MISSION: CONTROL

Department of Internal Audit
October 23, 2014
Today’s Takeaways

- Understand the concept and goal of an internal control system in the larger context of university operations

- Identify our business objectives, risks to meeting those objectives, and the role of controls in managing these risks

- Evaluate your role in implementing and monitoring the university’s internal control systems
How did we end up here?!

- Defense Industry
  - Fraud and “waste” in federal procurement systems
  - Federal False Claims Act (a/k/a “Whistleblower Act”)

- Health Care/Pharma Industries
  - Medicare/Medicaid Anti-Kickback and Stark Laws
  - HIPAA

- Securities Fraud
  - Ponzi schemes, insider trading, accounting fraud
  - Sarbanes-Oxley Act of 2002 (“SOX”)
Committee of Sponsoring Organizations (COSO)

- Foreign corrupt practices
  - Criminalized transnational bribery and required organizations to *implement effective internal control programs* . . .

- Sponsors (1985)
  - Five main professional accounting associations and institutes

- National Commission on Fraudulent Financial Reporting (a/k/a the Treadway Commission)
  - Report October 1987: Findings and Recommendations
  - COSO commissioned a follow up report on *an integrated framework of internal control* . . .
Internal Control: “Official” Definition

A process (effected by the Board, management and others) designed to provide *reasonable assurance* regarding the *achievement of objectives* in the following categories:

- Effectiveness and Efficiency of Operations
- Reliability of Reporting
- Compliance with Laws and Regulations

- COSO: Internal Control – Integrated Framework (Executive Summary)
Internal control is what we do to help assure that good things happen and bad things don’t!
Example: Internal Control Gone Bad

**WASTE MANAGEMENT SCANDAL (1998)**

**COMPANY**
Houston-based, publicly traded waste management company

**WHAT HAPPENED**
Reported $1.7 billion in fake earnings.

$100 million

**MAIN PLAYERS**
- Founder/CEO/Chairman Dean L. Buntrock and top executives
- Arthur Andersen Company (auditors)

**HOW THEY DID IT**
The company allegedly falsely increased the depreciation time length for their property, plant and equipment on the balance sheets.

**HOW THEY GOT CAUGHT**
A new CEO and management team went through the books.

**PENALTIES**
Settled a shareholder class-action suit for $457 million; SEC fined Arthur Andersen $7 million.

**FUN FACT**
After the scandal, the new CEO A. Maurice Meyers set up an anonymous company hotline where employees could report dishonest or improper behavior.
Example: Internal Control Gone Bad

**ENRON SCANDAL (2001)**

**COMPANY**
Houston-based commodities, energy and service corporation

**WHAT HAPPENED**
**Shareholders lost $74 billion,** thousands of employees and investors lost their retirement accounts, and many employees lost their jobs.

**MAIN PLAYERS**
CEO Jeff Skilling and former CEO Ken Lay

**PENALTIES**
Lay died before serving time; Skilling got 24 years in prison. The company filed for bankruptcy. Arthur Andersen was found guilty of fudging Enron’s accounts.

**HOW THEY DID IT**
Kept huge debts off the balance sheets.

**HOW THEY GOT CAUGHT**
Turned in by internal whistle-blower Sherron Watkins; high stock prices fueled suspicions.

**FUN FACT**
Fortune Magazine named Enron “America’s Most Innovative Company” for six years in a row prior to the scandal.
Example: Internal Control Gone Bad

**TYCO SCANDAL (2002)**

**COMPANY**
New Jersey-based blue-chip Swiss security systems company

**WHAT HAPPENED**
CEO & CFO stole $150 million and inflated company income by $500 million.

**MAIN PLAYERS**
CEO Dennis Kozlowski and former CFO Mark Swartz

**HOW THEY DID IT**
Siphoned money through unapproved loans and fraudulent stock sales. Money was smuggled out of the company disguised as executive bonuses or benefits.

**HOW THEY GOT CAUGHT**
SEC and Manhattan D.A. investigations uncovered questionable accounting practices, including large loans made to Kozlowski that were then forgiven.

**PENALTIES**
Kozlowski and Swartz were sentenced to **8-25 years in prison**. A class-action lawsuit forced Tyco to pay **$2.92 billion** to investors.

**FUN FACT**
At the height of the scandal Kozlowski threw a **$2 million birthday party** for his wife on an island, complete with a Jimmy Buffett performance.
Example: Internal Control Gone Bad

WORLDCOM SCANDAL (2002)

COMPANY WORLDCOM
Telecommunications company; now MCI, Inc.

WHAT HAPPENED
Inflated assets by as much as $11 billion, leading to 30,000 lost jobs and $180 billion in losses for investors.

MAIN PLAYER
CEO Bernie Ebbers

HOW HE DID IT
Underreported line costs by capitalizing rather than expensing, and inflated revenues with fake accounting entries.

HOW HE GOT CAUGHT
WorldCom’s internal auditing department uncovered $3.8 billion in fraud.

PENALTIES
CFO was fired, controller resigned, and the company filed for bankruptcy. Ebbers sentenced to 25 years for fraud, conspiracy and filing false documents with regulators.

FUN FACT
Following the scandal, Congress passed the Sarbanes-Oxley Act, introducing the most sweeping set of new business regulations since the 1930s.
Sarbanes-Oxley Act of 2002 (SOX)

- Improve corporate governance and restore the faith of investors in publically traded companies
  - New or enhanced standards for all company boards, management and public accounting firms (external auditors)

- Section 404: Management Assessment of Internal Controls
  - Management is responsible “for establishing and maintaining an adequate internal control structure and procedures . . . .”
  - Annual assessment of the effectiveness of the control structures (and disclose shortcomings)
  - External auditors must attest that internal controls are in place, operational, and effective as reported by management
Concept: Internal Control Components

- Control Environment
- Risk Assessment
- Control Activities
- Monitoring
- Information & Communication
Concept: Internal Control Components

Control Environment

Sets the tone of an organization, influencing “control consciousness” of its people

- Integrity, ethical values, competence
- Management’s philosophy and operating style
- Assignment of authority and responsibility
- Organization and development of people
- Board attention and direction
Concept: Internal Control Components

Control Environment

1. The organization demonstrates a commitment to integrity and ethical values.

2. The board of directors demonstrates independence from management and exercises oversight of the development and performance of internal control.

3. Management establishes, with board oversight, structures, reporting lines, and appropriate authorities and responsibilities in the pursuit of objectives.

4. The organization demonstrates a commitment to attract, develop, and retain competent individuals in alignment with objectives.

5. The organization holds individuals accountable for their internal control responsibilities in the pursuit of objectives.
Risk Assessment

Identification and analysis of *relevant risks* to achievement of *organizational objectives*

- Must first clearly identify objectives/“goals”
- Risks may come from internal or external sources
- Special risks associated with change in regulatory and operating conditions
6. The organization specifies objectives with sufficient clarity to enable the identification and assessment of risks relating to objectives.

7. The organization identifies risks to the achievement of its objectives across the entity and analyzes risks as a basis for determining how the risks should be managed.

8. The organization considers the potential for fraud in assessing risks to the achievement of objectives.

9. The organization identifies and assesses changes that could significantly impact the system of internal control.
Control Activities

*Policies, procedures, and practices* that help ensure management directives are carried out

- Occur at all levels and in all functions of an entity
- Wide range of activities:
  - Approvals/Authorizations
  - Verifications/Reconciliations
  - Reviews of Operating Performance
  - Physical and Virtual Security of Assets
  - Segregation of Duties
  - Training and Professional Development
10. The organization selects and develops control activities that contribute to the mitigation of risks to the achievement of objectives to acceptable levels.

11. The organization selects and develops general control activities over technology to support the achievement of objectives.

12. The organization deploys control activities through policies that establish what is expected and procedures that put policies into place.
Information and Communication

**Identify, capture and communicate relevant info** in a form and timeframe that supports accomplishment of assigned responsibilities

- Information systems produce operational, financial and compliance-related reports
- Effective communication must flow down, across and up the organization
- Understand your own role in the internal control system, and how your activities related to the work of others
13. The organization obtains or generates and uses relevant, quality information to support the functioning of internal control.

14. The organization internally communicates information, including objectives and responsibilities for internal control, necessary to support the functioning of internal control.

15. The organization communicates with external parties regarding matters affecting the functioning of internal control.
Monitoring

*Ongoing process* to assess the quality of the internal control system over time

- Continuous monitoring through regular management and supervisory activities and performance of other duties
- Separate evaluations based on assessment of risks and effectiveness of ongoing monitoring procedures
- Control deficiencies should be reported upstream in a timely manner
16. The organization selects, develops, and performs ongoing and/or separate evaluations to ascertain whether the components of internal control are present and functioning.

17. The organization evaluates and communicates internal control deficiencies in a timely manner to those parties responsible for taking corrective action, including senior management and the board of directors, as appropriate.
Concept: Internal Control Components

- Control Environment
- Risk Assessment
- Control Activities
- Information & Communication
- Monitoring Activities
- Operations
- Reporting
- Compliance

Entity, Division, Operating Unit, Function
“Companies with ineffective internal controls often face risks of embezzlement and self-dealing by employees, commercial bribery, export control problems, and violations of other U.S. and local laws.”

- Criminal Division, U.S. Dept. of Justice
What is the overall goal of the five interrelated components of an internal control system?

*Manage the risks* that would prevent us from meeting our goals...
You exercise internal control principles in your personal life when you:

- Lock up your home, vehicle or other valuable belongings
- Keep your debit card PIN number separate from your card
- Review bills and credit card statements before paying them
- Require children to ask permission before they do certain things
Objectives and Risks: At the University

University internal controls are similar:

- Buildings, offices, labs, university vehicles are locked or secured when not occupied
- Computer passwords are changed periodically and are not written down by the computer
- Management reports are reviewed and P-card charges are checked against source documents before paying them
- Authorizations are required prior to certain activities being performed or expenses incurred
Understanding objectives and risks will better enable you to:

- Assess the adequacy of the controls currently in place
- Prioritize your tasks
- Understand your role within the university’s system of controls...

and the value you provide to the success of the university as a whole!
Who is Responsible for the Success of CU’s Internal Control Systems?

EACH ONE OF US!
Internal Audit has seen the results of what can happen when university controls have failed or have not been implemented:

Researcher charged federal grant for purchase of bicycles for research associates and another researcher used university funds to purchase items for personal use.

- Control failure – approver did not review the purchases or look at the receipts
Internal Audit has seen the results of what can happen when university controls have failed or have not been implemented:

Researcher charged a grant for purchases of equipment at inflated prices from company owned by a family member.

- Control failures – Annual Conflict of Interest Disclosure statement
Former CU-Boulder employee pleads guilty to theft, forgery, embezzlement (2/12/10)
Trust is not a control

Remember:
Controls are not just put in place to protect the university. They are also put in place to protect you.
So, what can you do to address the risks faced by the university, your school, and your team?

Understand the controls put in place by the university

- Review policies and procedures
  - APS 4014: Fiscal Roles and Responsibilities
  - PSC Sensitive Expenses policy
  - “Do it right first; don’t ask for forgiveness later.”

Document what you do

- Create step-by-step procedural instructions or an employee position manual and keep them up-to-date
- Train a coworker who can fill in when you are out of the office
So, what can you do to address the risks faced by the university, your school, and your team?

Actively monitor, evaluate, and communicate

- Review financial reports on a regular basis and correct any errors you discover in a timely manner.
- Evaluate the accuracy, efficiency, and necessity of your procedures.
- If someone asks why you are doing something and the answer is “That’s the way its always been done,” it is time to re-evaluate the process!

*When in doubt, ASK!*
Implementation: Questions to ask yourself

How do my duties and tasks help me and my team to meet objectives?

Why have I been asked to perform some tasks that seem unnecessary?

What could happen if I don’t perform my assigned tasks or follow the procedures that have been set up?

Is there someone else on my team who has been designated as my “back-up” if I am unable to perform the control procedure/process assigned to me?
Principles of Good Internal Control

- Control is a person at the source, knowing the right thing to do, and DOING IT.

- If you are relying on someone else to be the “bad guy” (in terms of enforcing policy or reporting problems), we have lost control.

- Accountability is essential if we are all going to do the right thing every time.
Limitations on Internal Controls

- **Judgment:** Decisions are made by humans, under pressure with limited information

- **Breakdowns:** People misunderstand instructions or simply make mistakes; complex new technical systems result in errors

- **Collusion:** Controls may be circumvented by employees acting together

- **Management Override:** High level personnel override policies for personal gain, or because they like doing things “their way”
Implementation: Management Override
If it’s wrong or simply doesn’t feel right . . .

- Report it to someone! (Supervisor, manager, director)
- You can contact any of the following parties:
  - CU EthicsLine (phone or web: it’s anonymous!)
  - Internal Audit (we make every effort to keep reports confidential)
  - Campus Finance Office
  - University Counsel
  - Human Resources
  - Campus Ombuds Office (they give advice)
- Under Regent Policy, you have the obligation to report known or suspected violations of policy or law

Taking action protects you and the university!
Internal Audit Role

- Provide independent, objective *assurance, consulting and educational activity* designed to add value and improve CU’s operations

- Bring a systematic, disciplined approach to the *evaluation and improvement of processes* related to university-wide risk management, control, and governance in order to help CU accomplish its objectives

  - Charter, Department of Internal Audit
    (Adopted by the Board of Regents, 11-2-06)
“Promote understanding and use of sound business practices in operations . . .”

- Examination and evaluation
  - Formal audits of business processes
  - Investigations related to allegations of individual fiscal misconduct
- Counsel
  - Participate on committees
  - Provide info and consultative advice to management
- Education
  - Informal and formal opportunities within the university community
“The University of Colorado is a public research university . . . serving Colorado, the nation, and the world through leadership in high-quality education and professional training, public service, advancing research and knowledge, and state-of-the-art health care.”

- Laws of the Regents, Article 1, Part C
CU EthicsLine: 1-800-677-5590 or www.ethicspoint.com

Internal Audit  303-837-2195
AMC/UCD Finance Office  303-315-2250
AMC Ombuds Office  303-724-2950
University Counsel  AMC: 303-724-5534
                     UCD: 303-315-6617
Human Resources  303-315-2700
Where can you find...

Administrative Policy Statements (APS)
http://www.cu.edu/ope/policy/aps-az

PSC Procedural Statements (PPS)
http://www.cu.edu/psc/procedures

University Controller Accounting Handbook
https://content.cu.edu/controller/policiesandprocedures/accountinghandbook/
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QUESTIONS?