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***Internal Controls***

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# Internal Controls

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## ***Introduction***

Today, local governments are faced with providing needed services to citizens with limited public resources. Local officials are entrusted with these limited public resources and are responsible for complying with laws and regulations, meeting goals and objectives, safeguarding assets, and issuing reports that inform the public of the results of government activities. A good internal control system is necessary to assist local officials in meeting all their responsibilities. In this session, we will focus on the following areas:

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## ***Background***

Internal controls have always been an important element of any local government's financial and operating structure. In the 1990's, concerns about *fraudulent* financial reporting resulted in a group being formed and a study on internal controls being produced. This group – the Committee of Sponsoring Organizations (COSO) – developed a report that defined internal control and identified five key components of internal control.

## ***What are Internal Controls?***

Internal controls are essential to “good” government management and can be defined as activities (safeguards) that are in place to provide reasonable assurance that things are “going as planned.” Simply put, internal control is anything that local officials can do to safeguard assets and make more efficient and effective use of these assets.

Internal Control, as defined in the COSO report, *is “a process effected by the entity’s board of directors, management, and other personnel, designed to provide reasonable assurance regarding the achievement of objective in effectiveness and efficiency of operations, reliability of financial reporting, and compliance with applicable laws and regulations.”*

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There are four objectives of an Entity (local government):

- \* Protection of Assets
- \* Effectiveness and Efficiency of Operations
- \* Reliability of Financial Reporting
- \* Compliance with Applicable Laws and Regulations

The definition reflects certain fundamental concepts:

- It's a process. It's a means to an end, not an end in itself
- It's accomplished by people. It's not merely policy, procedures and forms.
- **It can provide only reasonable but not absolute assurance that assets and resources are safeguarded.**

## ***Why are Internal Controls Important?***

Internal controls can help a local government achieve its objectives. They are checks and balances to support the mission and to help prevent fraud, waste, and abuse. Although, as we mentioned above, internal controls can provide only reasonable but not absolute assurance that assets and resources are safeguarded, they are the first line of defense to prevent and detect fraud. All local governments need internal controls to:

- Ensure mission accomplishment
- Reduce fraud opportunities
- Prevent loss of funds or other resources
- Establish standards of performance
- Assure compliance with laws, regulations, policies, and procedures
- Preserve integrity
- Eliminate adverse publicity
- Assure public confidence

***Consequences of weak internal controls can be the waste or misuse of the local government's assets, inaccurate or incomplete information, and embezzlement and theft.***

## ***Who is Responsible for Internal Controls?***

Before we discuss the key components of internal control, let's talk about who's responsible for internal controls within a local government. Generally, ***everyone is responsible!***

- The Governing Board provides important oversight while the Chief Executive Officer provides leadership and direction to the governance team (management/leadership team).

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- The Governing Board and the Chief Executive Officer are responsible for establishing the presence of integrity, ethics, competence, and a positive control environment.
- The Governing Board is also responsible for establishing major operating policies that form the foundation of the internal control system.
- The Chief Executive Officer is responsible for establishing government-wide regulations/procedures to ensure implementation of the major operating policies.
- The governance team provides direction and oversight to senior administrators in major functional areas such as general operations, departments, auxiliary operations, and support services.
- The Chief Fiscal Officers, Managers, Administrators, directors, and departments execute the major government-wide control policies and procedures. They may also design and implement control systems at detailed levels within their specific units.
- Managers and other supervisory personnel are responsible for executing control policies and procedures at detailed levels within their specific units.
- Each individual within a local government or unit is responsible for being cognizant of proper internal control procedures associated with their specific job responsibilities.
- Claims auditors are responsible for auditing claims and internal auditors are responsible for examining the adequacy & effectiveness of the local government's internal controls, and making recommendations where control improvements are needed. ***Internal auditors contribute to the effectiveness of the controls, but they are not responsible for establishing or maintaining them.***

As you can see, every administrator, manager and staff member is responsible for assuring that established internal controls are followed and applied.

## ***Key Components of Internal Control***

The five components of internal control identified by the COSO report are:

1. The Control Environment
2. Risk Assessment
3. Control Activities
4. Information and Communication
5. Monitoring

We will now discuss each of these components and how they can be used in improving an internal control system.

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## **Control Environment**

This is also referred to as the “*tone at the top*.” It is the foundation for all other components of internal control, providing discipline and structure. Factors include the **integrity and ethical values** and competence of the unit’s people, management’s philosophy and operating style, the way management assigns authority and responsibility, organizes and develops its people and the attention and direction provided by the governing board.

**Integrity and Ethical Values-** Integrity and ethical behavior are essential elements of the control environment. As the Treadway Commission<sup>1</sup> reported, “A strong ethical climate at all levels is vital to the well being of the entity, all of its constituencies and the public at large.” The key element in a favorable control environment is management’s attitude, as demonstrated through its actions and example.

An example of unethical behavior by board members gives the green light to all employees of the unit to follow their example. A couple of years ago a state commissioner was accused of taking his state vehicle to Florida for vacation. What kind of example do you think that gave to the employees of his department?

On a more familiar level, what would employees of your municipality think if the board members’ travel or conference expenses bypassed the usual audit function of your municipality? What kind of example would that give to the poor employee whose expense accounts were gone over with a fine toothcomb?

**Commitment to Competence and Human Resource Policies and Practices-** A favorable control environment also requires competent and honest staff. The following personnel policies and practices can play an important role in meeting this need:

- ◆ Establish and maintain up-to-date job descriptions for all employees. These descriptions should detail the responsibilities of each position as well as the qualifications needed to fill the position. It is important that job descriptions be kept up to date to reflect changes in responsibilities.
- ◆ Follow appropriate hiring policies. It is essential that job qualifications and references be thoroughly checked before hiring new employees. In addition a government may wish (or be required by law) to require bonding for employees in sensitive positions. Moreover, the process of hiring should be open, thorough and well documented to ensure that conscious and unconscious biases are avoided.
- ◆ Assign authority and responsibility in an appropriate manner. Employees should possess all the authority and only the authority needed to fulfill their assigned responsibilities as outlined in their job description.

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<sup>1</sup> The Treadway Commission was created in 1985 to identify the causal factors of fraudulent financial reporting and to make recommendations to reduce its incidence.

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- ◆ Ensure that employees are properly trained. A combination of formal and on-the-job training is essential to ensure that employees are properly prepared to perform their duties. Moreover, training should be offered on an ongoing basis to reinforce existing skills and to help employees adjust to changes in their job responsibilities and work environment.
- ◆ Periodically review and document performance. It is not enough to hire honest and qualified individuals; management must also periodically review their performance and document that review. When corrective action is needed that action should be taken promptly and should be thoroughly documented. It is especially important that management pay particular attention to the performance of employees during their initial probation period of employment. Also, top management should periodically review the performance evaluations to ensure that managers at all levels are giving frank and objective evaluations of performance.

If a unit's control environment is lacking, it is a good indication that severe problems exist in some of its internal control processes. This does not say that severe problems exist in all its internal control processes. The same holds true for all of the other COSO principals. It is merely an indication not an absolute, because there is always the possibility that some other control principle or authority has established the proper procedures or processes.

**Participation of Governing Boards or Audit Committee-** An entity's control consciousness is influenced significantly by the governing board and audit committee, if any. Attributes include the board or committee's independence from management, the experience and stature of its members, the extent of its involvement and scrutiny of activities, the appropriateness of its actions, the degree to which difficult questions are raised and pursued with management, and its interaction with internal and external auditors.

**Managements Philosophy and Governing Style-** This covers a wide range of characteristics. It may include their approach to risk taking and monitoring risk and their attitude and actions toward information processing, financial and operational reporting, and personnel.

**Organization Structure-** This is in reference to the departments and offices of the municipality. Are they effective and conducive to controls and accountability?

**Assigning Authority and Responsibility-** What is the method of assigning authority and responsibility? Does this method provide for the proper delegation of authority and responsibility?

**Role of the Governing Board-** The elected board is responsible for establishing policies and procedures that help ensure that the assets of the unit are protected.

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## Risk Assessment

Risk assessment is one of the components and addresses the *local government's* (not the auditor's) assessment of control risk. Risk Assessment is the local government's identification and analysis of relevant risks to achieving its objectives, forming a basis for determining how the risks should be managed. This process identifies risk and analyzes its likelihood of occurrence and its impact. This process will allow management to determine how much risk they are willing to accept and to set priorities accordingly. Management may initiate plans, programs, or actions to address specific risks, or it may decide to accept a risk because of cost (cost/benefit analysis) or other considerations. The risk assessment is an ongoing process. Risks can arise or change due to circumstances such as the following:

- ◆ Changes in the operating environment; governments do not operate in a vacuum. Thus, changes in a government's circumstances can produce unanticipated risks. For example, intense media scrutiny or political debate surrounding a particular program could place extra pressure on staff to cut corners in order to achieve results. In the same way a change in regulations can have a serious effect on the way an activity is conducted. An example would be the disposal of municipal solid waste.
- ◆ New personnel - even the best systems and equipment are no better than the people who operate them. As a result, changes in personnel always carry with them a certain element of risk. New employees are likely to need some time before they become proficient in their new position. Likewise there may be an interval of time between the departure of an employee and the hiring of a replacement during which time the duties of the departing employee may be performed on a temporary basis by one or more individuals. The risks accompanying personnel changes especially increase when changes are numerous, involve high-level staff, or employees in highly sensitive positions.
- ◆ New or revamped information systems or technology- the revolution in data processing has profoundly affected how most state and local governments operate on a day-to-day basis. Moreover the computer revolution is an ongoing one requiring governments periodically to alter or replace their information systems to take advantage of technological advances. Such changes often entail considerable disruption and attendant risk.
- ◆ Rapid growth can place acute pressure on internal controls as staff attempt to respond to a rapid increase in the demand for services. In particular staff may attempt to cut corners in an attempt to avoid complaints and speed up services.
- ◆ Staff reductions - when staff is reduced, separation of duties and the normal checks and balances of a system can be drastically altered.
- ◆ New programs, activities, or services- staff may be unfamiliar with the program requirements and in some instances programs are begun before a well thought out internal control process has been formulated.

If the governing board alone is involved in assessing and monitoring risk, there is a good possibility that many of the specific risks facing individual programs and activities will be missed. Conversely, if a government's risk assessment and monitoring is performed by lower level managers, it is quite possible that more generalized risks may be completely overlooked.

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Accordingly, effective risk assessment and monitoring must include and involve managers at all levels.

Changes in a government's circumstances can render internal controls inadequate. Likewise, there is a tendency for internal controls to deteriorate over time unless they are properly maintained. Therefore, it is important for management to monitor on an ongoing basis the continued functioning of internal controls.

The basic concepts of the risk assessment process should be present in every entity, regardless of size, but the risk assessment process is likely to be less formal and less structured in small and mid-sized entities than in larger ones.

In a risk assessment process, the first step is to group naturally interrelated activities into "control cycles." After that, management should prioritize the examination of controls by department, activity, or control cycles based upon the perceived degree of "vulnerability" by considering the risk's impact, and likelihood of occurrence. Once priorities have been established, management should initiate the process of testing controls by documenting how transactions and events are selected for evaluation. This documentation, which may take the form of a narrative, memorandum or a flow chart, should clearly show who is responsible for doing what. Management's next step is to identify potential risks. Management then identifies all of the related control policies and procedures designed to compensate for those potential risks. The design of each compensating control should be evaluated to determine whether the control would be effective if it is operating as designed, followed by testing to see if the control has actually been implemented and is operational. If management discovers that controls are not working properly, they should be amended, or steps should be taken to improve compliance. Throughout this process, management needs to consider that the costs of the controls do not exceed their benefit.

## **Control Activities**

Control Activities are the policies established by the board and procedures developed by the board, department heads, or others in order to be in conformance with these policies. Policies are usually adopted in order to control the various risks identified in the unit's risk assessment and in some cases, in order to be in conformance with various laws, rules and regulations. *Some of these policies that I'm sure you are all familiar with are the Procurement Policy, the Investment Policy and the infamous Standard Workday Policy for retirement reporting purposes.*

Once policies are adopted, the concerned departments or functions must develop procedures in order to ensure that the policies are followed. These procedures must ensure that proper separation of duties is observed. The procedure must also ensure that proper reporting and reconciliations are adopted, proper authorizations are received, proper security of assets and records is maintained, periodic verifications are performed, and analytical reviews are performed.



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## **Information and Communication**

The information and communication component relates to the financial reporting process and, in particular, the accounting system and underlying transactions. It consists of methods and records established to identify, capture, and exchange information in a form and time frame that enables people to carry out their responsibilities effectively, and to maintain accountability for the related assets and liabilities. The information system should produce reports containing operational, financial and compliance-related information that make it possible to run and control the unit. Management should review the reports and use them in their decision-making process. There is nothing worse than when you had the necessary information in order to make the correct decision and did not utilize it.

## **Monitoring**

Once the governing board, in conjunction with management, has assessed the risk potential of the various processes within the municipality, a schedule of review should be planned and outlined. This monitoring also applies to the various policies passed by the board. All major policies should not be passed and then forgotten. Time has a way of changing the circumstances and conditions from when the policy was first passed. On at least a yearly basis all policies should be reviewed and a determination made as to whether they should be amended.

## ***Internal Control Examples***

### **General Controls**

Here are some general controls that are important:

- Timely records and reports
- Written policies & procedures
- Physical safeguards of assets (e.g. fire proof safe for cash & minutes book)
- Locking your desk and office when not there
- Keeping computer passwords secret
- Verifying the accuracy of another staff's work

There are many more controls but these give you the general idea.

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## Controls for Cash Receipts

There is no absolute control system for any transaction cycle including cash receipts, but there are certain control procedures that are usually effective. For cash receipts they include:

- **Central Cash Receipts Function** - Generally, the more central the cash receipts function is, the better it can be from an internal control standpoint. It allows management to properly segregate duties and provide good physical controls.
- **Individual Accountability** – Each individual collecting cash should be individually responsible for their accountability (i.e., have their own cash drawer and accountability records). This ensures that, if there is a problem, the problem can be pinpointed.
- **Point of Sale Control** - This means that the individual making the payment provides the control (e.g., a cash register that has a visible amount rung up, a sign that says that you should be sure to ask for a receipt).
- **Control of Forms** - These could be press-numbered duplicate receipt forms, permit forms, etc., that are controlled and reconciled by someone other than the person collecting cash.
- **Timely Recording and Deposit** - Ideally, cash should be recorded by some method at the same time it is received. This recording could be in a cash receipts book, on duplicate receipts or by other methods. Deposits should be made daily or more often if necessary. This control helps to prevent major loss by theft.
- **Segregation of Duties** - The same person receiving cash should not be responsible for recording receipts in detail customer accounts, enforcing of unpaid accounts or reconciling control or bank accounts.
- **Periodic Reconciliations** - This is the reconciliation of cash per books to cash in banks at least once a month by someone independent of the cash collection or enforcement functions.

## Controls for Cash Disbursements

The key word here is "Independent." The following tend to be effective internal controls for cash disbursements:

- **Independent Central Receiving Function** - Goods are received and receiving slips are verified and signed before the goods go to the department that ordered them. This process helps to make sure that goods are actually received prior to payment for them.
- **Independent Central Accounting Function** – All the accounting functions are handled through one central office, usually the business office.
- **Independent Central Pre-Audit Function**- The review of claims for completeness, authorization, itemization, legality, etc., prior to payment is a pre-audit function. This should be defined and well-documented in order to be most effective. This is usually the responsibility of the internal auditor if there is one.
- **Independent Check Signing and Mailing** - The signing of authorized checks and mailing them directly to the vendors. It also includes the control of blank checks and the control of signature plates to protect against unauthorized use.

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- **Segregation of Duties** - Ideally, none of the above functions or reconciliations should be performed by the same individual.
- **Reconciliations** - The reconciliation of cash in bank to book balances at least monthly by someone not involved in the check signing function. This is probably the best method of detecting irregularities in the cash disbursements function.
- **Reports to Departments**- Periodic (monthly) reports are distributed to departments showing a comparison of expenditures to budget with detail reports available on request.

### ***Top Ten Fraud Risk Indicators***

Just to reemphasize how important internal controls are, the Ohio State Auditor reported the following top ten risk indicators in school districts in Ohio:

- Key documents missing
- No separation of duties
- Accounting system in disarray
- Lack of policies that establish controls
- Inadequate monitoring to ensure the controls were working as intended
- Ineffective accounting, information technology or internal audit staff
- Documentation that is photocopied or lacking necessary information
- Unusual employee behavior
- Tips or complaints about fraud
- Lack of established code of ethics

### ***Internal Control Checklist***

In order to minimize the risk of fraud or abuse in your school district, the following checklist will assist you:

- Adhere to policies and procedures. Especially, documentation and authorization
- Ensure physical security over assets
- Provide appropriate training to employees
- Independently review and monitor tasks
- Provide for segregation of duties. If not possible, then provide additional controls
- Establish clear lines of authority
- Rotate duties in positions susceptible to fraud (if possible). You need to make sure certain jobs are possible to rotate (same level or job titles)
- Ensure that employees take regular vacations
- Schedule regular independent audits of areas susceptible to fraud
- Ensure background checks for employees handling financial information
- Make sure internal controls are being followed
- Review staff's work, documentation, policies and procedures continually

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- Ask for documentation
- Ensure that one person does not have total responsibility for a process
- Evaluate performance regularly
- Report suspicious activity

### *Conclusions*

As a result of increasing pressure on local governments, well-planned and documented internal control procedures are being recognized as becoming increasingly important in controlling local government financial operations. Local government managers must recognize this increasing importance and implement an improved control environment and additional or improved control procedures where a well thought out cost/benefit analysis indicates they would be cost effective. While the final decision on improved control procedures rests with the management of the local government, management should keep in mind that there is always more than one way, and almost always a cost effective way, to improve control procedures. Lastly, *documentation of existing control environment, accounting system, and control procedures generally has the effect of improving controls and making them more effective.*