



Department of State Treasurer
Policy Manual for Local Governments
Section 80: Internal Controls

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Executive Summary

Citizens demand the highest level of accountability from government officials and highest level of stewardship over the public's money. This document will define internal control, address internal control theory, and provide examples of controls for large and small units as well as units that have automated accountings system and those that don't. It is important to remember that examples of controls are just that; units need to determine what controls are appropriate through the risk-based evaluation of their operations.

Internal control consists of the following five interrelated components: a) the control environment, b) risk assessment, c) control activities, d) information and communication, and e) monitoring. These components are explained in Part I. Management is clearly responsible for the review, development and maintenance of internal controls in the entity. Management would be interpreted at a minimum to include the governing body, managers or mayors, and department heads. Management's attitude, integrity and ethical values are key components of internal control. Various actions that management can take to fulfill their responsibility are provided.

A critical component of an effective system of internal control — the one most difficult for small units to achieve — is segregation of duties. General guidelines for segregation of duties are described. With a limited number of personnel in a small unit, members of the governing body may need to take on some of these responsibilities. Techniques to assist small units are provided throughout Part III and are referenced by page number in the Index at the end of this document.

Units of government often receive federal and/or state funds to carry out specific programs and grants. These programs may be executed directly by the unit, or the unit may pass on these funds to a third party who in turn carries out the program. In both cases, the unit must ensure that controls are in place to provide reasonable assurance that funds are recorded and expended in compliance with program requirements while adequately safeguarding any assets associated with the program. Part II describes the federal and state laws and regulations applicable to units receiving federal or state funds and describes internal controls related to these programs.

Internal control, no matter how well designed and operated, can provide only reasonable assurance to management and the board of directors regarding achievement of an entity's control objectives. Part III discusses the basic internal controls that are an essential part of the operation of the unit as a whole and the critical internal control procedures for specific areas of operations.

Part IV provides additional resources and references regarding internal control.



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Part I – Objectives and Components of Internal Control

A. Introduction

Citizens demand the highest level of accountability from government officials and stewardship of public dollars. There have been significant developments that have changed how managers, auditors and finance professionals view internal controls. A significant publication was the report of the Committee of Sponsoring Organizations of the Treadway Commission, entitled *Internal Control – Integrated Framework (COSO Report)*. This document is designed to provide managers at the local government level information they need to design, implement and maintain a framework of internal controls.

This document will address internal control theory, control cycles and examples of controls for large and small units as well as units who have automated accountings system and those who don't. It is important to remember that examples of controls are just that. Units need to determine what controls are appropriate for their units through the risk-based evaluation of their control cycles.

A system of internal control consists of many specific policies and procedures, which are often called controls. Internal control is defined as a process – established by an entity's board of directors, management and other personnel – designed to provide reasonable assurance regarding the achievement of objectives in the categories of a) effectiveness and efficiency of operations; b) reliability of financial reporting; and c) compliance with applicable laws and regulations (AICPA SAS No. 115 paragraph 3). This generic definition is applicable to all types of entities, including a government of any size.

Internal control consists of the following five interrelated components: a) control environment, b) risk assessment, c) control activities, d) information and communication, and e) monitoring.

Objectives and components are directly related. Objectives can be viewed as the goals to be achieved while components are the means to achieve those objectives. Control objectives and components of internal control are discussed in more detail below. Section C expands the discussion on the three objectives of management in the development of a system of internal control for all governments and public authorities.

B. Responsibility for Internal Control

COSO Report clearly defines management as responsible for review, development and maintenance of internal controls in the entity. Management would be interpreted at a minimum to include governing body, managers or mayors, and department head positions. Their support is critical to implementation and maintenance of internal controls.

The following are ideas for ways they can contribute to this important responsibility.

- Invite the Auditor to make a presentation to upper levels of management (governing board, manager, mayor, Department Heads, Division Heads) on their roles and responsibilities on internal controls



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- Have a manager or board chairman communicate, in a letter, to employees such topics as ethics and compliance with policy and procedures, and hot line numbers to report issues of concern other than personnel.
- Create an internal control plan for each department and update annually – document signed by department head
- Discuss with auditors about department heads also signing letter of representation or at least key department heads, such as Tax Assessor, Sherriff, Tax Collector and DSS, Health and Mental Health Directors.
- Key members of management sign ethics statements along with adequate disclosure of other business interest.
- Exit conference with auditor should involve key departments as well as management and finance departments. Request that exit conference involve a specific section on how internal controls can be improved or discussion of any violations.
- Work plans for department heads should require development, maintenance and compliance of good internal controls in consultation with the Finance Department.

C. Control Objectives

The three categories of control objectives incorporated in the definition of internal control are what an entity strives to achieve. These distinct but somewhat overlapping categories have differing purposes and allow a directed focus to meet the needs of the entity and others regarding each separate purpose.

1. Reliability of Financial Reporting

Financial Reporting provides decision makers, both inside and outside the government, the information they need to make decisions. Internal reports need to be timely and accurate, and are used to provide management information needed to make informed decisions as well as serve as an internal control tool. Reporting can be used to monitor budgetary compliance and monitor for irregularities. External Financial Reporting can be general purpose, such as comprehensive annual financial report (CAFR), or special purpose, such as grant reports. Units of government must have appropriate internal controls to make sure reports are prepared accurately.

2. Efficiency and Effectiveness of Operations.

Controls within an organization are meant to encourage efficient and effective use of its resources, including personnel, to optimize the entity's goals. Good internal controls should also provide for a more streamlined operational system. Unnecessary duplication of effort or inefficient processing of work can be detected by a good internal control system. This aspect of a functional internal control system could be especially important for units operating on limited budgets without the resources for other means or systems to monitor work efficiencies. These controls help to ensure that information is accurate for internal decision making. These controls include those associated with both reliable financial reporting and efficient operations.

3. Compliance with Applicable Laws and Regulations.

For units of government, a good system of internal controls should identify applicable laws and regulations and provide reasonable assurance that the local government



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complies with those laws and regulations (Government Auditing Standards, paragraph 4.29.1).

These laws and regulations include:

- The Local Government Budget and Fiscal Control Act (G.S. Chapter 159),
- Grantor Requirements,
- IRS requirements,
- Bond covenants,
- Unit policies, and
- State policies – G.S. Chapter 153A, G.S. Chapter 160A, etc.

D. Components of Internal Control

1. Control Environment

The control environment is the atmosphere that surrounds the organization and is a result of the actions, policies and procedures of management, with respect to internal control. It is the basis for the other four components.

The control environment is determined from the following:

a. Management's Attitude and Example

Management's attitude, integrity and ethical values are communicated through its actions and examples. Are department heads made responsible in their work plans for internal controls in their own departments? Does the manager's office follow procurement policy? Does the manager support internal control discussion at senior management meetings? Does management discuss ethics with employees through memorandums and other venues? Are staff and management who disregard the rules dealt with appropriately by management? The integrity and the ethical values of those who establish, manage and follow up on internal control are important because it sets the example for others to follow in an organization. The design, administration and monitoring of the other components require integrity and ethical values in management. Ethical and behavioral principles established, conveyed and supported by management determine the integrity and ethical behavior in the entity. These principles also include management's attempts to eliminate incentives and temptations that might lead to dishonest, illegal or unethical acts by personnel. They also include formal policy statements concerning ethical conduct by personnel and also principles conveyed informally by management's example. It is recommended that management establish a code of conduct and conflict of interest policy. They should also consider establishment of a whistleblower policy and fraud hotline.

b. Qualified Staff

Competence is the knowledge and skills needed to complete a job's specific requirements. Management's commitment to competence concerns evaluating the competence levels needed for particular jobs and the associated knowledge and required skills.



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The following are important practices that support this objective.

- Establish and maintain up-to-date job descriptions – these descriptions should detail the responsibilities of each position along with qualifications needed to fill the position.
 - Follow appropriate hiring policies – hiring should be open, thorough and well documented. References should be checked for all hired employees, and at a minimum, positions critical to internal controls should undergo a background and credit check. The manner in which human resource activities are carried out, from recruitment, to training, to remediation, to retirement, also influence the control environment. For example, evaluation procedures that communicate expected performance levels and require objective documentation of that performance demonstrate an entity's commitment to openness and fairness. They also directly communicate expected levels of job performance and behavior.
 - Assign authority and responsibility in an appropriate manner – employees should have all the authority they need, but only the authority they need. Clear, concise lines of authority for each transaction that takes place in the unit are essential. This authorization may be general or specific. For example, a purchasing clerk may have general authorization to purchase office supplies up to a certain dollar limit. However, where the purchase of fixed assets is concerned, a specific and individual authorization should be required. The organizational structure is an outline encompassing the entire entity which indicates how it functions to fulfill its objectives. This outline should clearly specify each position in the entity, the lines of authority and responsibility, and the duties of each position. There should be a detailed procedures manual, developed in the context of this structure, indicating how each transaction occurring within the entity should be initiated, which position should initiate it, which position(s) should approve it, and which position(s) should record and verify it. The organization's structure should be developed and communicated to all parties involved (the governing board, unit manager, finance officer, and all other elected or employed persons).
 - Ensure that employees are properly trained – a combination of formal and on-the-job training is necessary for every employee
 - Periodically review and document performance – all employees need to have their performance reviewed and documented at least on an annual basis.
- c. Board of Directors or Audit Committee Participation

An entity's board of directors or audit committee can have a significant effect on the control environment. An effective board or audit committee is independent of management. Its members are actively involved in and scrutinize management's activities. Other characteristics of its members which can affect the control environment include their experience, their integrity, the type of questions raised with management, and their involvement with internal and external auditors.

The Local Government Commission recommends that all local governments establish audit committees. Governing bodies often do not provide sufficient control over the activities of the unit's staff. Attention should be given to the committee's



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complaints and recommendations to help locate problem areas or inefficient activity. This is especially true **in small units** of government because of the inherent challenge created by the limited staff size.

In conclusion, management's philosophy and operating style affects the functionality of the system of internal control. If a unit's management does not provide clear signals to employees about the importance of an internal control system, employees will feel the system is unimportant and will not follow it. Philosophy and style are characterized by management's response to risk. This response is reflected in its approach toward financial reporting in terms of its choice of conservative or liberal alternatives and estimates, and in its views towards the accounting function and staff. A system of internal control is only as good as the persons who manage it.

2. Risk Assessment

Risk assessment must involve managers at all levels and an ongoing process for risk monitoring and assessment must be developed. The unit must develop an internal control framework that identifies risks that would prevent it from ensuring effectiveness, efficiency, compliance with laws and regulations, and proper financial reporting.

Risk assessment, with respect to the financial statements, is management's identification and analysis of risks that affect financial statement preparation and the actions taken to minimize those risks. Management assesses risks as a part of designing and operating internal controls to minimize error and fraud. For example, risk assessment may address how the unit processes cash receipts or classifies and records disbursements.

Situations and events, both internal and external, may occur in ways that impair the integrity of an entity's accounting system and impact the quality of its financial statements with respect to the assertions of management. After identification of these risks, analysis by management determines their importance, the potential for happening and management's response. Management may decide to tackle specific risks through changes in policies or procedures. However, depending on the costs involved or for other reasons, management may take no action and judge the level of risk to be acceptable.

Factors affecting risks include changes in the operating environment and inherent risk.

a. Changes in the Operating Environment

Change by its very nature creates a degree of risk.

The following are examples of changes potential effects on internal controls.

- Staff turnover – A change of key employees, either line or management, can result time needed before a replacement employee becomes proficient with the new position. The time a position is empty may affect the unit's performance. As staff help to cover the work while position is vacant, incompatible duties could result in an internal control weakness.
- Information systems and technology – New systems and new technologies, or major changes to existing ones, can impact operations and financial reporting. They can also require changes to internal control procedures. Unit could have



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system expertise concentrated in limited staff, making unit vulnerable. Improper segregation of duties among IT staff can provide access to assets and accounting records that could go undetected for a long period of time. Development of new systems could allow older system controls to go unnoticed or require change that goes unnoticed.

- Structural changes – Downsizing, decentralization or restructurings often result in decreases in staffing and consolidation of operations which would require internal control procedures to be re-evaluated. Likewise, an entity may grow so rapidly or expand into new service areas that existing internal controls become ineffective.
- Economic, political and regulatory environment – Changes in economic, political and regulatory conditions may put additional stresses on management which could compromise internal control procedures. External or internal stress on a program to succeed or report to the press the outcomes could put undue pressure for managers to cut corners to achieve results.
- Accounting standards – New or changing standards may require changes in financial reporting and thus affect any associated risks.

b. Inherent Risk

Inherent Risk is the susceptibility of an activity to error which could be material assuming that there are no related internal controls.

The following are factors that could cause management to pay special attention or provide close scrutiny due to the inherent risk of the situations.

- Complexity – complexity increases the danger that a program or activity will not operate properly or in compliance with laws and regulations.
- Cash Receipts – any time an easily converted asset, such as cash, is involved, it increases the chance that the asset will be converted to personal use
- Direct third-party beneficiaries – cash-like benefit payments of food stamps and public assistance, etc. have an increased risk of being converted to inappropriate individuals
- Prior internal control issues – Situations that have had prior internal control issues might be an indicator of poor controls in other areas involving the same management.
- Prior unresponsiveness to identified control weaknesses – If management has a previous history of failing to respond to identified internal control weaknesses, it may be an indicator of future weaknesses.

Once a risk has been identified, the unit must decide the significance of the risk and the likelihood of occurrence.

3. Control Activities

Control activities refer to the guidelines instituted by management to ensure that their orders are executed. Through the implementation of these activities, the levels of risk inherent in an entity's operations are reduced to acceptable levels.



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The following policies and procedures are control activities.

a. Performance Reviews

This includes the analysis of operating results with respect to budgets, prior period results and applicable benchmarks. Both fraudulent and unintentional misstatements of performance data are possible. Therefore, an essential characteristic of the persons performing internal verification procedures is independence from individuals originally responsible for preparing the data. Performance review is the least expensive means of internal verification. It is essential that persons reviewing the data understand reasons for valid deviation and do not accept superficial answers from person in-charge of the data.

b. Information Processing

These control activities are carried out to ensure accuracy, completeness and authorization of transactions. Information processing controls can be put into two broad categories: general controls and application controls. General controls can consist of controls over data center functions, software purchase and maintenance, access security, and application system development and maintenance. General controls apply to mainframe, personal computers, network, and end-users environments. Application controls are specific to each particular application. These controls help ensure the integrity of the information collected. This includes the validation of transactions, proper authorizations, and complete and accurate processing. New regulations dealing with sensitive data both in automation and manual system such as red flag rules, payment card information (PCI) standards regulated by VISA and MasterCard, Federal Trade Commission's Fair and Accurate Credit Transactions Act of 2003, the Identity Protection Act of 2005, G.S. 75-60, G.S. 14-113.2 and G.S. 132-1.10 all related to protection of sensitive information require internal controls to ensure compliance with these regulations.

c. Supervisory Reviews

A supervisory review of records serves as an internal check of records and transactions. A thorough review of records may help detect irregularities and unintentional errors. The timeliness of the review is extremely important to its effectiveness. A supervisor who reviews the ledgers and journals only on an annual basis is not effective in preventing frauds and errors committed eleven months earlier. Supervisors must be thorough and knowledgeable in the area they are reviewing. A cursory review serves little purpose. Supervisors should physically document that they reviewed the records (e.g., initial the records reviewed). By reviewing the records, the supervisor assumes responsibility along with the employee who performed the transaction that the records are reasonably accurate and are legitimate. Another essential duty of supervisors is to ensure that controls performed by staff are in fact performed and to document review of controls in some manner typically with a signature indicating review. For example, it is not enough that bank reconciliations are performed monthly; there must be documentation that supervisor has reviewed the bank reconciliation on a timely basis. Therefore, if reconciliations were behind or some other form of irregularity was occurring, it would be detected timely.



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d. Physical Controls.

This category deals with physical security of assets including procedures for authorized access to assets and records. This includes access to computer programs and data files, and taking periodic physical inventories to verify book balances.

It is essential for adequate internal control to protect assets and records. If assets are left unprotected or are not adequately protected, they can be stolen, damaged or lost. The most important type of protective measure for safeguarding assets and records is the use of physical precautions. For example, loss of inventory items may be reduced if they are controlled by the use of a storeroom. Hard to replace and valuable assets also should be protected from physical damage by use of fireproof safes or safe deposit boxes. Such assets should be locked up at all times. Cash on hand should be maintained under the sole control of the person directly responsible for it.

When a unit is highly computerized, it is important to protect its computer equipment, programs and data files. There are three categories of controls related to safeguarding Electronic Data Processing (EDP), equipment, programs and data files. The three categories are physical controls (lock doors to computer room and terminals, adequate storage space for software and data files, proper fire extinguishing systems, etc.); access controls (only authorized employees can use the equipment and have access to software and data files, etc.); and backup and recovery procedures (backup copies of programs and critical data files are stored in a safe remote location).

Bonding protects the unit from loss should an employee commit fraud or misappropriate funds. As required by G.S. 159-29, the finance officer must be bonded for at least \$50,000. The tax collector must also have a separate bond in an amount determined by the governing body. Additionally, any employee who has custody of more than \$100 of public funds or has access to inventories of the unit at any time also must be bonded for an amount to be determined by the governing board. In situations where a staff member is fulfilling the dual responsibilities of tax collector and finance officer (which requires annual approval by the Secretary of the Local Government Commission), a separate bond can be obtained for each position. If a single faithful performance bond is obtained, the amount should reflect the fact that the two offices are included within its coverage.

e. Segregation of Duties. In the internal control process, adequate segregation of duties reduces the opportunities for someone to be in a position to both commit and hide errors or irregularities in their duties. Generally, this is achieved by dividing the responsibilities of authorizing transactions, recording transactions and maintaining custody of assets between staff members. **In small units** with a limited number of personnel, governing board members may need to take on some of these responsibilities.

To prevent fraud and errors, the general guidelines for separation of duties are: a) separate the custody of assets from accounting; b) separate the authorization of transactions from the custody of related assets; c) separate duties within the accounting function; d) separate operational responsibility from record-keeping responsibilities and e) separate duties within Electronic Data Processing (EDP).



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These guidelines are discussed as follows:

- Segregation of the control or custody of assets, including cash, from the accounting function.

This aspect of segregation of duties helps protect a unit against fraud. One person should not handle both the custody of and the accounting for assets because there is excessive risk of that person using the assets for personal gain and adjusting the financial records to cover up the misuse. Also, because a person performing a programming or input function in an EDP environment would have access to the accounting records, that person should not have access to assets because the same type of misuse and cover-up could occur.
 - Segregation of authorization of transactions from custody of related assets.

This element of segregation also helps to prevent fraud within a unit. Examples include not allowing staff members who authorize the hiring of new personnel to key and approve time sheet for employee.
 - Segregation of duties within the accounting functions.

One person should never be responsible for executing and recording a transaction. Procurement transactions should be approved (ideally prior to purchase) by someone other than person making the purchase. Person reconciling general ledger to subsidiary should not be the person updating the subsidiary ledgers.
 - Segregation of operational responsibility from record-keeping responsibility.

A separate record-keeping function should always be in place and should function independently of other operations of the unit. Persons approving or executing transaction should not be person recording transactions. The use of procurement cards places the procurement and payment process in the hands of the cardholder. That is why it is essential that procurement cards are tightly controlled. Compensating controls, such as detail review of all documentation for purchases by appropriated staff, is critical.
 - Separate duties within Electronic Data Processing (EDP).

Ideally, within EDP, separate the following functions: the system analyst (responsible for the general design of the system and sets objectives of the overall system and the specific design of applications), programmer (develops special flowcharts for the application, prepares computer instructions, tests the program, and documents results), computer operator (responsible for running data through the system in conjunction with the computer program), and the librarian (maintains computer programs, transaction files, and other computer recordings, providing physical control over these records and releases them only to authorized personnel.) It is important that the programmer not have access to input data or computer operation, since understanding of the program can easily be used for personal benefit. Ideally, the operator should be prevented from having sufficient knowledge of the program to modify it before or during use.
- f. Rotation of Duties
Job duties should be rotated within a department on occasion, preferably on a surprise basis. This will reduce the likelihood of fraud since employees are aware that, at any time, another employee could be given their work assignments or tasks,



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and therefore may detect fraud being committed. As an extra benefit, employees become cross-trained in other job functions, which increases the overall efficiency of the unit. Job duties should also be rotated when employees are on vacation. In this regard, all employees should be required to take vacations, with persons in finance or cash-handling positions required to take several consecutive days off at some point during the year. This practice helps to detect lapping, which is the postponement of entries for the collection of receivables in order to conceal an existing cash shortage.

4. Information and Communication

The purpose of a unit's accounting information and communication system is to identify, classify, record, assemble, analyze, and report the unit's transactions and to maintain accountability for its account balances. Management's ability to make decisions and report on an entity's financial standing requires timely and accurate information. Providing management the appropriate information to meet their needs is essential in order to accomplish the goals of the organization.

a. Criteria

Meeting the following criteria will help meet the unit's information needs.

- Appropriate content – Provide the right information to the right individuals. Ensure that critical information is not obscured by massive amounts of information. Appropriate content is essential to all levels of staff in an organization.
- Timely – Information must be received soon enough to allow management to respond to the situation. Some information is timely if delivered weekly, monthly or quarterly, while other information needs to be delivered if certain criteria are met. An example is that significant fluctuations in interest rates might alter an investment strategy.
- Current – Information has to be current. A monthly bank reconciliation might not be sufficient any longer. Units might have to implement daily or weekly matching of transactions.
- Accurate – Information has to be reliable and accurate. Degree of accuracy depends on how the information will be used and type of information.

b. Transaction Recording

Properly recording transactions is essential to accurately communicating financial information.

The following are criteria for properly recording each transaction.

- Appropriate transactions are recorded. The control system should identify all legitimate, valid transactions and ensure that they are recorded.
- Transactions are properly valued. Procedures must be in place to detect errors in recording and summarizing the value assigned to a transaction, including mathematical and clerical errors.



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- Transactions are properly classified. Internal control procedures must ensure that each recorded transaction contains sufficient information for accurate classification.
- Transactions are recorded at the proper time. Procedures must be in place to ensure that transactions are recorded in a timely manner and in the proper reporting period.
- Transactions are properly included in subsidiary records and correctly summarized. The internal control system must provide for accurate summations of transactions and ensure that subsidiary records are correctly updated.
- The system of control should not permit invalid transactions to be posted to the accounting records.

c. Adequate Documentation

Adequate documentation is essential to a good system of internal control. Fraudulent activity may be deterred if appropriate documentation is required to initiate and complete a transaction. Errors in recording transactions can more easily be detected if adequate documentation exists. Good documentation also helps assure that all transactions have been properly authorized. Technology now makes it very easy to create fraudulent invoices, checks and other documents used in transaction processes. Also, movements towards paperless documents further complicates business processes, as controls need to be designed to handle paper invoices as well as electronic invoices and physical payment of cash as well as electronic deposit of cash. Internal controls therefore must rely on other tools than original documentation. Approval of transactions by multiple people has become a critical control.

Criteria for adequate documentation include the following:

- Well-designed and properly used documents increase the effectiveness of internal control. Whenever possible, documents should be pre-numbered consecutively to help account for missing documents. Pre-numbered documents will alert management to missing records and help to ensure that all existing transactions are recorded. Numbered documents also are easier to file and locate at a later date when needed. Documents that should be pre-numbered include: all receipts for payment of funds to the unit, purchase orders, bills or invoices, and checks.
- Transactions should be documented in a timely manner (e.g., at the point of transaction when possible).
- Documents should be as simple as possible to use and be in such a format that encourages correct preparation. Forms should have spaces designated for the signatures of authorizing personnel, columns for numerical data, spaces for account numbers, directions for the routing of the document, and should be comprised of the correct number of copies.
- Documents should be designed for multiple uses whenever possible. This reduces the number of forms to be maintained in inventory and makes it easier for staff members to learn the proper way to complete them.



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- For documents that are electronic or converted to electronic format, it is important to make sure that they have a unique identification system that will prevent duplication of invoices.
- Documents should be approved by persons outside the decision making process for the procurement or service. The approver should be able to attest by their approval that the transaction was received, units policies and procedures were followed, program guidelines were followed, and the budget was authorized for this purpose.
- If procurement cards are used, it is critical that all procurement card transactions be reviewed by supervisor timely to make sure they were authorized, all policy and procedures were followed and unit of government received benefit of transaction. Proper documentation of purchase card transactions has been provided by the employee and reviewed by the supervisor. The supervisor must send to finance for a second review in a timely manner also.
- Another element of documentation is the chart of accounts, which is used to classify transactions into balance sheet and income statement accounts. The chart of accounts is important because it provides the framework for determining the information that is presented to the management, the general public and others. The classifications should assist unit's management in its decision-making. If the chart of accounts is complete and thorough, it also assists in detecting misclassification errors. See the Policy Manual for Local Governments, Section 5 – Chart of Accounts, for additional information.
- The use of a procedures manual is another element of good internal control. A detailed procedures manual encourages consistent application of a unit's policies, including those concerning internal controls.

Communication in a system of internal control also involves making staff members aware of their responsibilities and the part they play in the system. They must also understand the effect of their actions in terms of financial reporting. Communication also includes making personnel aware of how their activities relate to the work of others in terms of financial reporting and the procedures for reporting exceptions along the chain of command. An open communication channel in a system of internal control facilitates the reporting of exceptions and appropriate follow-up action.

Policy and procedures manuals, accounting and financial reporting guides, and memoranda are forms of communication.

5. Monitoring

An important management responsibility is to establish and maintain internal control. Management monitors controls to consider whether they are operating as intended and that they are modified as appropriate for changes in conditions.

For internal controls to be effective, staff independent of the controls should review that they are being performed and follow-up on any flags that are raised. An example would be that staff independent of revenue recognition should review that bank reconciliation are preformed timely and accurately. They should also follow up on a significant lag in cash deposits. Is the discrepancy evidence of a possible kiting scheme?



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Accepting explanations from staff without follow up can defeat the purpose of the control. Management must not accept unsubstantiated oral explanations, but require documentation or evidence.

Monitoring is ongoing. It should be part of the normal routine in an entity's operations and include regular activities performed by staff not involved in process being reviewed. Department managers should routinely review internal reports and investigate further any significant differences from their knowledge of their department's operations. In many larger entities, resources are available to support internal auditors.

Monitoring may also consist of information received from external parties. Taxpayers and users of services implicitly verify billing data when paying their bills or making complaints about them. Oversight agencies, grantors or the staff of the Local Government Commission may communicate with the unit regarding compliance issues, reporting problems or operating problems. Also, an important part of monitoring by management is communications with external auditors on the subject of the unit's internal control.

E. SAS No. 115 – Communicating Internal Control Matters Identified in an Audit

1. Introduction

When an auditor expresses an opinion on financial statements, this statement "... establishes standards and provides guidance on communicating matters related to an entity's internal control over financial reporting identified in an audit of financial statements." In addition, it defines various terms including terms deficiency in internal control, significant deficiency and material weakness, and it provides guidance on evaluating the severity of deficiencies in internal control identified. The auditor is required to communicate in writing to management and the governing board internal control weaknesses identified during an audit that are classified as significant deficiencies or material weaknesses.

2. Definitions

A deficiency in internal control is defined "...when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect and correct misstatements on a timely basis." A deficiency can occur in either the design or operation of a control.

If a control objective cannot be met when a control is present and operating or because a control is missing, it is considered a design deficiency. Examples of design deficiencies include "...insufficient control consciousness within the organization; for example, the tone at the top ...; absent or inadequate segregation of duties within a significant account or process; ...employees or management who lack the qualification or training to fulfill their assigned functions", etc.

When "a properly designed control does not operate as designed; or the person performing the control does not possess the necessary authority or competence to perform the control effectively", a deficiency in operation exists. Examples of deficiencies in operation of internal controls include "...failure to perform reconciliations of significant accounts; ...undue bias or lack of objectivity by those



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responsible for accounting decisions, for example, consistent understatement of expenses ...; management override of controls”, etc.

Material weakness is defined as “a deficiency, or combination of deficiencies, in internal control, such that there is a reasonable possibility that a material misstatement of the entity’s financial statements will not be prevented, or detected and corrected on a timely basis.” A significant deficiency is “... less severe than a material weakness, yet important enough to merit attention by those charged with governance.”

Management may have identified a control deficiency and implemented a compensating control to mitigate the effect of the control deficiency. A compensating control is a control that limits the severity of the control deficiency and prevents it from rising to a level of significant deficiency or, in some cases, material weakness. Although the compensating control mitigates the effects of a control deficiency, it does not eliminate the control deficiency.

For example, consider a situation in which there is a lack of segregation of duties within the accounts payable function in a small municipal government. As a compensating control, a board member reviews the supporting documents for all disbursements exceeding \$500. The auditor is responsible for checking to see if the compensating control is working effectively. Although a control deficiency still exists – the board members review does not eliminate the segregation of duties – the significances may be mitigated by the compensating control so it is not considered a significant deficiency or material weakness.

3. Responsibility of Governing Body

Upon receipt of a communication from the auditor regarding significant deficiencies and material weakness, those charged with governance and management should review the communication carefully. While the auditor is not required to perform procedures to identify deficiencies in internal control, it is the auditor’s responsibility to communicate significant deficiencies and material weakness identified during the audit. It is the responsibility of the governing board and management to evaluate risk associated with the weaknesses, the cost required to correct or mitigate the weakness, and determine the course of action.

SAS No. 115 lists examples of circumstances in the design of controls and failures in the operation of controls that may be deficiencies, significant deficiencies or material weaknesses. It is left to the professional judgment of the auditor to determine if these are deficiencies and, if so, do they rise to the level of significant or material deficiencies.

SAS No. 115 does require that if any of the following occur they are to be reported as material weaknesses:

- Indication of fraud, whether or not material, on the part of senior management,
- Restatement of previously issued financial statements to correct material misstatement due to error or fraud,
- Identification of a material misstatement that would not have been detected by the entity’s internal control, or
- Ineffective oversight of the entity’s financial reporting and internal control by those charged with governance.



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The staff of the State and Local Government Finance Division occasionally feels it is necessary to require the auditor to include certain findings based on the experience and knowledge our staff has as a result of our oversight of the unit. The list below is not all inclusive:

- Material budgetary violations (G.S. 159-13);
- Lack of segregation of duties;
- Inadequate oversight of staff;
- Failure of unit staff to properly perform account reconciliations;
- Inadequate design of controls over preparation of financial statements being audited;
- Inadequate or incomplete accounting records that result in consistently late audits;
- Failure of the unit to secure the approval of the Local Government Commission for the dual appointment of one individual to serve as both the tax collector and finance officer, as required by G.S. 105-349(e).

In determining the course of action necessary to correct or mitigate a deficiency in internal control, the governing body and management should remember that G.S. 159-26 requires units to "... establish and maintain an accounting system designed to show in detail its assets, liabilities, equities, revenues, and expenditures. The system shall also be designed to show appropriations and estimated revenues as established in the budget ordinance and each project ordinance as originally adopted and subsequently amended." Furthermore, G.S. 159-25(c) authorizes the Local Government Commission to "inquire into and investigate the internal control procedures of a local government or public authority, and may require any modifications in internal control procedures which, in the opinion of the Commission, are necessary or desirable to prevent embezzlements or mishandling of public moneys." Additionally, in approving debt issuances of units, the Commission must generally find and determine that "... the unit's debt management procedures are good", a vital component of internal control.



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A. OMB Circular A-133 Definition of Internal Control over Federal Programs

For units receiving federal funding directly or through a state agency, the U.S Office of Management and Budget's ("OMB") [OMB Circular A-133](#), "Audits of States, Local Governments, and Non-Profit Organizations" (dated 6/24/97) (includes revisions published in *Federal Register* 06/27/2003), [June 2007 Amendment](#), defines internal control over federal programs as pertaining to the compliance requirements for federal programs (internal control over federal programs).

It is a process designed to provide reasonable assurance regarding the achievement of the following objectives for Federal programs:

1. Transactions are properly recorded and accounted for to:
 - Permit the preparation of reliable financial statements and federal reports;
 - Maintain accountability over assets; and
 - Demonstrate compliance with laws, regulations and other compliance requirements;
2. Transactions are executed in compliance with:
 - Laws, regulations and the provisions of contracts or grant agreements that could have a direct and material effect on a federal program; and
 - Any other laws and regulations that are identified in the compliance supplement; and
3. Funds, property and other assets are safeguarded against loss from unauthorized use or disposition.

B. Management Controls Requirement Under Federal or State Funding

For units receiving Federal or State funds, management is responsible for establishing effective management controls. The lack of administrative continuity in government units because of the continuing changes in elected bodies and in administrative organizations increases the need for effective management controls. Management controls, in the broadest sense, include the plan of organization, methods and procedures adopted by management to ensure that its goals are met. Management controls include the processes for planning, organizing, directing, and controlling program operations. They include the systems for measuring, reporting and monitoring program performance.

Management controls can be classified as follows:

1. Program Operations
Controls over program operations include policies and procedures that management has implemented to reasonably ensure that a program meets its objectives.
2. Validity and Reliability of data
Controls over the validity and reliability of data include policies and procedures that management has implemented to reasonably ensure that valid and reliable data are obtained, maintained and fairly disclosed in reports. These controls help assure



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management that it is getting valid and reliable information about whether programs are operating properly.

3. Compliance with Laws and Regulations:

Controls over compliance with laws and regulations include policies and procedures that management has implemented to reasonably ensure that resource use is consistent with laws and regulations.

4. Safeguarding Resources

Controls over safeguarding resources include policies and procedures that management has implemented to reasonably ensure that resources are safeguarded against waste, loss and misuse.

C. Internal Controls for Federal and State Grants and Programs

Units of government often receive federal and/or state funds to carry out specific programs and grants. These programs may be executed directly by the unit, or the unit may pass on these funds to a third party who in turn executes the program. In both cases, the unit must ensure that controls are in place to provide reasonable assurance that funds are recorded and expended in compliance with program requirements while adequately safeguarding any assets associated with the program. However, the responsibilities for compliance requirements are significantly different for direct recipients and pass-through entities with subrecipients. Finally, a unit should have controls in place to distinguish vendors from subrecipients. Vendors are not subject to compliance requirements. For a list of factors distinguishing vendors from subrecipients, refer to OMB Circular A-133, section 210.

The following is a discussion of the basic internal controls that are applicable to federal and state grants and programs.

1. Critical Internal Control Procedures for Monitoring Grants Expended Directly by the Unit

A responsible official should monitor activities under grant programs (draws, advances and deposit of funds; expenditures; matching of funds; and filing of financial reports) for compliance with grant contracts, applicable regulations and matching requirements.

Monitoring, to be effective, usually requires some or all of the following policies and procedures:

- a. Separate accounts for identifying receipts and expenditures by grant.
- b. Budget categories for grant receipts and expenditures by grant.
- c. Documentation of a time schedule for filing financial reports with grantors.
- d. Reconciliation of grant financial reports that have been prepared, reviewed and approved by a responsible official before filing with supporting account records.
- e. Review of eligibility determination.
- f. Written notification to employees when grant provisions or related regulations impose requirements that differ from the governmental unit's normal policies and procedures.



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- g. If applicable, monitoring the indirect cost allocation plan and approval of allocations and requests for reimbursements.

2. Critical Internal Control Procedures for Monitoring Subrecipients of Grants

A pass-through entity is responsible for ensuring that subrecipients expend awards in accordance with applicable laws, regulations and provisions of contracts or grants.

OMB Circular A-133 requires a pass-through entity to perform the following for grants to subrecipients:

- a. Identify the awards made by informing each subrecipient of the CFDA title and number or State program number, the award's name and number, the award year, whether the award is for R&D, and the name of the grantor agency. When some of this information is not available, the pass-through entity should provide the best information available to describe the award.
- b. Advise subrecipients of the requirements imposed on them by federal and state laws, regulations, and the provisions of contracts or grant agreements, as well as any supplemental requirements imposed by the pass-through entity.
- c. Monitor the activities of subrecipients, as necessary, to ensure that the awards are used for authorized purposes in compliance with laws, regulations, and the provisions of contracts or grant agreements and that the performance goals are achieved.
- d. Ensure that subrecipients expending \$500,000 or more in federal awards during the subrecipient's fiscal year have met the audit requirements of OMB Circular A-133 for that fiscal year.
- e. Issue management decisions on audit findings within six months after receipt of subrecipients' audit reports, and ensure that subrecipients take appropriate and timely corrective action.
- f. Keep subrecipients' report submissions (or other written notification when a subrecipient is not required to submit a reporting package) on file for three years from the date of receipt.
- g. A written contract with proper approvals between the unit and subrecipient should document all of the above.

The monitoring procedures used by the pass-through entity may include on-site visits, reviews of documentation supporting requests for reimbursement, and limited-scope audits.

The following are other monitoring procedures that a pass-through entity may perform:

- a. Reviewing grant applications submitted by subrecipients to determine that:
 - Applications are filed and approved in a timely manner.
 - Each application contains the condition that the subrecipient comply with the federal and state requirements set by the federal or state agency.
- b. Establishing internal control over compliance to provide reasonable assurance that:
 - Funds are disbursed to subrecipients only on an as-needed basis



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- Funds are disbursed to subrecipients only on the basis of approved, properly completed reports submitted on a timely basis.
 - Refunds that are due from subrecipients are billed and collected in a timely manner
 - Subrecipients and other entities and individuals receiving federal funds meet eligibility requirements.
- c. Reviewing financial and technical reports to evaluate them for completeness and for compliance with applicable laws and regulations.
 - d. Evaluating audit findings, issuing appropriate management decisions, if necessary, and determining if an acceptable plan for corrective action has been prepared and implemented.
 - e. Reviewing previously detected deficiencies and determining that corrective action was taken.



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A. Internal Control in Small Units of Government

Segregation of duties, a fundamental part of internal control, has always posed special challenges for small local government and public authorities, as well as providing advantages. In these units, there are generally only one or two persons responsible for all accounting functions. Especially with only one person, segregation of duties is not possible to the extent necessary to provide proper internal control. However, compensating controls can be put in place in such a manner that the integrity of the accounting records or safety of assets is not jeopardized. In **small units** of government, employee or board member involvement is generally required to provide adequate compensating controls. The employee should not be involved in the unit's financial operations, except for internal control purposes. The board's involvement usually requires that a member carry out their board responsibilities for internal controls by performing certain accounting tasks. The board also may get involved by testing transactions that have not been subject to proper segregation of duties due to the small number of available employees. Internal controls in smaller units also have advantages. Management, including governing boards, is normally more familiar with operations than larger units and much more likely to spot unfamiliar vendors and transactions. Also, due to knowledge of unit and community, they will be able to determine if explanations for unusual transaction are valid.

Cross-references to techniques available to assist small units achieve an efficient and cost effective internal control environment are provided in the Index.

B. Limitations of an Entity's Internal Control

Internal control, no matter how well designed and operated, can provide only reasonable assurance to management and the board of directors regarding achievement of an entity's control objectives. The likelihood of achievement is affected by limitations inherent to internal control. These include the realities that human judgment in decision making can be faulty and that breakdowns in internal control can occur because of such human failures as simple error or mistakes. Additionally, controls can be circumvented by the collusion of two or more people or management override of internal control.

Another limiting factor is that the cost of an entity's internal control should not exceed the benefits that are expected to be derived. Although the cost-benefit relationship is a primary criterion that should be considered in designing internal control, the precise measurement of costs and benefits usually is not possible. Accordingly, management makes both quantitative and qualitative estimates and judgments in evaluating the cost-benefit relationship.

Generally, the cost of the control should not exceed the benefits that will be derived from it. However, some controls are necessary regardless of cost to ensure compliance with statutory requirements.

C. Internal Control in Specific Areas of Operations

The following sections discuss specific areas of internal control. Certain essential tasks are identified in each area of operation. Also, information is provided for small units of



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government that operate with only one or two persons performing accounting functions. These are not intended to be exhaustive lists, but rather are intended to provide guidance in each area. Other items also may be important. Units of government with automation have additional tools to aid in internal control and different challenges.

1. General Internal Controls That Affect the Control Environment

The following is a discussion of basic internal controls that are an essential part of the operation of a unit of government as a whole.

- a. Each unit should have a written organization chart that clearly defines the lines of authority and responsibility. Specific approval authority for specific positions should be documented and updated as needed.
- b. Transaction approval authority and amount limitations (if any) should be in writing and updated annually. If automated systems are used for accounting, tax or other accounting systems, security assess and authorization should be documented and approved annually.
- c. Terminated employees should have access to banks and all systems removed immediately.
- d. Up-to-date job descriptions should be on file for each position within the unit of government.
- e. For smaller units of government, the governing body should participate closely in the day-to-day operations of a unit, especially a unit with a small accounting staff.
- f. Monthly financial reports, including monthly budget to actual statements that include encumbrances or committed funds, bank and other account reconciliations, check registers, and similar items, should be prepared on a timely basis and should be reviewed and understood by management and the governing body. Review of statements should be documented with signatures of reviewers.
- g. All employees should take annual, uninterrupted vacations. Other adequately trained employees should perform the tasks of those employees on vacation. If vacations are not mandated, task should still be rotated among employees.
- h. All personnel performing fiscal functions must be adequately trained.
- i. The internal audit staff should be adequately trained and have the proper resources and authority to effectively evaluate a unit's policies and procedures.
- j. Management and the governing body should take steps, in a timely manner, to implement suggestions for improvement made by the auditor or internal audit staff.
- k. Unit should consider implementing a written code of conduct or ethics that is communicated to their employees. Employees should acknowledge their receipt of the code of conduct in writing on an annual basis.



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2. Internal Control in the Accounting System

The following is a discussion of the basic internal controls that are applicable to every unit's accounting system.

- a. All journals, ledgers and other accounting records should be kept up-to-date at all times and should be balanced.
- b. All subsidiary records should be periodically reconciled to the control accounts. These reconciliations should be timely, accurately documented, reviewed and maintained on file including documentation of the review of each of the reconciliations.
- c. Each unit should maintain written accounting procedures. These procedures should contain the following: a uniform chart of accounts with explanations as to what items are charged to each account; approval authority for financial transactions; cash receipting policies and procedures and guidelines for controlling expenditures, such as purchasing requirements and travel authorizations.
- d. There should be specific authorization and approvals for writing of standard and non-standard journal entries as well as adjustment to accounts; both requiring detail supporting documentation.
- e. Access to books of original entry, whether automated or manual, needs to be restricted to authorized personnel.
- f. The unit should maintain the number of funds needed to meet legal and operating requirements.
- g. Duties should be segregated as much as possible between custody of the assets and recording of the transactions.
- h. Each unit should maintain and follow records filing, retention and disposal policies in compliance with the Public Records Laws, G.S. Chapter 132, and the guidelines established by the Record Services Branch, Division of Archives and History, and the Department of Cultural Resources. Detailed information can be found on their website, <http://www.records.ncdcr.gov/local/default.htm>.
- i. Bond records should be retained in accordance with bond documents and guidance provided by bond counsel.
- j. All expenditures made in excess of appropriations and other deviations from the adopted budget should be investigated and resolved.
- k. System should be in place to prevent over-obligation or over-expenditure.
- l. Records should be subject to analytical reviews and prompt investigation of any unusual items.

3. Internal Control Procedures - General and Statutory

The following is a discussion of general and statutory controls that apply to every unit's operations.

- a. All minutes of the governing body should be maintained in final form in the permanent records of the unit.



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- b. The following transactions should always be approved in the minutes of the meetings of the governing body:
 - Contracts to buy or rent land, or other real estate
 - Continuing contracts that cross fiscal year
 - Construction contracts \$500,000 or more
 - Intergovernmental agreements
 - Any other major contract
 - c. The unit's official records should be maintained in a fireproof location after regular business hours.
 - d. All funds remaining unclaimed after one year should be escheated to the State as required by G.S. Chapter 116B.
 - e. The unit should develop, adopt and approve its budget according to G.S. 159-13. The accounting system should show in detail the revenues and expenditures as they are shown in the budget and track budget amendments.
 - f. All taxes should be distributed according to the statutes (G.S. 159-27).
 - g. All employees who handle public moneys or have access to inventories must be bonded either individually or under a blanket bond (G.S. 159-29).
 - h. The Finance Director must be individually bonded for at least \$50,000. (G.S. 159-29) The collector must be individually bonded at an amount set by the governing board. [G.S. 105-349(c)].
 - i. A complete schedule of insurance coverage and limits should be maintained, showing expiration dates, premiums, co-insurance clauses, and other essential information.
 - j. Officials independent of the responsibility for placing coverage should periodically review all insurance coverage and costs. Independent, professional advice should be utilized on coverage and use of forms.
 - k. The unit should have a contract approval policy which includes approval original contracts and amendments, and is in compliance with the statutes.
4. Internal Control in Cash Receipts

Proper internal control over cash receipts is essential because, if uncontrolled, cash is the easiest of all assets to misuse without detection. Access to cash must be limited; therefore, it must be controlled as soon as possible after it is received by the local government. The “Cash Management” section of this manual has additional information concerning cash.

Critical internal control procedures for cash receipts include the following:

- a. Control of incoming cash should be established at the earliest possible point, which is normally with the delivery of the mail. A non-accounting staff person should receive the mail, open it, and list all checks received on a Daily Mail Collection Report. This report should show the date, the name of the person submitting the



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payment, and the amount and type of the payment. All checks should be restrictively endorsed immediately upon receipt. If there is more than one accounting position, the accounting clerk may perform these endorsements and prepare receipts. The finance officer should perform these duties position if there is only one accounting position.

- b. Cash and checks also are received from the issuance of licenses, permits, or sales of other items. Any payments received by the cashiers should be controlled at the point of collection, and appropriate receipts issued. All licenses and permits should be issued from prenumbered forms and be of such form that similar receipt books could not be easily obtained. All copies should be marked if a form is voided. All copies should be maintained on file for the proper retention period. Unused copies should be controlled by someone other than the issuer(s).
- c. Cash collection should be centralized to the maximum extent possible without hindering operations.
- d. The staff members and cashiers receiving the checks and cash should prepare receipts for all collections. The receipts should be prenumbered, and all issued numbers should be accounted for with receipt registers or lists. Voided receipts should be marked and recorded as such and should not be destroyed. Unissued receipts should be controlled by the staff members authorized to receive cash. The finance officer should perform these functions if he or she is the only accounting staff member. Otherwise, the accounting clerk should assume these responsibilities.
- e. Whenever possible, cash should be tied to goods or services provided, to verify amount of revenue that should have been received. For example, licenses and permits should be controlled through use of prenumbered forms or another manner, such that unit can assure itself that all revenues were received for these services.
- f. An accounting staff member should receive the checks and control listings from the person opening the mail and from the cashiers, Daily Mail and Daily Collection Reports, respectively. The deposit slip should be prepared in duplicate by this accounting staff member. The finance officer should assume this responsibility in a small unit.
- g. Bank deposits should be made daily (G.S. 159-32). However, if daily cash receipts are less than \$250, the unit may elect to make deposits only on days when cumulative receipts on hand amount to at least \$250 (G.S. 159-32). The governing board must approve this election prior to its being enacted. In any case, all funds received must be deposited on the last business day of the month. Deposits should be taken to the bank by someone other than the person who prepared the deposit. All deposits should be made in official depositories. In **small units**, these functions should be performed by the finance officer. Daily deposits are extremely important in units of government that have decentralized operations since a number of locations will be receiving cash and the amounts may be material.
- h. After the deposit is made and the duplicate has been validated by the bank, the duplicate should be compared to the Daily Collection Report(s) to verify that all cash received was deposited. Physical evidence that the verification was made, such as the staff member making the deposit actually initialing the deposit slip, should



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be required. **In small units**, the finance officer should assume these responsibilities.

- i. After the duplicate deposit slip is compared to the Daily Collection Report(s), the Daily Collection Report(s) and all duplicate deposit slips should be turned over to the accounts receivable clerk for posting to the subsidiary ledgers and the cash receipts journal. The accounts receivable clerk should reconcile postings to the deposit slips and evidence this reconciliation with his or her initials. Discrepancies should be brought to the attention of appropriate supervisory personnel. **In small units**, the finance officer should assume these responsibilities. Units of government that use on-line banking can reconcile deposits to general ledger record of deposit on a daily basis and no less frequently than weekly.
- j. Cash maintained on the premises should be kept to a minimum. All cash maintained should be in either a cashier's change fund or a petty cash fund. In either case, the staff member directly responsible for it should maintain the cash under strict sole control; no one else should have access to the cash. In other words, cashiers should never work out of each other's cash drawers. Cashiers should reconcile their change funds at the end of each day and maintain written reconciliations bearing their signatures as evidence that the reconciliations were performed. If at all possible, reconciliations should be conducted in the presence of another person for verification purposes. Periodic surprise cash counts should be conducted for both change funds and petty cash funds by staff members other than those responsible for the cash. These counts should be documented and also should include the reconciler's signature. Any discrepancies in a cash reconciliation should be reported immediately to the finance officer or to a board member if the finance officer is responsible for the cash. **In a small unit**, the finance officer or a board member should conduct the surprise cash counts.
- k. Funds not deposited should be located in a safe location, such as a safe on the premises. Access to the safe should be controlled. A locked file cabinet is not considered a safe location. Several Units deposit cash daily for amounts less than \$250 due to lack of safe location on site.
- l. Back-up keys to the cash should be maintained under dual control at all times for each cash supply so that cash can be obtained in case of emergencies or unexpected absences. These keys should be signed in and out by both staff members having control over them whenever it is necessary to use the keys. Any cash that is accessed by these staff members should be counted under dual control prior to the cash being used, and the amount of cash on hand should be reconciled to the last reconciliation performed by the staff member normally responsible for the cash. A written record of the reconciliation should be maintained and signed by both staff members. **In small units**, the finance officer can be one of the two persons responsible for the back-up keys. In very small operations, it might be necessary for a board member to serve as one of the two persons necessary to access the cash.

5. Internal Control Over Deposits in Financial Institutions

In addition to providing a deterrent to misuse, a good internal control system over a unit's deposits held in financial institutions should detect quickly any errors made by those institutions. Units rely on their institutions to provide accurate records, yet as a



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part of the stewardship responsibilities over public funds, the finance officer must be prepared to ensure the accuracy of such records.

Critical internal control procedures for deposits in financial institutions include the following:

- a. All deposits should only be in institutions authorized by the governing body of the unit.
- b. All funds held by financial institutions must either be insured by the FDIC or fully collateralized in accordance with G.S. 159-31(b). Units should insure that their accounts are classified as public depositories with the bank.
- c. The financial institutions that hold the unit's funds should be instructed to notify the governing body, or their delegate, of any unusual items or transactions occurring on the account, such as insufficient funds notices or checks made payable to cash.
- d. Current signature cards and other documents required by the institution(s) should be maintained on file with the unit's financial institution(s) at all times, indicating which staff members can sign checks on which accounts. These documents should be in strict accordance with the authorizations to sign checks as approved by the governing body. Terminated employees should be removed from signature cards and other bank documents immediately.
- e. All bank statements should be reconciled promptly upon receipt by a staff member independent of the cash receipts and disbursements functions. Statements should be delivered unopened to this staff member. Units can use on-line banking to monitor cash withdrawals daily or weekly to ensure that unauthorized transactions are not being made.

In performing the monthly reconciliations or daily monitoring, the staff member should check for the following:

1) For all deposits:

- Compare dates and amounts of daily deposits as shown on the bank statements with the cash receipts journal.
- Investigate bank transfers to see that both sides of the transaction have been recorded in the unit's financial records.

2) For all disbursements:

- Account for all check numbers, including voided checks.
- Examine cancelled checks for authorized signatures, irregular endorsements and alterations.
- Look for checks payable to cash. Investigate these items.

All discrepancies should be reported to the finance officer immediately. All reconciling items should be investigated and approved by the finance officer or reviewing board member. Upon completion, all reconciliations should be reviewed by a responsible official. **In small units**, a board member may perform the bank



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reconciliations. If an accounting clerk is available to do the reconciliations, he or she may do so, but a board member should review the reconciliations.

See the Policy Manual for Local Governments, Section 30 – Cash and Investments for a more complete discussion of bank reconciliations and additional protection against check fraud, including positive pay and similar services.

6. Internal Control Over Petty Cash

While petty cash funds are generally immaterial to a unit's financial condition as a whole, they are easy targets for misuse of funds. Good internal control over petty cash funds can help to prevent such a misuse. Petty Cash should never be used to advance funds to employees. If a unit can offer reimbursement to an employee in a reasonable time frame, there is no need to a petty cash fund. A unit should carefully evaluate the need for these funds.

Critical internal control procedures for petty cash funds include the following:

- a. Petty cash funds should be maintained on the imprest basis at the minimum effective amount. One individual should be responsible for the fund and should maintain sole control over it. Back-up, dual control access to the fund should be available in the event of an emergency.
- b. Petty Cash should only be used to reimburse employees for small purchases. Employees seeking reimbursement should present a receipt that documents what was bought, the public purpose, amount, and a receipt that breaks out sales tax. Receipts should be accompanied by written authorization in compliance with unit's authorization policy. Many units use the same form used for other check request.
- c. All petty cash funds should be replenished no less frequently than monthly and more frequently if necessary. All petty cash vouchers should be used to document the check request to replenish the fund. The petty cash should not be controlled by the person responsible for writing checks.
- d. All petty cash funds should be subject to a surprise cash audit from time to time. This control is essential.

7. Internal Control Over Revenues

Internal controls over revenues primarily focus on two areas: proper billing and proper recognition of the revenue earned. Most of these controls apply to all areas of revenue collection, but there are some controls specific to tax collections that are presented in the following section.

Critical internal control procedures for revenues include the following:

- a. The organization and integration of the records for collections should identify probable taxpayers as a result of issuance building permits, license purchases, register of deeds, or other contacts with the unit.
- b. Records should be updated on a timely basis to prevent incorrect billing of amounts due to the unit.
- c. There should be, to the greatest extent possible, a separation of duties between the collections, billing, and receivables functions.



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- d. All partial payments must be included in the daily deposit made by the finance officer. All partial payments, except those properly deferred until subsequent years, should be recognized as revenue in the current year.
 - e. All subsidiary records should be reconciled with the control accounts on a monthly basis.
 - f. All delinquent accounts should be periodically reviewed by an appropriate official outside the collection function.
 - g. Billings for enterprise and other service revenues should be based on usage as determined by accurate and timely information, such as meters for water usage.
 - h. For enterprise revenues, meter readers assignments should be periodically rotated on a surprise basis.
 - i. For service revenues, procedures should be in place to identify irregular service patterns. Any irregularities identified in this manner should be thoroughly investigated.
8. Internal Control Over Tax Revenues

Critical internal control procedures specific to tax collections are as follows:

- a. The unit of government should perform, at least monthly, a reconciliation of levy, taxes receivable and revenue collected. This should be performed if the unit levies or collects the taxes or it has been outsourced to the County. This reconciliation should be reviewed and the review documented by signature of reviewer. In **small units**, this might be a board member.
- b. The unit should take necessary steps to verify that all property has been included in the levy.
- c. All taxes must be levied within statutory limitations and for the purposes permitted by the statutes (counties, G.S. 153A-149; municipalities, G.S. 160A-209).
- d. There should be a clear separation of duties between the tax collector and the tax assessor functions. If there is not a separation of duties over these two functions, there should be compensating controls over the tax scrolls and receipts.
- e. Taxes receivable must be reconciled periodically to the control accounts.
- f. The tax scrolls must be adequately maintained and balanced periodically with the control accounts.
- g. All releases, refunds and write-offs of taxes must be authorized by the governing body in its minutes or by the tax supervisor as permitted by law [G.S. 105-325(b)]. Controls over these functions must ensure that transactions are legal, documented and authorized.
- h. All discoveries should be properly recorded as a part of the current year's levy.
- i. All uncollected delinquent taxes more than ten years old should be written off the books, unless collection proceedings are underway.



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9. Internal Control in Cash Disbursements

There are three important aspects of the cash disbursement function that must be controlled. They are: 1) checks must be signed by authorized personnel, 2) check signers must thoroughly review documentation supporting the disbursement prior to signing the check, and 3) check signers should be independent of the accounts payable function.

Critical internal control procedures for cash disbursements include the following:

- a. Prenumbered checks should be used for all disbursements.
- b. The unused check supply should be locked up at all times. Listings of the check numbers in the unused supply should be maintained so that at any time a check inventory could be obtained and verified.
- c. Voided checks should be so indicated on the check register. The checks themselves should be sufficiently defaced so that no one could use them. Methods of defacing voided checks include writing "VOID" across the payee and signature lines of all copies of the check using permanent ink and by punching holes through the account number at the bottom of the check. Voided checks should be maintained on file in numerical order with other cancelled checks.
- d. Blank checks should never be signed in advance.
- e. Checks should never be made payable to cash.
- f. Checks should be prepared by someone not authorized to sign them. **In small units**, the finance officer may prepare checks if there are no other accounting staff members; however, a check register should be reviewed and signed by a board member after reviewing documentation to support the checks. If an accounting clerk is on staff, that person should prepare the checks.
- g. Check signers should review documentation supporting the disbursements prior to signing the checks. Check signers should review documentation for the following:

Amounts and payees on documentation (purchase orders and invoices) should agree to the checks.

Documentation should be stamped "paid" to prevent duplicate payments. Only original invoices should be paid - photocopies should not be accepted.

Original invoices are not as strong a control in this age of electronic invoicing and the easy access to duplication or creation of authentic looking documents. Having invoices authorized by at least two independent employees of the unit who can attest that goods or services were received, were for a public purpose, that unit policies were followed, and that an arm's length transaction occurred is one of the most important controls in the disbursement cycle.

If goods or services were received by another department, their signature should be obtained to verify and attest to the following:

- goods or services were received,
- used for a public purpose,



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- policies were followed, and
- an arms length transaction occurred.

Many units attach a form to the invoice documenting accounting code, authorization for payment signatures (two), description of the public purpose, and any special handling instructions. This form should have an attestation statement for signature by the approver.

- h. For maximum cash management, payables should not be disbursed before or after they are due, unless a discount is realized by paying early. Even then, the discount should be more than the potential interest earnings on the funds needed to pay the bill.
- i. All purchase orders, contracts, or checks and warrants should have properly signed pre-audit certificates (G.S. 159-28).
- j. Purchase orders and receiving reports should be initialed by an authorized individual when goods are received and matched to the purchase order. This purchase order would eventually be matched to the corresponding invoice to facilitate payment authorization. All personal services should be verified before payment is made. **In small units** with only one accounting position, the finance officer may initial his or her approval on purchase orders indicating receipt of goods or services. If there are two accounting positions, the accounting clerk should perform this task. It is important that person receiving the goods initials the receiving document or purchase order.
- k. Two signatures are required on all checks per G.S. 159-25(b). The second signature should be that of someone not having access to the accounting records. Both persons signing the checks are equally responsible for reviewing supporting documentation. If facsimile signatures are used, they should be adequately controlled. If the facsimile is one signature, employees with the authority to sign checks as the second signature should not have access to the other facsimile signature. If the facsimile is two signatures, the plate should be under dual control at all times. Any employee having access to facsimile signature plates should be properly bonded. The governing board may waive the dual signature requirements if the board determines that satisfactory internal control procedures are in place. **In small units**, checks should be signed by the finance officer and a board member. However, the finance officer should not have access to the signature plate of the board member and vice versa.
- l. Employee expense reports should be properly completed prior to payment. Reports should be signed by the employee, approved by the appropriate persons as required by the policy, and supported by all required documentation. Documentation should include a description of the public purpose or benefit derived from the travel. See the following section III.C.11 and the Policy Manual for Local Governments, Section 45 – Travel for an additional discussion of policies and procedures related to travel.
- m. All checks should be mailed or distributed by someone other than the person who prepared the checks. **In small units**, a board member should mail or distribute all checks.



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- n. Disbursements should only be made to authorized vendors. Units should state in their policy if additional approvals are needed for use of out-of-state vendors.
- o. Prior to making disbursements to a vendor, a unit should obtain the necessary information to complete the IRS Form 1099.
- p. All items that are outstanding for a lengthy or irregular amount of time should be investigated. Payment should be stopped on checks held outstanding for long periods of time. Having controls that highlight irregularities is only part of the control. Investigation of the irregularity is essential.
- q. All wire or other electronic transfers should be made by persons authorized by the governing body. The financial institution should require written evidence of the authorizations. These authorizations should be kept current. All electronic transfers should be treated just like any other transactions and have all necessary documentation and approvals.

10. Critical Internal Control Procedures Specific to Payroll Disbursement

In addition to all control procedures that apply to cash disbursements, the following procedures apply specifically to payroll disbursements.

- a. Each employee should have a personnel file that includes, at a minimum, the following data:
 - hiring authorization,
 - salary history,
 - hours authorized to work,
 - federal and state withholding forms,
 - hospital and retirement deduction information, and
 - authorization for all other payroll deductions.
- b. Any changes in an employee's status should be supported by the appropriate documentation in the employees' personnel file.
- c. Payroll checks should be handled like other cash disbursements except that a time sheet or card signed by the employee and approved by the appropriate supervisor (evidenced by the signature of the authorized person) will be the supporting documentation for disbursement. (Some employees may be exempt from completing time records. These positions must be declared exempt by the governing board.) Pre-audit certificates are not required on each payroll check. **In small units**, the finance officer and a board member should sign all payroll checks, and the board member should distribute them.
- d. Medium to large units that maintain a separate payroll checking account should maintain it on an imprest basis.
- e. Unclaimed checks should be placed in a secure area under the control of the person distributing the checks or other staff member independent of the disbursement function. **In small units**, a board member should assume this responsibility. Any unclaimed checks should be investigated immediately.



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- f. Units should have written personnel policies prohibiting employment practices that result in nepotism, conflicts of interest, or discrimination.
- g. In units with appropriate staff, the functions of payroll, additions and deletions to payroll, and timekeeping functions should be segregated.

See the Policy Manual for Local Governments, Section 40 – Payroll for an additional discussion of policies and procedures related to payroll.

11. Critical Internal Control Procedures Specific to Travel Expenditures

Critical internal control procedures for cash receipts include the following:

- a. There should be a definite, written policy for requesting travel advances, reporting travel expenses, and reimbursing the unit for unexpended advances.
- b. All travel advances should be approved by a department head (or in larger units, his designee) and effectively controlled.
- c. All employees should provide an estimate of expenditures and description of the public purpose so approvers can take into account the cost benefit of the travel advance.
- d. All reimbursed travel expenses should be made in accordance with the travel policy as adopted by the unit.

See the Policy Manual for Local Governments, Section 45 – Travel for an additional discussion of policies and procedures related to travel.

12. Internal Control in Accounts Receivable

The primary control in the receivable function is the segregation of duties for receipting cash and posting it to the accounts receivable ledger. Receivables should be reconciled periodically, and delinquent accounts should be reviewed by an appropriate official. One of the reasons for the review of delinquent accounts is that if someone was intercepting cash from the receivables area, it would most likely be from receivables that were paid but still remain unpaid on the books in order to hide the embezzlement. So the person reviewing the list of delinquent accounts would need to have knowledge of accounts that wouldn't look reasonable, and then follow up on any issues. Duties should be separated as much as possible between the three sectors of the revenue cycle – billing, collections and maintenance of the receivable records. Ideally, these sectors should be completely separate. **For small units** of government, board involvement in this area is critical in order to maintain the integrity of the accounting records.

Critical internal control procedures for accounts receivable include the following:

- a. On a periodic basis (at least monthly), a list of delinquent accounts should be prepared. For utility or other services, a "cut-off" policy should be in place to terminate services to delinquent customers. The list of delinquent customers should be reviewed by someone other than the staff members responsible for collections and accounts receivable to see that the policy is being enforced. The governing body **in a small unit** of government should assume the responsibility of determining the "cut-off" policy and enforcing it.



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- b. Daily posting of receipts to accounts receivable ledgers should be done by someone other than the staff member responsible for cash receipts. **In small units**, if this is not possible, a board member should test a sample of receipts and trace them to the accounts receivable ledger.
- c. Subsidiary receivable ledgers should be reconciled at least monthly with the control ledgers. Ideally, this should be done by someone other than the staff member posting the receivables. **In small units** with only one person on the accounting staff, a board member should perform these duties. In units with two or more accounting positions, an accounting clerk would be responsible for these tasks.

13. Internal Control Over Investment Management

According to G.S. 159-30(a), the finance officer is responsible for managing investments subject to the law and to whatever additional restrictions and directions the governing board may impose. The finance officer has the power to purchase, sell and exchange securities on behalf of the governing board. The investment program should be so managed that investments and deposits can be converted into cash when needed. The finance officer should, at the same time, see that securities and funds are safeguarded from bankruptcy of financial institutions, theft, fire, or other damage, and that duties are properly segregated to prevent the misuse of funds. The investment function should operate efficiently, with as few people as possible having access to funds and investments; however, the management of investments should be transparent and reviewed.

Critical internal control procedures for investment management include the following:

- a. All investments should be in compliance with G.S. 159-30.
- b. A cash management and investment policy, approved by the governing body, should be on file. The investment officer, cash manager or staff member fulfilling those duties should follow that policy. A sample cash management and investment policy can be found in the Exhibits to the Policy Manual for Local Governments, Section 30 – Cash and Investments.
- c. Levels of acceptable risk should be included as part of the unit's investment policy. The governing board should be informed of the various risk categories of investments in the unit's policy statement. The finance or investment officer should evaluate the credit and safekeeping risks of all investments prior to investing the funds to insure they comply with policy.
- d. Perfecting custody of investments is a vital cash management function. Adequate custody of investments decreases the possibility of suffering losses from investments of public funds. Although the statutes (G.S. 159-30(d)) require physical possession of securities, that is not possible in the "book-entry" environment. In these cases, the Attorney General has issued an opinion indicating that a custodial account should be established in the name of the unit with a trust company authorized to do business in North Carolina and who is a member of the Federal Reserve. Safekeeping by the broker or on the operating side of the bank is not acceptable. It might be wise to have these arrangements reviewed by the unit's attorney to assure the unit's claim on the assets. See the Policy Manual for Local



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Governments, Section 30 – Cash and Investments for an additional discussion of custody requirements for investments.

- e. Access to securities should be limited to personnel authorized by the governing board. Any securities physically held by the unit should be maintained under strict dual control. **In small units**, a board member can act as the second control person if there is only one accounting staff person. If there are two accounting staff members, an accounting clerk can be the second control person.
- f. Securities should be adequately safeguarded in locked, fireproof compartments.
- g. Statements provided by safekeeping agents also should be reconciled to the investment records monthly. Securities held by the unit should be inventoried on a surprise basis periodically and reconciled to the accounting records. The inventory should be conducted by someone independent of the investment function. **In a small unit**, if there is only one accounting position, a board member should perform the inventory and reconciliation. In units with two accounting positions, an accounting clerk can perform these functions.
- h. On an "as received" basis, broker confirmations and safekeeping receipts should be reconciled and any discrepancies investigated. The unit's investment record card also should be reconciled to the confirmations and safekeeping receipts. Items that should be reviewed include amount, interest rate, purchase price or sale price, and purchase or sale date. Written evidence should be provided of such reconciliations. A board member should perform these reconciliations **in a small unit**.
- i. Units who engage brokers and dealers should make sure policy includes procedures to require competition to ensure the unit is receiving the best pricing.
- j. Any approvals required by the unit's written cash management policy for purchases, sales or other investment activities should be obtained, with written evidence of such approval provided. **In small units**, a board member should approve these transactions.
- k. A permanent record should be maintained on each investment reflecting principal, due date, interest payment dates, rate or amount of interest, seller, safekeeping agent, and ultimate disposal of the investment. This information should match that on the selling broker's confirmation and on the safekeeping receipt.
- l. A system should be in place to insure that all interest is credited as due for the proper amount and to the proper funds. In addition, an investment schedule should be maintained that calculates accrued interest amounts for each investment. These amounts should be analyzed for reasonableness, compared to market rates, and reconciled to the actual amounts paid.
- m. Investments should be reported in compliance with GASB statements including Statement No. 31, Accounting and Financial Reporting for Certain Investments and for External Investment Pools, which establishes accounting and financial reporting standards for all investments held by governmental external investment pools and certain investments held by other governmental entities and GASB Statement No. 53 Accounting and Financial Reporting for Derivative Instruments. See the Policy Manual for Local Governments, Section 30 – Cash and Investments and the



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Illustrated Financial Statements available at www.nctreasurer.com under “State & Local Government” at “Auditing and Reporting Resources” for an additional discussion and illustration of the accounting and reporting requirements for deposits and investments.

- n. All underlying securities in repurchase agreement transactions should be held by a third party safekeeping agent. The selling bank's trust department does not qualify as a third party.
- o. If unit of government uses on-line banking, proper controls need to be maintained in the banking application. Wires and Automated Clearing House (ACH) transactions should require dual authorizations. Personal computers used by units should be properly protected from electronic theft, and tokens provided by the financial institution should be used to increase security around user authentication.

14. Internal Control Over Accounts Payable, Expenditures and Encumbrances

G.S. 159-28(a) states that "no obligation may be incurred in a program, function, or activity accounted for in a fund included in the budget ordinance unless the budget ordinance includes an appropriation authorizing the obligation and an unencumbered balance remains in the appropriation sufficient to pay in the current fiscal year the sums obligated by the transaction for the current fiscal year." Internal controls in the expenditures, encumbrances, purchasing, and contracting areas should ensure that all expenditures are properly documented and made in accordance with the authorized budget. Within the expenditure function, purchasing and contracting require special procedures.

Critical internal control procedures for accounts payable, expenditures and encumbrances include the following:

- a. Expenditures should be controlled using the budget ordinance. For any budgeted fund, all expenditures must be budgeted. There must be sufficient budgeted revenue or available fund balance to cover each expenditure. See the Policy Manual for Local Governments, Section 10 – Budgeting for an additional discussion of policies and procedures related to budgeting.
- b. All budget appropriations should be recorded in the appropriate expenditure account.
- c. All expenditures must be charged against an appropriation account. The exact timing of the accounting entry will vary depending on the type of transaction.
- d. An encumbrance system must be used by:
 - Counties with populations of 50,000 or more,
 - Cities and towns with populations of 10,000 or more, and
 - School systems with average daily memberships of 6,000 or more.

Other units may use an encumbrance system if they choose [G.S. 159-26(d)]. In fact, even small governments commonly use an encumbrance accounting system to aid them in compliance with pre-audit requirements. See the Policy Manual for Local



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Governments, Section 35 – Purchasing and Contracting for an additional discussion and illustrations of encumbrance accounting.

- e. An effective year-end cut-off policy should be in place for all liabilities, including accounts payable.
- f. All accounts payable subsidiary records should be reconciled to the general ledger on a monthly basis by someone who does not have access to the subsidiary records. **In small units**, the finance officer or accounting clerk may perform this task. A board member should review the reconciliation and test a sample of postings to the records to verify that all items are being properly posted.
- g. Any adjustments to recorded accounts payable should be fully documented and approved by the finance officer. In a small unit, a board member should approve any adjustments.
- h. Any debit balances in accounts payable should be investigated thoroughly.

15. Internal Control Over Purchasing and Contracting

Critical internal control procedures for purchasing and contracting include the following:

- a. Units should have a written procurement and contracting policy that clearly outlines levels of authorization and approvals necessary for all purchasing and contracting transactions as well as procedures to be used by unit employees.
- b. Prenumbered purchase orders should be used for purchases. Voided purchase order forms should be recorded as such and copies maintained on file.
- c. The approval of invoices for payment should be independent of the purchasing function. The preaudit certificate (G.S. 159-28) should be signed by the finance officer in all units. In some units, automated systems verify available balance which aides finance officers with their approvals. If facsimile signatures are used, they must be under the control of the finance officer.
- d. Invoices and other supporting documentation should be thoroughly reviewed prior to approval being given for payment. The documentation should provide evidence that the item was received, of the public purpose of the transaction, that the unit's policies were followed, that an arm's length transaction occurred, and that the item was billed as ordered.
- e. An open file for outstanding purchase orders should always be maintained to facilitate monitoring of outstanding orders.
- f. All department purchases should be requisitioned or approved by the department head prior to purchase. This approval should be in writing. In units with only a finance officer and no other accounting staff, a board member should approve all purchases.
- g. Department heads should be provided a detailed list of revenues, expenditures and encumbrances with comparisons to the budget at least monthly. Not only will this allow the managers to keep track of their budgets, but it serves as a good check for errors.



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- h. Those contracts requiring public bids per G.S. 143-128 through G.S. 143-133 should be handled as required by the statutes. Complete documentation should be maintained on the bids and the awarding of the contract.
- i. Unit should have standard form that persons making bid evaluation should fill out that ensure that no conflict of interest statutes are being violated. Units might require additional disclosure in the interest of transparency. Persons evaluating the bids and making vendor award recommendation should disclose any potential conflict of interest before the evaluation of the bids begins. [G.S. 14-234]
- j. The governing board may grant some level of contract authorizations to staff members to enter into contracts to purchase goods or services. These authorizations should be very specific as to the maximum dollar amount, type of assets being purchased, and other terms of such contracts. All contract and purchase order authorization not delegated by the board does require board approval.
- k. A unit of government might allow small or routine procurement to be made outside the purchase order or contract control process. The unit must still have alternate controls in place to ensure compliance with preaudit statute G.S. 159-28. Department heads should review these purchases made by their staff on at least a monthly basis. These reviews should be documented and sent to finance for additional reviews.
- l. No contracts or purchase orders should be made with persons forbidden by law to sell to the unit. G.S. 14-234 states the restrictions on related party transactions.
- m. Accommodation purchases for employees should be expressly prohibited. These include purchases of goods made for employees for their personal use from vendors at the unit's contract price. An exception is authorized programs, such as the one allowing teachers to purchase computers.

See the Policy Manual for Local Governments, Section 35 – Purchasing and Contracting for an additional discussion of policies and procedures related to purchasing and contracting as well as for references to additional materials provided by the UNC School of Government.

16. Internal Control Over Inventories

It is essential that all inventories be adequately controlled to prevent misuse. It is the responsibility of each department or area supervisor to see that keys to the supplies storage facility are adequately controlled and that physical counts are conducted on a periodic basis. However, controls should be cost-effective. Some departments may have a very limited amount of inventory, while certain enterprise and service departments may have significant inventories on hand. Not all procedures may be applicable to insignificant inventories as they are not cost effective. The costs of inventory tracking should be weighed against the potential benefits.

Critical internal control procedures for inventory management include the following:

- a. A unit should inventory and control in its general ledger all major classes of materials and supplies, if material.
- b. Perpetual inventory systems should be maintained for all major classes of inventory.



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- c. Custodial responsibilities should be clearly defined. For areas with significant inventories, this responsibility should be included in the appropriate job descriptions.
- d. Inventory should be controlled with physical barriers, such as locked cabinets or storehouses.
- e. Keys to inventory should be controlled in such a manner that does not inhibit day-to-day operations. For utility departments, the engineer must have a key to the inventory. Ideally, no one else should have a key, so the inventory stays under the strict control of one person. However, a back-up key should be maintained under dual control in case the engineer is unexpectedly absent. If his or her absence is foreseen, such as scheduled vacation time, the key should be turned over to the appropriate assistant. (The key should be returned to the engineer upon his or her return to work.) Written records should be maintained of these relinquishments and assumptions of control with each person initialing and indicating the date and time of exchange. Written records can provide important information regarding responsibility if a problem should occur. The same procedures should be followed if the back-up key is used. Those persons having control of the key should release it to the appropriate staff member, and each should give written evidence of the exchange.
- f. Physical inventory counts should be made once a year at a minimum. The count should be made by an independent staff member or members (one or more who have no control over the inventory, even in back-up situations). Counts should be conducted from "scratch" (i.e. not using the previous year's count sheets). All counts should be recorded in writing and should be signed or initialed by the person(s) performing the counts. Once the count is complete, it should be reconciled to the perpetual inventory records and the general ledger. This reconciliation should be evidenced in writing. **In small units**, inventory counts should be taken by a board member if there is only one accounting or finance staff member.
- g. Records should be maintained showing all additions, withdrawals and transfers of inventory. Persons receiving the inventory should initial the records. For transfers and withdrawals, the person releasing the inventory should initial as well.
- h. An adequate requisition system should be in place for all issuing stores. These requisitions should be approved by the department head or other designated person.
- i. Significant inventories should be insured against loss.
- j. Persons having control of inventory should not have access to the accounting records.
- k. Provisions should be made for obsolete or inactive inventory. Periodic reports should be made to the governing body concerning obsolete items.
- l. A workable system should be in place to maintain optimum quantities of inventory at all times.



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See the Policy Manual for Local Governments, Section 25 – Inventories for an additional discussion of policies and procedures related to control and accounting for inventories.

17. Internal Control Over Fixed Assets

It is essential that all fixed assets be adequately controlled to prevent misuse.

Critical internal control procedures for fixed asset management include the following:

- a. Adequate accounting records should be maintained that identify and classify all fixed assets.
- b. Adequate guidelines should be established and followed to distinguish between expensed items and capital additions; federal, state or other special revenue purchased items; and betterments or improvements to assets.
- c. Physical inventories of fixed assets should be taken on an annual basis by independent parties. Inventory counts should be taken "from scratch" – not using the previous year's count lists. Count sheets should be initialed by the person(s) taking the inventory. The count should be reconciled to the accounting records, with written evidence of the reconciliation maintained. **In small units**, the inventory should be taken by a board member if there is only one accounting or finance staff member. If there are two accounting or finance staff members, the finance officer may take the inventory.
- d. All fixed assets should be tagged or identified in the accounting records by a control number, as applicable. Tags should be prenumbered, with all numbers accounted for, and should identify the assets as belonging to the unit. Tags should be affixed in a permanent manner.
- e. All property, buildings, titled equipment and vehicles, and other items should be held in the name of the unit. All deeds on real property should be properly recorded and stored in a secure place.
- f. All fixed assets purchased, transferred, sold, scrapped, or destroyed should be recorded as such in a timely manner in the accounting system. This facilitates proper valuing of assets and helps to prevent loss or misuse.
- g. All sales of surplus property should be conducted in accordance with G.S. Chapter 160A, Article 12 (municipalities) or G.S. 153A-176 (counties).
- h. Fixed assets are often used to help determine adequate insurance coverage on all real and personal property. An independent review of insurance coverage should be conducted at least every three years.

See the Policy Manual for Local Governments, Section 20 – Fixed Assets for an additional discussion of policies and procedures related to control and accounting for fixed assets.

18. Internal Control Over Interfund Transfers or Loans

While interfund transfers are permissible with the approval of the governing body, there are certain statutory restrictions to which the unit must adhere. There also are



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several standard procedures that should be followed. Some restrictions and procedures also apply to interfund loans.

Critical internal control procedures for interfund transfers and loans include the following:

- a. There should be no transfers or loans whatsoever from the following funds, as the revenues in these funds are restricted for use as defined by the fund itself:
 - Funds to account for taxes specifically voted by the people
 - Funds to account for taxes or other revenues collected for others
 - Public assistance funds
 - School funds
 - Reappraisal fund [G.S. 159-13(b)(17)]
- b. All transfers and loans from the following funds should be checked for legality and propriety:
 - Capital reserve fund (G.S. 159-22)
 - Capital project fund for bond issue proceeds[G.S. 159-13(b)(19)]
 - Debt service funds
 - Enterprise funds [G.S. 159-13(b)(14)]
 - Funds that account for taxes other than those voted by the people or those collected for others, on which there is no restriction as to the amount of levy.
 - Service district funds [G.S. 159-13(b)(18)]
- c. Each interfund transaction should be authorized in the minutes of the meetings of the governing body. Interfund loans that will remain outstanding for more than one fiscal year must be approved by the board and should be included in the budget. Authorization for interfund loans should include provisions for the method and time of payment and if interest is to be charged.

See the Policy Manual for Local Governments, Section 10 – Budgeting for an additional discussion of policies and procedures related to control and accounting for interfund transactions.

19. Internal Control Over Current Liabilities, Bonds Payable and Other Long-Term Debt

Internal control procedures for liabilities and debt outstanding are primarily statutory requirements that must be met.

Critical internal control procedures for current liabilities include the following:

- a. Detailed records of all outstanding contracts should be maintained.
- b. All amounts withheld from contract payments upon completion of a project should be reflected on the books (retainage).
- c. All bid and other deposits held by the unit should be adequately controlled. The subsidiary ledger should be reconciled to the control accounts on a periodic basis.
- d. Do recorded liabilities represent valid current obligations.



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Critical internal control procedures for bonds payable include the following:

- a. Each bond issue should be approved in the minutes of the meetings of the governing body. These minutes should also authorize the bond election (G.S. 159-60). Publication of the notice of referendum should be made and should agree with the purposes and restrictions contained in the board meeting minutes (G.S. 159-61).
- b. All proceeds from a bond issue must be used in accordance with the stated purpose of the issue.
- c. Separate accounting records should be maintained for each bond order as required by G.S. 159-26(b)(6).
- d. The unit should have procedures designed to assure compliance with all debt service requirements, rate covenant obligations and other fiscal requirements of revenue bond resolutions.
- e. The unit should have procedures designed to assure compliance with all bond order and secondary market disclosure requirements, and to assure that all required IRS forms (Form 8038-G or Form 8038-GC) are timely filed.
- f. All proceeds from bond issues subject to arbitrage rebate requirements should be accounted for separately from the unit's other funds to facilitate tracking of the investment earnings.
- g. Written procedures for debt service payments and tracking of arbitrage must exist.
- h. Staff charged with execution of debt payments and arbitrage tracking must be trained and understand policy, procedure and regulations.
- i. Controls must be in place to ensure that expenditures qualify for the purpose for which the bonds were issued. The budget office must understand which revenues can be used to pay for which expenditures when bonds or restrictive grants are involved.

See the Policy Manual for Local Governments, Section 95 – Arbitrage for an additional discussion of policies and procedures related to bond covenant compliance.

Critical internal control procedures for other long-term debt include the following:

- a. All lease-purchase agreements, installment contracts to purchase land or other fixed assets, and contracts involving the purchase of realty and assumption of existing debt should be properly reflected on the financial records as long-term debt and fixed assets.
- b. All contracts should be approved by the Local Government Commission if the Commission's approval is required (G.S. 160A-20, G.S. 159-148).
- c. The unit should be meeting the arbitrage rebate requirements for all tax-exempt financing.
- d. Controls must be in place to ensure that expenditures qualify for purpose for which debt was issued. Budget office must understand which revenues can be used to pay for which expenditures when bonds or restrictive grants are involved.



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It should be noted that in determining whether a bond or other debt issue should be approved, the Local Government Commission is authorized to inquire into and give consideration to the debt management policies and procedures of the unit, as well as compliance with the Local Government Budget and Fiscal Control Act and other matters having a bearing on the approval. To approve an application to issue debt, the Commission generally must find and determine that the unit's "... debt management procedures and policies are good, or that reasonable assurances have been given that its debt will henceforth be managed in strict compliance with law." [G.S. 159-52, G.S. 159-86, G.S. 159-151] It is difficult to make the required finding if the internal controls of the unit are inadequate.

20. Internal Control in an EDP Environment

Many small units of government outsource their EDP function to vendors. Normally these vendors have more experience, better technology and equipment and can deliver services at a better price than the local unit could provide. The unit will still have to address internal controls which also include data recovery and backup. The vendor and the units' auditors are great resources to provide internal control recommendations for each unit's unique situation.

Large units run complex environments and have the resources to develop appropriate controls for their environment. The following link is to the Federal Information Systems Control Audit Manual which provides detail guidance on EDP environments for larger units: www.gao.gov/special.pubs/fiscam.html.

Similarly, most audit firms as well as other organizations provide services that will evaluate a unit's internal controls over EDP and make recommendations.

There are several basic internal controls that are essential in the EDP environment. The first is the segregation of duties to ensure accurate input, processing and output of data. Second is the physical control of the hardware. Third is the physical control of the software and data files. Control over software and data files is vital to maintain the integrity of the accounting records.

Segregation of duties is difficult to achieve in a small system environment; therefore, other checks and controls must be designed and implemented to compensate for the lack of segregation of duties. Units of government should work with their auditors

Critical control procedures in a small system EDP environment include the following:

- a. Controls over identity theft along with unauthorized access to a unit's systems must be in place and may require outside assistance to ensure proper controls are in place.
- b. Access to system from home, wireless and non-unit computers should not be authorized unless proper controls are in place.
- c. Computer hardware should be included in the fixed asset inventory. All hardware should be clearly identified as property of the unit and should be tagged.
- d. Hardware should be adequately protected against damage. Surge protectors should be used on all electrical hook-ups. Adequate insurance should be maintained to cover damage of the equipment.



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- e. Purchasing of computer equipment for a unit should be centralized in order to prevent purchasing of incompatible equipment. Purchases should always be made from reputable dealers.
- f. All software should be identified as property of the unit. The unit should comply with all licensing requirements. Inventories of all software should be maintained. Adequate documentation of the operation of all software programs should be kept on file and updated when necessary.
- g. Back-up copies of all software should be maintained. Off-site storage of software back-ups may be desirable if the software has been significantly modified for the unit or is an original program.
- h. Back-up copies of all data files should be maintained. Off-site storage of critical data is necessary for full protection against loss.
- i. All back-ups maintained on-site should be kept in fireproof facilities. Data files and software should be adequately protected against damage.
- j. Data files containing sensitive data should be maintained under the control of the staff member responsible for the related function.
- k. Access to the equipment, software and data should be controlled. An independent verification should be made from time to time to ensure that computers and software are not being used for personal business without express authorization.
- l. A disaster recovery plan should be in place. Part of this plan should include alternatives for computing resources, either through contract or reciprocal agreement, in the event of a complete loss of critical computer hardware. This plan could be coordinated with the unit's overall emergency management operations. This is critical as off-site storage of data files does not protect unit against loss of all operating software and applications used by the unit. Test of disaster recovery plan is essential.
- m. An independent verification should be made periodically to ensure that application programs are functioning properly.
- n. The unit should have maintenance agreements on file for the hardware or should have made an express decision to self-insure for repairs and maintenance costs.



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AICPA. Statement on Auditing Standards No. 78, *Consideration of Internal Control in a Financial Statement Audit: An Amendment to SAS No. 55*. December 1995.

AICPA. Statement on Auditing Standards No. 99, *Consideration of Fraud in a Financial Statement Audit*. October 2002.

AICPA. Statement on Auditing Standards No. 115, *Communicating Internal Control Related Matters Identified in an Audit*. October 2008.

Arens, Alvin A. and James K. Loebbecke. *Auditing: An Integrated Approach*, 7th edition. Prentice Hall, New Jersey. 1997.pp. 290-303.

FEMA. Emergency Management Guide for Business and Industry, Section 3: Hazard-Specific Information, Technological Emergencies.

COSO, *Internal Control over Financial Reporting – Guidance for Smaller Public Companies*; Volume 1: Executive Summary

Current LGC memorandums related to internal control include the following:

- No. 569 Internal Controls – Small Local Government Units
- No. 568 Internal Controls



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