Internal Control: The Human Risk Factor

PRESENTATION FOR THE TREASURER ORIENTATION FOR THE NAD
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Although gold dust is precious, when it gets in your eyes it obstructs your vision.

Hsi-Tang Chi  735-814
The primary purposes of internal control are to:

1. Protect the assets of the organization
2. Ensure the reliability of the accounting records
Purposes of Internal Control

Protect the assets that are most easily misused (e.g., cash and inventory).

Reliability requires the reduction of the risk of misstatement *due to error* or misstatement *due to fraud.*
Misstatement due to fraud can occur two ways:

- Fraudulent financial reporting ("cooking the books")
- Misappropriation of assets (theft)
Occupational Fraud:

“The use of one’s occupation for personal enrichment through the deliberate misuse or misapplication of the employing organization’s resources or assets.”

Association of Certified Fraud Examiners
Three categories:

Asset misappropriation – 83.5%; $125,000
Corruption – 35.4%; $200,000
Financial Statement Fraud – 9.6%; $975,000
Not-for-profit organizations: 10.1% of the cases; median loss: $100,000

Religious, Charitable, or Social Service organizations: 2.4% of the cases; median loss: $82,000
Primary areas of fraud in Religious, Charitable, and Social Services Organizations:

- Billing: 25.0%
- Cash: 23.1%
- Check Tampering: 25.0%
- Corruption: 28.8%
- Expense Reimbursement: 25.0%
- Skimming: 19.2%
- Payroll: 13.5%
Primary Internal Control Weaknesses for all types of fraud:

- Lack of internal controls: 29.3%
- Override of existing controls: 20.3%
- Lack of management review: 19.4%
- Poor “tone at the top”: 10.4%
- Lack of competent personnel in oversight roles: 6.4%
The Control Environment

Control Pressure Points:

1. Pressures on the individual
2. Rationalization
3. Perceived Opportunity
Elements of Good Internal Control

1. Putting the cash in the bank as soon as possible.
2. Not leaving the door to the safe wide open.
3. Accurate record-keeping and timely reporting.
4. Monitoring the budget; examining any variances.

Segregation of duties.
Segregation of Duties:

Establish responsibility for each task to one person

Separate the record keeping for the assets from the custody of the asset
Case Study for Cash Receipts:

The deacons collect the offerings at the local church. The funds are handed over to the local church treasurer.

The local church treasurer takes the money home; puts it in a drawer; counts it at home on Sunday evening; takes the funds to the bank on Monday morning.
Specifics for Segregation of Duties

What problems do you see?

What should have been done differently?
Specifics for Segregation of Duties

1. More than one deacon should count the monies before handing them over to the church treasurer.
2. Deacons should retain a separate slip indicating the amount collected.
3. Separate slip should be given to the pastor or the chair of the church finance committee.
4. Funds should be deposited immediately; not taken to the treasurer’s home.
Case Study for Cash Disbursements by check:

Unused checks are kept in a box just inside the safe. Check signing machine next to box of unused checks. Large petty cash fund on hand. Petty cash drawer just inside safe; usually unlocked.
What problems do you see?

What should have been done differently?
1. Make all disbursements by prenumbered checks and disburse checks in numerical order.
2. Store blank checks in a secure location.
3. Blank checks should never be signed in advance.
4. Use petty cash for small expenditures; keep petty cash box locked and under the custody of only one person.
5. Bank reconciliations should be done monthly.
Specifics on Segregation of Duties

General Controls for Disbursements:

1. Require all employees who have anything to do with the payment process to take at least five consecutive days of vacation.
2. Checks awaiting signature should be left in a secure location—not on someone’s desk in an empty office.
3. Checks should only be printed when they are going to be mailed--not earlier so they reflect a date that matches your payments terms.

4. By policy, checks should not be returned to the individual who requisitioned the check.

5. Open receivers and purchase orders should always be extinguished when an invoice is paid, even if the invoice is paid outside of accounts payable.
Specifics for Segregation of Duties

6. The organization should have an anonymous tip hotline.

7. The organization should have a written fraud policy, signed by a top-level executive, indicating zero tolerance for employee fraud.
Specifics on Segregation of Duties

Cash Disbursements by credit card:

1. Use corporate credit cards sparingly.
2. Employees should sign an agreement for cc use.
3. Employees are responsible for detailed documentation for all purchases.
4. CC statements should be reviewed regularly.
5. Employees with cc should not submit expense reports.
Specifities on Segregation of Duties

Cash Disbursements by Electronic Methods:

1. Changes made to the master vendor file should be periodically checked, no less frequently than once a month; ideally every week.
2. Inactive accounts in the master vendor file should be annually deactivated.
Specifics on Segregation of Duties

3. Access to the master vendor file for entering vendors or changing vendor information should be severely limited.
4. The positive pay file should be uploaded only when checks are mailed.
5. Processors should not be writing their passwords down where they can be seen.
6. Managers should be prevented from having access to all phases of the payment process.
Specifics on Segregation of Duties

7. The same individual should not both approve invoices and enter invoice data.

8. When a new vendor is to be entered into the master vendor file, two signatures should be required before adding them.

9. When a new vendor is to be entered into the master vendor file, checking should be done to be certain that the vendor is legitimate before adding them.
Specifics on Segregation of Duties

10. When an employee making electronic payment transfers is terminated or leaves voluntarily, the bank should be notified immediately and passwords should be changed.
Specifics on Segregation of Duties

Petty Cash:

- Use an imprest petty cash fund
- Use as infrequently as possible
- Keep the amount small
- Reimburse monthly
- No more than one custodian
- Custodian should have no access to the accounting records or cash receipts
• Make sure the location of the key to the petty cash box is not common knowledge.
• Hold surprise audits, and let everyone know that surprise audits occur.
## Two Person Segregation of Duties

<table>
<thead>
<tr>
<th>CFO</th>
<th>Accountant</th>
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<tbody>
<tr>
<td>Sign checks</td>
<td>Post accounts receivable</td>
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<tr>
<td>Sign employee contracts</td>
<td>Mail checks</td>
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<tr>
<td>Custody of securities</td>
<td>Write checks</td>
</tr>
<tr>
<td>Complete deposit slips</td>
<td>Post general ledger</td>
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<tr>
<td>Perform inter-fund transfers</td>
<td>Reconcile bank statements</td>
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<tr>
<td>Distribute payroll</td>
<td>Post credits/debits</td>
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<tr>
<td>Reconcile petty cash</td>
<td>Give credits and discounts</td>
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<tr>
<td>Record initial charges</td>
<td>Approve payroll</td>
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<tr>
<td>Approve employee time sheets</td>
<td>Open mail/receive cash</td>
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<tr>
<td>Prepare invoices</td>
<td>Disburse petty cash</td>
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<tr>
<td>Complete check log</td>
<td>Authorize purchase orders</td>
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<td>Authorize check requests</td>
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<td>Authorize invoices for payment</td>
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I/C for the Small Organization

1. Record all cash receipts immediately

2. Deposit all cash receipts intact daily

3. Make all payments by serially numbered checks; use an imprest petty cash fund for small disbursements
4. Reconcile bank accounts monthly

5. Use serially numbered sales invoices and purchase orders

6. Issue checks to vendors after the invoices are matched with source documents and approved for payment
7. Balance subsidiary ledgers with control accounts monthly

8. Prepare comparative financial statements monthly in sufficient detail to disclose significant variations in revenue or expense
Questions?
References


