



**JOSEPH ABRUZZO**  
CLERK OF THE CIRCUIT COURT & COMPTROLLER  
PALM BEACH COUNTY



**KELVIN SOTO**  
CLERK OF THE CIRCUIT COURT & COUNTY COMPTROLLER  
OSCEOLA COUNTY

# *Let's Talk Internal Controls*

FGFOA Central Florida Chapter  
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# Let's Talk Internal Controls

*Presented by:*

- **Shannon Ramsey Chessman, CPA, CGFO**  
Chief of Staff and Chief Deputy Clerk, Palm Beach County
- **Jamie Roberson, CGFO**  
Director of Finance & Accounting, Osceola County

# Today's Road Map

- Fundamentals of Internal Control
- Internal Controls for Financial Reporting
- Internal Controls for Cash Management and Investments
- Internal Controls for IT



# Recent Headlines

“Moody's agreed to pay \$15 million to settle charges of **internal controls failures**...”

“SEC charges four public companies with longstanding internal control failures. Adequate **internal controls** are the first line of defense in detecting and preventing material **errors** or fraud in financial reporting.”

“Audit shows Village of Waterproof the victim of embezzlement and poor accounting practices”



## *Headline*

“State Orders Audit of Okaloosa Finance,  
Clerk’s Office”

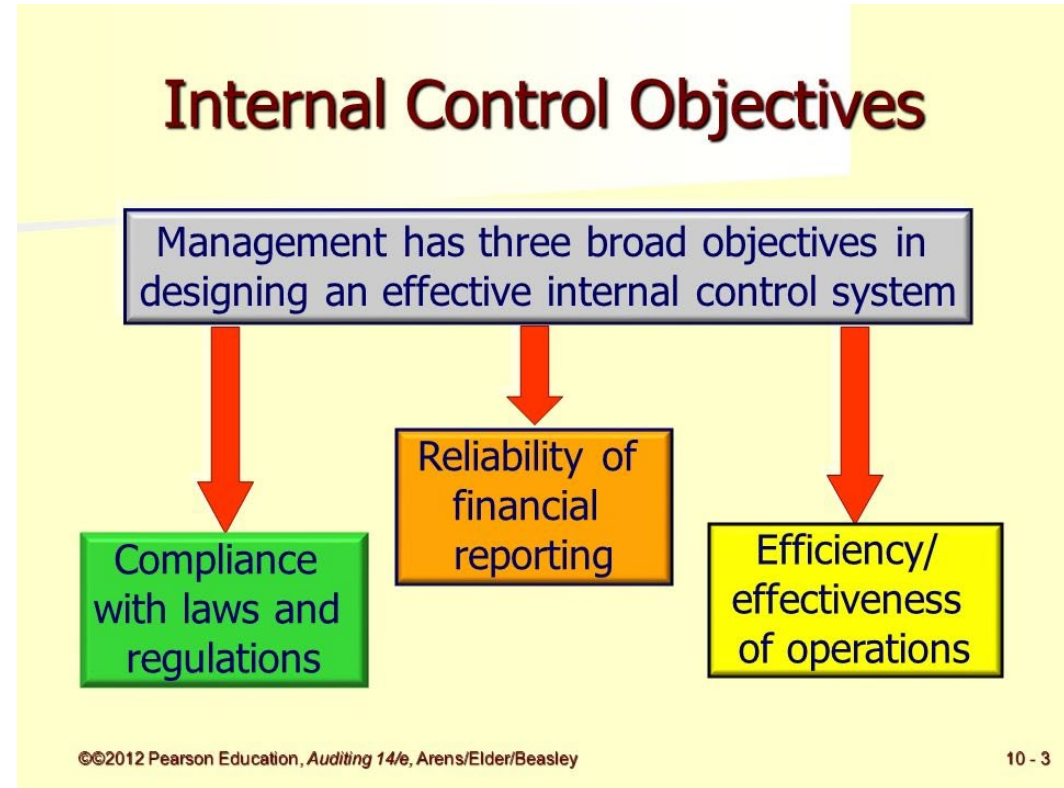
***“The Key”***– Did the County establish  
adequate internal controls over the use  
of Bed Tax and BP Oil Spill funds?



# FUNDAMENTALS OF INTERNAL CONTROL

# Objectives of Internal Control

- Reliable Financial Reporting
- Efficient Operations
- Legal Compliance
- Accountability to the Public



# W h a t i s I n t e r n a l C o n t r o l ?

*Here's the technical answer:*

Internal Control is “a process, affected by an entity’s board of directors, management, and other personnel, designed to provide reasonable assurance regarding the achievement of objectives relating to operations, reporting, and compliance...”

HUH??





# W h a t i s I n t e r n a l C o n t r o l ?

*Let's try this again*

- At its simplest, internal control is a process.
- The goal of this process is to provide reasonable assurance (not absolute assurance) that we can achieve our objective related to operations, reporting, and compliance.
- Internal Controls are TOOLS to help management avoid problems like misappropriation of funds, non-compliance with rules and laws, operational failures, and inaccurate financial reporting.



# W h a t i s R i s k ?

Risks are uncertain internal and external factors that can affect an organization's objectives positively, present an opportunity or be a threat.

How can we identify risks? We need to ask ourselves...

- What can go wrong?
- How can we fail?
- What activities do we do that are the most complex?
- What activities are the most regulated?
- Where do we spend the most money?
- What assets do we need to protect?

# Types of Risk

- Financial – risk that could result in a negative financial impact including waste or loss of assets;
- Regulatory – risk due to non-compliance with laws and regulations that may result in the assessment of penalties;
- Operational – risk that disrupt our office and hinder us from operating in the most effective and efficient manner;
- Strategic – risk that could prevent a department from accomplishing its goals;
- Reputational – risk that bring negative publicity to the office and elected officials.

# Risk Management

- Assess relevant risks
- What's your risk tolerance?
  - Avoid
  - Reduce
  - Share
- If we do it right...we are better informed to make decisions AND put the right *controls* in place.



# Internal Control Process – Key Components

## The process is:

- Dynamic
- Affected by people
- Supported by a documented structure



# I n t e r n a l C o n t r o l P r o c e s s

The internal control process should include the following activities:

- **Performance controls:** Management review of assessment on general performance;
- **Physical controls:** Focus on verification of compliance with restriction procedures concerning accessibility, use and security of assets such as cash, inventory, and controlling records
- **Approval and authorization system:** Approvals combined with verification through segregation of duties

*Control activities can either be preventive or detective and require monitoring*

# C a t e g o r i e s   o f   C o n t r o l   A c t i v i t i e s

**Preventive:** Designed to keep errors or irregularities from occurring. Many of these controls are **based on the concept of segregation of duties.**

**Example:** An employee who is responsible for approving transactions should not be the one who also records the transactions.

**Detective:** Designed to identify errors or irregularities that already exist.

**Examples:** Monthly bank reconciliations, physical inventory counts, audits.

**Monitoring:** Implemented to ensure that internal controls continue to operate effectively over time.

**Examples:** Periodic review of internal controls, supervisory review of reconciliations.

# P u r p o s e o f I n t e r n a l C o n t r o l

## Minimize Waste:

- Significant loss or misuse of resources that results from deficient or negligent practices, controls, or decisions.
- Waste involves behavior that is deficient or improper when compared with behavior that a prudent person would consider reasonable and necessary given the facts and circumstances.
- Waste does not necessarily involve fraud or other violations of law.



# P u r p o s e o f I n t e r n a l C o n t r o l

## Minimize Abuse:

- Grossly intentional, wrongful, or improper use of resources or misuse of rank, position, or authority.
- Abuse involves behavior that is deficient or improper when compared with behavior that a prudent person would consider reasonable and necessary given the facts and circumstances.
- Abuse does not necessarily involve fraud or other violations of law.

# Purpose of Internal Control

## Minimize Fraud:

Fraud is generally defined in the law as an intentional act to deceive or cheat, ordinarily for the purpose or result of causing a detriment to another and/or bringing about some benefit to oneself or others.

- Pressure— this is the motivation for the crime.
- Opportunity – the method in which the crime can be committed.
- Rationalization— “I’m not a criminal”.



# C o s t s   o f   I n t e r n a l   C o n t r o l

- Costs associated with assessing the efforts to select develop and perform control activities
- Efforts that add to the overall process
- Efforts to maintain and update the control process
- Costs of added technology – not just the technology itself
- Cost of additional information requirements and the collection, storage and access

# Documentation of Internal Control

## Why?

- Provides clarity regarding roles and responsibilities
- Promotes consistency in the procedures and adherence to the policy
- Assists in capturing the design of the internal control
- Establishes standards and expectations of performance
- Provides evidence of the processes and procedures in place
- Enables proper monitoring
- Supports effective reporting which is important for external auditing
- Documents the information for the future

# Limitations of Internal Control – Reasonable Assurance

- Effective internal control is designed to provide reasonable assurance risks are mitigated
- “Reasonable assurance” acknowledges that there are limitations to what internal controls can identify and protect against
- Effective internal control increases the likelihood risks are averted

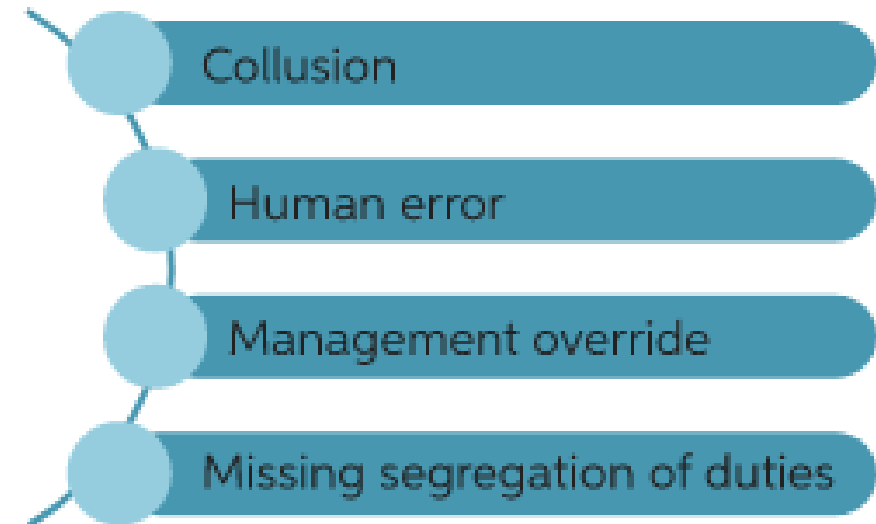


# Limitations of Internal Control – Why?

- Human Error – a simple transposition in a journal entry or due to complexity
- Judgment – sometimes decisions must be made with judgment in the time available, based on information at hand and under the pressures to conduct business
- Breakdowns – Even well designed internal controls, they can break down
- Misunderstanding instructions or just making a mistake
- Management override – High-level personnel may override prescribed policies or procedures for personal gain or advantage

# Limitations of Internal Control – Why?

- **Collusion** - Individuals acting collectively can circumvent the control system
- **Resource limitations** – Every agency must prioritize control activities because resources are not available to put every control activity into practice
- **Costs versus benefit** – Does the benefit outweigh the cost of the control Excessive control is costly and counterproductive



*It's a balance!*

# W a t c h O u t - R e d F l a g s

## Employees

- Lifestyle or behavioral change
- Significant personal debt and credit problems
- Refusal to take vacation or sick leave
- Lack of segregation of duties in vulnerable areas

## Management

- Reluctance to provide information to auditors
- Management decisions are dominated by an individual or small group
- Weak internal control environment
- Excessive number of checking accounts or frequent changes in banking accounts
- Excessive number of year-end transactions
- High employee turnover rate
- Service contracts result in no products



# W a t c h O u t - R e d F l a g s

## Records and Reports

- Large number of write-offs of accounts
- Discrepancies between bank deposits and postings
- Excessive or unjustified cash entries and/ or adjustments
- No supporting documentation for adjusting entries
- Incomplete or untimely bank reconciliations

## Cash Receipts and Disbursements

- Lack of segregation of key duties
- Deposits not made intact
- Cash receipts issued out of sequence
- No cash receipt log kept
- Lack of control over CFO's signature
- Uncontrolled access to blank checks.

# W a t c h O u t - R e d F l a g s

## Purchasing Flags

- Lack of segregation of key duties
- Purchases that bypass normal procedures
- Changes made to vendor files
- Vendor addresses match employee addresses

## Fixed Asset Flags

- Lack of segregation of key duties
- Lack of asset tags and periodic physical inventories
- Lack of physical security over assets.



# INTERNAL CONTROL AND FINANCIAL REPORTING

# Adopting Financial Policies - GFOA

Financial policies are central to a strategic, long-term approach to financial management. Some of the most powerful arguments in favor of adopting formal, written financial policies include their ability to help governments:

1. Institutionalize good financial management practices
2. Clarify and crystallize strategic intent for financial management
3. Define boundaries - financial policies define limits on the actions staff may take
4. Support good bond ratings and thereby reduce the cost of borrowing
5. Promote long-term and strategic thinking
6. Manage risks to financial condition
7. Comply with established public management best practices

# Internal Control for Financial Reporting

We as Finance Officers are instrumental in overseeing accounting and financial reporting controls.

## Priorities and responsibilities include:

- Supervising the preparation of accounting records
- Producing financial reports
- Fostering a positive control environment
- Identifying risks and designing/implementing internal controls for each area of responsibility
- Ensuring controls in place are still effective



# Objectives of Internal Control for Financial Reporting

## Common Objectives for Financial Reporting Internal Controls:

- Safeguard assets
- Provide efficient and effective management of assets and operations
- Check the accuracy and reliability of accounting data
- Encourage adherence to policies for accounting and financial controls



# SEC Guidance

## SEC DEFINITION OF Internal Controls Financial Reporting (ICFR)

The U.S. Securities and Exchange Commission's (SEC) rules define internal control over financial reporting as “**a process** designed by, or under the supervision of, the [company's] principal executive and principal financial officers, or persons performing similar functions, and effected by the registrant's board of directors, management and other personnel, **to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with GAAP** and includes those policies and procedures that—

- 1) Pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company;
- 2) Provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with GAAP, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and
- 3) Provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.”

# Internal Controls from a Financial Perspective

## Definition From the American Institute of CPAs

- Internal control is a process—effected by plan management and other personnel, and those charged with governance, and designed to provide reasonable assurance regarding the achievement of objectives in the reliability of financial reporting
- Your plan's policies, procedures, organizational design and physical security all are part of the internal control process
- The following are some general characteristics of satisfactory plan internal control over financial reporting:
  - Policies and procedures that provide for appropriate segregation of duties to reduce the likelihood that deliberate fraud can occur
  - Personnel qualified to perform their assigned responsibilities
  - Sound practices to be followed by personnel in performing their duties and functions
  - A system that ensures proper authorization and recordation procedures for financial transactions



# Internal Controls from a Financial Perspective

## Internal Controls Financial Reporting:

- Do the financial statements fairly reflect all transactions?
- Are all transactions recorded in accordance with applicable policies and rules?
- Is there an assurance that transactions are carried out in accordance with the appropriate authorized individuals within the entity?
- Is there a reasonable assurance that financial resources are safeguarded against theft and loss due to waste, abuse, mismanagement, errors, fraud, and omissions?



# INTERNAL CONTROL AND INVESTMENTS

# Objectives of Internal Control for Investments

- Establish formal written procedures
- Identifying risks
- Creating a separation of duties
- Safeguard physical and financial assets
- Efficiency of operations
- Reliability of financial reporting
- Compliance with legal requirements
- Minimize opportunities for fraud, employee error



# Examples of Control Objectives

| Control Objectives                      | Types of Fraud  | Audit Procedures   |
|---|---|--|
| Transaction Authorization and Execution | Investments could be made in violation of regulations or company policies   | Review policies for selecting and approving investment transactions  |
|   | Unauthorized adjustments resulting in misstated accounts  | Require specific authorization for significant adjustments   |
| Recording                               | Detailed or subsidiary records may be inaccurate, resulting in misstated account balances or class of transactions      | Review processing and recording procedures<br>Review board minutes regularly for directives related to transactions. |
|   | Securities may be lost, stolen or diverted, resulting in reporting of inaccurate carrying values and misstated accounts | Analyze physical barriers over investment securities and place them with independent parties                         |
| Access to Assets                        | Fraudulent behavior could be used to sell securities and divert the cash proceeds                                       | Review the segregation between investment approval, accounting and custody of security                               |

# I n t e r n a l C o n t r o l f o r I n v e s t m e n t s

- Identify events and transactions that make up the investment function
- This will help identify potential weakness
- Create a list or chart of investment activities
- Discuss each step and the risk involved
- What controls can be put in place to reduce risks



# Design of Internal Control for Investments

- Investment Authorization
- Investment Selection
- Investment Purchase and Payment
- Security Safekeeping
- Investment Accounting
- Investment Disposition/Payment
- Investment Reporting



# INTERNAL CONTROL AND CASH MANAGEMENT

# Internal Control for Cash Management

- Florida Statutes 218.415(13) Financial Matters Pertaining to Political Subdivisions – Local Government Investment Policies:
  - *“The internal controls should be designed to prevent losses of funds which might arise from fraud, employee error, and misrepresentation by third parties, or imprudent actions by employees of the unit of local government.”*
- Provide a copy of the Internal Control document to all members of staff who participate in cash and investment activities on behalf of the organization



# Internal Control for Cash Management

- Because of the risk involved with cash management, personnel is key
  - Recruit and hire individuals whose qualifications are best suited for a particular position
  - Recruit and hire in accordance with your Personnel Policies.
  - As required by Statute, staff authorized to make investment decisions must annually complete at least eight hours of continuing education in subjects or courses of study related to investment practices and products.



# Internal Control for Cash Management

## Follow Prudence

and

## Ethics Standards

Use the “prudent person” standard in the management of the overall investment portfolio

Full disclosure of any material interests (lesser of \$5,000 or 5% of employee net worth) that they may hold in a financial institution (brokers/dealers, banks, etc.) that conducts business with the government

The prudent-person rule is a legal principle that is used to restrict the choices of the financial manager of an account to the types of investments that a person seeking reasonable income and preservation of capital might buy for their own portfolio.

# Control Activities Cash Management

- Separation of Duties
- Security Administration
- Recurring Cash Transfer Templates
- Incoming Cash Transfers
- Outgoing Cash Transfers



# Control Activities Cash Management

- EFT Disbursement Accounts
- Transfers Via Telephone
- ACH Debits
- ACH Debit Blocks
- Bank Fraud Procedures
- Perform Monthly Bank Reconciliations



# Reporting - Cash Management

## Examples include:

- Daily Activity Reports:
  - Account worksheets
  - Maturing Investments and Expected Interest
  - Incoming fedwires and ACH Transfers
  - Transfer Request Documents
  - Investment Transactions
- Portfolio Composition Reports
- Monthly and Annual Investment Reports
- Qualified Public Depository Reports



# INTERNAL CONTROL AND IT

# Basic IT Internal Controls

| Security Administration  | Logical Security                    | Change Management             | Operations     |
|--|-------------------------------------|-------------------------------|----------------|
| Policy and Procedure: Information Security, Change Management, Backup Operations |                                     |                               |                |
| User Provisioning  | Authentication/<br>Password Control | Authorization and<br>Approval | Backups        |
| User Removal   | Privilege User Access               | User Acceptance<br>Testing    | Restore Test   |
| User Access Review   | General Account<br>Review           | Access to Production          | Job Monitoring |
| Segregation of Duties  | Security Monitoring                 | Emergency Change              |                |
|  | Physical Access                     |                               |                |

# IT Internal Control - Policy and Procedures

*Stating the obvious- The risk and the consequences of risk are high with IT!*

Risks include:

- Lack of management awareness
- Lack of agreement to specific organization security measures
- Inaccurate policies and procedures applied to security requirements
- Lack of security knowledge within the organization which provide opportunities for security risks





# IT Internal Control - Policy and Procedures

## Internal Controls Activities include:

- Define security protocol for IT personnel including the use of super user and/or administrative accounts
- Establish user account creation/change protocol (including user account name standards and timeliness requirement)
- Establish standards for account suspensions and terminations
- Routine review of access privileges
- Establish password standards (i.e., length, complexity, age, lockouts)
- Determine how security violations are tracked, identified and resolved
- Establish backup policy, configuration and frequency
- Determine critical system/application restoration priorities

# IT Internal Control – Security Administration

## Risks include:

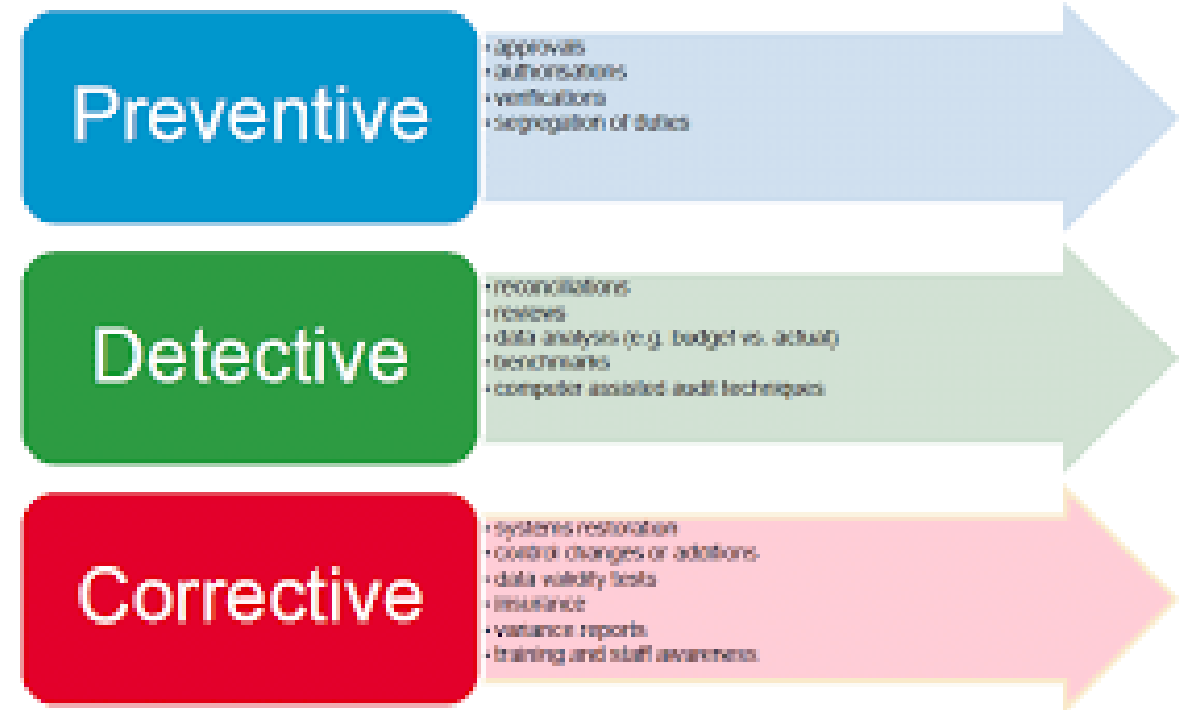
- Unauthorized use
- Disclosure of proprietary information
- Modification, damage, or loss of data



# IT Internal Control – Security Administration

## Internal Controls Activities include:

- New hire access provisions
- Transfer access provisions
- Vendor/contractor access provisions
- Access removal and disable process
- User access review
- Segregation and separation of duties



# IT Internal Control – Logical Security

## Risks include:

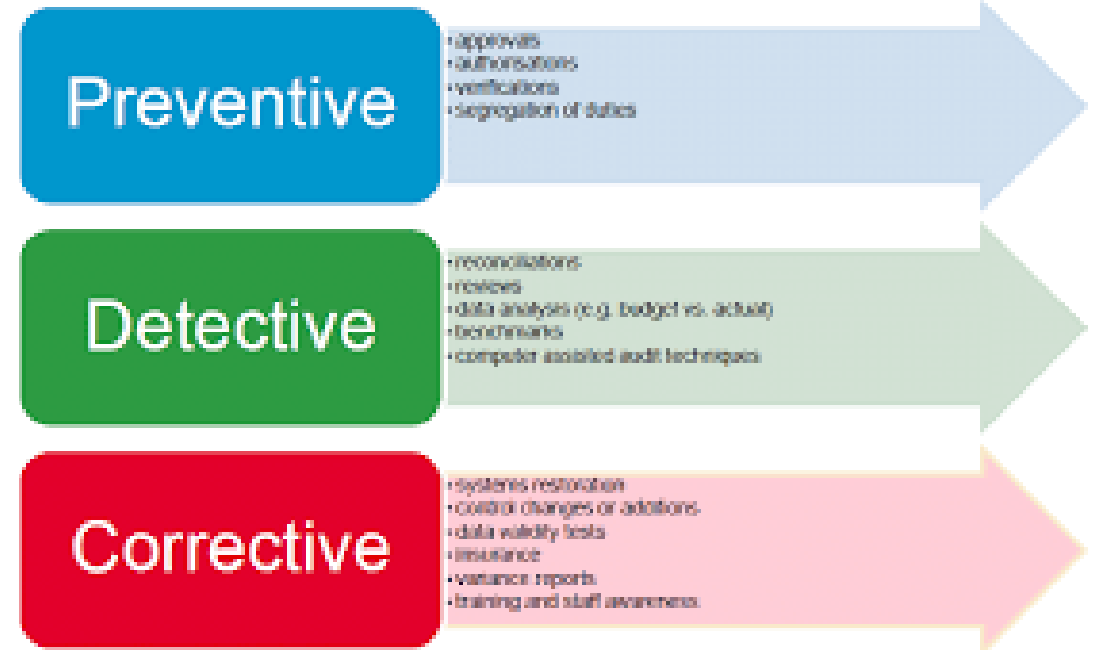
- Unauthorized use
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# IT Internal Control – Logical Security

## Internal Controls Activities include:

- Authentication/password control provisions (i.e. single sign on, password vault)
- Privilege user/elevated/superuser access provisions
- Generic/vendor/temporary account review
- Security monitoring of failed login attempts
- Limit Physical access to restricted area



# IT Internal Control – Change Management

## Risks include:

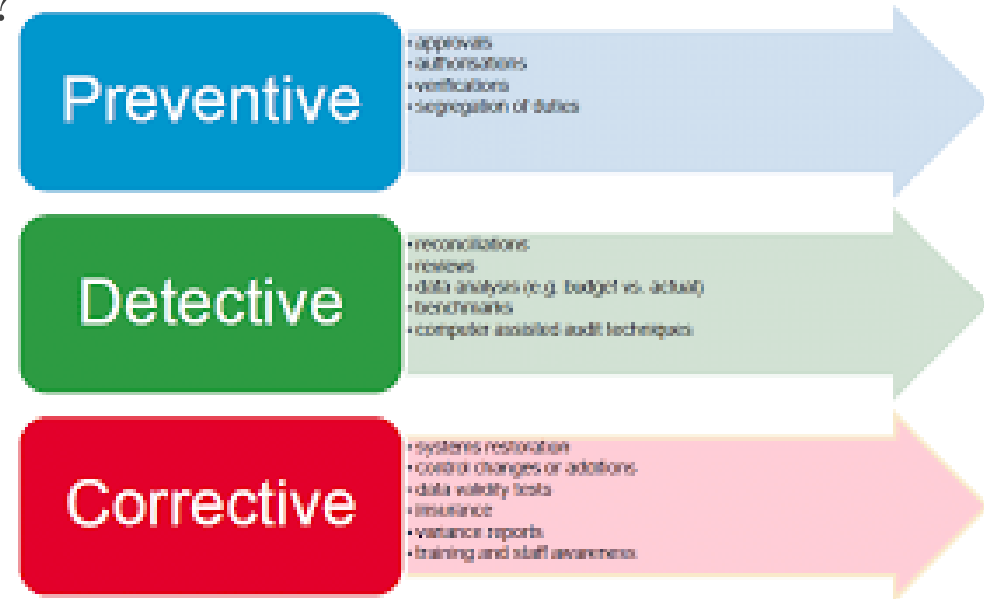
- In adequate policies and procedures for acquisition and maintenance of systems
- Systems may not function as intended and may provide invalid information
- Unreliable financial information and reports



# IT Internal Control – Change Management

## Internal Controls Activities include:

- Change management policy
- Determine what type of changes are made if the servers are in-house i.e.
  - Is there a different process for emergency changes?
  - Is UAT (user acceptance testing) an option?
  - Was the change approved prior to implementation?
  - Is there a rollback plan?
- New system implementation plan to include:
  - Project plan, project approval, system selection process
  - UAT and QA (quality assurance)
  - Post implementation review
  - End user training



# IT Internal Control – Operations

## Risks include:

- Lack of or an inadequate strategy for backup of data and systems
- Lack of or an inadequate strategy and/or poor testing for data and system restoration
- Potential operational disruption including legal ramifications

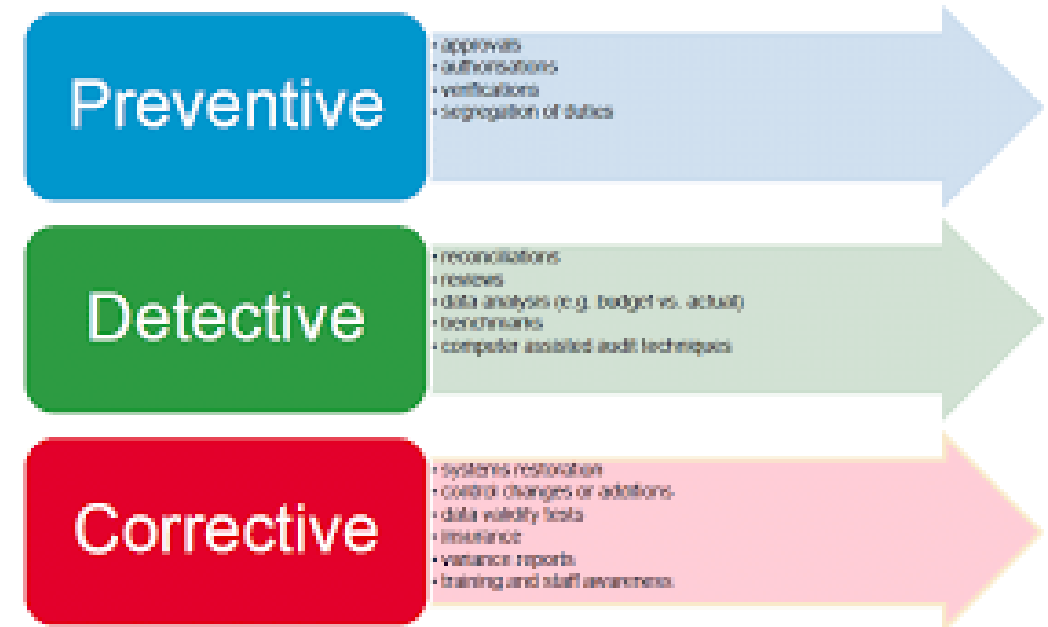




# IT Internal Control – Operations

## Internal Controls Activities include:

- Formal backup process
- Standards for backup frequency
- Standards for system and data restoration
- Full testing of restoration process
- Job monitoring including a failed job (i.e. interfaces) resolution process
- Business Continuity of Operations Plan and Disaster Recovery Plan
  - Regular “table-top” exercises to test these plans is critical
  - Exception Reporting



# IT and Cybersecurity

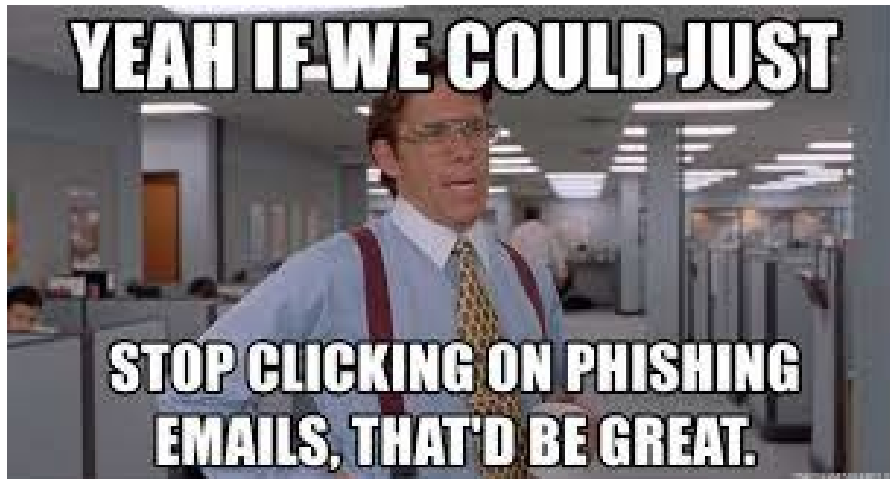
Clerks are an attractive target because we are connected to large local and statewide networks and house a tremendous amount of valuable data...

## Concerns to consider and address:

- Lack of security professionals in government
- Social Engineering
- Patch Management
- Security Monitoring
- Security Awareness Training
- Resource and commitment from Executive leadership



Let's have a laugh...



# Any Questions?





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