Internal Controls and Segregation of Duties

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AGENDA

- Internal control overview
- How are internal controls developed?
- What does it mean to “segregate duties”?
- Learn why….
- Where to begin
- Fraud risk

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Internal Control Defined:

The Committee of Sponsoring Organizations of the Treadway Commission (COSO) is a joint initiative of five private sector organizations and is dedicated to providing thought leadership through the development of frameworks and guidance on enterprise risk management, internal control and fraud deterrence.

Internal control, as defined by COSO in its Internal Control—Integrated Framework is "a process, effected 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."

Effective internal control is an integral part of an organization's governance system and ability to manage risk.

Source: http://www.coso.org/

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Say that again in English please

Anything that helps safeguard assets

- An alarm system on municipal buildings
- Passwords on computers
- Collateralizing bank accounts
- Protect our Employees

Anything that makes more effective and efficient use of those assets

- Town Clerk and Tax Collector software
- Segregation of duties
- Investment of cash not needed in the next 60 days

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What are Internal Controls?

Anything that helps safeguard assets.

Anything that helps make more effective and efficient use of those assets.

NH RSA 41:9	Objectives	Policy Considerations
• requires the **governing body** to be responsible for establishing and maintaining internal control policies and procedures to ensure the safeguarding of all town assets and properties.	• Operations – effectiveness and efficiency of operations • Reporting – Reliability of reporting for internal and external use • Compliance – Compliance with applicable laws and regulations	• Protect assets from waste and abuse. • Promote operational effectiveness and efficiency. • Ensure accurate, reliable records. • Encourage adherence to policies, rules, regulations and laws.

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What are Internal Controls?

Internal control is a process. Dynamic – ongoing and active

Each process is defined and implemented by a set of policies and procedures- a series of ongoing actions and activities that occur throughout the organization.

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Internal Controls Are Meant To:

1. Promote operational effectiveness and efficiency.
2. Protect assets from waste and abuse.
3. Ensure accurate, reliable records.
4. Encourage adherence to policies, rules, regulations and laws.

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Examples of Internal controls – personal life

- Lock your home and your vehicle
- Keep your Debit Card separate from your PIN
- Check your bills and credit card statements before paying
- Don’t leave large quantities of cash laying around
- Expect our children to ask permission to do certain things
- Expect our spouse to discuss prior to purchasing large ticket items

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Examples of Internal controls – Local Government

- Lock your offices, buildings, vehicles
- Keep your passwords hidden / locked up
- Get approval on invoices before you pay them
- Don't leave cash laying around – make regular deposits
- Expect our employees to ask permission to do certain things
- Expect dept heads to discuss prior to purchasing large ticket items

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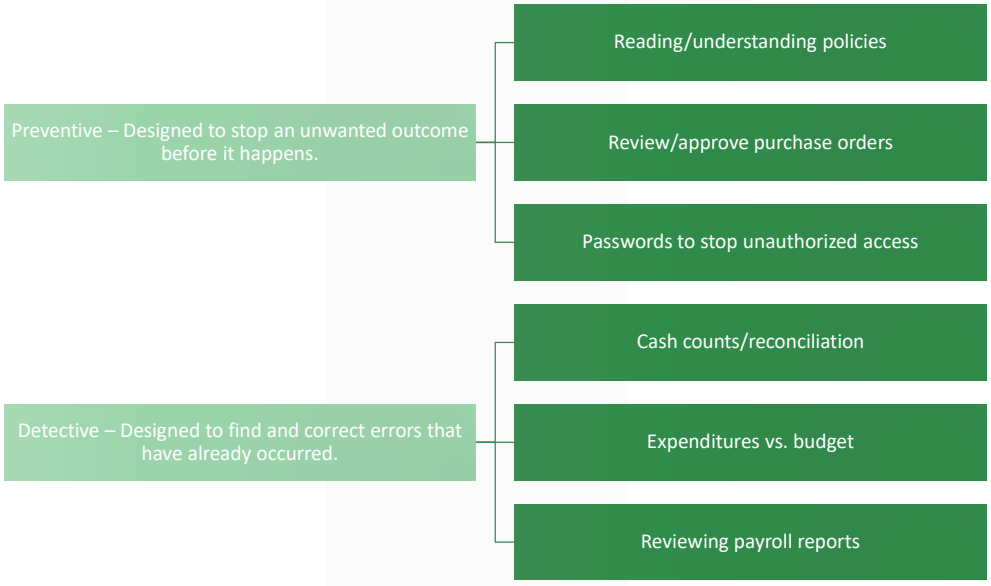
Types of Internal Controls:



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Importance of Internal Controls

Prevent	Prevent loss of funds or other resources.
Reduce	Reduce fraud opportunities.
Ensure	Ensure objectives are accomplished.
Preserve	Preserve integrity.
Assure	Assure compliance with laws, regulations, policies and procedures.
Reassure	Reassure the public their trust and monies are safe.
Establish	Establish standards of performance.
Diminish	Diminish adverse publicity.

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INTERNAL CONTROL OBJECTIVES

- **Operations -** Analyze operational and performance goals along with the effectiveness and efficiencies of operation, including the safeguarding of assets
- **Reporting -** Considers both financial and non-financial information, internal and external to the unit, with an expectation of reliability, accountability and transparency
- **Compliance -** Assure adherence to laws and regulations

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Internal Control Objectives

- Internal Controls, Policy and Procedures are ***not*** simply "Accounting Functions"
- They are not designed or intended to be "more red tape"
- They are ***not*** the responsibility of the outside auditor or banking institution

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A process: a means to an end, not the end itself.

Accomplished by people, not merely policy, procedures and forms.

Reasonable, but not absolute, assurance that assets and resources are safeguarded.

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The Framework of Internal Controls

The Control Environment.

Risk Assessment.

Implementing Control Activities.

Information and Communication.

Monitoring.

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The Control Environment

Set the tone at the top – Internal controls are important!

Integrity and ethical values - must be clearly communicated in writing and by example.

Commitment to competence –sound personnel policies including job descriptions, hiring policies, background checks, job qualifications, performance evaluations and Training.

Authority and responsibility – have clear lines of authority. If everyone is responsible, then no one is responsible. Provide all the authority necessary and only the authority necessary.

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The Control Environment

Controls are an activity that take care of something	Integrity and ethical values	Authority and responsibility
• Cash Procedures • Vehicle safety inspections • Brushing your teeth	• Set the tone at the top – management must be onboard • Discuss at personnel evaluations	• Job descriptions stating responsibilities and supervisors • Request or even require training

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What is Risk?

- When working toward its objectives, every organization faces a wide range of uncertain internal and external factors = Risks.
- The effect of this uncertainty on the organization's objectives is called risk, which can be either positive, representing opportunity, or negative, representing a threat.
- Risk should always be assessed in light of setting and achieving your organization's objectives. If there are no objectives, there is no risk.
- This risk assessment process is both active and frequent.

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Types of Risks

Human Factor
- Employee error
- No training
- Collusion
- Lack of separation of duties

Technology Factor
- Cybersecurity
- IT Malfunctions
- Inadequate technology

Physical Factors
- Unauthorized access to facilities
- Vehicle or equipment failure

Reporting Factors
- Inaccurate or incomplete records
- Misappropriation of assets
- Not knowing the software

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What is the Objective Risk Management?

Identification & analysis of relevant risks to achievement of objectives, forming a basis for determining how the risks should be managed.

Reliable Financial Reporting
- Timeframes should be set for each report (daily/monthly/ annually)
- Procedures established to ensure accuracy

Efficient Operations
- Eliminate redundant operations
- Utilize technology when available to reduce time (cost)

Legal Compliance
- Identify applicable laws and confirm compliance

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Types of Risk

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Changes Increasing Risk

- Operations – economic, political
- Personnel
- IT Systems
- Municipal population spurts
- Programs, activities, services or vendors

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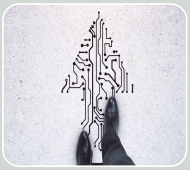
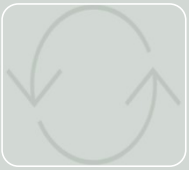
Inherent Risks




Cash
- The more easily an asset can be converted to personal use, the more likely it is to be stolen

Complexity
- The more that can go wrong, the more that is likely to go wrong

Decentralization
- The less overarching control over a process, the greater the chances of steps being missed

Prior problems
- History repeats itself, but in such cunning disguise that we never detect the resemblance until the damage is done
  - Sydney Harris, Journalist

Unfamiliarity
- Unfamiliarity lends weight to misfortune, and there was never a man whose grief was not heightened by surprise
  - Senaca the Younger

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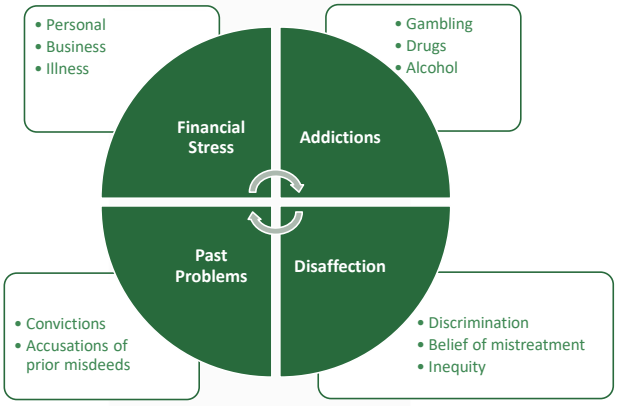
Fraud Risk



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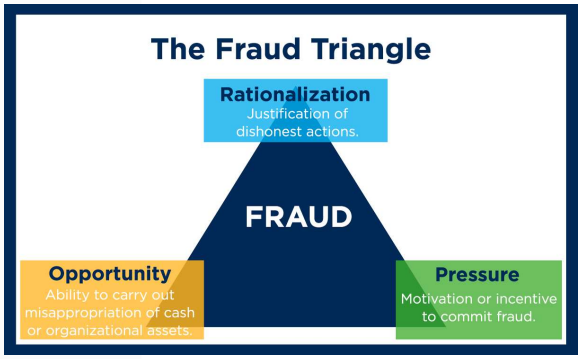
Risk Assessment – Consider Fraud Risks

Embezzlement/Conversion
- Cash, securities, broker/dealers, investment managers

Mechanical errors
- Incorrect amounts
- Improper amortization of premiums and discounts
  Incorrect payees
- Wire transfer failures

Judgement Errors
- Inappropriate securities selection Poor market timing (?)
- Selection of an insolvent dealer or depository

Cover Up
- Fraud
- Delaying or avoiding recognition of losses



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Goal of Risk Assessment

Municipal-wide Objectives	• Set up training programs for all employees • Purchase Policy • Set maximum departmental budget increases
Process-level Objectives	• Town Clerk / Tax Collector cashout procedures • Recycling program rules • Parking ticket process
Perform Risk Analysis	• Changes in personnel • New IT systems or providers • Explosion of population and therefore the need for extra services
Manage / implement changes	• Have independent audit done • Perform employee evaluations • Create new policies or procedures

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Risk Assessment – Questions to Ask

Potential

- What and where is the Risk?
- What is the likelihood of an unwanted occurrence and what would be the impact?

Controls

- What compensating controls can be implemented?
- Does the cost of the control exceed the benefit?

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Risk Assessment

Probability	Severity: Catastrophic - 4	Severity: Critical - 3	Severity: Marginal - 2	Severity: Negligible - 1
Frequent - 4	High (16)	High (12)	Serious (8)	Medium (4)
Probable - 3	High (12)	Serious (9)	Serious (6)	Medium (3)
Remote - 2	Serious (8)	Serious (6)	Medium (4)	Low (2)
Improbable - 1	Medium (4)	Medium (3)	Low (2)	Low (1)

Risk Assessment Matrix

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Red Flags

- **Cash Receipts and Disbursements**
- **Records and Reports**
- **Purchasing**
- **Fixed Assets**
- **No Segregation of Duties**

Employee Red Flags

- Employee 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 Red Flags

- 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;
- Contracts but no services or products.

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Implementing Control Activities

COSO says…

- Policies and procedures should be designed to ensure that the objectives are achieved.
- Policies (what should be done) and procedures (how it should be done) should be designed to ensure that the objectives (protect our assets through effectiveness/efficiency, accurate records, and compliance) are achieved.

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Control Activities

DIRECTIVE CONTROLS PROVIDE GUIDANCE TO EMPLOYEES TO HELP ACHIEVE THE DESIRED OBJECTIVES IN THE DEPARTMENT

PREVENTIVE CONTROLS ARE DESIGNED TO DETER THE OCCURRENCE OF AN UNDESIRABLE EVENT. THE DEVELOPMENT OF THESE CONTROLS INVOLVES PREDICTING POTENTIAL PROBLEMS BEFORE THEY OCCUR AND IMPLEMENTING PROCEDURES TO AVOID THEM.

DETECTIVE CONTROLS ARE DESIGNED TO IDENTIFY UNDESIRABLE EVENTS THAT DO OCCUR AND ALERT MANAGEMENT ABOUT WHAT HAS HAPPENED. THIS ENABLES MANAGEMENT TO TAKE CORRECTIVE ACTION PROMPTLY.

CORRECTIVE CONTROLS IDENTIFY FLAWS IN THE PROCESS AND DETERMINE ACTIONS TO BE TAKEN (EMPLOYEE TRAINING)

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Control Activities

Authorizations
- In writing
- In advance
- By specific individuals
- Documentation

Properly designed Records
- Sequential numbering
- Original receipts
- Statements vs invoices

Security of assets and records
- Controlled access
- Physical security
- Confidential vs not
- Computer backups

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Control Activities examples

Periodic Reconciliations	Periodic Verification	Analytical Review
• Bank accounts • Accounting record to other departments • Agency liability accounts	• Physical inventory • Payroll payout • Time sheet accurateness • Capital Asset list	• Expected vs reported • Date entry controls • Exception reporting

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Implementing Control Activities

- Segregate incompatible duties – duties where someone can both commit an irregularity and then conceal it:
  - Authorize a transaction
  - Record the transaction
  - Maintain custody of the asset resulting from the transaction
- Provide compensating controls when segregation not possible – vacation, periodic rotation of duties, have someone else do the job and see if there is any noticeable change.
- Appoint a Deputy!

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Policy vs Procedure

POLICY	PROCEDURE
The formal guidance needed to coordinate and execute activity throughout the district. When effectively deployed, policy statements help focus attention and resources on high priority issues - aligning and merging efforts to achieve the district's vision. Policy provides the operational framework within which the district functions.	*The operational processes required to implement district policy. Operating practices can be formal or informal, specific to a department or building or applicable across the entire district. If policy is "what" the district does operationally, then its procedures are "how" it intends to carry out those operating policy expressions.*
• Widespread application • Changes less frequently • Usually expressed in broad terms • States "what" and/or "why" • Answers operational issues	• Narrow application • Prone to change • Often stated in detail • States "how", "when", and/or "who" • Describes process

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Information and Communication

TO BE USEFUL, INFORMATION MUST BE:

- ✓Appropriate
- ✓Accurate
- ✓Timely
- ✓Current
- ✓Accessible

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Information and Communication

Up, down, lateral and around.

Accounting policies and procedures manual:

- Clearly outlines specific authority and responsibility
- Serves as a reference tool
- Lessens the threat to continuity due to employee turnover

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Monitoring

- Investigate and resolve discrepancies.
- Maintain professional skepticism – explanations should be supported by some type of evidence.
- Promptly follow-up on all indications of potential errors and irregularities.

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Monitoring

Just as a smoke alarm does not put out a fire, the same is true of internal controls – both are designed to provide an "alert".

Internal controls are a tool to detect and prevent errors and irregularities (Getting kickbacks to always use a certain vendor, intentional misstatement of the financial statements or a theft of assets).

Be alert to "red flags" such as unusual or unexplained discrepancies.

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Accountability

Organization holds individuals accountable for their internal control responsibilities

- Enforces Accountability through structures, authorities and responsibilities
- Establishes Performance Measures, Incentives and Rewards
- Evaluates Performance Measures, Incentives and Rewards
  - Align incentives and rewards with fulfillment of internal control responsibilities
  - Clear objectives, defined implications, meaningful metrics
- Consider Excessive Pressures – evaluate the pressures associated with achieving objectives
  - Do not set unrealistic performance targets
- Evaluate performance of internal control responsibilities
  - Adherence to standards of conduct
  - Expected levels of competence

Accountability is interconnected with leadership and is the result of the tone established by the governing body and senior management.

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Who Is Responsible?

EVERYONE plays some role in effecting internal controls.

- Governing Body – BOS, Council, School Board, Commissioners, Aldermen
- Manager, Superintendent
- Department Heads, Principals
- Supervisory Personnel
- Each Individual Employee
- Budget Committee

All personnel should be responsible to communicate:

- Problems in operations
- Deviations from established standards or expectations
- Violations of policy, law or regulations

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Management's Role

- Monitoring Compliance
- Planning, organizing, directing
- Safeguarding assets
- Segregating duties
- Adhering to the P&Ps

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Employee's Role

- Participating
- Reporting issues
- Regular training and awareness
- Understanding and adhering to the P&Ps

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Where to Start: Internal Control Self-Assessment

A basic checklist from the checklist from the Vermont State Auditors Office and adapted by NHMA

Answers on the right indicate a potential internal control weakness that may need attention.

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Internal Controls Checklist

GENERAL		Comments:
1. Is governing body aware that establishing and maintaining appropriate internal controls is their responsibility under RSA 41:9, VI?	Y N	
2. Does municipality management show commitment to establishing and maintaining controls?	Y N	
3. Do municipality offices have an organizational chart defining the activities and person responsible for them?	Y N	
4. Are the duties of officials and employees clearly defined in the personnel policy and written job descriptions?	Y N	
5. Are employee evaluations routinely conducted with corrective action addressed if needed?	Y N	
6. Does municipality management consistently exhibit high ethical and professional standards in its conduct, setting the standard for the entire organization?	Y N	
7. Are personnel involved in accounting functions and or revenue and expense collection and disbursement required to take an annual vacation?	Y N	
8. Are accounting functions performed by other personnel during the vacation of accounting personnel?	Y N	
9. Is other staff trained in the accounting functions to provide backup in the case of vacation or other absence of the primary bookkeeping employees?	Y N	
10. Is responsibility for accounting duties ever rotated among staff?	Y N	

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Government Finance Officers Association Statement on Fraud Prevention

Fear of detection and punishment is a product of effective internal controls. Weak internal controls both permit and invite irregularities by reducing or removing that fear.

The single most important step that can be taken to prevent fraud is for management to establish and maintain an effective internal control structure!

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Minimum Level of Internal Control Standards

FIVE COMPONENTS

- Control Environment
- Risk Assessment
- Control Activities
- Information & Communication
- Monitoring

KEY AREAS

- Accounting
- Auditing
- Budget
- Cash
- Revenue
- Fund Balance
- Purchasing/Bidding
- Expenditures
- Assets (Capital & Fixed)
- Investments
- Debt
- Documentation
- Record Retention
- Purchasing
- Risk Management

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Where to Start: Where Are the Risks?

Cash, decentralization, no segregation of duties, change, potential for fraud.

Where does the money come from, where does it go?

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Where to Start: Address the Identified Weakness

- Authorization controls
- Record controls
- Security controls
- Segregate duties
- Personnel policies
- Reconciliation
- Verification
- Analytic review

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Control Activities

Policies & procedures that help ensure mgmt. directives are carried out.

Ensure necessary actions are taken to address risks to achievement of objectives

Occur throughout the city/town, at all levels & in all functions.

Includes:

- Segregation of duties
- Approvals
- Authorizations
- Verifications
- Reconciliations
- Performance Reviews

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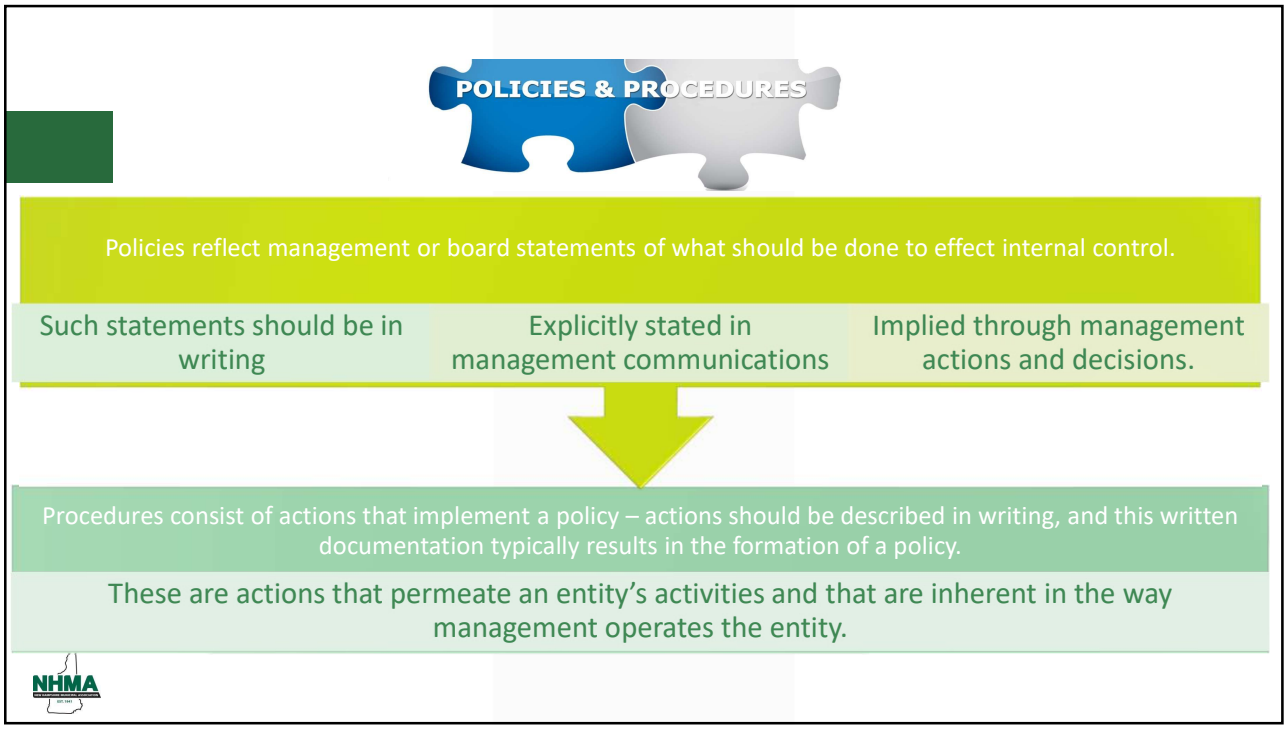
POLICIES & PROCEDURES
Policies reflect management or board statements of what should be done to effect internal control.
Such statements should be in writing
Explicitly stated in management communications
Implied through management actions and decisions.
Procedures consist of actions that implement a policy – actions should be described in writing, and this written documentation typically results in the formation of a policy.
These are actions that permeate an entity's activities and that are inherent in the way management operates the entity.
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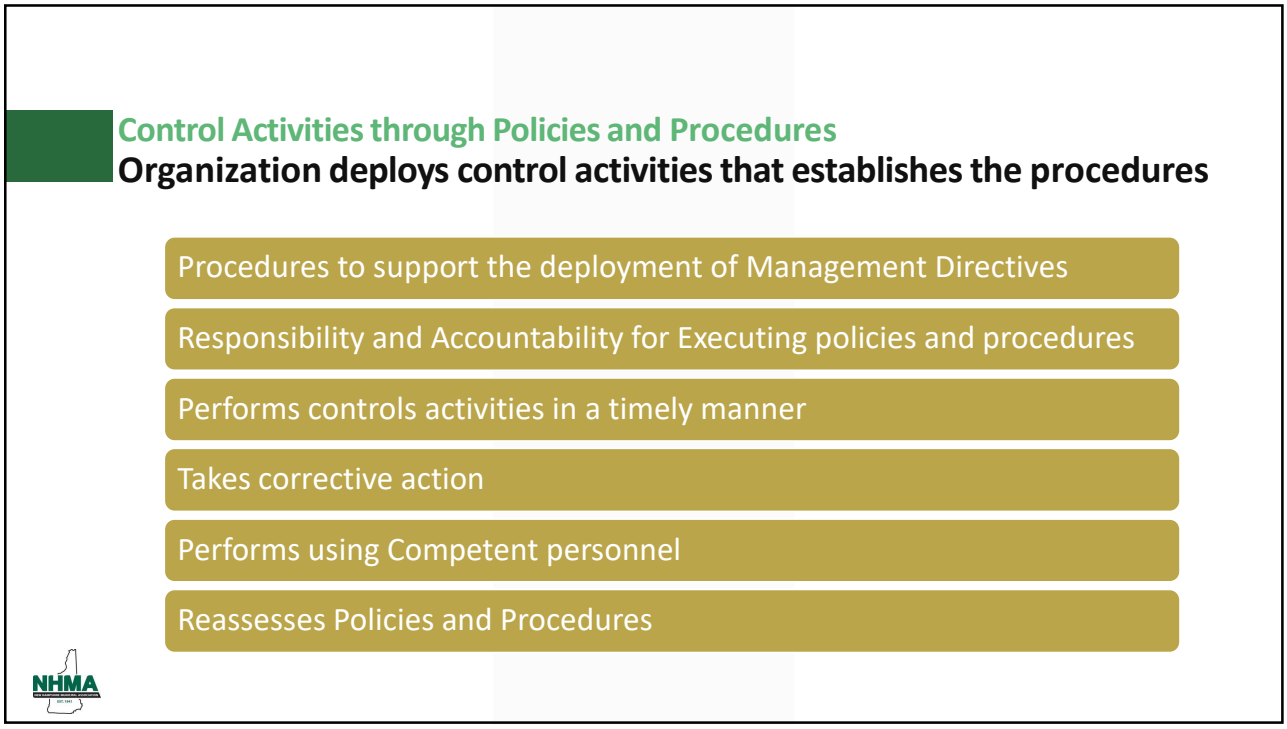
Control Activities through Policies and Procedures
Organization deploys control activities that establishes the procedures
Procedures to support the deployment of Management Directives
Responsibility and Accountability for Executing policies and procedures
Performs controls activities in a timely manner
Takes corrective action
Performs using Competent personnel
Reassesses Policies and Procedures
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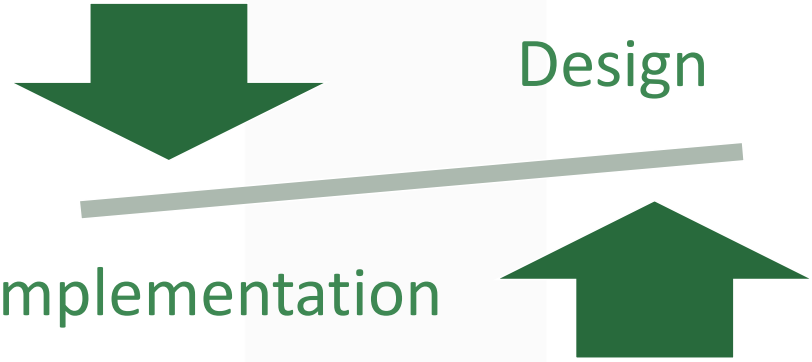
Two Parts of a Control



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Most Common Internal Control Deficiencies

- Lack of written financial policies and procedures.
- Inadequate cash and receipts procedures.
- Inadequate reconciliations.
- Lack of personnel policies.
- Lack of personnel evaluations.

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Limitations of Internal Controls

Judgement – decisions made by people under pressure and time constraints, based upon information on hand.

Breakdowns – lack of understanding, simply making mistakes.

Management Override – high level management override prescribed policies and procedures.

Collusion – 2 or more individuals circumventing controls.

Cost vs. Benefit – risk and effect must be weighed against the cost of establishing controls.

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Balancing Risks and Controls

Reasonable Assurances:

Excessive Risks – loss of assets, loss of funding, poor decisions, non-compliance, increased regulation, public scandal.

Cost-Benefit

Excessive Controls – increased bureaucracy, complexity, time, non-value-added activities, reduced productivity

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Common Methods of Control Activities

Authorization –designed to provide reasonable assurance that all transactions are within the limits set by policy or that exceptions to policy have been granted by the appropriate officials.

Review and approval – designed to provide reasonable assurance that transactions have been reviewed for accuracy and completeness by appropriate personnel.

Verification – Control activities in this category include a variety of computer and manual controls designed to provide reasonable assurance that all accounting information has been correctly captured.

Reconciliation –Provide reasonable assurance of the accuracy of financial records through the periodic comparison of source documents to data recorded in accounting information systems.

Physical security over assets – Designed to provide reasonable assurance that assets are safeguarded and protected from loss or damage due to accident, natural disaster, negligence or intentional acts of fraud, theft or abuse.

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Source: GFOA

Internal Control and Financial Reporting

- Institutionalize good financial management practices.
- Formal policies usually outlive their creators, and, thus, promote stability and continuity. They also prevent the need to re-invent responses to recurring issues.
- Clarify and crystallize strategic intent for financial management.
- Financial policies define a shared understanding of how the organization will develop its financial practices and manage its resources to provide the best value to the community.
- Define boundaries – policies define limits on the actions staff may take.
- The policy framework provides the boundaries within which staff can innovate in order to realize the organization's strategic intent.
- Support good bond ratings and thereby reduce the cost of borrowing.
- Promote long-term and strategic thinking.
- The strategic intent articulated by many financial policies necessarily demands a long-term perspective from the organization.
- Manage risks to financial condition.
- A key component of governance accountability is not to incur excessive risk in the pursuit of public goals.
- Financial policies identify important risks to financial condition.
- Comply with established public management best practices.

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Internal Control In the Treasury Function

Internal controls constitute specific policies and procedures (the controls) designed to achieve the objectives of:

- 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

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Internal Controls for Investment Activity

Investment Authorization — Authorized decision makers

- Guidelines on permitted investments (investment policy) Flexible to respond to changes in the markets
- Restrictive to minimize the risk of fraud or loss

Investment Selection — Only permitted investments

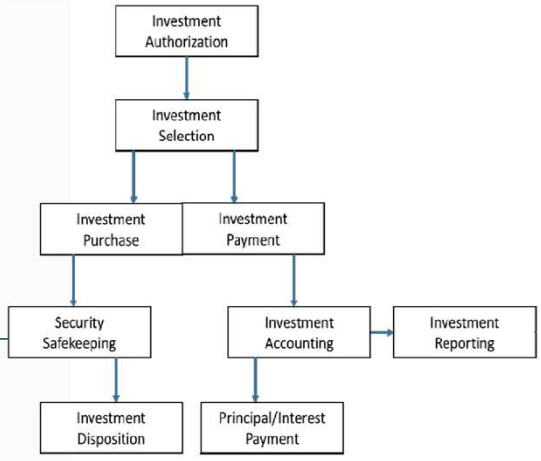
- Risk reward and market conditions
- Factors to consider: Yield, Maturity, Credit worthiness *Permitted does not equal appropriate*

Investment Purchase and Payment — Clearly, well documented transactions

- Trade ticket, custody statement, investment report

Security Safekeeping — Establishing and maintaining ownership

- Reconcile custody statements and other internal/external reports



Source: Investing Public Funds second edition

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Internal Controls as They Relate To Cash Management

Internal controls specifically ensure:

- The safety of all funds
- The timeliness of recording the receipt of all funds
- That assignment of duties complies with separation of duties guidelines
- That reconciliations are completed and reviewed on a monthly schedule
- A sound audit trail and adequate documentation are created

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Common Methods of Control Activities

- Segregation of duties – Reduce the risk of error and fraud by requiring that more than one person is involved in completing a particular fiscal process.
- Education, training and coaching – Reduce the risk of error and inefficiency in operations by ensuring that personnel have the proper education and training to perform their duties effectively. Education and training programs should be periodically reviewed and updated to conform to any changes in the agency environment or fiscal processing procedures.
- Performance planning and evaluation –Establish key performance indicators for the agency that may be used to identify unexpected results or unusual trends in data which could indicate situations that require further investigation and/or corrective actions. Evaluations may be done at multiple levels within the agency, as appropriate: the agency as a whole; major initiatives; specific functions; or specific activities.
- Performance reviews may focus on compliance, financial or operational issues. For example, financial reviews should be made of actual performance versus budgets, forecasts and performance in prior periods.

Source: http://www.coso.org/

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Segregation of Duties

Although control activity procedures are not intended to increase staffing levels, acceptable procedures are to be established and followed which may require changes in existing workloads and/or additional staff position(s).

A periodic thorough internal review of control activities may identify policies and procedures that are no longer required.

Small to medium size operations may not be able to institute internal control procedures on the same level as larger, more complex agencies.

In cases where staffing limitations may prohibit or restrict the appropriate segregation of duties, management must either have more active oversight of operations or utilize personnel from other units to the extent possible as compensating controls.

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Segregation of Duties

Separation of duties protects the organization and the individual by ensuring that no one person has the ability to control all of the steps involved in handling and accounting for money received by the local government.

Custody

Record Keeping

Authorization

Reconciliation

The ideal is that any one person performs no more than 2 functions; three people are needed for the four functions.

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Implementing Control Activities

Segregate

- Segregate incompatible duties – duties where someone can both commit an irregularity and then conceal it:
  - Authorize a transaction
  - Record the transaction
  - Maintain custody of the asset resulting from the transaction

Provide

- Provide compensating controls when segregation not possible – vacation, periodic rotation of duties, have someone else do the job and see if there is any noticeable change.

Appoint

- Appoint a Deputy
- Cross train an alternate

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Segregation of Duties

	Receipt of Goods/Custody of Assets	Record Keeping/Document Prep	Authorization/ Approval	Reconciliation Prepared By	Reconciliation, Independent Approver
Receipt of Goods/Custody of Assets	Same Function	Incompatible unless a compensating control is built	Incompatible	Incompatible unless a compensating control is built	Incompatible
Record Keeping/Document Prep	Incompatible unless a compensating control is built	Same Function	Incompatible	Incompatible unless a compensating control is built	Incompatible
Authorization/ Approval	Incompatible	Incompatible	Same Function	Incompatible	Compatible
Reconciliation Prepared By	Incompatible unless a compensating control is built	Incompatible unless a compensating control is built	Incompatible	Same Function	Incompatible
Reconciliation, Independent Approver	Incompatible	Incompatible	Compatible	Incompatible	Same Function

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When Segregation Is Not Possible

If one person performs two or more of the functions:

- Risk exists that presents the opportunity for something to go wrong
- A compensating control is needed to reduce the risk
- The compensating control might be an extra layer of review

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Examples of compensating controls may include:

A manager/dept head may perform a high level of review of detailed transaction reports

A manager may periodically sample transactions and request supporting documentation to ensure the transactions are complete, appropriate, and accurate.

Someone from another area may perform an external review of a reconciliation.

- For instance, two departments within a municipality may share responsibility to review each others' reconciliations.

Some local governments have a centralized collections and/or financial services department

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Reconciliation & Balancing

What should you reconcile ?

Who should reconcile?

All accounts and transactions-**credit card transactions, accounts payable, accounts receivable, payroll, fixed assets, Due to/Due From accounts, special revenue, and other areas against the general ledger, or balance sheet**

- Reconciliation should be performed by a person with no cash handling responsibilities
- The reconciliation must be dated and signed or initialed
- The reconciliation should be reviewed by an independent party

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Commitment to Competence

Commitment to attract, develop and retain competent individuals aligned to the objectives

- ✓ Establish Policies and Practices
  - ✓ Reflect expectations of competence to support objectives
    - ✓ Define accountability and performance
- ✓ Evaluates Competence and Addresses Shortcomings
  - ✓ Governing Body and Management evaluate competence internally and externally
  - ✓ Requires relevant skills and expertise
- ✓ Attract, Develop and Retain Individuals
  - ✓ Training, mentoring, evaluate, retain
- ✓ Plans and Prepares for succession
  - ✓ Contingency plans for responsibilities for internal controls
  - ✓ Governing Body is responsible, management identifies and assesses

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- www.fgfoa.org
- www.afponline.org
- www.AICPA.org

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Formal Policies *SHOULD* Outlive Their Creators

- Generally, written policies:
  - clarify governing body intent;
  - define boundaries;
  - resolve conflicts;
  - create consistency;
  - avoid allegations of bias or favoritism;
  - foster positive culture and climate;
  - instill public confidence.

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Is your organization at risk for fraud?

73

Objectives

Gain Greater Understanding of Fraud Risk

Understand the Importance of Conducting a Fraud Risk Assessment

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Why should I care?

- It's your tax dollars!
- Impacts ability to provide programs and services.
- Impacts state agency operations.
- Tarnishes reputation of the fraudster, the agency, government in general.
- Creates new work to implement preventative or corrective internal controls.

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What is fraud?

- A deliberate act.
- Something someone does knowing it's not truthful.
- Can involve more than one person.
- **Mistakes are not fraud.**

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2 Categories

External	Internal
• Bad Actors • Customers • Vendors/Contractors	• Employees • Public Officials

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Types of Fraud

External Attack	Internal Attack	Internal Error
Hacking	Theft	Carelessness
Spoofing	Curiosity	Distraction
Phishing		Negligence

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Cybersecurity

Role of every employee in cybersecurity

Weapons and tactics used against local governments

Detecting and defending against cyberattacks

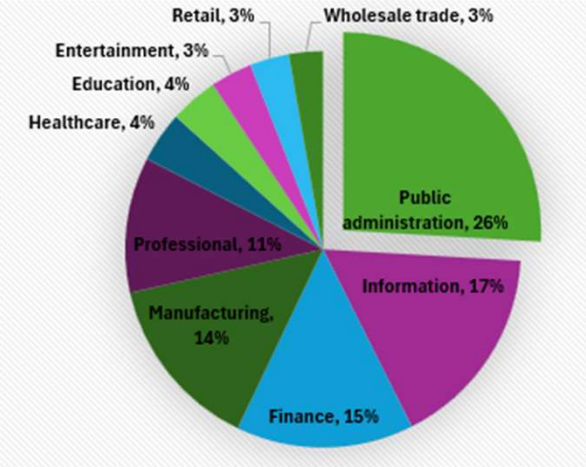
U.S. Department of Homeland Security (DHS) Cyber Resilience Review — These assessments are offered free of charge to local governments.

79

Cyber Threat Statistics

2025 Highlights per DemandSage

- 2,200 cyber attacks **DAILY**
- Global cyber attacks rose by 30%
- Education and research faces the highest number of attacks with 3,341 per WEEK
- Manufacture sector led in ransomware attacks making up 29%
- Cyber insurance costs increased by 28%
- Every **14 seconds** a company falls victim to a ransomware attack
- The total recorded damage from ransomware attacks was $7.08 trillion from 236.1 million attacks



Cybercrime incidents between November 2021 and October 2022 showing the top 10 industries

80

Technology Then and Now

1992	2023

81

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Common Issue - Phishing

Phishing Email

A threat actor sends a phishing email containing a link to a phishing site.

Fraudulent Website

The user visits the fraudulent website, which appears almost identical to the "legitimate" website, and enters his or her username, password, and secondary form of authentication.

Intercepted Communication

The threat actor intercepts the communication, using the authentication information to immediately login to the legitimate website.

- **Personal Information**: Requesting anything personal – information, credentials, account information, etc.
- **Timestamp**: Messages sent at strange times of day
- **Sender Email Address**: "Phishy" domain names (@dell3.com, @MICROSFT.com, etc.)
- **Subject**: Generic greetings
- **Body**: Bad spelling or grammar
- **Attachments**: Requesting that you open an attachment, especially an HTML file or Microsoft Office (Word or Excel) document
- **Urgency**: Instructing you to complete a task in short period of time or that something catastrophic will happen if you don't do what the sender is asking

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Basic Preventative Steps

Secure Passwords

System accounts should be protected with secure passwords.

- **Unique**: Each login should use a different password from any others.
- **Long/Complex**: It should meet the minimum length required by the organization, contain multiple words, and not use easy substitutions (@ for "a" or $ for "s").
- **Private**: Don't write it down and don't share it with anyone.
- **Changed**: Changed when the system prompts, or if you ever suspect it was compromised. If you do suspect a potential compromise, this should also be reported.
- **Enforced**: Lock your workstation when you're away from your desk (Windows key + L).

Multi-Factor Authentication

- Multi-factor authentication is implemented when a user must provide two or more pieces of evidence to verify his or her identity to gain access to a system or application.
- Enabling multi-factor authentication on any systems or applications containing confidential or sensitive data ensures that if your username and password are compromised, your account remains protected against unauthorized access.

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Password strength

Number Of Characters	Numbers Only	Lowercase Letters	Uppercase And Lowercase Letters	Numbers, Uppercase And Lowercase Letters	Numbers, Uppercase, Lowercase And Symbols
4	Instantly	Instantly	Instantly	1 sec	1 sec
5	Instantly	1 sec	19 secs	45 sec	1 min
6	Instantly	15 sec	16 mins	46 mins	2 hours
7	Instantly	7 min	14 hours	2 days	5 days
8	5 sec	3 hours	4 weeks	4 months	11 months
9	49 sec	3 days	4 years	21 years	63 years
10	8 min	3 months	225 years	1k years	4k years
11	1 hour	6 years	11k years	80k years	307k years
12	14 hours	148 years	607k years	5m years	21m years
13	6 days	3k years	31m years	311m years	1bn years
14	2 months	100k years	1bn years	19bn years	105bn years
15	2 years	2m years	85bn years	1tn years	7tn years
16	16 years	67m years	4tn years	74tn years	516tn years
17	156 years	1bn years	231tn years	4qd years	36qd years
18	1K years	45bn years	12qd years	284qd years	2qn years

From the above table, it is evident that the length and the complexity of the password are the two major factors that affect the time required to crack a password.

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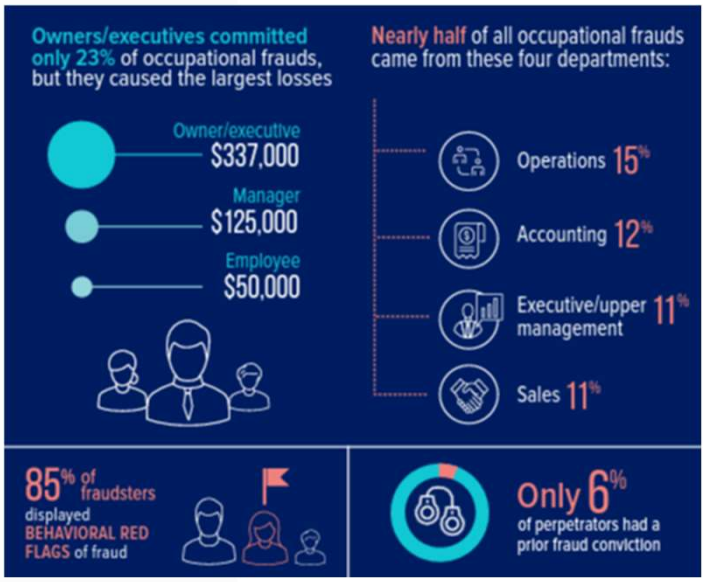
Internal Fraud

The Association of Certified Fraud Examiners (ACFE) defines Occupational Fraud as:

"The use of one's occupation for personal enrichment through the deliberate misuse or misapplication of the employing organization's resources or assets



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MUNICIPAL Fraud Cases

BIGGEST CONVICTED MUNICIPAL EMBEZZLER IN UNITED STATES HISTORY

Rita Crundwell and the Dixon Embezzlement

THE $53 MILLION BAMBOOZLE: How the trusted comptroller of a small Illinois town became the biggest municipal embezzler in U.S. history, according to the feds—and no one noticed

BY BRYAN SMITH

PUBLISHED SEPT. 24, 2012

18 COMMENTS

Rita Crundwell leaves a Rockford, Illinois, courthouse after a hearing on her embezzlement case in August 2012. PHOTO: RAY WHITEHOUSE

UPDATE (11.14.12): Rita Crundwell pleaded guilty to fraud on November 14 in federal court in Rockford.

MARKETPLACE

Source: http://www.telegram.com/article/20160102/NEWS/160109825

Source: www.chicagomag.com/Chicago-Magazine/December-2012/Rita-Crundwell-and-the-Dixon-Embezzlement/

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CONCORD, N.H. - Ex_school official to plead guilty

A former Keene School District treasurer and former banker will plead guilty to embezzling $365,500 in school scholarship money, the US attorney's office says. George McDonnell, 56, of Keene, former vice president of commercial lending at Savings Bank of Walpole, will plead in US District Court, the US attorney's office said. He faces up to 30 years in prison, a $1 million fine and three years' probation.

3/15/01 - ASHLAND, N.H. Ex-town official says she stole $1m

A former town manager who pleaded guilty to stealing $111,300 of town money told authorities she actually stole close to $1 million over a decade by raiding town accounts whenever she wants money. "No area was sacred," said Rosemarie McNamara. McNamara was sentenced to two years in jail.

50 CENTS. NEWSSTAND

Fire secretary charged with padding pay

Investigation continues

By Dan Hackett
RCN Staff

EXETER — A secretary in the Exeter Fire Department was arrested Friday evening for allegedly padding her paycheck by claiming more than $1,000 in overtime.

Christine A. Lawrence, 46, of 156 Front St. in Exeter, has been charged with theft by deception. Police are investigating further, and Lawrence is expected to face more charges. The case will probably go to a grand jury. Police are trying to determine exactly how much money was involved. At this point, police believe Lawrence falsified at least $1,000 in overtime, which makes it a felony crime.

Lawrence had worked in the Fire Department for 9½ years. Police are reviewing pay records to determine when the alleged theft began.

Meanwhile, Lawrence has been suspended without pay from her job in the Fire Department, according to Town Manager George Olson.

Firefighters training on Pickpocket Road on Saturday privately expressed shock that Lawrence, an easygoing and friendly member of their de-

See OVERTIME, Page 8

works.

Ex-Dorchester Town Clerk to Admit Theft

Plea Bargain Calls for 6-Month Jail Term, Restitution of Stolen $4,500

By ROBERT M. COOK
Newfound Area Bureau

HAVERHILL — A former Dorchester town clerk charged with stealing $4,500 from car registrations fees has agreed to plead guilty to the charges and make restitution to the town.

Lynn Carter, 36, served as Dorchester's town clerk during a 15-month period from 1995-96. During that span, she allegedly embezzled almost $4,500 from car owners who registered their motor vehicles at the town office.

Court documents in Grafton County Superior Court indicate that Carter, who currently lives in Massachusetts, filed her intent to plead guilty to the felony theft charge.

Carter resigned as town clerk after she was indicted in Grafton County in January following an investigation conducted by the Dorchester Police Department and the Grafton County Sheriff's

DORCHESTER, Page 12

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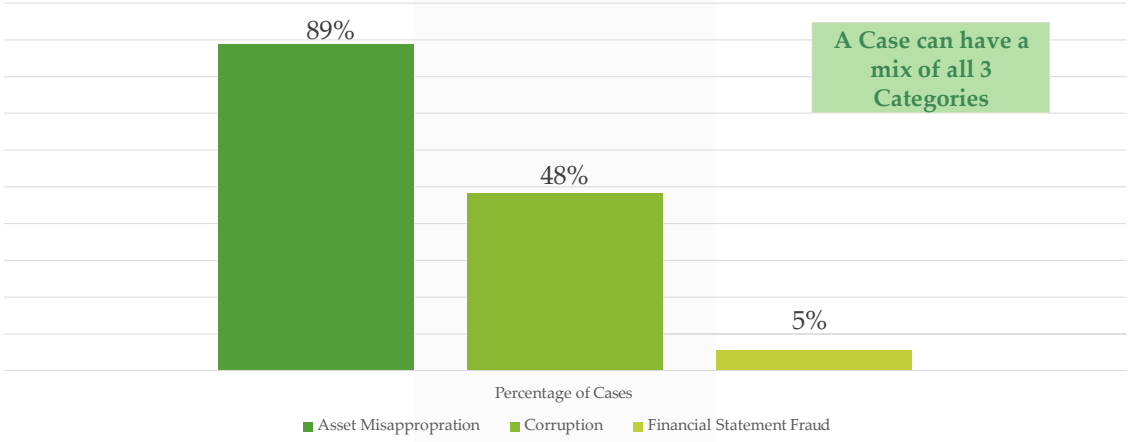
89% of ACFE Cases involved Asset Misappropriation.



A Case can have a mix of all 3 Categories

Source: 2024 ACFE Report

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3 MAIN FRAUD CATEGORIES

Asset Misappropriation	Corruption	Financial Statement Fraud

• Theft of Cash
• Skimming
• Theft of Inventory or Assets
• Fraudulent Disbursements thru Invoices, Payroll, Expense Reports, Voids, Refunds, Check Tampering
	• Bribes
	• Conflicts of Interest
	• Illegal Gratuities
	• Economic Extortion
		• Intentionally misrepresenting the values such as:
		  • Revenue
		  • Expenditures
		  • Assets
		  • Liabilities
		  • Equity
		  • Improper Disclosures

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ACFE United States Fraud Scheme Statistics

Asset Misappropriation Is the Largest Category!

Source: 2022 ACFE Report

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Levels of Fraud

- minor employee theft
- unproductive behavior
- misappropriation of assets
- fraudulent financial reporting

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Common Fraud Themes

Smaller Organization typically have **fewer anti-fraud controls** which increase the risk of fraud.

Median **duration** of a fraud scheme is **16 months**.

Internal Control weaknesses were responsible for over 50% of Fraud!

Only **4% of fraudsters had a prior conviction**.

Majority of Victim organizations **recovered nothing**.

Source: 2022 ACFE Report

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HOW DOES FRAUD HAPPEN?

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INTERNAL FRAUD MAY RESULT FROM

Complacency

- Unknowingly committing security infractions or violations
- Discussing confidential information in public
- Unknowingly clicking on a phishing scam

Unawareness

- Unknowingly committing security infractions or violations
- Discussing confidential information in public
- Unknowingly clicking on a phishing scam

Malice

- Using personal storage devices for official business without authorization
- Uploading confidential data to unapproved, third-party systems
- Allowing individuals without access into buildings or workspaces

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Facts about Fraud

The Association of Government Accountants (AGA) survey outlines the types of fraud posing the greatest risk, barriers to effective fraud prevention and detection, and strategies to improve fraud outcomes.

53% of government agencies agree fraud risk is rising

70% of respondents report resource constraints in addressing fraud

44% lack a formal antifraud program

Source: 2022 AGA Survey

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TOP 5 Government Fraud Schemes

01	Check Fraud	• Name Altered & Cashed • Cashed Check not Received by Payee
02	Credit Card Fraud	• Unauthorized Charges • Merchant Disputes
03	ACH Fraud	• Unauthorized ACH Debit
04	Wire Fraud	• Imposter Emails Asking for Wire Transfers
05	IT Fraud	• Divulging Sensitive Information

NHMA

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FRAUD TRIANGLE

Unable to Pay Personal Bills

I will pay it back and no one will notice.

No one will get hurt.

I'm underpaid and deserve more money.

Weak Internal Controls - Signs checks, records all transactions, and reconciles the bank statements.

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Pressure

- Non-shareable financial problem
- Desires
- Envy
- Lifestyles

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Rationalization/Attitude

Behavior vs. Decency and Trust

- I need the money more than "they" do.
- I've earned it...I work long and hard and get no respect.
- That person does half the work that I do and makes twice as much money.
- I'll pay it back once I get on my feet.
- History of questioning rules, or violating regulations.

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Opportunity

An opportunity is an open door for solving a non-shareable problem in secret by violating a trust.

- Weak internal controls
- Circumvention of internal controls
- The greater the position, the greater the trust and exposure to unprotected assets
- Low chance of getting caught

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Opportunity is the only element over which a local government has significant control

- Opportunity is generally provided through weaknesses in the internal controls

Supervision and review

- Inadequate oversite
- Inadequate recordkeeping

Segregation of duties

Management approval

System controls

- Cash transactions

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The Fraud Triangle Is Interdependent

Greater the perceived pressure, the less rationalization needed

Greater the rationalization, the less pressure needed

Greater the opportunity, the less pressure or rationalization needed to motivate the fraud!

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Theft
Concealment
Conversion

Fraud is different than unintentional errors or mistakes.

The elements of fraud always involve deception, confidence and trickery.

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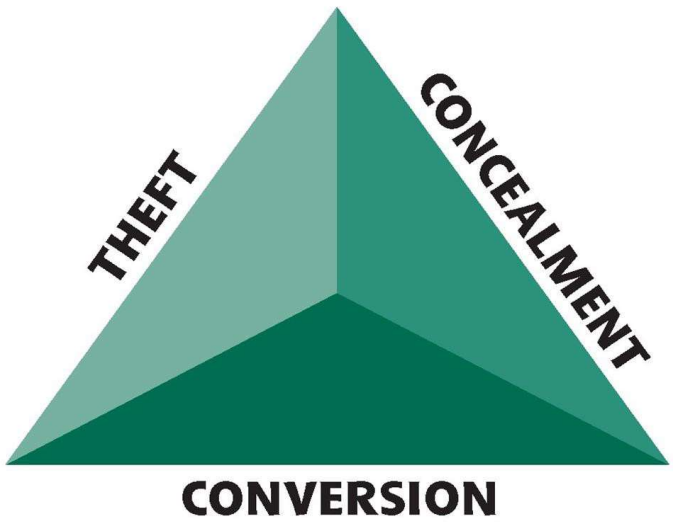

Elements of Fraud

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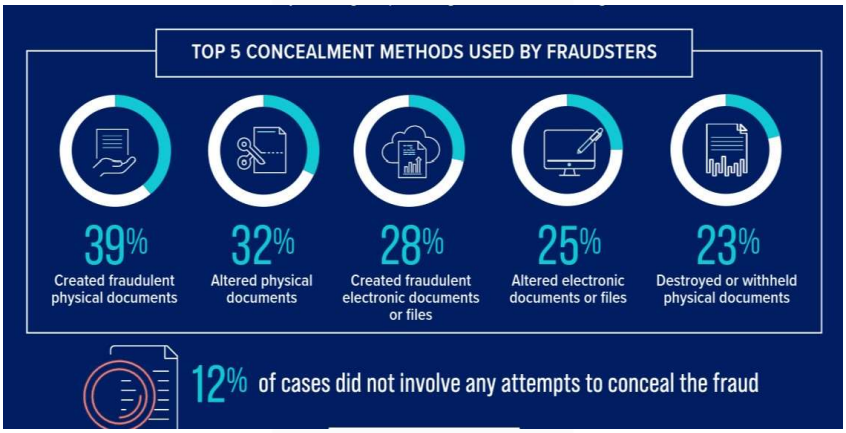
HOW DO PERPETRATORS CONCEAL THEIR FRAUD?

Examining the methods fraudsters use to conceal their crimes can assist organizations in more effectively detecting and preventing similar schemes moving



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Fraudulent Financial Reporting

Misstatements resulting from fraudulent financial reporting is often referred to as "management fraud". These are intentional misstatements or omissions of amounts or disclosures from the financial statements with the intent of deceiving the financial statement user.

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Fraudulent Financial Reporting – Why is it done?

- Meet revenue estimates
- Achieve a certain fund balance level
- Comply with budget limitations or debt covenants
- anticipated tax rate
- Conceal a misappropriation of assets

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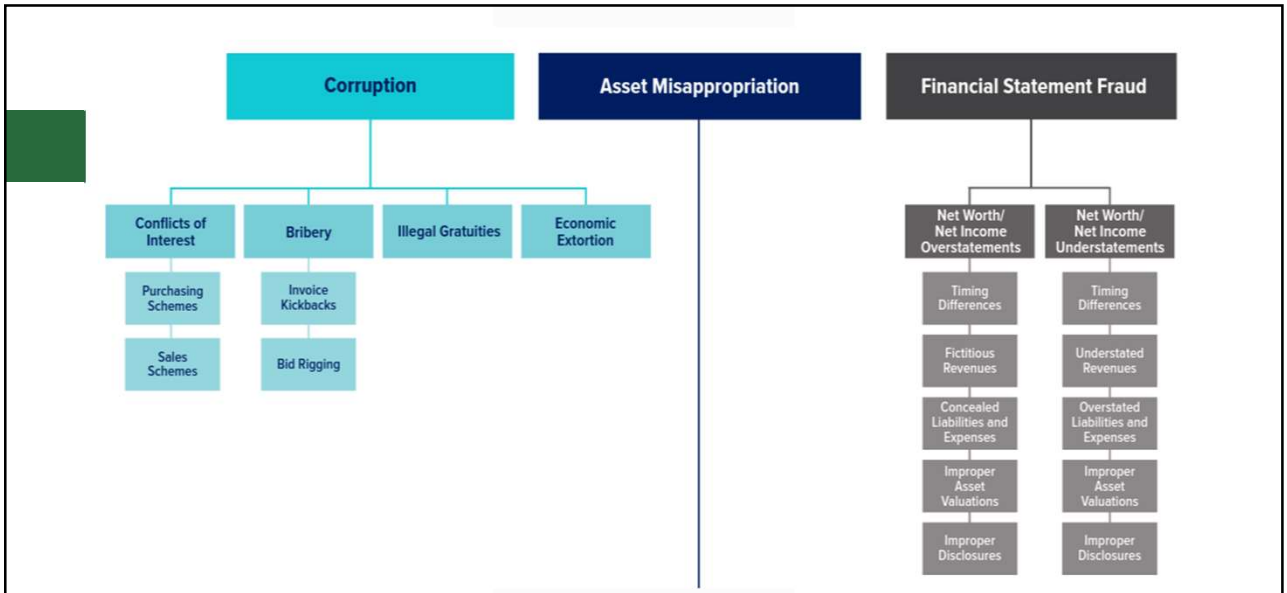

The Fraud Tree

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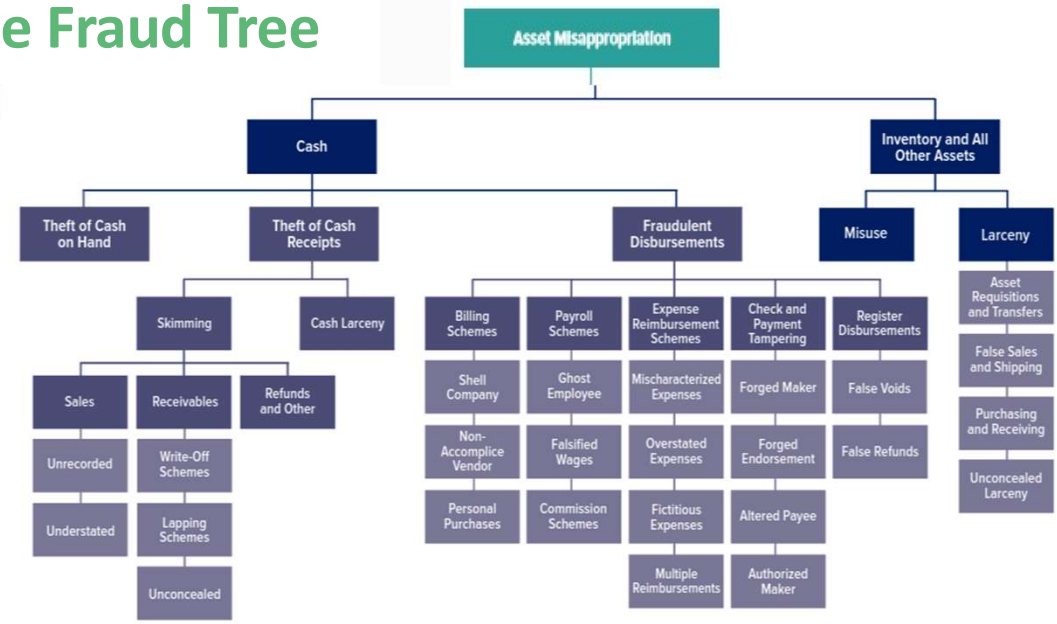
The Fraud Tree



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Stealing assets:

Government services or benefits - free permits or benefits for non-employee

Use of government assets - vehicles, equipment or employee labor

Theft of physical assets - supplies or software

Bribes, kickbacks or use of government-earned discounts

Misappropriation of Assets

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Misappropriation of Assets

- Payment for goods and services not received:
- Payments to fictitious vendors
- Overpayments to vendors for goods or services received
- Payments for unauthorized wages and benefits

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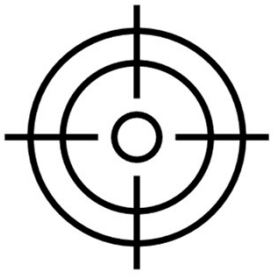
Misappropriation of Assets-Targets



- Embezzlement of cash receipts:
- Motor vehicle registrations (both state and town portions) and various other permits and fees
- Tax payments
- Developer deposits and fees
- Ambulance and police charges and fees
- Transfer station collections
- Food service programs
- Student activity accounts

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Misappropriation of Assets - How is it done?

- Falsification, alteration, or other manipulation of accounting records or source documents, such as invoices, purchase orders and checks
- **Circumventing controls**
- **Committed by:**
  - Management
  - Employees
  - Third Parties

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HOW?

INTERNAL CONTROLS

POLICY

PROCEDURE

TAKE AWAY OPPORTUNITY

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Fraud Awareness and Prevention

- Raise employee awareness about fraud.
- Educate and train employees about fraud prevention, detection, and reporting techniques.
- Fight fraud to safeguard state assets and resources.

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PRACTICE POINTER: Custody

- Having access to or control over any physical asset
- Custodians:
  - Collect and handle payments
  - Prepare deposits
  - Have access to safes, lock boxes, & file cabinets where funds are kept

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PRACTICE POINTER: Record Keeping

- Record keeping is the process of creating and maintaining official records
- Record keeping may occur manually or through an automated data system

- Record Keeping Examples:
  - Customer receipts
  - Deposit slips
  - Credit card receipts
  - Cash register reports
  - EFT (electronic funds) payment documents
  - Balancing and reconciliation reports
  - Record Retention

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PRACTICE POINTER: Authorization

Authorization is the process of granting formal approval to perform a specific function

For example, someone must be authorized in order to perform one of the following functions:

Verify cash collections

Review daily balancing reports

Approve discounts, voids, or refunds

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PRACTICE POINTER: Authorization

- The person who originally created a transaction should not be:
  - The one who makes a correction
  - The one who creates a void
  - The one who creates/approves a refund
- The best practice is to have a supervisor/department head/manager, etc., take these actions

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PRACTICE POINTER: Custody – System Passwords

Every person must have their own password

Passwords must never be shared

Don't write your passwords down

If you need to leave the work area, sign off your password; log back on when you return

Passwords should be changed periodically

Passwords should be inactivated whenever a custodian vacates the position

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PRACTICE POINTER-Develop General Controls over Technology

Organization selects and develops control activities over technology that supports the achievement of objectives

- Determines dependency on Technology in processes
  - How much of the process is automated
  - Deployed to ensure automation works properly
- Establishes relevant technology infrastructure
  - Designed to help ensure completeness, accuracy and availability of the process
  - Networking, computing resources
  - Can be internal or external
- Establishes relevant security management
  - Restrict to authorized users
  - Which users can execute transactions
- Establishes relevant technology development and maintenance of process controls
  - Provides a structure for system design
  - Documentation, approvals, checkpoints

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- Record Retention

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PRACTICE POINTER: Paper/Electronic Documentation

Documentation is essential for an effective internal controls program in the investment function

Every transaction should be documented with a confirmation from the broker, the custodian and should include specific detail including

- Date of transaction
- Buy/Sell
- Broker/Dealer
- Competitive Bid quotes when appropriate
- Account number name
- Wire transfer instructions (limited internal control)
- Security Description
- Investment yield, price
- Dollar amount
- Maturity of investment
- Delivery instructions

Source: Investing Public Funds second edition

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PRACTICE POINTER

Wire Transfer Agreements

Source: Investing Public Funds second edition

Wire transfers typically involve large sums of money

Policies should be in place to minimize risk of loss

- Listing of accounts
- Custody functions
- Authorized personnel and dollar limits
- Allowable types of communications (email, verbal, fax)
- Requirement that the instructions are on letterhead
- Confirmation and notification procedures
- Bank liability

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- www.fgfoa.org
- www.afponline.org
- www.AICPA.org

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