



# Why Me? Why Internal Controls?

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# Contact Information

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*The Opinions expressed during this presentation are my own. They do not necessarily represent the views of the Tennessee Comptroller of the Treasury, his representatives, or the Tennessee Department of Audit.*

# Kids are a lot of trouble!

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- ◆ Car Seats
- ◆ Changing Diapers
- ◆ Shoes and Socks
- ◆ Cabinet locks and stair gates
- ◆ Special foods
- ◆ Doctor Checkups and Immunizations
- ◆ Listening to children's videos over and over, and over, and over, etc. ....!!
- ◆ Cleaning after stomach viruses

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We take care of what we value!

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**Internal Controls are a lot less  
trouble than Kids!**

**And they cost a lot less too!**

## Section 9-18-102(a), TCA

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- ◆ Each agency of state government and institution of higher education along with each county, municipal, and metropolitan government shall establish and maintain internal controls, which shall provide reasonable assurance that:

# Section 9-18-102(a), TCA

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- ◆ (1) Obligations and costs are in compliance with applicable law
- ◆ (2) Funds, property, and other assets are safeguarded against waste, loss, unauthorized use, or misappropriation; and
- ◆ (3) Revenues and expenditures are properly recorded and accounted for to **permit the preparation of accurate and reliable financial and statistical reports and to maintain accountability over the assets.**

# Section 9-18-102(a), TCA

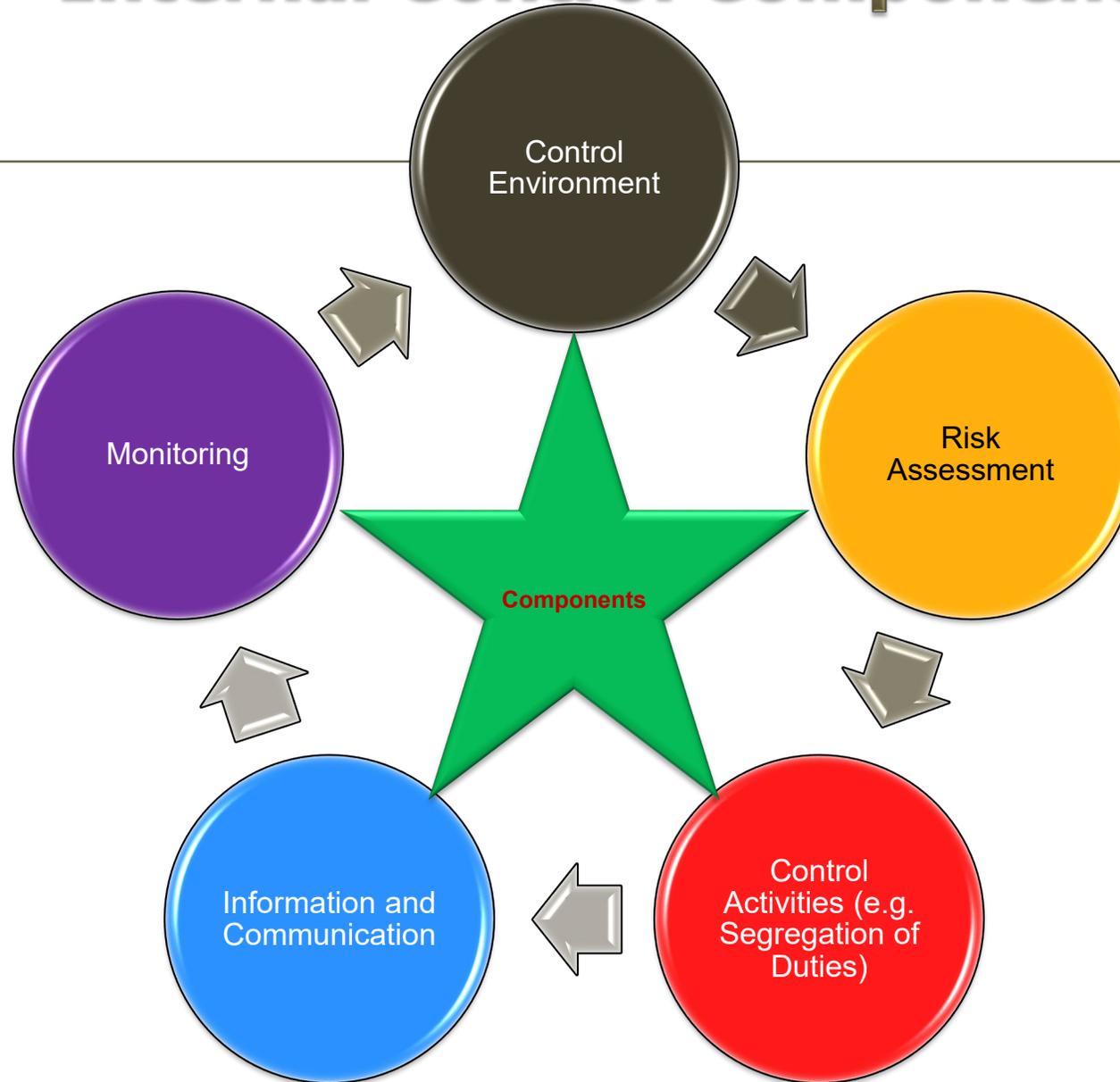
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- ◆ This act shall take effect June 30, 2016, the public welfare requiring it.

# OMB Uniform Guidance

- ◆ **Effective for new grants received after December 26, 2014.**
- ◆ 200.303 Internal controls.
- ◆ The non-Federal entity must:
- ◆ (a) Establish and maintain effective internal control over the Federal award that provides reasonable assurance that the non-Federal entity is managing the Federal award in compliance with Federal statutes, regulations, and the terms and conditions of the Federal award. These internal controls should be in compliance with guidance in “Standards for Internal Control in the Federal Government” issued by the Comptroller General of the United States or the “Internal Control Integrated Framework”, issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO).
- ◆ (b) Comply with Federal statutes, regulations, and the terms and conditions of the Federal awards.
- ◆ (c) Evaluate and monitor the non-Federal entity’s compliance with statutes, regulations and the terms and conditions of Federal awards.
- ◆ (d) Take prompt action when instances of noncompliance are identified including noncompliance identified in audit findings.
- ◆ (e) Take reasonable measures to safeguard protected personally identifiable information and other information the Federal awarding agency or pass-through entity designates as sensitive or the non-Federal entity considers sensitive consistent with applicable Federal, state, local, and tribal laws regarding privacy and obligations of confidentiality.

# Internal Control Components



# Internal Controls

## ◆ Control Environment:

- ◆ The **control environment** is the foundation for any internal control system. This is sometimes known as the tone at top. It provides the discipline and structure to help a government achieve its objectives. The control environment relates directly to the direction and tone set by government leaders such as governing bodies and elected officials. ***The control environment is generally seen as the most important of the five components.*** Examples:
- ◆ The governing body and managers establishing a **professional code of conduct for the government**. This would demonstrate a commitment to integrity and ethical values. Government leaders would need to be shining examples of professional integrity and ethical values for the control environment to be effective.
  - Conflict of Interest Policies
  - Nepotism Policies
  - Internal Audit
  - Audit Committee
  - Fraud Reporting Method or Hotline
  - Harassment Policies and a Method of Communication.
  - Discrimination Policy and a Method of Communication.
- ◆ Management is primarily responsible for establishing a comprehensive framework of internal control, but the governing body remains ***ultimately*** responsible for ensuring that management meets its responsibilities in this regard. An independent audit committee would help provide this necessary oversight.

# Internal Controls

## ◆ Risk Assessment:

- **Risk Assessment** is just what it sounds like it is. The government would intentionally assess the risks it faces. What might keep me from achieving my objectives? The risk assessment provides the basis for developing policies and procedures to respond to risks. An example would be, considering the possibility that an employee might use a government credit card to purchase personal items.
- **Ask, Where could something go wrong?**
  - ◆ I'll just purchase Insurance?
  - ◆ I'll contract for an Audit?

# Internal Controls

## ◆ Control Activities:

- **Control Activities** are the actions the governing body and management take to achieve their objectives and to respond to risks identified during the risk assessment process. Control activities generally consist of written policies and procedures to ensure that risks are reduced to an acceptable level.
- Examples would be, issuing prenumbered receipts and checks, reconciling the bank statement, controlling access to credit cards, managing gasoline inventory, locking cash in a safe at night, segregation of duties, etc. Control activities are typically not complex or costly to implement. They are mostly just common sense.
- Most of the internal control findings auditors write fall under the control activity area and most of these weaknesses are considered significant because potentially they could lead to fraud, waste, and abuse.

# Internal Controls

- ◆ Information and Communication:
  - **Information and Communication** deal with the ability of the government to produce and communicate accurate information. This just doesn't happen by magic. It is an intentional result of an interaction of the control environment, risk assessment, and control activities.
  - For example, actions taken ensure the quality of a government's financial statements. Producing high quality financial statements in accordance with generally accepted accounting principles requires training and hiring employees that understand accounting.
  - That just sounds like common sense, but the reality is, for many governments in Tennessee, employees responsible for preparing financial statements do not understand generally accepted accounting principles (GAAP).

# Internal Controls

## ◆ Monitoring:

- **Monitoring** is the activity management undertakes to assess the quality of the performance of internal controls over time. Monitoring also helps detect and promptly correct any weaknesses before they get out of control. **It is similar to looking for cracks in a dam before the dam bursts or checking the oil in a car.** An example might be surprise cash counts or examining some purchases to be sure that all purchasing controls had been followed.
- **The reality is, internal controls can be properly designed, implemented, documented, and communicated, but if they are not monitored, over time they will eventually deteriorate and cease to be effective.**
- **Sometimes management overrides internal controls. Whenever management overrides internal controls, it is a bold announcement to employees that the internal controls are unimportant. If the boss doesn't do it why should I? This is only one example of why internal controls deteriorate over time.**
- Another aspect of monitoring involves any **grant** that you receive and pass-through to another entity.

# Internal Controls

## ◆ Another Way to Look At Internal Controls:

- Government managers spend a lot of time and effort trying to make sure that things go right with their governments. Sometimes they spend almost as much time reacting and trying to fix the problems that arise when things go wrong. Internal controls are a means of ensuring that governments meet their stated objectives.
- **In other words, internal controls are a simple way to make things go right and to prevent things from going wrong.** These controls should be designed to work even when no one is watching. Government managers cannot watch or be hands on with regard to every transaction that occurs within a government operation. There are too many moving parts, too many transactions, too many different people involved.
- This is where internal controls are the most valuable. They help ensure that even though the “cats away” transactions and events are managed in accordance with management’s directions and policies.
- Most government problems that get published as audit findings are the direct result of the absence or failure of some type of internal control.

# Internal Control Training

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- ◆ There has been more training and more presentations made about internal controls over the last four years than on any other subject of which I am aware.
- ◆ State Statute was passed.
- ◆ Since then MTAS and CTAS have both implemented internal control classes.
- ◆ The Comptroller has issued several articles and press releases related to internal controls.
- ◆ I have taught about internal controls to participants at TGFOA, NASACT, AGA, ACFE, virtually every County Officials Association, and much more.

# Internal Control Training

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◆ And yet,

◆ We are not there yet.

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**Too much fraud  
by  
Justin P. Wilson  
Comptroller of the Treasury**

Wearing a seat belt, looking both ways before crossing a street, glancing occasionally over a teenager's shoulder when she is on the internet. We do these things to manage risk and most risks are not difficult to spot. Auditors call this "implementing internal controls."

Governments need internal controls to operate efficiently. They need them to manage fraud, waste, and abuse. **The frauds reported in a recent XXXXXXXXXXXX-News article could have been prevented by the most basic of internal controls. This is rather obvious in hindsight, but hindsight does prevent fraud. Only foresight prevents fraud.**

**There is far too much fraud occurring in local governments in XXXXXXXXXXXXXXXXXXXXXXXX.**

Basic internal controls are not difficult or costly to implement. An effective control can be as simple as having one person place an order, and another person pay the bill. Just as simple as using numbered receipts, locking a file cabinet containing sensitive documents, or periodically changing passwords. The controls should be as sophisticated as necessary to deal with the risk involved.

# Too much Fraud

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Basic internal controls are not difficult or costly to implement. An effective control can be as simple as having one person place an order, and another person pay the bill. Just as simple as using numbered receipts, locking a file cabinet containing sensitive documents, or periodically changing passwords. The controls should be as sophisticated as necessary to deal with the risk involved.

Recent legislation requires local governments to adopt and implement a system of internal controls for their finances. Some have taken this responsibility seriously. Others, well, may have gone through the motions, but leadership for one reason or another is not fully committed. Only when elected officials, top management, and governing bodies, such as the County Commission, are committed to integrity and this commitment is modeled and communicated throughout the organization, will even the best designed internal control effectively prevent, detect, or correct fraud, waste or abuse. For good or bad, the "tone at the top" trickles down into the entire organization and becomes its culture and shared values.

When government leaders decide to get serious about fraud, waste, and abuse, we will see a sharp decline in the number of cases reported in our audits, investigative reports, and local newspapers.

Ensuring that public funds are spent properly is not just the responsibility of government leaders. Citizens and government employees also have a role to play. Citizens need to insist that the "tone" is based on ethical values and that findings reported by auditors are corrected. Government employees are often aware of what is happening long before a report of fraud, waste, or abuse appears in an audit report, investigation, or newspaper. **Employees must report inappropriate behavior by government leaders or other employees. Every government should have in place a safe mechanism for employees and citizens to report fraud, waste, abuse, and harassment.**

The Comptroller's Office has operated a toll-free hotline since 1983. Anything you report to the hotline is considered confidential information. If you have reason to suspect fraud, waste, or abuse of government funds or property, please call the hotline at 1-800-232-5454, or use our online reporting form at [comptroller.tn.gov](http://comptroller.tn.gov).

- ◆ **A Simple Idea That Works**
  - ◆ By Justin P. Wilson
  - ◆ **Comptroller of the Treasury**
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Americans are familiar with the concept of “separation of powers” or “checks and balances” in the U.S. Constitution. Because of this idea, one branch of government cannot control the implementation of any important law. The president is subject to congress, and congress is subject to the decisions of the Supreme Court. In addition, it takes both the House of Representatives and the Senate to pass a law. This system of checks and balances as outlined in our constitution has served us well since 1789. These simple ideas are basic to our democracy. The same types of ideas apply to state and local governments.

As Comptroller of the Treasury, I head the Department of Audit. The Department of Audit is responsible for auditing the State of Tennessee, all county and city governments in Tennessee, and a large group of related entities. State and local governments have various types of checks and balances in place. The main purpose of these checks and balances is to prevent or detect errors and fraud. Auditors refer to these checks and balances as “internal controls”. They are described as “internal” because the government intentionally puts them in place within the government’s management system. They are described as “controls” because their purpose is to control and protect public assets. Auditors see fraud in Tennessee governments all too often. Where there is fraud, there is almost always a corresponding weakness in internal controls.

# A Simple Idea that Works

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One of the simplest and most basic forms of the check and balance principle is called “separation of duties”. This principle requires that no employee involved in a transaction should be able to initiate, approve, and record the same transaction. These duties should be separated between at least two employees. Another way of saying the same thing is: one employee should not control a transaction from start to finish. For example, if a government employee issues a receipt for a taxpayer’s property taxes, that same employee should not record the transaction on the books, deposit the money in the bank, and then reconcile the bank account. Another simple example is requiring two signatures on a check before it is approved for payment. Makes sense doesn’t it? And what is even better, separation of duty controls work and they don’t cost a lot implement!

If separation of duty controls are simple and are not expensive to install, why have many offices within local governments in Tennessee not installed them? Good question. It’s not because auditors haven’t made government officials aware of the benefits. We have. It’s not because separation of duty controls don’t work. They do. It’s not because they are expensive. In most situations, they aren’t. The main reason seems to be that “it has always been done this way.”

Separation of duties is a simple idea that works. Auditors have first-hand knowledge of how checks and balances can prevent errors and fraud. Separation of duties is really the beginning point for all other types of checks and balance controls. **Regardless of how complex government becomes, the separation of duties principles will always apply.**

If you would like to learn more about checks and balances, my office would like to help. You may contact auditors that work with local governments by visiting the Comptroller’s website at [www.comptroller.tn.gov](http://www.comptroller.tn.gov) or by calling the Division of Local Government Audit at 615.401.7841. Our mission is to make Tennessee governments work better.

Have You Ever Wondered?  
By Justin P. Wilson  
Comptroller of the Treasury

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**Have you ever wondered what our world would be like if there were no standards.** An inch was not an inch; A mile was not a mile; A pound was not a pound; A gallon was not a gallon; A size ten was actually size two; A DVD would not work in but one type of player; etc. You get the point! We need standards, the world works better when we have basic standards.

In 1988 the federal government designated the metric system as the preferred system of weights and measures for the United States in trade and commerce. The metric system was designated for use by federal agencies but not for the private sector. It's 2013, and I'm still using inches and gallons. Just a little reminder of how much we all resist change even though the change may be for the better.

As Comptroller of the Treasury, I head the Department of Audit. The Department of Audit is responsible for auditing the State of Tennessee, all county and city governments in Tennessee, and a large group of related entities. You may not be aware of this, but auditors have standards they must follow. Auditors cannot just perform an audit any way they like. This makes sense, otherwise every auditor would do things differently from every other auditor and no one would know whether or not to rely on our audits. In other words, a pound would not be a pound.

One of the most important standards auditors must follow relates to internal controls or what you may know as “checks and balances.” Auditors are required to look for internal controls and then report on what we find. It should not surprise you when I say; there are also standards for the types of internal controls that should be in place within a government.

State and local governments should have various types of internal controls in place. The main purpose of these internal controls should be to prevent or detect errors and fraud. These controls are described as “internal” because the government should intentionally put them in place within the government’s management system. They are described as “controls” because their purpose should be to control and protect public assets. Public officials and government employees have a responsibility to guard the public trust by controlling and protecting public assets. **So what type of controls should be standard for local governments? The following list represents the general types of controls auditors expect to see when they perform an audit of a local government:**

# Have you ever wondered?

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**Separation of Duties – No one person should initiate, approve, and record a transaction.**

**Computer – General and Application controls such as using passwords or the software not allowing changes to file information.**

**Collections – Controls that ensure all collections are deposited.**

**Purchasing – Controls to make sure that purchases are properly approved and are in accordance with the budget.**

**Payments – Controls that ensure that checks are issued for only authorized purchases and for the correct amount. Travel and Credit Card Policies, etc. should be developed and implemented.**

**Equipment and Buildings – Controls to ensure that equipment and buildings are protected from loss or misuse. Equipment and Buildings should be insured and not used for a private purpose.**

**Fraud – Controls should be implemented to discourage fraud and abuse. One example might be establishing a Fraud Hotline for reporting fraud or abuse. The Comptroller of the Treasury has a fraud hotline that you can call to report suspected fraud, waste, or abuse in your local government. You may report anonymously. The number for the Hotline is 1-800-232-5454.**

Obviously, this list is not intended to be all inclusive, but it does give you an idea of what auditing standards require auditors to look at.

Auditors see fraud in Tennessee governments all too often. Where there is fraud, there is almost always a corresponding absence or weakness in the government's internal controls. Auditors have first-hand knowledge of how internal controls can prevent errors and fraud. Governments will never become so sophisticated that internal controls are not required. Regardless of how small or large, simple or sophisticated, a government may be, certain basic internal controls such as those listed above will always be necessary. Remember, our world does not work as well when a pound is not a pound.

If you would like to learn more about internal controls, my office would like to help. You may contact auditors that work with local governments by visiting the Comptroller's website at [www.comptroller.tn.gov](http://www.comptroller.tn.gov) or by calling the Division of Local Government Audit at 615.401.7841. Our mission is to make Tennessee governments work better.

# The Itch

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- ◆ Everyone has an itch from time to time. It's just part of life. If you have a normal itch, the answer to this problem is simple, you scratch it. This is a natural and virtually automatic reflex. The Office of Comptroller of the Treasury in the state of Tennessee has been stressing the "itch" for many years. The response to that itch has been less than automatic and far from adequate in many local governments. However, maybe, just maybe, local governments have begun to recognize and deal with the problem. **The "itch" is fraud, waste, and abuse. The "scratch" is internal controls.**

An inconvenient truth!

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People will  
Steal

# QUIZ

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- ◆ **How many components of internal control are listed in the COSO Framework and GAO Greenbook?**
  - A. It depends on the type of government.
  - B. Three
  - C. Five
  - D. Seventeen
  - E. None of the above

# QUIZ

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- ◆ **Which of the following components of Internal Control is considered the most important??**
  - A. Risk Assessment
  - B. Monitoring
  - C. Control Environment
  - D. Control Activities
  - E. Fraud Detection
  - F. None of the above.



STATE OF TENNESSEE  
**EXECUTIVE ORDER**  
BY THE GOVERNOR

No. 2

**AN ORDER CONCERNING ETHICS POLICIES APPLICABLE TO, AND ETHICS  
DISCLOSURES REQUIRED OF, EXECUTIVE BRANCH EMPLOYEES**

**WHEREAS**, establishing, communicating, complying with, and enforcing a robust and comprehensive ethics policy within the Executive Branch of the State of Tennessee is essential to maintaining public trust in government and ensuring the proper performance of government; and

# Governor's 2<sup>nd</sup> Executive Order

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Each employee shall avoid any action, whether or not specifically prohibited by statute, regulation, or this Order, which might result in or create the appearance of:

- a. Using public office for private gain;
- b. Giving preferential treatment to any person;
- c. Impeding government efficiency or economy;
- d. Losing complete independence or impartiality;
- e. Making a government decision outside of official channels; or
- f. Affecting adversely the confidence of the public in the integrity of the government.

# QUIZ

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◆ **Which of the following statements are true?**

- A. I only need a general internal control policy. Specific policies are not necessary.
- B. I need to have more policies where there is more risk.
- C. I need to have specific policies at remote collection sites.
- D. I need to have specific policies where cash is collected.
- E. If someone has worked for me for 20 years, they can be trusted, and internal controls are good but not essential.
- F. All of the above are true.
- G. B, C, and D are true.

# QUIZ

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◆ **Which of the following statements are true for Cybersecurity?**

- A. I will never get hacked.
- B. Cybersecurity is the least of my worries.
- C. Ransomware is only something large governments (Atlanta) have to worry about.
- D. The easiest way to breach cybersecurity is through my office email account.
- E. Any email message that has the name of an employee of my government attached is safe.
- F. All of the above are true.
- G. Only D is true.

# Trust

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- ◆ “There is no kind of dishonesty into which otherwise good people more easily and more frequently fall than that of defrauding the government.”

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# HOW ON EARTH COULD THIS HAPPEN??

An actual Tennessee fraud case

# Could this happen to you?

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- ◆ How could one man divert cash deposits totaling \$338,000 for his own benefit?
- ◆ How could one man replace most of that cash in separate deposits (lapping) and this not be noticed?
- ◆ How could one man still manage to keep over \$69,000 for his own use that never was deposited?

# Could this happen to you?

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- ◆ **How could one man prepare a check, sign the check, and prepare a fake invoice. How could one man direct an employee to cash the check and bring the cash to him.**

# Could this happen to you?

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- ◆ How could one man add 3,000 hours of compensatory time to his leave balance even though city policies prohibited the employee from accruing comp time?
  - This would amount to 97 hours per week, 14.5 hours a day for a seven-day week or 19.5 hours a day for a five day week.

# Could this happen to you?

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- ◆ How could one man add approximate 2,000 hours of compensatory time to his leave balance for the previous two years and then begin to pay himself for the leave?
- P.S. Did I mention that he had another job on the side that was unauthorized.

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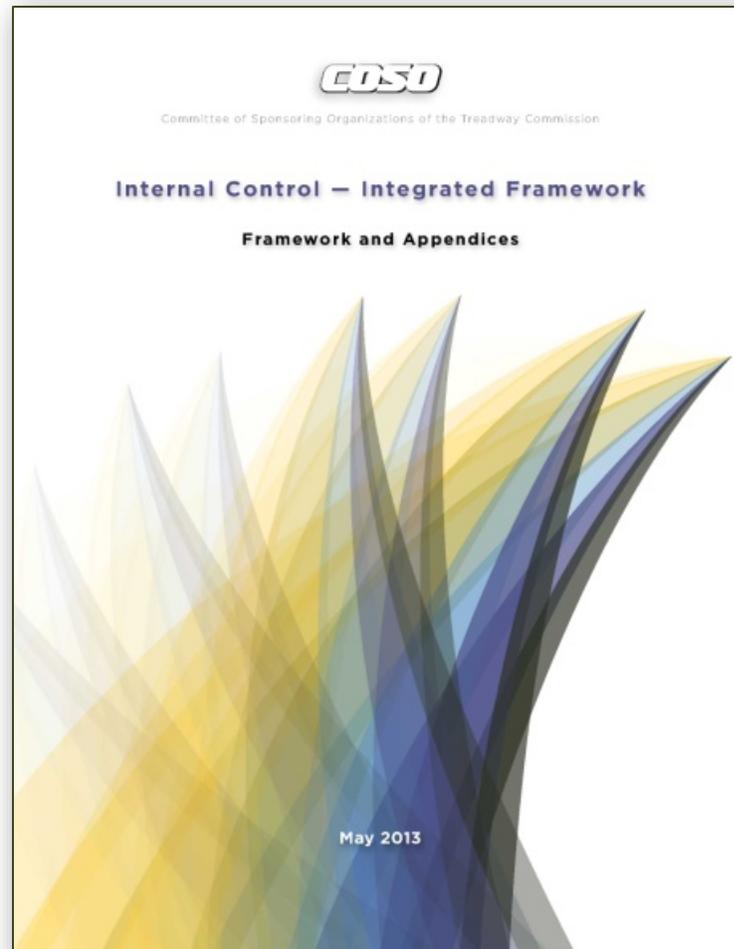
**NOT ROCKET  
SCIENCE!**

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# SOURCES OF GUIDANCE

# Updated COSO Framework

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Released  
May 14, 2013

# The COSO Framework

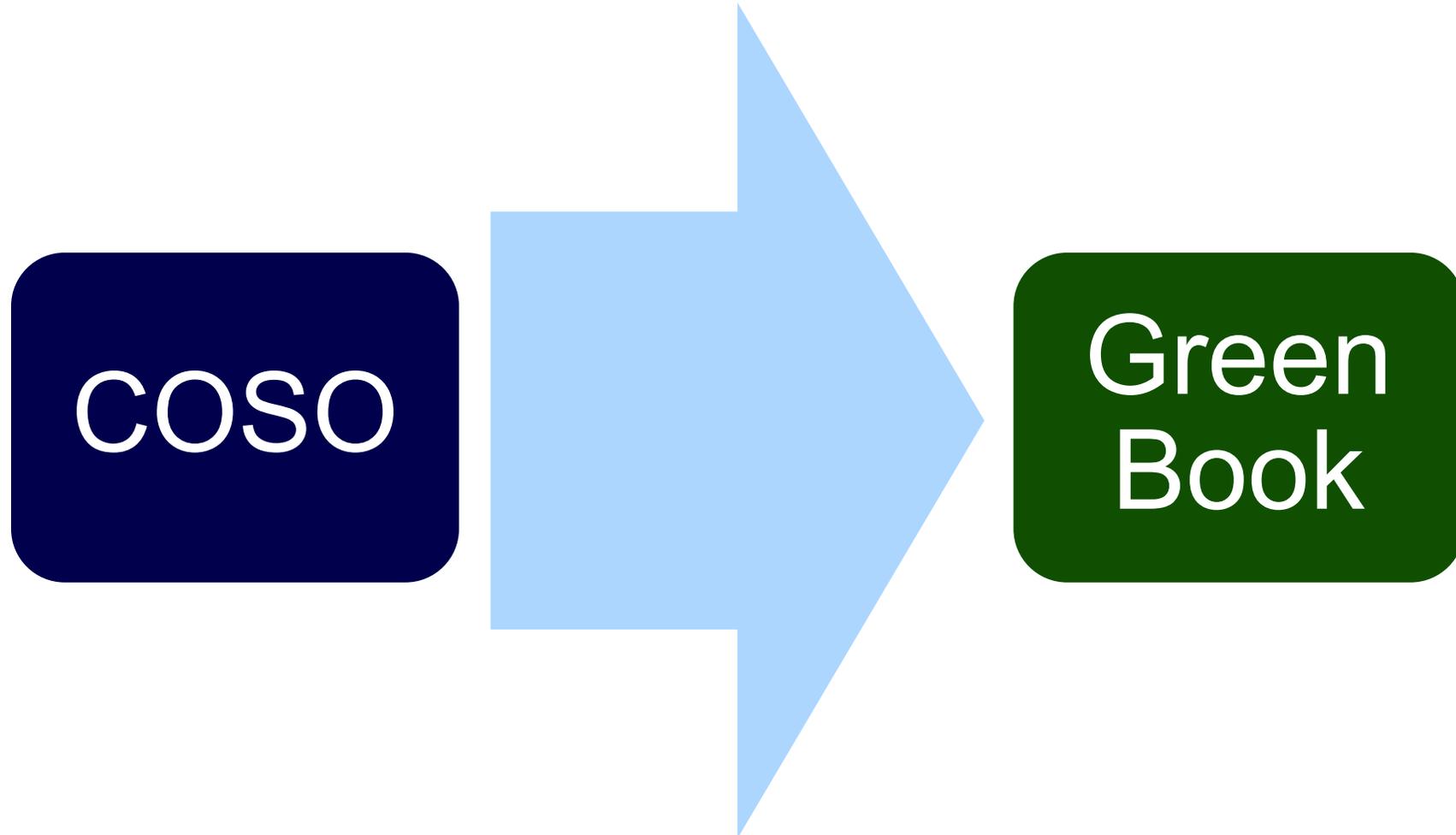
- Relationship of Objectives and Components
  - Direct relationship between objectives (which are what an entity strives to achieve) and the components (which represent what is needed to achieve the objectives)
- COSO depicts the relationship in the form of a cube:
  - The three objectives are represented by the columns
  - The five components are represented by the rows
  - The entity's organization structure is represented by the third dimension



Source: COSO

# From COSO to Green Book: Harmonization

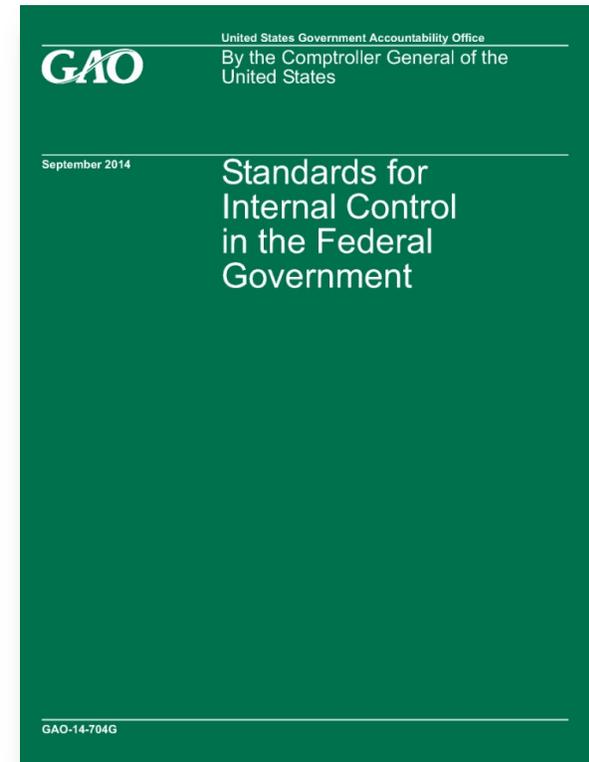
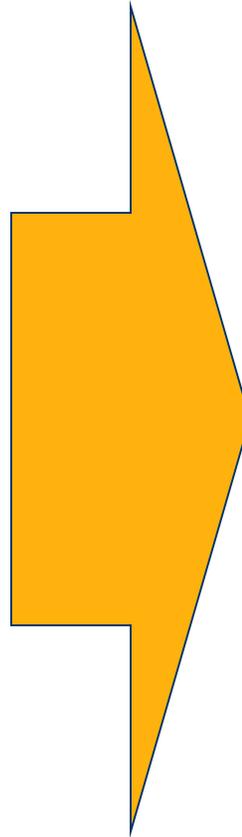
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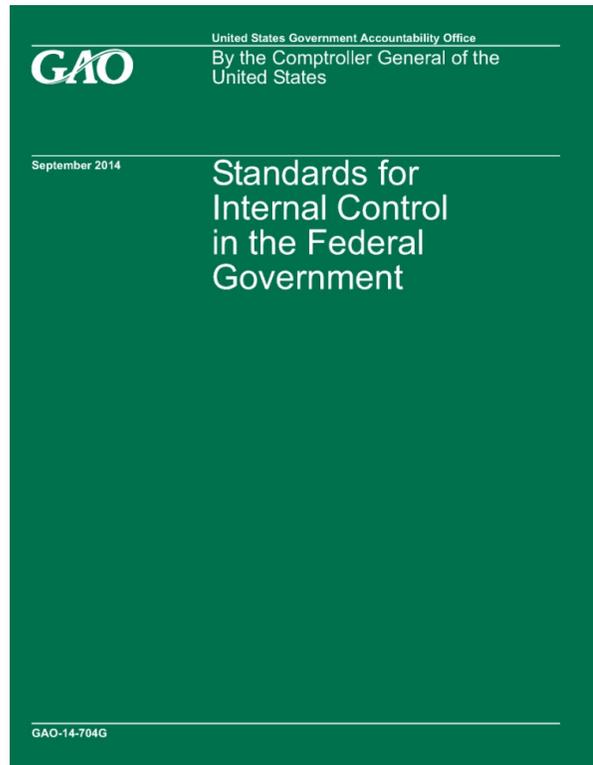
# Revised Green Book:

Overview

Standards



# Revised Green Book:



- Consists of two sections:
  - Overview
  - Standards
- Establishes:
  - Definition of internal control
  - Categories of objectives
  - Components and principles of internal control
  - Requirements for effectiveness

# Revised Green Book: Principles

## Control Environment

1. Demonstrate Commitment to Integrity and Ethical Values
2. Exercise Oversight Responsibility
3. Establish Structure, Responsibility, and Authority
4. Demonstrate Commitment to Competence
5. Enforce Accountability

## Risk Assessment

6. Define Objectives and Risk Tolerances
7. Identify, Analyze, and Respond to Risk
8. Assess Fraud Risk
9. Analyze and Respond to Change

## Control Activities

10. Design Control Activities
11. Design Activities for the Information System
12. Implement Control Activities

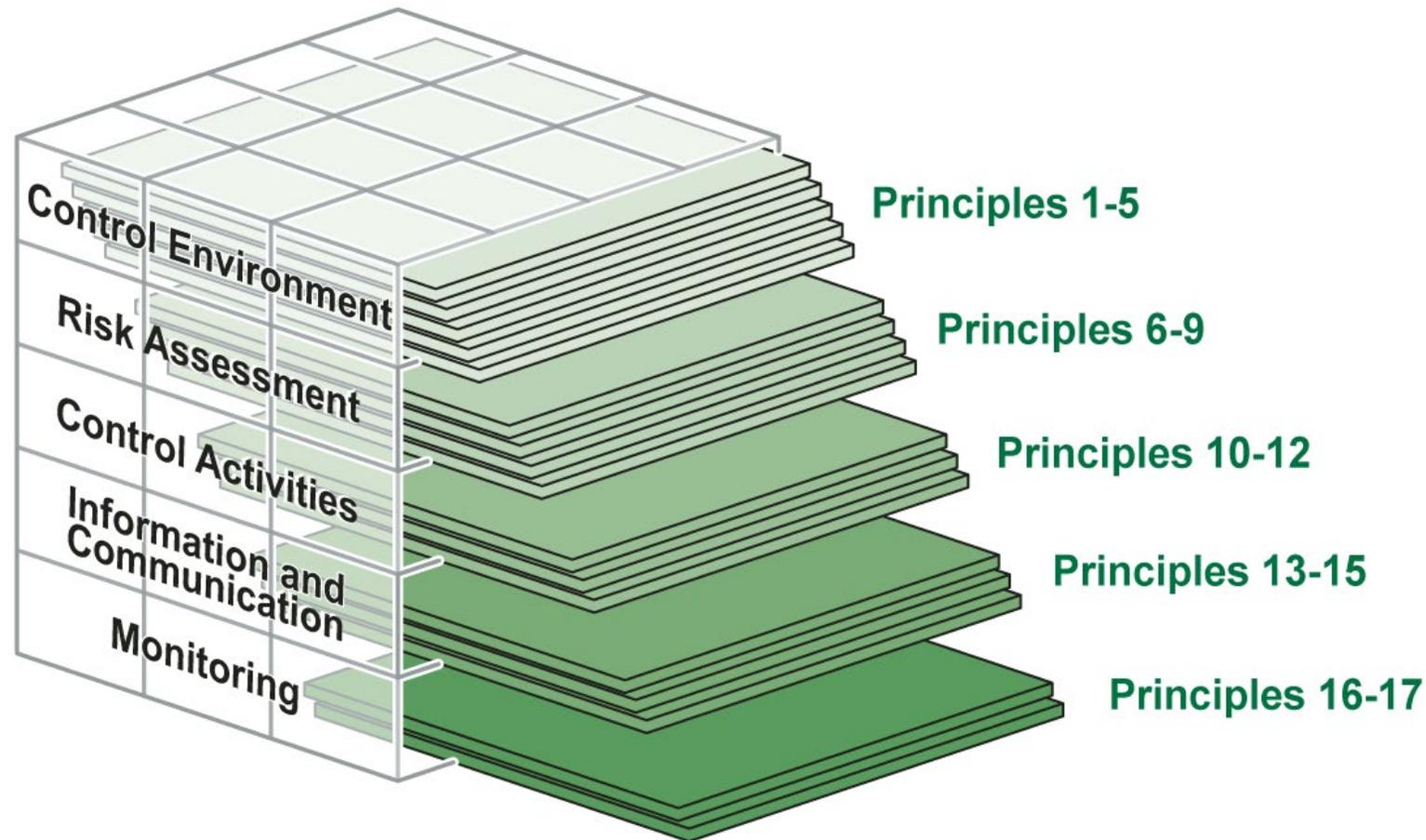
## Information & Communication

13. Use Quality Information
14. Communicate Internally
15. Communicate Externally

## Monitoring

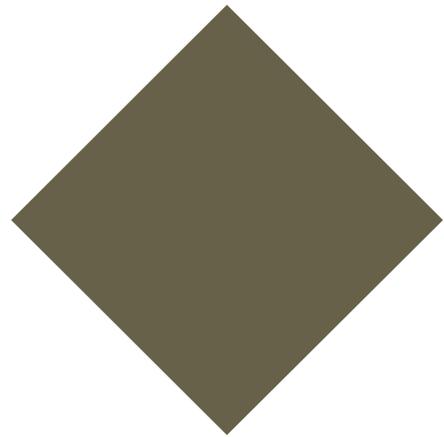
16. Perform Monitoring Activities
17. Remediate Deficiencies

# Components and Principles



# LGA Internal Control Compliance Manual



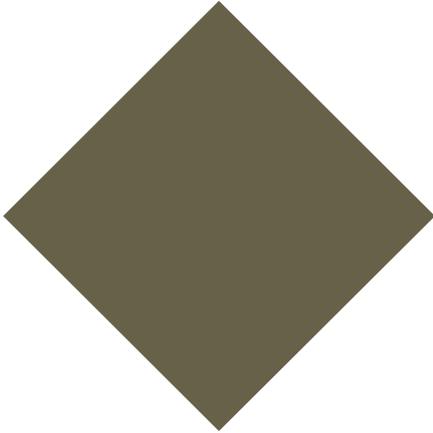


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**MTAS**



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CTAS

# Questions

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