

# NAVIGATING THE AUDIT TRAIL AND THE IMPORTANCE OF INTERNAL CONTROLS



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## Agenda

- 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?

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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?

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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

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- Financial
- Compliance
- Information Systems
- Operational




## Types of Audits

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- 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

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- Financial
- Compliance**
  - Adherence to laws and regulations
- Information Systems
- Operational



## Types of Audits

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- Financial
- Compliance
- Information Systems**
  - System access
  - Physical security
  - Back-up
  - Confidentiality
- Operational

## Types of Audits

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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

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### **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

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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?

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“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?

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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

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“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

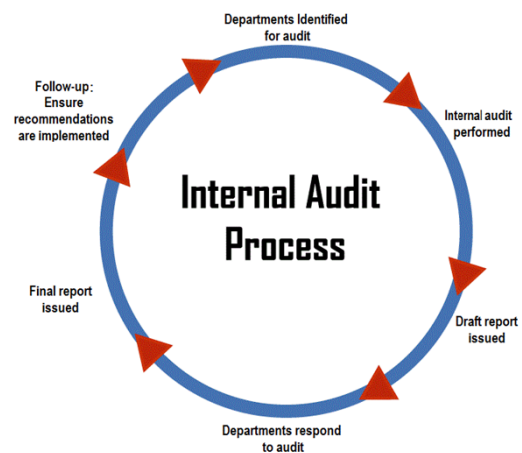
Question:

When do you begin preparing for an audit?

Answer:

Always be prepared for an audit.

## The Internal Audit Process





## Risk and Internal Controls

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### 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

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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?

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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?

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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?

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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?

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## Internal Controls

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

## Personal Internal Control Systems

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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

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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

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Internal control activities can be:

Preventive

Detective



## Preventive Controls

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

Preventive controls are proactive and help to prevent loss.

## Preventive Controls Examples

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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

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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

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Reconciliations

Reviews

Analyses

Investigation of discrepancies

Physical inventories

Audits

## Objectives, Risks, and Internal Controls

Every entity has objectives

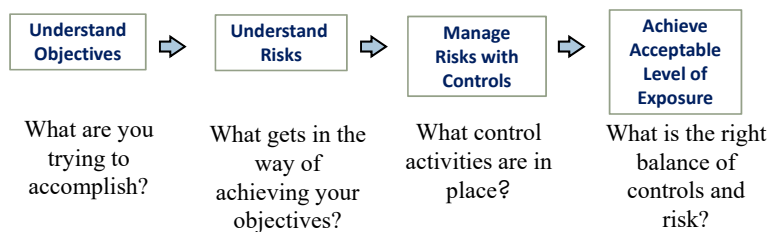
### Risks

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

### Risks

Traffic  
Parking  
Speeding ticket  
Car breakdown  
Flat tire



Getting up late  
Accident  
Run out of gas  
Illness  
Dead battery



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## Internal Control Framework Case Study – Getting to work

What Internal Controls do you need to implement?

Listen to traffic reports  
Use an alarm clock  
Arrive early  
Obey laws



Get enough sleep  
Car maintenance  
Check gas gauge  
Check tires



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## Internal Control Framework Case Study – Department Revenue

Objective

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

Cash, checks, credit card payments





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## Internal Control Framework Case Study – Department Revenue

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### Risks

Theft

Loss

Not deposited timely (stale dated checks)

Not credited to proper account



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## Internal Control Framework Case Study – Department Revenue

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### 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

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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

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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

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Objectives

Risks

Internal Controls



## Internal Control Framework Case Study– Student Timesheet

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Objectives

- Allowable expenditures
- Account for grant expenditures
- Pay authorized wages





## Internal Control Framework Case Study– Student Timesheet

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### 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

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### 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

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### Objectives

Right grades are reported

Security of grade reporting



## Internal Control Framework Case Study– Grade Reporting

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### Risks

Fraudulent Grade Reporting

Errors

Reputation – makes the University look vulnerable



## Internal Control Framework Case Study– Grade Reporting

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What Internal Controls should be implemented?

Reconciliations

System access

Users receive notification if password has changed.

Never share passwords



## Responsibility for Internal Controls

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

**Every employee** is responsible for following and applying those practices.

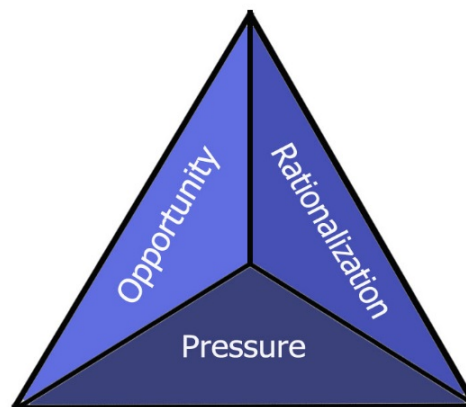
## What is Fraud?

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



## 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






## Profile of an Internal Fraudster

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- Male
- Intelligent
- Egotistical
- Inquisitive/risk taker
- Hard worker/Rule Breaker
- Under stress
- Disgruntled/Complainer





## Fraud Red Flags & Warning Signals

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- 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”

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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

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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.

## 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

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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

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Any questions before we begin the quiz?





## Contact Information

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