to banking information, cash, or other assets that an employee didn't need access to. Quite often, detective controls including traditional supervisory review activities are not being performed. But these controls can provide an additional level of assurance beyond front-end and often daily transactional controls.

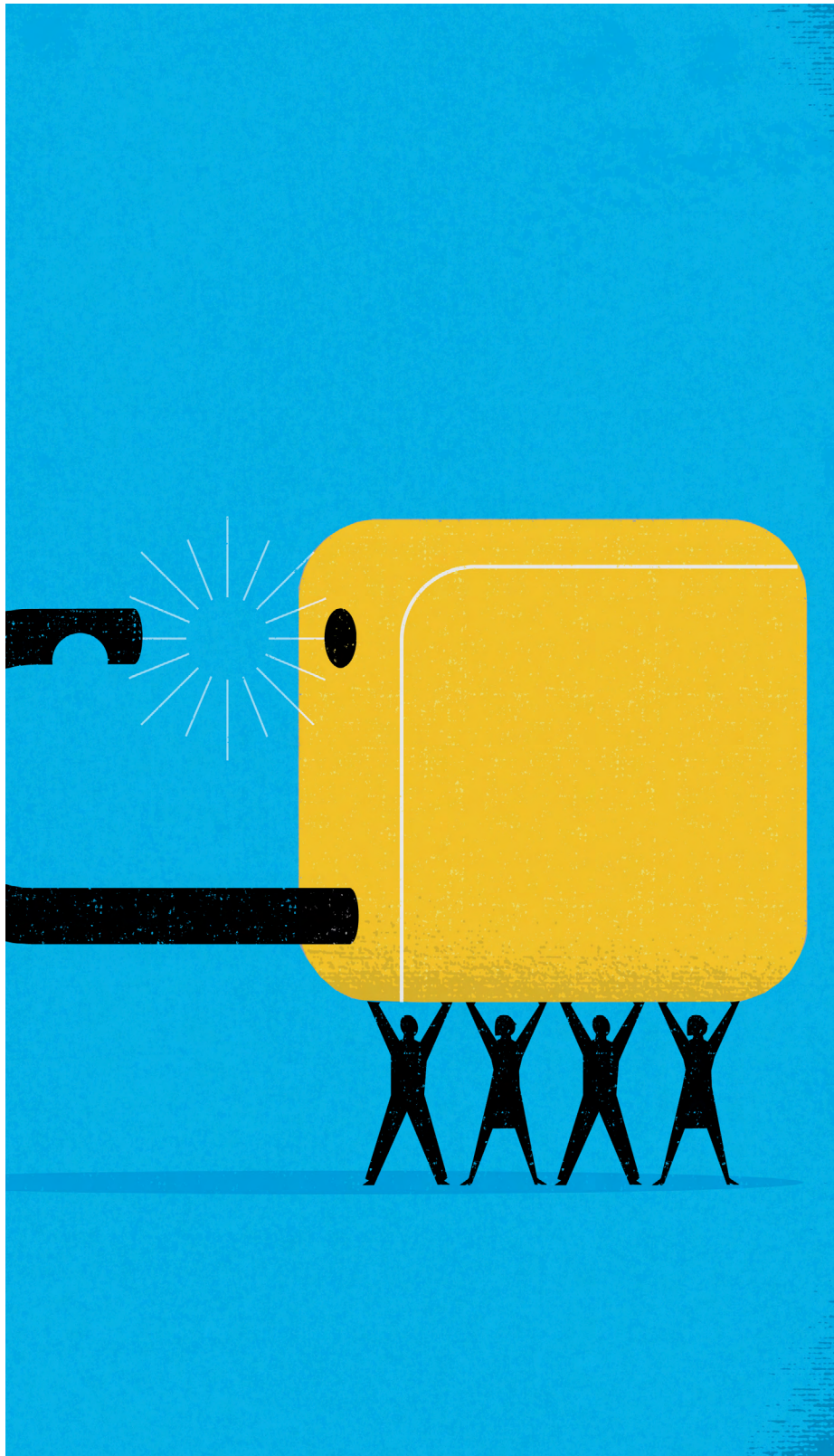
## Why controls are so important

Examples abound of what can happen when proper internal controls aren't implemented. In one recent case, a school district employee gained access to cash deposits and skimmed thousands of dollars from the district before the scheme was finally identified. At another municipality, the council was hesitant to spend American Rescue Plan Act (ARPA) funds because they were concerned about millions of dollars that might have gone missing. In other organizations, inappropriate credit card activity and checks written to ghost companies went undetected for months before coming to light.

In many of these situations, a simple supervisory review would catch these schemes. However, one key control for all organizations—

particularly smaller offices, where segregation of duties can be a challenge—is the completion and review of bank reconciliations. This is a fundamental step, but it obviously isn't being performed as well as it should be. Of further concern, many bank reconciliations are superficial in nature and aren't performed to the degree required to achieve effective cash control. It's been proven that timely completion of bank reconciliations can help mitigate instances of fraud or detect it more quickly.

Segregation of duties is a key internal control that should be implemented wherever possible. For example, once accounts payable cuts a check, someone other than accounts payable should mail it. Bank deposits should be made by someone other than the person who



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records the deposits. The person who deposits funds or writes checks should not be the person who completes the bank reconciliation or posts to the general ledger. Segregation of duties holds individuals accountable. Bank reconciliations should be completed in a timely manner, and any differences should be investigated and resolved right away.

Another example of fraud occurred because the business manager had total control over the checking account. The business manager's supervisors relied on the business manager and trusted his work. There was no supervisory review. It was not until the business manager resigned and a new manager was hired that the fraud was discovered. The bank had implemented a new process of including check numbers on the bank statements, so the new business manager wondered why there were two checks issued with the same check number. The investigation revealed that the previous business manager had obtained two check books—one for the business, and one he used to supplement his lifestyle.

An additional best practice is to periodically review your organization's vendor listing. Any vendor that has been added to the list, or a vendor that isn't on the government's approved list, is a red

flag. Vendors should be reviewed and approved before any payments are made to them.

To share another story, a trusted business manager was able to set up her husband as a fictitious consultant, whom she paid a monthly fee. This went on for some time until a whistleblower complained, and an investigation uncovered the scheme.

Governments need proper system access controls. Be sure that only individuals who are granted access are those who require it to do their jobs. This includes access to bank accounts, the general ledger, inventory, payroll, and other such assets. Proper access controls protect the individual as well as the organization. If an individual does not have access, then they won't be suspected if an issue arises.

### Tips to protect your organization

So, what can we do to help mitigate the risk of fraud? Here are a few tips.

First and foremost, make sure that management sets the tone at the top and implements sound ethical practices. Management must communicate that controls are important, and they must hold all employees accountable for their actions. Management must be transparent and communicate frequently. Management must also act as an example for others to follow.

Management controls are also key internal controls. These include communication and transparency—because, to reiterate, transparency, communication, and openness about public funds act as a control. The acts of management will trickle down to staff, and when management overrides internal controls, the possibility of fraud increases. Sound, ethical procedures from management are a critical success factor to sound internal controls overall.

Evaluate the risk and control culture and engage in cross-functional dialogue about the strategic, operational, financial, compliance, and reputational risks that exist



## 4 simple tips to effective internal controls

- 1 Make sure management sets the tone with sound ethical practices
- 2 Establish communication, transparency and openness about public funds from the top down
- 3 Engage in cross-functional dialogue about the organization's strategic, operational, financial, compliance and reputational risks
- 4 Conduct a supervisory review on the accounts payable disbursements, deposit register and bank reconciliations

within the organization. Identify high-priority risk exposures that should be highlighted for focused management attention and action. Develop policies and implement internal controls that help mitigate the risk of fraud.

A supervisory review should be completed on the accounts payable disbursements, deposit register, and bank reconciliations. All journal entries should be reviewed and approved by management. Your external auditors may require you to sign off on all these reviews.

These are just a few examples of the many internal controls that can be implemented, quite a few of which are unobtrusive and can be baked into the process. If you have only a few staff members, compensating controls can be implemented. Employees can cross check each other's work, and supervisory reviews should always be completed.

If you have a weakness and no control, you have a problem. However, if you have a control and no weakness, you also have a problem—an efficiency problem. We do not want to implement controls for the sake of implementing controls; this is not a “feel safe” process. Too many controls will hinder the process and cut down on efficiency. Controls need to

be focused for a specific process, and reviewed, and then tested periodically. When a process changes, it is a good practice to review the controls in place to ensure that they are still necessary and effective.

### Conclusion

The controls discussed in this article are just a few examples of where simple internal controls could save an organization from loss of funds and the reputational cloud that is associated with fraud once it is publicized. Check out the best practices of Sarbanes Oxley and Internal Controls over Financial Reporting for a more comprehensive listing. Sarbanes Oxley isn't required for government entities, but it is considered good guidance and can be adapted to fit your municipality, regardless of size. There are also many organizations that can help in determining what controls are best for your organization. Check with your external auditors if you are not sure where to turn. ■

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