STRENGTHENING INTERNAL CONTROLS
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Featuring Real Life Examples by:

HIGGINS CAPITAL MANAGEMENT, INC.
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What We Will Cover Today

1. Background

2. Integrated framework of internal control

3. Five elements of internal controls, with real life examples

4. Additional resources
BACKGROUND
What Is Internal Control?

A combination of people, policies and procedures that allows an organization to achieve 3 objectives:

- **Operational**
  - Operate effectively and efficiently
  - Safeguard assets

- **Reporting**
  - Provide reliable information

- **Compliance**
  - Comply with all applicable constraints
Who Is Responsible?

- **Management**
  - Implement and maintain effective internal control

- **Governing Body**
  - Oversee all aspects of management performance
Who Is Responsible?

**Management**
Implement and maintain effective internal control

**Governing Body**
Oversee management’s performance

**Audit Committee**
Assists the governing body in meeting its internal control responsibility

**Internal Auditor**
Assist management in meeting its internal control responsibility
SCO’s Internal Control Guidelines

- Effective 1/1/2015
- Provides guidance
- Suggestions NOT requirements

- See Guidelines at:
  http://www.sco.ca.gov/Files-AUD/2015_internal_control_guidelines.pdf
Integrated Framework of Internal Control
Five Components

- Control Environment
- Monitoring
- Risk Assessment
- Information and Communication
- Control Activities
Integrated Framework of Internal Control Must Provide for:

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

Infrastructure

Standards

Processes

Structures
Overview

- Covers both Management and Governing Board
Overview

- Should include some or all of the following elements:

1. Commitment to integrity and ethical values
2. Independent oversight
3. Assignment of authority and responsibility
4. Competent staff
5. Accountability
Examples on How to Apply?

1. Commitment to integrity and ethical values
   - Prompt reaction towards violation of internal control
   - Governing body demonstrate desire to gain a basic understanding of internal control and oversee management’s performance
Examples on How to Apply?

2. Independent oversight
   - Audit committee

3. Assignment of authority and responsibility
   - Segregate incompatible duties
   - Employees not given authority beyond what they need to perform their assigned duties.
Examples on How to Apply?

4. Competent staff
   - Practices to minimize staff turnover and hiring replacement staff in timely manners

5. Accountability
   - Individuals are held accountable for their lapses
   - Realistic performance measures
“Glad to see you maintaining an arm’s length relationship with your client.”
Risk Assessment
What is Risk?
Risk Assessment

- Identification, analysis, and management of risks relevant to the preparation and fair presentation of financial statements

- Should be done on an On-Going basis.
The Process

- Identify
- Estimate
- Decide
- Assess
On Going Risk Assessment

Specific Objectives

Risk?

Fraud?

Changes?
Rationalization

FRAUD

Opportunity

Pressure
Fraud Triangle

- Pressure
  - Severe business pressure, for example:
    - Unrealistic budgetary goals
    - Cash flow pressures
    - Economic decline
    - Maturing debt or restrictive bond covenants
Fraud Triangle

- Pressure (continued)
  - Immediate financial needs, for example:
    - Substance abuse
    - Involvement in an expensive relationship
    - Excessive debt
    - Medical/financial emergencies of family members
Real Life Examples

Severe business pressure for example: Unrealistic budgetary goals and cash flow pressures

- 1994 Orange County
1994 Orange County Bankruptcy

Severe business pressure for example: Unrealistic budgetary goals and cash flow pressures

- County Treasurer vowed to provide 11% of budget from portfolio returns; secretive; no reporting requirements
- Treasurer invested heavily in “inverse floaters”
- Reversed and leveraged portfolio to raise cash to invest in more inverse floaters
- Reverses were not matched; portfolio was not hedged
- Fed began to tighten; County could not make its margin calls; losses of $1.64 billion
- Legislation implemented for professional qualifications, oversight committees and regular reporting
Real Life Examples

Severe business pressure for example: Excessive Debt

- 2016 Placentia
2016 Placentia

Severe business pressure for example: Excessive Debt

- Finance Services Manager embezzled $5.16 million bypassing accounting safeguards when transferring money to personal accounts
- Bank statements and ledgers manipulated with software
- City notified by IRS after a suspicious wire transfer to a Las Vegas casino
- March 20, 2017, former finance-services manager sentenced to 25 years in prison
- July 2017, $4.66 million of stolen funds returned
Fraud Triangle

- Opportunity
  - Examples:
    - Weak design of internal controls
    - Lack of monitoring or periodic review of internal control system
    - Employee turnover/lay off
Real Life Examples

Opportunity: Weak design of internal controls

- 1991 Wymer Investment Fraud
- 1999 Oceanside Prime Bank Notes (exception)
- 2014 City of Pasadena
- 2016 Beaumont
1991 Wymer Investment Fraud

Opportunity: Weak design of internal controls

- Multiple CA public agencies affected $105 million in losses
- Steve Wymer was unknown but hired retired treasurers to open doors
- Touted sophisticated investment strategy using US treasuries
- Accounts were co-mingled and assets held by Institutional Treasury Management (ITM), a Wymer account
- Client accounts were transferred days before the SEC obtained a court order freezing the assets
- September 1992, Wymer received 14 year prison sentence
- Wymer spent $29 million in 6 years on himself
Opportunity: Weak design of internal controls

- EXCEPTION
- Mayor approached Treasurer with investment that was “risk free” and chance for 130% monthly return
- International Monetary Fund went outside the chain-of-command to the Mayor vs. Treasurer
- Required a Power of Attorney on $100 million and secrecy
- Major signed a “Letter of Intent”
- Elected Treasurer refused to sign documentation
- Matter was brought to the attention of City Council and press
- Deal dropped; Mayor was not re-elected
2014 City of Pasadena

Opportunity: Weak design of internal controls

- Employee in Public Works Department embezzled $3.5 million by generating false invoices (2004-2014) for a program to move utilities underground.
- Employee funneled some of the money to a contractor, Collins Electric.
- A 2014 audit uncovered the embezzlement.
- January 11, 2019, public works analyst was sentenced to 14 years and contractor was sentenced to 7 years.
2016 City of Beaumont

Opportunity: Weak design of internal controls

- EXCEPTION: CITY-WIDE CORRUPTION
- $43 million corruption case involving: former City Mayor, Police Chief, Public Works Director, City Attorney, Economic Development Director, Finance Director and City Planner
  - Outsourced work to Urban Logic Consultants for planning economic development, diverting funds from the joint power agency’s Transportation Uniform Mitigation Fee
  - 6 pled guilty to a felony; 1 to a misdemeanor
  - December 2018, City Attorney pled to a misdemeanor
  - None received jail sentences (probation and files)
Risk Assessment – Fraud Triangle

- Rationalization
  - Examples:
    - “It is for the good of the organization.”
    - “I am just borrowing the money.”
    - “I am getting what I deserve.”
    - An attempt to depersonalize his/her actions.
Real Life Examples

- 1993 San Bernardino County
- 1995 Vista
- 2016 Compton
1993-1998 San Bernardino County

Rationalization: “I’m getting what I deserve.”

- County officials engaged in a pay-to-play corruption such as travel and lodging to places like Hawaii and Mexico
- Invested in mutual funds paying commissions and trailers vs. institutional money market mutual funds.
- In 2000, the Treasurer-Tax Collector and Investment Officer pled guilty to misconduct charges and sentenced to 1 year and a day in halfway houses
- The county settled with a major brokerage firm for 10mm.
1995 City of Vista

Rationalization: “I’m getting what I deserve.”

- Began taking gratuities from a broker
- Invested in interest-only strips, equity mutual funds and limited partnerships
- In 1999 the former Finance Director admitted to putting the city in illegal investments, submitting false reports to the council, and getting preferential treatment from a broker
- Pleads guilty to fraud after millions in losses
2016 City of Compton

Rationalization: “I’m getting what I deserve.”

- Deputy Treasurer arrested in December 2016 for embezzling City funds
- Handled cash for 22 years; started to embezzle in May 2010
- Colleague spotted a discrepancy, triggering an investigation; when confronted by supervisor, admitted to stealing money for years
- November 3, 2017 Ex-Deputy Treasurer and wife plead guilty to embezzling over $3.7 million
- Ex-deputy treasurer sentenced to 6.5 years; wife sentenced to 3 years probation, 12 months home detention and 800 hours community service
Opportunity, Pressure, Rationalization

- 1984 San Jose-Treasurer bet on interest rates using reverse repo
- 1987 Camarillo-Bet on lower rates, co-mingled various accounts, bought private placements
- 1988 Lawndale, Palmdale & San Marino-invested in forward contracts; broker engaged in excessive & unsuitable trading; hid loses
- 1991 Wymer-embezzled funds; co-mingled client accounts
- 1993 San Bernardino Cty-pay to play
- 1994 Orange County Bankruptcy
- 1995 Vista-Investments not permissible under 53601
- 1999 Oceanside-Prime Bank Notes presented to mayor; Treasurer would not agree
- 2016 Beaumont-7 City officials charged in corruption case
- 2016 Placentia-greed & opportunity
- 2016 Compton-greed & opportunity
- 2017 Unknown District-used financial futures to speculate, not hedge
Control Activities
Overview

- Policies and procedures that help ensure that management directives are carried out.

- Benefits vs. Cost
Effective Control Activities

Must be:

- Appropriately selected and developed
- Incorporate general controls over technology
- Effectively implemented
No, a tweet made up entirely of emojis is **not** sufficient documentary evidence!
Examples on How to Apply?

1. Well written policies and procedures
2. Regular analyses of financial data
3. Controls over information processing
   a. Application controls
   b. General IT controls
4. Physical controls
   - Tangible + Intangible
Examples on How to Apply?

5. Segregation of duties

- Authorization
- Recording or reconciling
- Custody of assets

SHOULD Segregate!!!
Information and Communication
Overview

Reliable  Relevant  Timely

Information and Communication
Three Essential Characteristics

- Availability of relevant, high-quality information
- Internal communication
- External communication
COMMUNICATION

THE KEY IS
Examples on How to Apply?

- Job descriptions for all personnel
  - Documented?
- Policies and procedures
  - Detail expectations and actions?
  - Articulate distinct responsibility and accountability of each involved?
  - Communicated to the appropriate personnel periodically?
Examples on How to Apply?

- Monthly or quarterly reports
  - Available for review by management and governing body?
- Board agenda items and decisions
  - Reviewed regularly by staff to make sure that they are carried out?
- Staff meetings
  - Feedback welcome?
- Reporting channels for wrongdoing
Monitoring
ALL I KNOW IS THE BOSS SAID WE HAD TO MONITOR THE CLOUD.
Overview

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.
Assessment of Existing Internal Control

To ensure that:

• They are in place/have been performed
• They are effective
• Control deficiencies have been communicated to appropriate parties and follow through on corrective actions
Examples on How to Apply

Policies and Procedures
- Have they been updated to adequately address new challenges?

Control Activities
- Are they functioning properly?

Audit findings
- Have they been resolved?
Additional Resources

- Governmental Accounting Auditing, and Financial Reporting (2012) (i.e. the Blue Book), Chapters 42 & 43
- COSO’s Internal Control – Integrated Framework 2013. Executive Summary can be downloaded from COSO’s website (http://www.coso.org/IC.htm).
Image Source

- https://www.sco.ca.gov/pubs_guides.html
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QUESTIONS??