

Fighting Fraud with Strong Internal Controls

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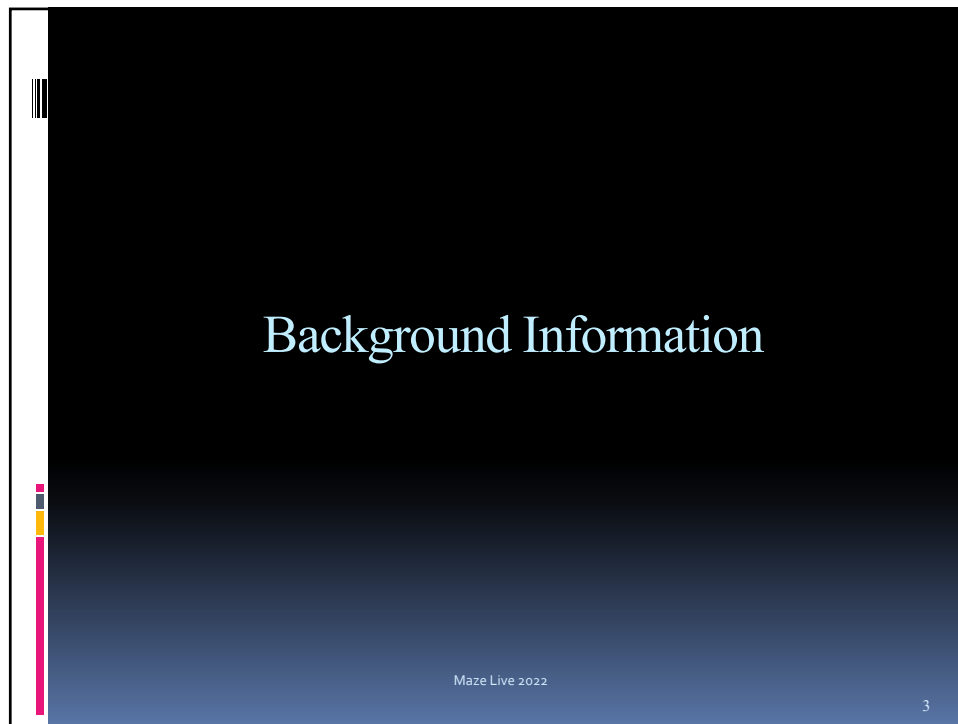
What We Will Cover Today

1. Integrated framework of internal control
2. Five elements of internal controls and challenges in today's working environment
3. Real-life fraud cases



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Internal Control

- What is **internal control**?
 - A system consists of people, policies and procedures that allow the organization to function.
- What is **good internal control**?
 - Good internal control allows an organization to achieve 3 objectives:
 - Operation -- safeguarding assets, operating effectively and efficiently
 - Information -- providing reliable information
 - Compliance -- complying with all applicable constraints

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Who Is Responsible for Internal Control (IC)?

<p><u>Management</u> Design, Implementation, and maintenance of effective IC</p>	<p><u>Governing Body</u> Overseeing management's performance</p>
<p><u>Internal Auditor</u> Assisting management in meeting its internal control responsibility</p>	<p><u>Audit Committee</u> Assisting the governing body in meeting its IC responsibility</p>

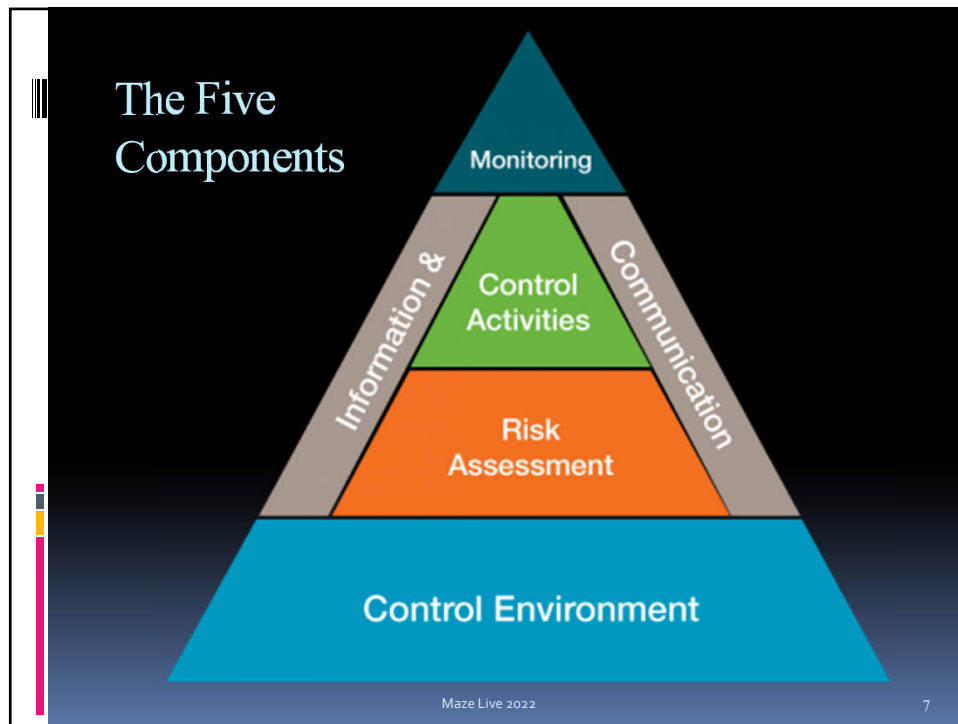
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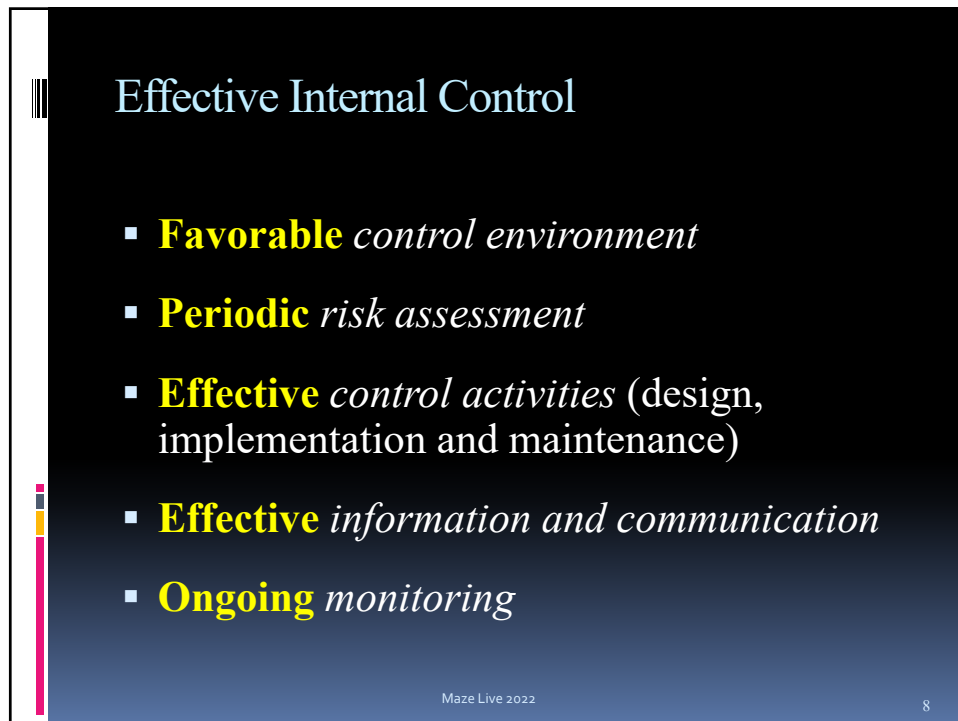
The Five Components of the Integrated Framework of Internal Control

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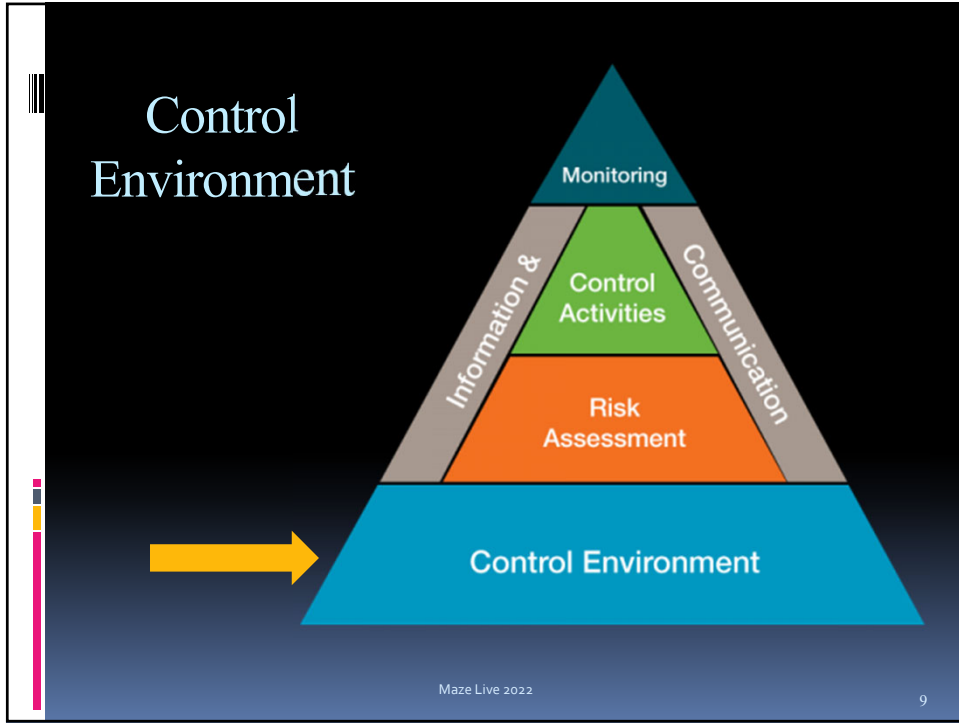
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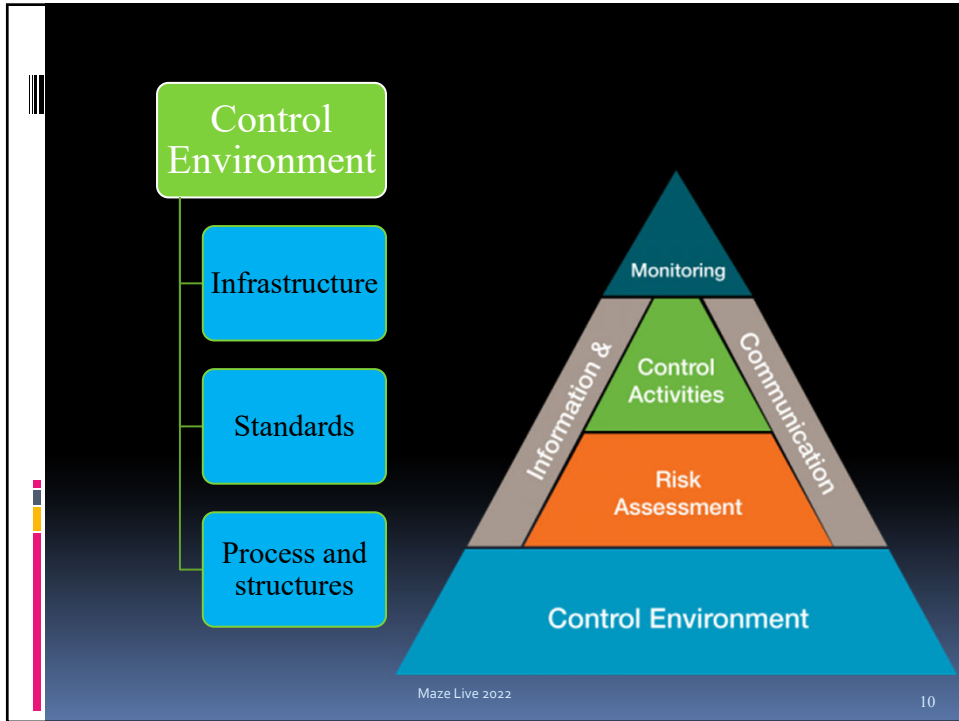
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Does your organization.....

- Demonstrate integrity and ethical values?
- Has a governing board that takes the role of overseeing management performance actively and seriously?
- Clearly assign and document authorities and responsibilities?
- Have a process to attract, develop, and retain talents?
- Have measures, incentives and rewards to drive accountability for performance?(*)

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Challenges Nowadays

- Everchanging environment**
 - Procedures that once worked do not anymore
 - Changing organizational goals and priorities
- Reduced or lack of facetime**
 - Corporate culture becomes harder to cultivate and preserved
 - Harder to detect control weakness or inefficiency in virtual workplace
- The Great Resignation**
 - Loss of institutional and technical knowledge

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Possible Responses

Active effort to maintain communication

- Periodic emails to staff
 - Set goals and benchmarks
 - Promote corporate culture
 - Status update for major projects
- Videoconferencing
 - One-on-one meetings
 - Team building activities
- Check in and ask for feedback

Frequent risk assessment

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Risk Assessment

- Risk = Anything that could negatively affect the achievement of the corporate objectives
- Four steps:
 - Identify
 - Estimate
 - Assess
 - Decide



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Ask the Questions

- Is risk assessment done periodically?
- Sample risk assessment questions:
 - What are the weak spots?
 - What could go wrong?
 - What if a team member is unable to work for a period?
Is there cross-training?
 - How do the latest changes (e.g. legislation, organizational, accounting...etc.) affect my organization?
 - Does the organization have a succession plan and disaster recovery plan?

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Challenges Nowadays

Everchanging environment

- Risk assessment should be done more frequently, especially when major changes happen
- Meet with the IT professional regularly to identify new risks

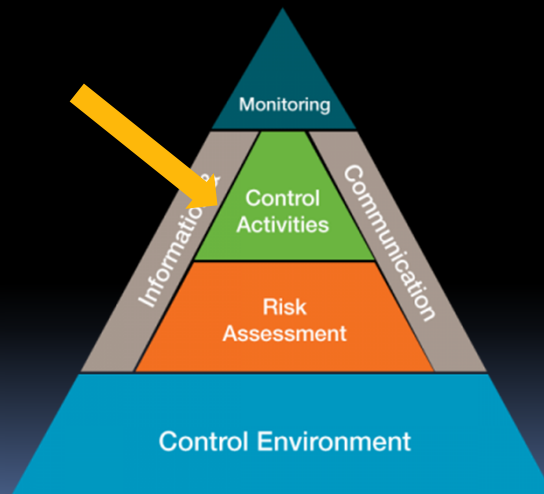
The Great Resignation

- People responsible for risk assessment should have the SKE (Skill, Knowledge and Experience)

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Control Activities



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Control Activities

Control activities = actions established through policies and procedures, which help ensure that management's directives to mitigate risks to the achievement of objectives are carried out

3 Objectives: operation, information, compliance

Risks

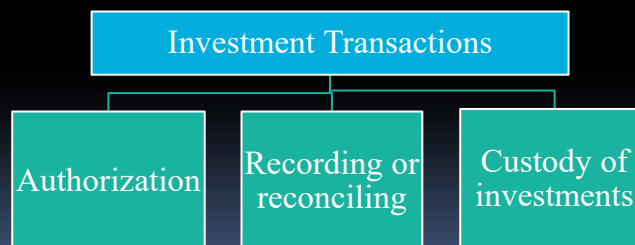
Policies and procedures

Actions (i.e. Control Activities)

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Segregation of Duties

- Should segregate:
 - Authorization
 - Recording/reconciliation
 - Custody of assets



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Other Control Activities

- Are proper procedures and appropriate authorizations documented in a meaningful manner?
- Is financial data regularly analyzed by someone with SKE?
- Are there controls over information processing?
 - Are information produced by the system reliable?
 - Are there control procedures in place to restrict
 - (1) the access to the program data, and
 - (2) the ability to make modifications to the data?
- Are there physical controls over assets and records?

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Benefits vs. Cost

- Benefits > Cost of control activities
- For smaller governments, an **appropriate** second person may be a member of the governing body

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Challenges Nowadays

-- Not Ready for Paperless Environment

- Rely heavily on email exchanges for approvals and reviews in remote work environment.
- Document of completion of controls can lack integrity
- ❖ Should explore:
 - ❖ The capability of the accounting system to incorporate control procedures in the workflow.
 - ❖ Consider use of digital signatures

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Challenges Nowadays

-- Change of Process

- Individuals are taking on multiple duties due to:
 - Workforce reduction
 - Lack of competent staff
 - Alternative work schedules
 - Remote work environment
- ❖ More frequent risk assessments are needed

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Challenges Nowadays

-- Change of Physical Control in remote work environment

- What used to be locked in the safe are relocated
 - How are checks printed?
 - Where is the check stock located?
 - ❖ Need to review physical security of assets and records
 - ❖ File cabinets should be securely locked and any documents containing confidential or proprietary information should be filed away. Desks and work areas should also be clear of clutter and paper files. This will help prevent wandering eyes from accessing confidential information

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Challenges Nowadays

-- Employees may be accessing systems from networks outside of the organization

- ❖ Ensure proper IT and cybersecurity measures are in place
 - ❖ Evaluate policies and controls for access and authorizations. Remote access to servers should be established via secure connections (e.g. virtual private network (“VPN”)).
 - ❖ Communicate to staff clearly the policies about using devices owned by your organization.
 - ❖ Consider implementing security measures such as automatic locking of devices after a period of inactivity to prevent access without re-entering credentials, two-factor authentication for log-ins.....etc.

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Challenges Nowadays

-- Changing Priorities

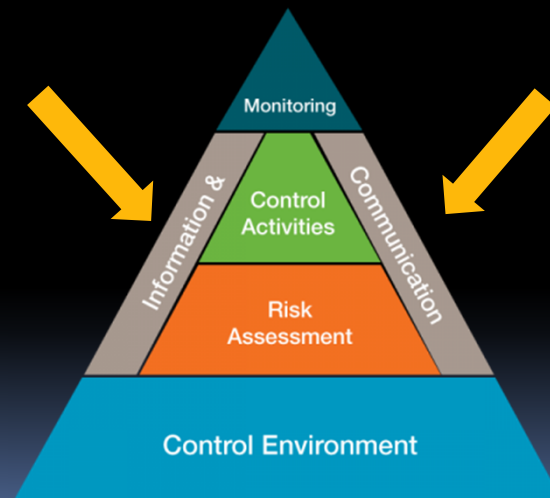
- Highest priorities were giving to immediate needs:
 - Adaptation to remote/hybrid work environment
 - Budget revision
 - Grant management
 - Making payroll/payments
 - Effect: other key controls such as reconciliations, reviews, and compliance management are given less priority
- ❖ Evaluate the current internal control environment and help staff to re-prioritize their duties

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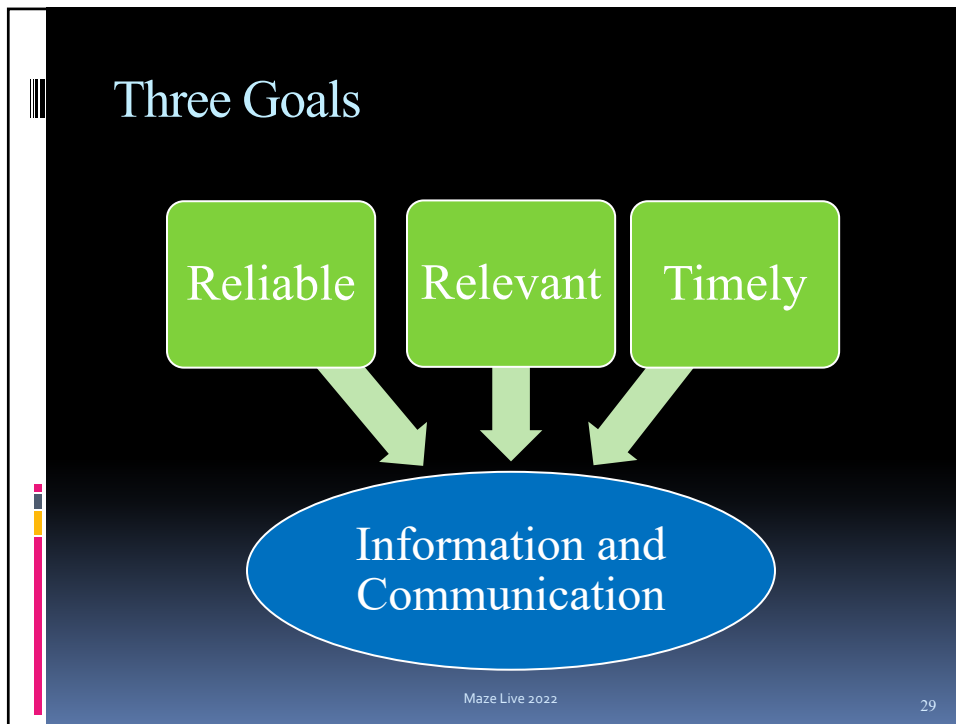
Information and Communication



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- ## Does your organization.....
1. Record transactions accurately?
 2. Resolve errors timely?
 3. Leave an audit trail when making corrections to financial records?
 4. Allow management overrides in financial system?
 5. Ensures accurate data transfer between systems?
 6. Has procedures to capture other information timely and accurately?
 7. Produces accurate and timely financial reports?
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Does your organization.....

8. Have available to the stakeholders relevant and reliable information in a timely manner?
9. Have means for external parties to provide feedback?
10. Have regular inter- and intra-departmental meetings to encourage communication?

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Challenges Nowadays

– Remote/Hybrid Work Environment

- Public Wi-Fi may be used
- People have access to that network and, without a firewall between you and them, nefarious personnel can hack away at your computer from across the room.
- Any interested observers on either the current network or any other public networks your data hits between you and your workplace can monitor your traffic.

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Challenges Nowadays

– Remote/Hybrid Work Environment

- ❖ Consider using:
 - ❖ Personal hotspots from a dedicated device or cellphone, does eliminate getting hacked by people on the same public Wi-Fi.
 - ❖ Remote access applications that can protect your traffic.
 - ❖ Encrypted remote connections into a remote desktop or other individual server.

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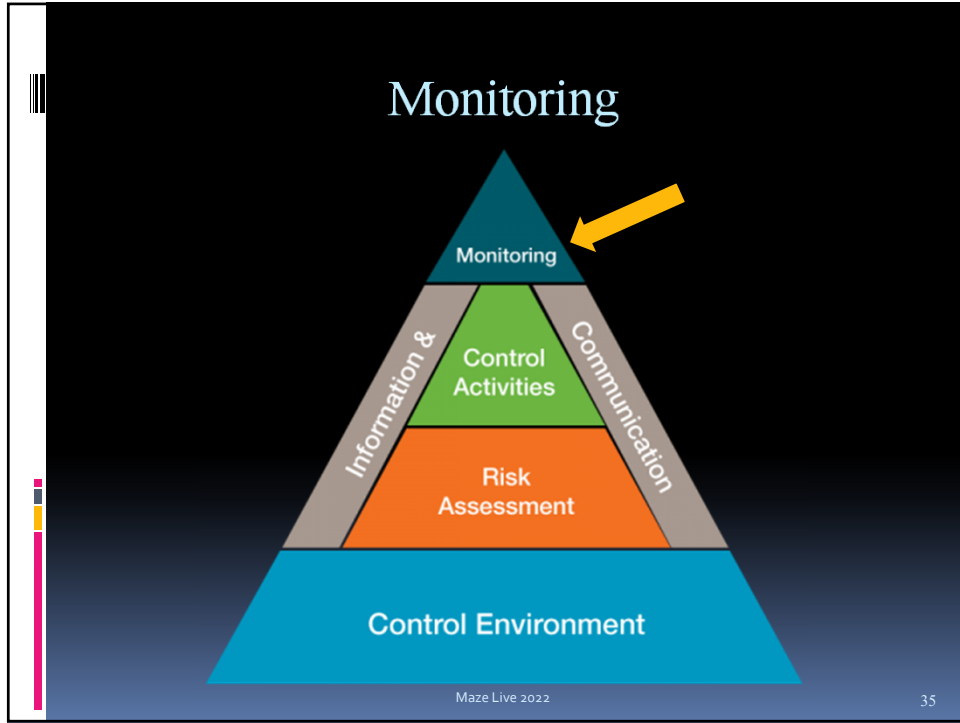
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Protect Information

- Educate your employees to:
 - Keep work data on work computers
 - Block the sight lines
 - Encrypt sensitive data in emails on the device
 - Use a USB data blocker when charging up at a public phone charging station

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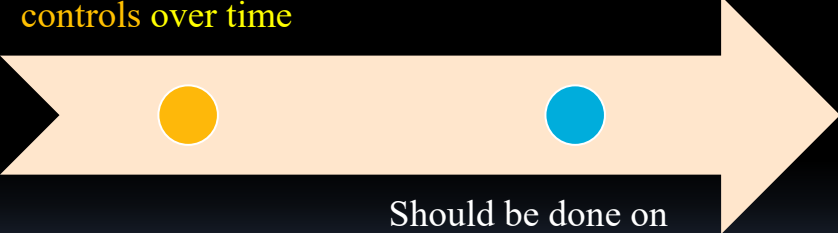
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What is Monitoring?

A process that is used by management to **assess the effective operation of internal controls over time**



Should be done on **an on-going basis** and taking **remedial actions** when necessary

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Does Your Organization Have Procedures to Ensure.....

Control procedures are:

- 1.in place,
- 2.have been performed, and
- 3.are effective?

Control deficiencies:

- 1.have been communicated to appropriate parties, and
- 2.mitigated by corrective actions?

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Challenges Nowadays

Outdated policies or procedures that do not correspond with the current environment

Audit findings go unresolved due to priority change

- ❖ Frequent conversations with staff to ensure changes to processes do not render controls ineffective.
- ❖ Identified gaps in internal controls should be addressed proactively.
- ❖ Once changes to control procedures are made, solicit feedbacks in order to the effectiveness of the new procedures.

- ❖ Evaluate the current internal control environment and re-prioritize tasks.
- ❖ Speak to the auditor to find feasible alternatives to mitigate the control deficiencies.

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Reminder: Effective Internal Control

- **Favorable** *control environment*
- **Periodic** *risk assessment*
- **Effective** *control activities* (design, implementation and maintenance)
- **Effective** *information and communication*
- **Ongoing** *monitoring*

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Recent Fraud Cases



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Salvador Galvan – Compton, CA



- Galvan was sentenced to six and half years in prison for embezzling \$3.7 million from the City over a course of six years.
- Galvan was responsible for preparing bank deposits each day for the City’s cash receipts and was able to skim between \$200-\$8,000 per day without anyone noticing.

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Rita Crundwell – Dixon, IL



- Crundwell embezzled \$53.7 million from the small town over her twenty-two years as the City Comptroller and Treasurer.
- Was sole signatory on City accounts and created fake invoices which allowed her to transfer money between accounts without scrutiny.
- Eventually outside auditors discovered the issues and Crundwell was sentenced to nearly twenty years in prison.

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Michael Minh Nguyen – Placentia, CA



- Financial Services Manager for the city of Placentia, CA embezzled approximately \$5.16 million from the small city.
- A lack of controls during a period of low-staffing allowed Nguyen access to not only outgoing payments but also the financial records for the City.
- Nguyen was able to send wire transfers to outside accounts belonging to him and falsify records to hide his theft.

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Fresno, CA



- In March of this year it was announced that the City of Fresno, CA had fallen victim to an online phishing scam in which they lost \$613,737.
- A fraudster created convincing looking invoices matching an existing vendor and City Officials didn't learn until months later when the legitimate vendor inquired about the missing payment.

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Kern County

Treasurer: More than \$19 million stolen from schools

BY JAMES BURGER |burger@bakersfield.com Mar 7, 2017 Updated Oct 12, 2018



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Types of Fraud

- Internal
 - Sole perpetrator
 - Collusion
 - Money Incoming or Outgoing
- External
 - Phishing/Business Email Compromise (BEC)
 - Fraudulent ACH Debits
 - Check Fraud

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How to Safeguard

- External
 - Take advantage of banking products to safeguard
 - Have policy in place for “emergency” payments
- Internal
 - Policies and procedures
 - Dual Control
 - Independent verification of payment instructions and invoices

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Other Best Practices

- Ensure that all accounts have appropriate fraud prevention products and services.
 - Positive Pay and Payee Validation or \$0 threshold.
 - ACH Fraud Filter with dual control needed for exception items and independent verification on ACH Company ID.
 - Dual Control for all functions for both outgoing payments, template creation/maintenance as well as online user access for all accounts (operating, custody, JPAs, MMMFs etc.) and payment systems.
 - Be aware of business compromise email attempts. Independently verify wire instructions for all vendors/debt service.
 - Routinely verify that proper staff have access to required reporting.

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Other Best Practices

- Be aware of SFTP payment processes and vulnerabilities, both administratively and technologically. The less time the file sits on your servers the better and be sure to immediately terminate access for employees who are resigning.
- Have policy in place for last minute/emergency payments – don't get tricked by urgency.
- Lastly....RECONCILE, RECONCILE, RECONCILE – NACHA rules only give commercial accounts 24 hours for reclamation of funds. If you only reconcile once a month, it's already too late.
- If possible, have separate auditing firm for your entity and outside agencies.
- Independently confirm changes to payment instructions (Google vendor and call. Never use contact info in email).

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ADDITIONAL RESOURCES

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SCO's Internal Control Guidelines

“...to assist local agencies in establishing a system of internal control to safeguard assets and prevent and detect financial errors and fraud.”

Internal Control Guidelines



California
Local
Agencies

Provides
guidance

Suggestions
NOT
requirements

http://www.sco.ca.gov/Files-AUD/2015_internal_control_guidelines.pdf

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QUESTIONS??

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Image Sources

- https://blog.volkovlaw.com/wp-content/uploads/2018/03/ic_Fotor.jpg
- https://www.sco.ca.gov/pubs_guides.html

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