

NAVIGATING THE AUDIT TRAIL AND THE IMPORTANCE OF INTERNAL CONTROLS



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Learning Objectives

What is Auditing?

Types of Audits

External Audit vs. Internal Audit

Risk and Internal Controls

Case Studies

Responsibility for Internal Controls

Fraud

Quiz

What is Auditing?

A methodical examination and review

Verification activity of a process or system to ensure compliance to requirements.

Can apply to an entire organization or might be specific to a function, process, or department.

Often associated with finances and accounting

Some audits, such as internal audits or information technology audits, do not involve financial activity

What is an Audit Trail?

A record of all the transactions or data entries that a person or firm has carried out over a specific period showing the activity from beginning to end. Synonymous with “paper trail.”

Can be paper and/or electronic

Written records that document a process, activity, or event.

A reliable and easy to follow audit trail is an indicator of good internal controls.



Types of Audits

Financial

Compliance

Information Systems

Operational

Types of Audits

Financial

Reviews financial transactions to verify if assets, liabilities, authorizations, and receipt and disbursement of funds are properly and accurately recorded and reported.

Annually, CPA firm expresses a professional opinion on the financial statements

Compliance

Information Systems

Operational

Types of Audits

Financial

Compliance

Adherence to laws and regulations

Information Systems

Operational

Types of Audits

Financial

Compliance

Information Systems

System access

Physical security

Back-up

Confidentiality

Operational

Types of Audits

Financial

Compliance

Information Systems

Operational

Examines the use of resources to determine if they are being used in the most effective and efficient manner to fulfill the organization's mission and objectives.

Evaluates internal controls

An operational audit may include elements of the other audit types listed above.

External vs. Internal Audit

External Audit

Annual financial statement audit by CPA

Federal and State Government Audits

Department of Education

IRS

Grants

Financial Aid

Sales and Use Tax

Payroll

Financial Aid

Internal Audit

Introduction to Internal Audit

Dear Abby,

I am getting married in the near future. However, some of my relatives have questionable backgrounds, and I am not sure whether I should tell my fiancé about them.

My cousin was arrested for shoplifting. My brother is a bank robber. My father is an embezzler. My niece was arrested for assault and battery. My nephew was arrested for insider trading violations, and my second cousin is an internal auditor.

My question, Abby, is whether I should tell my fiancé that my second cousin is an internal auditor.

*Sincerely,
Anonymous – Long Beach, CA*

What is Internal Audit?

“An independent, objective assurance and consulting activity designed to add value and improve an organization’s operations.”

Institute of Internal Auditors

What Do Internal Auditors Do?

Identify and evaluate organizational risk

Ensure internal control systems are well-designed and effective relative to those risks

Review records and obtain information by interviews, questionnaires, and physical inspections

Make recommendations to improve or establish internal controls

Follow up to ensure corrective actions are implemented

Myths About Internal Auditors

“You guys do taxes – right?”

Solely focus on financial records

Auditors are nitpickers and fault finders

It's best not to tell the auditors anything unless they specifically ask

Internal audit is the corporate police function



When Will My Department Be Audited?

Internal Audit annual plan

- Departments are generally notified in advance

- Cashiering areas may be subject to surprise cash counts

Fiscal year-end

- Financial statement audits

No set time frame – but will be notified in advance

- Department of Education

- Granting agencies

What to Do If Your Department is Audited?



What to Do If Your Department is Audited?

Does *not* mean you did something wrong

Prepare to be interviewed

Provide appropriate documents

What Happens During an Audit?

Risk Assessment determines areas of potential risk:

Cash, hazardous waste, identity theft, security threats, etc.

Requests for documents

Internal Control Questionnaire (ICQ)

Review of policies and procedures

Interviews with management and staff

Testing – Trust but Verify



Preparation for an Audit

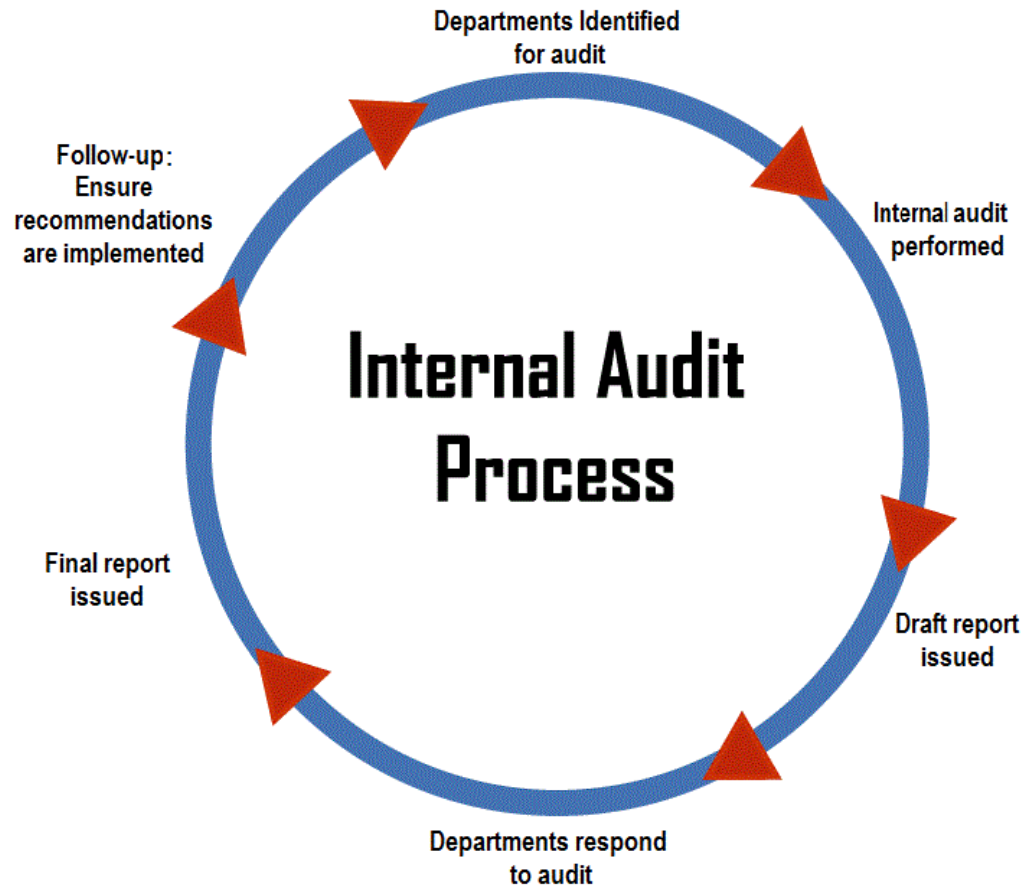
Question:

When do you begin preparing for an audit?

Answer:

Always be prepared for an audit.

The Internal Audit Process



Risk and Internal Controls

Risk definition:

Any issue that could impact the ability of the institution to meet its objectives.

Types of risk:

Financial

Operational

IT

Safety

Personnel

Compliance

Reputation

Risks in the University Environment

Errors and omissions that are not detected

Loss or misuse of valuable resources

Negative publicity and legal costs

Reduced state funding

Reduced private contributions

Disallowances on contracts and grants

A Risk Management Example



Risk Management

Managing the entire range of threats to the well-being of an institution.

Goal is to eliminate negative risk

Reduce risks to an acceptable level

Transfer risks – insurance, third-party vendors

Internal Controls help to reduce or mitigate risk.

What Are Internal Controls?

Steps taken to obtain reasonable assurance that objectives are achieved.

The policies and procedures that help ensure management directives are carried out.

Why Are Internal Controls Important?

Internal controls reduce the likelihood of errors and provide for:

Compliance with laws and regulations

Accountability

Reliable management reporting

Efficient and effective operations

Safeguarding of assets including organizational reputation

Why Are Internal Controls Important?

Internal controls reduce the likelihood of errors and provide for:

**C
A
R
E
S**

That sounds kind of technical.
What does it mean in layman's terms?



Internal Controls

Internal Controls are those processes that management relies on to make sure things *don't get goofed up*.

Personal Internal Control Systems

When you go to work, do you lock the doors to your house?

Do you keep the PIN number of your ATM card confidential and in a safe place?

Do you reconcile your checking account each month?

Do you compare credit card statement charges with your signed receipts?



Similar Internal Controls at the University

Offices, buildings, labs, and state vehicles are kept locked when unoccupied

Computer passwords are periodically changed and shouldn't be written down

Checking management reports and purchase card charges against source documents

Locked cash drawers and safes

Authorizations required for certain activities

Types of Internal Controls

Internal control activities can be:

Preventive

Detective

Preventive Controls

Preventive controls attempt to deter or stop undesirable events from occurring.

Preventive controls are proactive and help to prevent loss.

Preventive Controls Examples

Segregation of duties

No single individual should have control over two or more phases of a transaction or operation

Proper authorization

Supporting documentation

Physical safeguards against fire and theft

Using passwords to protect computer files



Detective Controls

Detective controls attempt to identify undesirable acts

Detective controls provide evidence that a loss has occurred
after the fact.

Detective controls do not prevent a loss from occurring



Detective Controls Examples

Reconciliations

Reviews

Analyses

Investigation of discrepancies

Physical inventories

Audits

Objectives, Risks, and Internal Controls

Every entity has objectives

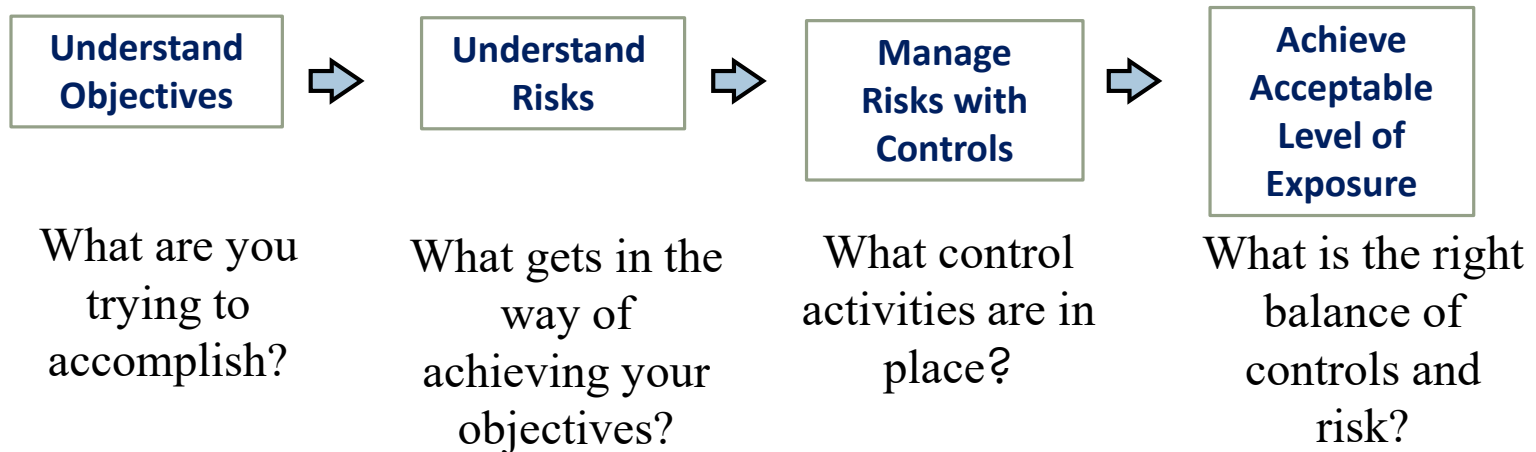
Risks

Threats to achievement of objectives

Internal Controls

Tools to mitigate or manage risk

Internal Control Framework



Internal Control Framework Case Study – Getting to work

Objective

Getting to work on time.





Internal Control Framework

Case Study – Getting to work



<u>Risk</u>	<u>Internal Control</u>
Traffic	Listen to traffic reports
Parking	Arrive early
Speeding ticket	Follow the speed limit
Car breakdown	Schedule regular maintenance
Flat tire	Examine tires
Getting up late	Set an alarm clock
Accident	Drive defensively
Run out of gas	Observe fuel gauge
Illness	Healthy diet, exercise, wellness check-ups
Dead battery	Check headlights, store jumper cables

Internal Control Framework Case Study – Department Revenue

Objective

Deposit funds timely, record in proper accounts, prevent theft and loss

Cash, checks, credit card payments



Internal Control Framework

Case Study – Department Revenue

Risks

Theft

Loss

Not deposited timely (stale dated checks)

Not credited to proper account



Internal Control Framework

Case Study – Department Revenue

What Internal Controls should be in place?

Maintain logs

Provide receipts

Segregation of duties – receipt, processing, reconciling

Security – safes or other locked receptacles

Reconciliations



Internal Control Framework Case Study– Student Timesheet

A student worker on a research grant delivered her timesheet for processing after obtaining her supervisor's signature.

See a problem?

Internal Control Framework Case Study– Student Timesheet

The student falsified her hours after the professor approved the timesheet.

She forged signatures and bypassed the approval process.

An employee questioned the signatures

Consequence to student:

- Expelled

- Criminal conviction

- Served jail time

Internal Control Framework Case Study– Student Timesheet

Objectives

Risks

Internal Controls

Internal Control Framework Case Study– Student Timesheet

Objectives

Allowable expenditures

Account for grant expenditures

Pay authorized wages

Internal Control Framework Case Study– Student Timesheet

Risks

Fraud – theft of funds

Waste, abuse, and misuse of resources

Loss of future grants

Loss of reputation and negative publicity

Internal Control Framework Case Study– Student Timesheet

What Internal Controls should be implemented?

Segregation of duties

Students don't deliver timesheets

Reconciliations

Verification of authorized signatures

Internal Control Framework

Case Study– Grade Reporting

Several students reported that the final grades they expected were not what they received.

How could this happen?



Internal Control Framework Case Study– Grade Reporting

Objectives

Risks

Internal Controls

Internal Control Framework Case Study– Grade Reporting

Objectives

Right grades are reported

Security of grade reporting

Internal Control Framework Case Study– Grade Reporting

Risks

Fraudulent Grade Reporting

Errors

Reputation – makes the University look vulnerable

Internal Control Framework Case Study– Grade Reporting

What Internal Controls should be implemented?

Reconciliations

System access

Users receive notification if password has changed.

Never share passwords

Responsibility for Internal Controls

Management is responsible for developing an appropriate system of internal controls.

Every employee is responsible for following and applying those practices.

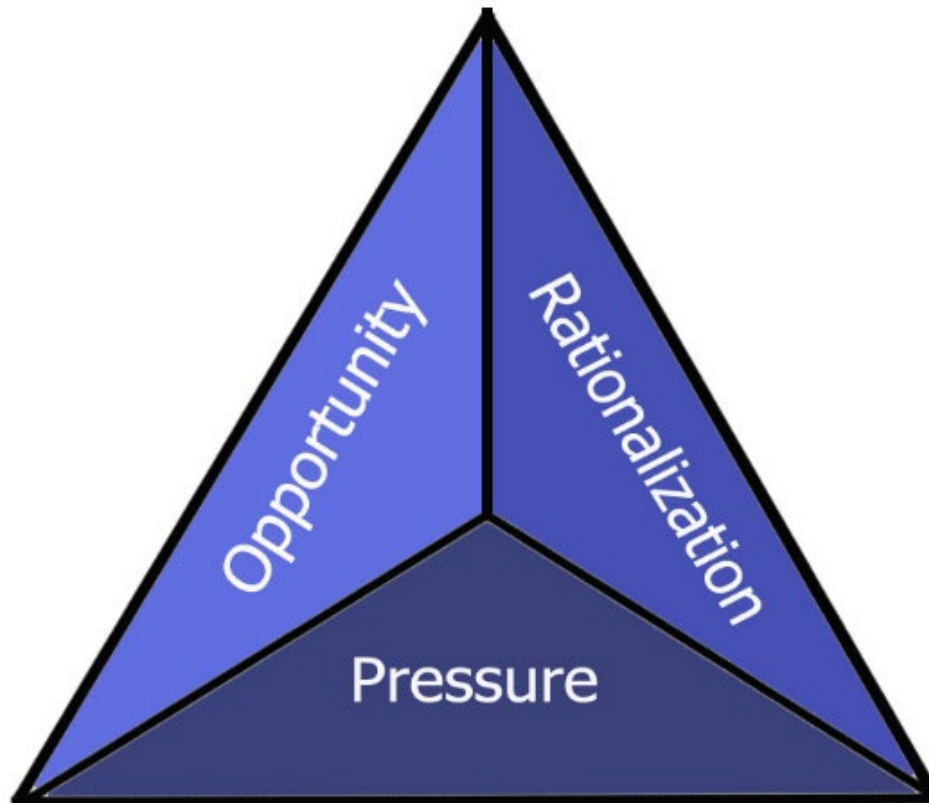
What is Fraud?

Any intentional or deliberate act to deprive another of property or money by guile, deception, other unfair means.

Lying for money

Fraud Factors

The Fraud Triangle



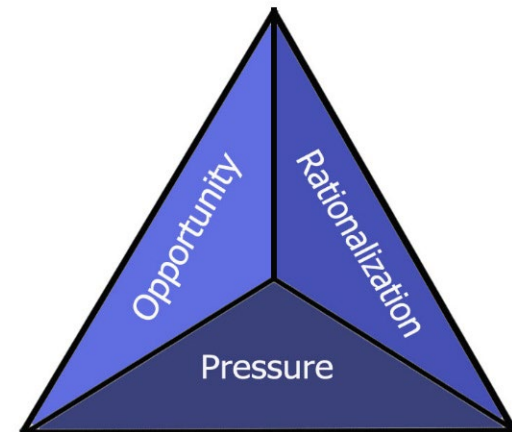
Fraud Factors

- ▶ Pressure/Motive
 - Financial need; Revenge

- ▶ Opportunity
 - No segregation of duties; no supervision

- ▶ Rationalization
 - I'm underpaid
 - They won't miss it
 - I need it more than they do
 - I'll pay it back

The Fraud Triangle



Fraud Factors

Pressure/Motive

Financial need; Revenge

Opportunity

No segregation of duties; no supervision

Rationalization

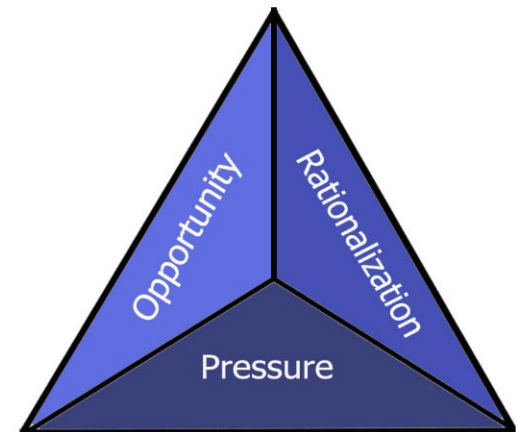
I'm underpaid

They won't miss it

I need it more than they do

I'll pay it back

The Fraud Triangle



Profile of an Internal Fraudster

Usually male

Intelligent

Egotistical

Inquisitive/risk taker

Hard worker/Rule Breaker

Under stress

Disgruntled/Complainer



Fraud Red Flags & Warning Signals

Rationalization of contradictory or irrational behavior

Absence of strong code of personal ethic

Unstable life style; “Wheeler-Dealer” personality

Braggs about past criminal background or friends

Salary garnishment, calls from credit/collection agencies

Expensive lifestyle – cars, jewelry, Vegas weekends

Never takes vacation

Unrealistic desire for self-enrichment/personal gain w/o the necessary ambition

White-Collar “Red Flags”

Outside internal interest

Rising department expenses

Significant increases in revenue – explanation not
plausible

Poor internal controls

Too much control in key employee

Lax management

Fraud & Abuse

Personal use of campus equipment, services, & postage

Approval of a contract based on favoritism

Check theft (receipts & disbursements)

Use campus to receive stolen/illegal goods

Theft

False time sheets

Not charging for services

Fraud at Universities

EUREKA

Ex-University Official Gets Jail Term for Fraud

Humboldt State's former director of university advancement has been sentenced to a year in jail for a string of charges related to fraudulent expenses and lying to officials.

John Sterns was sentenced by Humboldt County Superior Court Judge John T. Feeney on nine counts of forgery, falsifying government records and theft by false pretenses.

During his three years as director of university advancement, Sterns claimed nearly \$50,000 in fraudulent expenses and told the university he raised \$15 million more than he had actually raised.

Fraud at Universities

Admissions Scandal

Cheating on standardized tests

Student-athlete recruitment
scam

You're on Thin Ethical Ice When You Hear:

Well, maybe just this once...

No one will ever know...

Everyone does it.

Shred that document.

We can hide it.

No one will get hurt.

What's in it for me?

We didn't have this conversation.



When in Doubt, Ask

Are my actions legal?

Am I being fair and honest?

Will my actions stand the test of time?

How will I feel about myself afterwards?

How will it look in the newspaper?

Will I sleep soundly tonight?

What would I tell my child to do?

How would I feel if my family, friends and neighbors knew what I was doing?

Internal Control Quiz

Any questions before we begin the quiz?



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