

The Internal Control Process

Rebecca Badgett
Teaching Assistant Professor
UNC School of Government
rbadgett@sog.unc.edu

Greg Allison
Teaching Professor
UNC School of Government
Allison@sog.unc.edu

Your School of Government Facilitators



Greg Allison

*Teaching Assistant Professor of
Public Law and Government*

cuccaro@sog.unc.edu

- Governmental Accounting
- Cash management & investments
- Municipal and County Administration Program



Rebecca Badgett

*Teaching Assistant Professor of
Public Law and Government*

rbadgett@sog.unc.edu

- Local government finance
- Internal control
- Grants management



Learning Objectives

Our goal is that when you leave this course, you will be able to:

- ***Understand*** the internal control process
- ***Assess*** gaps in your organization's internal control system
- ***Implement*** controls via policy & procedures

What is Internal Control?

Internal control is a process effected by the governing board and management that provides reasonable assurance that the objectives of an entity will be achieved.



A business practice, policy, or procedure that, when effectively implemented, adds value and minimizes risk.

Why are internal controls necessary?

- Communication
- Consistency & standardization
- Accurate financial records
- Compliance with governing law
- Risk mitigation



Internal controls exist at all levels of the organization & for each transactional process & activity



Governing Board Meetings



Budget and Accounting



Departmental Operations



Accounts Receivable



Grants Management



Accounts Payable



HR Operations



Payroll

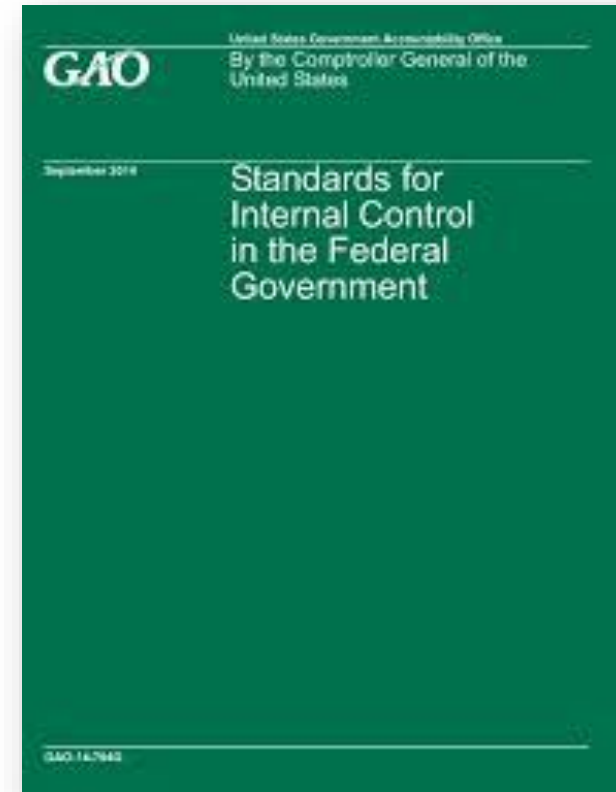
Are Internal Controls Required by Law?

“The Local Government Commission has the authority to issue rules and regulations having the force of law governing procedures for the receipt, deposit, investment, transfer, and disbursement of money...and may inquire into and investigate the internal control procedures of a local government...and may require any modifications in internal control procedures...” G.S. 159-25(c)

Two Frameworks of Internal Control



COSO Internal Control-Integrated Framework



GAO Standards for Internal Control in the Federal Government "Green Book"

Implementing a System of Internal Control



5 Components & 17 Principles

Control Environment

1. Demonstrate Commitment to Integrity and Ethical Values
2. Exercise Oversight Responsibility
3. Establish Structure, Responsibility, and Authority
4. Demonstrate Commitment to Competence
5. Enforce Accountability

Risk Assessment

6. Define Objectives and Risk Tolerances
7. Identify, Analyze, and Respond to Risk
8. Assess Fraud Risk
9. Analyze and Respond to Change

Control Activities

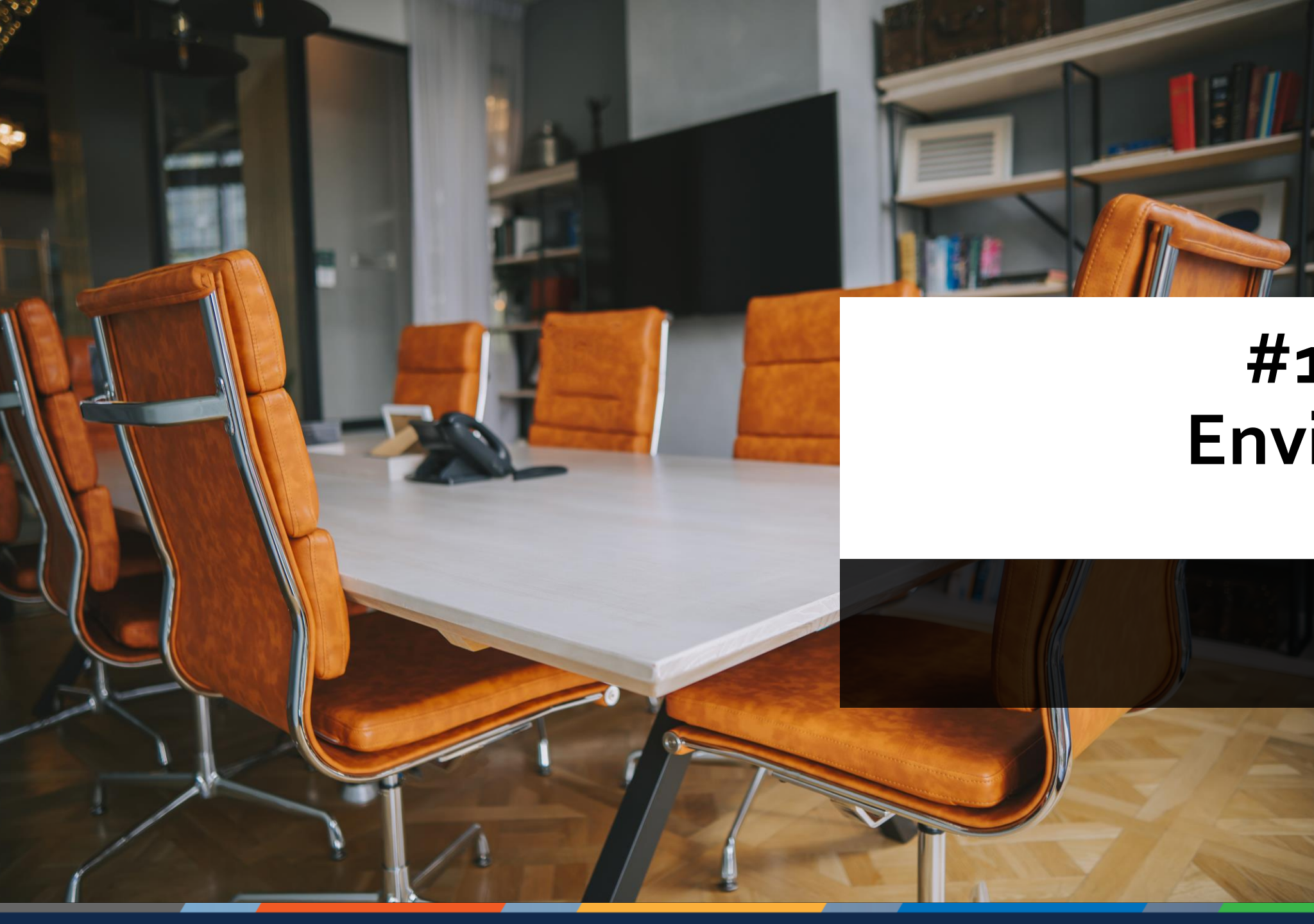
10. Design Control Activities
11. Design Activities for the Information System
12. Implement Control Activities

Information & Communication

13. Use Quality Information
14. Communicate Internally
15. Communicate Externally

Monitoring

16. Perform Monitoring Activities
17. Remediate Deficiencies



#1: Control Environment

“Tone at the Top”



Control Environment

- **Oversight body** is by default the governing board
- **Management** includes upper-level management
 - Finance officer
 - Manager
 - Department heads
 - Attorney
 - Mayor
 - Administrator



Who is Responsible for Internal Control?

“Tone at the Top”

The governing board and management must...

Governing board and management demonstrate a commitment to integrity and ethical values

Governing board exercises oversight responsibility for the internal control system

Management establishes structure, responsibility, and authority for the internal control process

Management demonstrates a commitment to competence to hiring and retaining talent

Management enforces accountability for individuals performing their internal control responsibilities



Management Responsibilities

- Develop internal control processes
- Establish reporting lines
- Recruit competent employees and provide training
- Make succession and contingency plans
- Hold personnel accountable for performance and conduct
- Ensure internal control responsibilities are performed
- Use performance appraisals and disciplinary actions

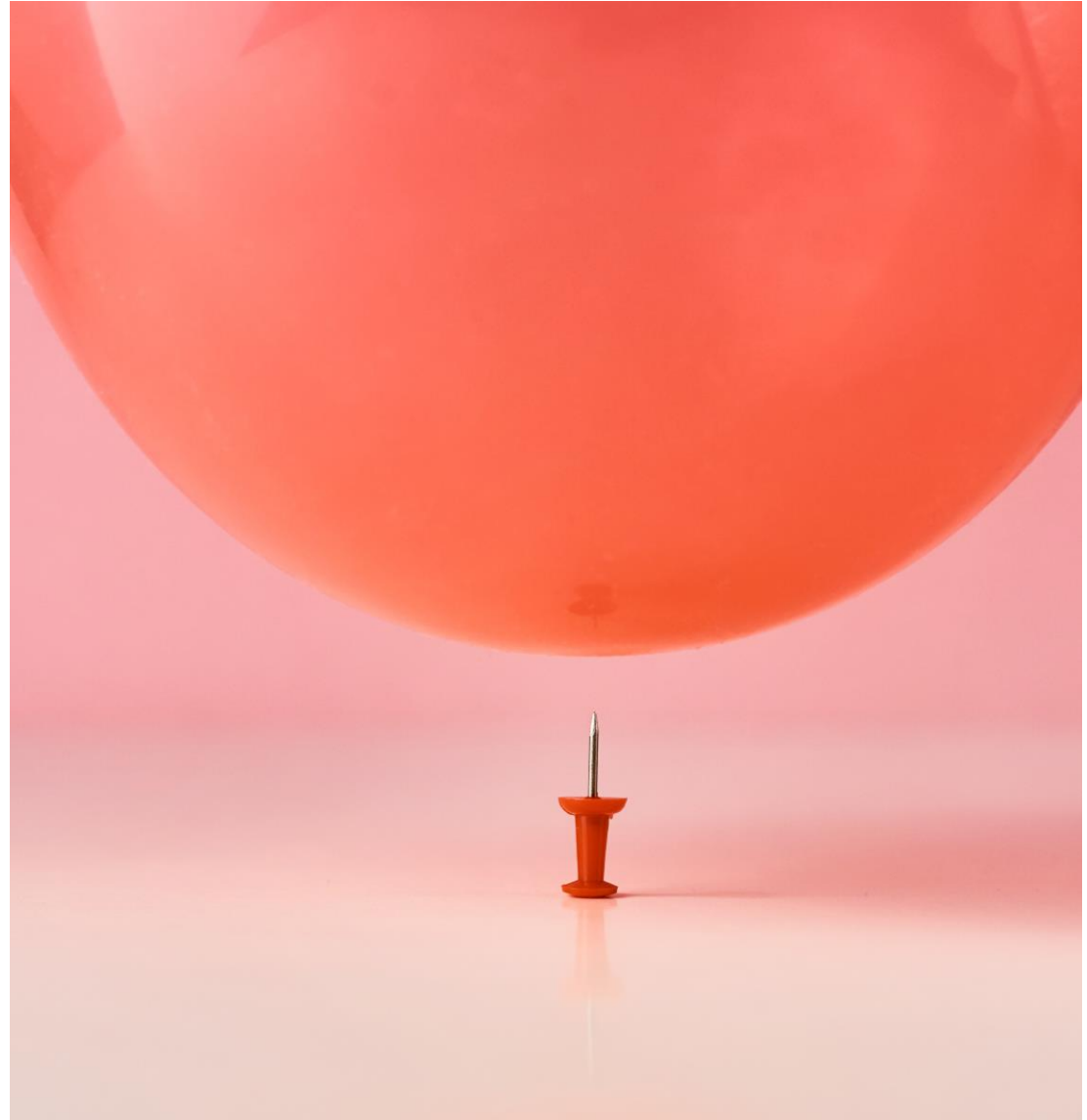
Signs of a Weak Control Environment

- Ethical standards not properly established or communicated
- Limited interaction between the governing board and senior staff
- Lack of updated policies and procedures (or no enforcement)
- Untrained staff
- Unresolved audit findings
- The importance of internal control is not communicated



#2: Risk Assessment

The possibility that an event will occur and adversely affect the achievement of objectives.



Risk Assessment

RISK = internal & external events that threaten the accomplishment of objectives

Identify
Objectives

- Efficient operations
- Reliable reporting
- Legal compliance

Identify
risks

Assess the
severity of
harm if the
risk occurs

Determine
response

Document

Identify objectives and risks for each department, financial process, and major program

RISK ASSESSMENT QUESTIONNAIRE ORGANIZATION – WIDE				
Question	Yes	No	N/A	Comments
General				
General				
What are our primary objectives?				
What events or conditions can prevent us from achieving these objectives?				
Which of our assets are <i>most liquid or desirable</i> and, therefore, in most need of protection?				
Are there certain personnel who pose a fraud risk?				
What are our most complex activities or programs?				
What potential legal liabilities can result from our operations?				
Do we have sufficient insurance? Are employees sufficiently bonded?				
Where do we spend most of our money?				
What changes do we see on the horizon?				
Cash Collection and Billed Receivables				
Where is cash collected?				
Are employees responsible for collecting cash and preparing bank deposits different from those who record cash transactions in the accounting records?				
Can unauthorized employees access cash prior to deposit?				
Are receipts recorded in the accounting system in a timely manner?				
Disbursements				
Is there a clearly defined approval process for all disbursements?				
Are all disbursements properly documented?				
Is the responsibility for acknowledging the receipt of goods or services segregated from those preparing claims and making payments?				
Is a review completed by an individual outside the department responsible for the claim amount?				

Assess Identified Risks

- **Likelihood.** Rate the possibility that the risk may occur.
- **Impact.** Rate the severity of the risk should it occur.

$$\text{Likelihood} \times \text{Impact} = \text{Risk Priority}$$

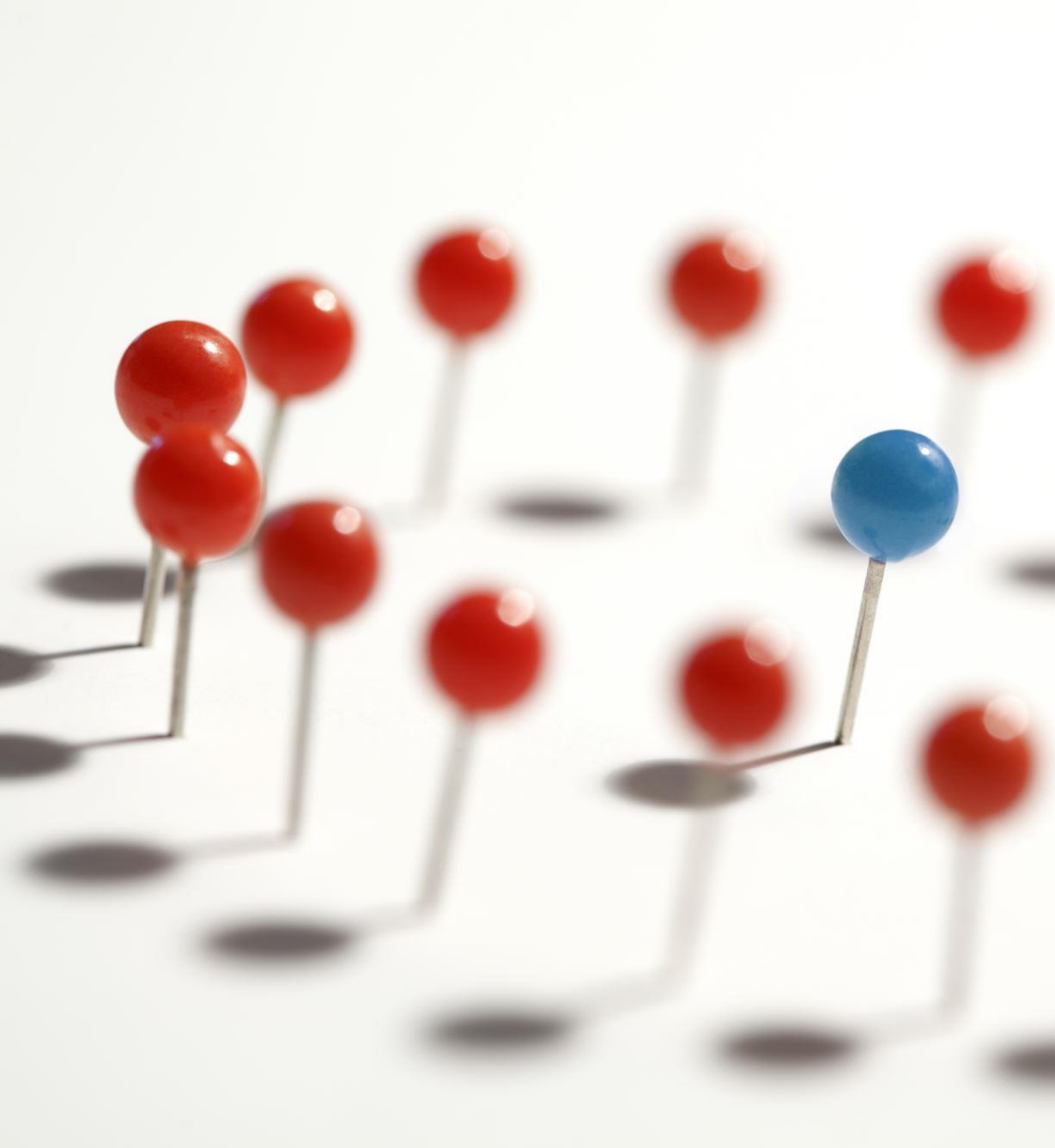
After rating each risk for likelihood & impact, multiply to identify which risks are highest priority to control for.

		Risk Priority				
		1	2	3	4	5
Likelihood	5	5	10	15	20	25
	4	4	8	12	16	20
	3	3	6	9	12	15
	2	2	4	6	8	10
	1	1	2	3	4	5
		1	2	3	4	5

Priority Rank Scale	
Low	1 to 4
Moderate	5 to 9
High	10 to 19
Very High	20+

Prioritize Risks

	Risk Description	Likelihood Rating	Impact Rating	Priority Rating	Priority Description	Control? <input checked="" type="checkbox"/>
7						
8	Entry of accounts payable data is duplicative or inaccurate.	3	4	12	High	
9	Only the business manager knows how to conduct payroll and is authorized to review and approve payments.	5	4	20	Very High	
10	Personnel spend too much time on personal internet use resulting in lost productivity.	3	1	3	Low	
11	Unauthorized individuals may gain access to facilities.	3	3	9	Moderate	
12				0	Low	
13				0	Low	



#3: Control Activities

The policies, procedures, and techniques implemented to help prevent identified risks from occurring or detecting them if they do.

Control Activities

Types of controls:

- Preventative
- Detective

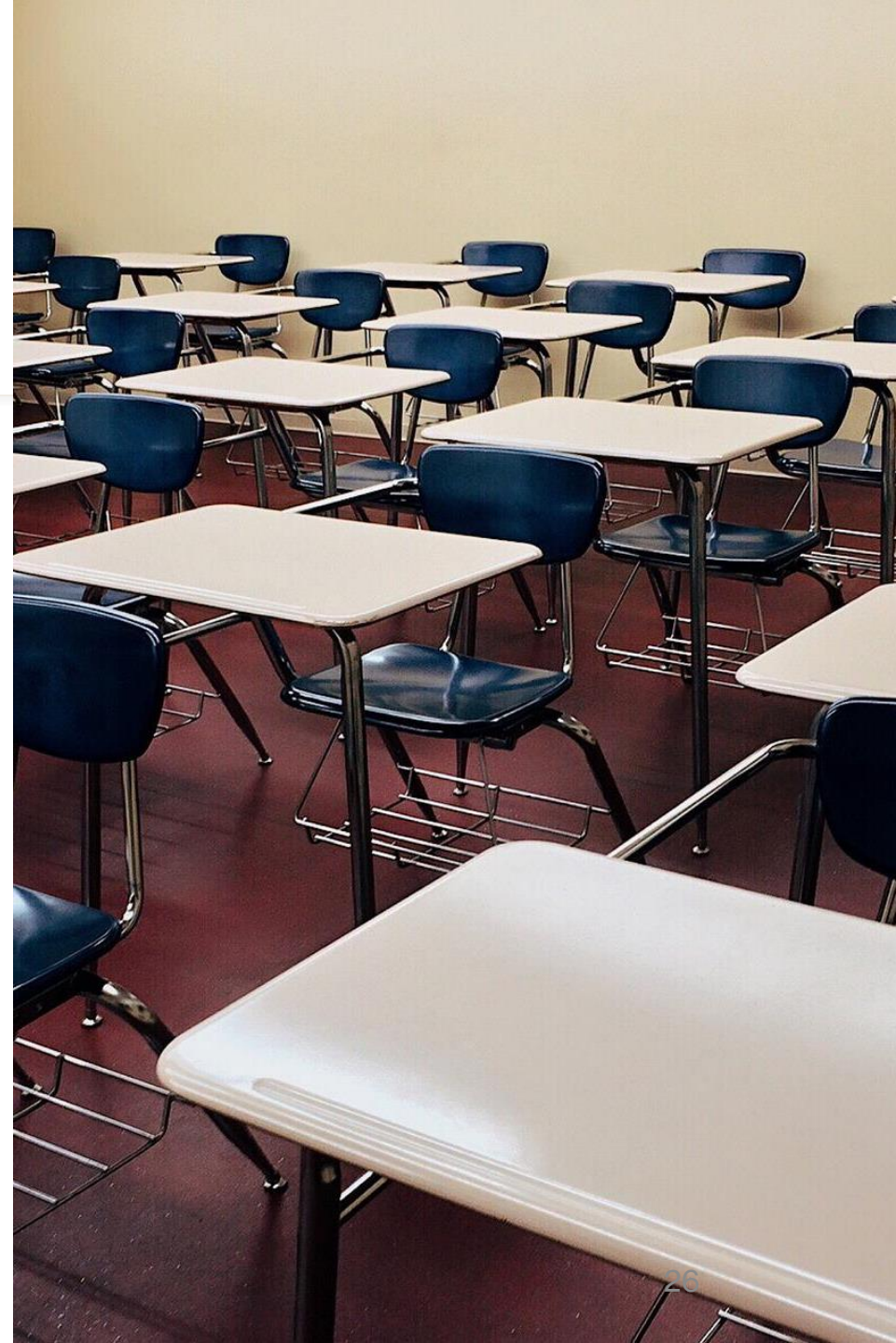


Control Activity “Toolkit”

- Segregation of Duties
- Policies and Procedures
- Authorizations/Approvals
- Documentation
- Physical Controls
- IT Controls
- Staff Training
- Reconciliation

Policies & Procedures: What's the Difference?

- Policies: broad guidelines for the entire lifecycle of activities
- Procedures: practical, step-by-step processes that employees must follow to execute the principles outlined in procurement policies



Does your unit have strong, updated policies and procedures?

- Accounting and financial reporting
- Fund balance
- Cash management
- Preaudit and disbursement
- Accounts receivable
- Accounts payable
- HR/Payroll
- Code of Conduct
- Capital
- Procurement
- Investments

Establish policies and procedures for financial operations and significant transaction cycles

SOG Finance Resources

[NCFinanceConnect.com](https://www.ncfinanceconnect.com)

The screenshot shows the homepage of the NC Finance Connect website. At the top left is the 'Finance Connect' logo. At the top right is the 'UNC SCHOOL OF GOVERNMENT Public Service' logo. Below the logos is a navigation menu with links for 'ABOUT', 'TOPICS', 'JOB BOARD', 'LISTSERV', 'OFFICE HOURS', 'COURSES & CONFERENCES', and 'OTHER RESOURCES'. A search bar is located on the right side of the navigation menu. The main content area features a purple header with the text 'Welcome to NC Finance Connect' and a white line-art illustration of a city skyline. Below this is a white section titled 'TOPICS' with a decorative graphic of yellow dots. Underneath are four topic cards, each with a purple circular icon and a title: 'Intro to the Local Government Budget & Fiscal Control Act' (with a classical building icon), 'Budgeting' (with a calculator icon), 'Statutory and Other Internal Controls' (with a flowchart icon), and 'American Rescue Plan Act (ARP) Grants' (with a folder icon).

Finance Connect





UNC SCHOOL OF GOVERNMENT
Public Service

ABOUT TOPICS JOB BOARD LISTSERV OFFICE HOURS COURSES & CONFERENCES OTHER RESOURCES

Search

Welcome to
NC Finance Connect

TOPICS

- 
Intro to the Local Government Budget & Fiscal Control Act
- 
Budgeting
- 
Statutory and Other Internal Controls
- 
American Rescue Plan Act (ARP) Grants

2. Segregate Incompatible Duties

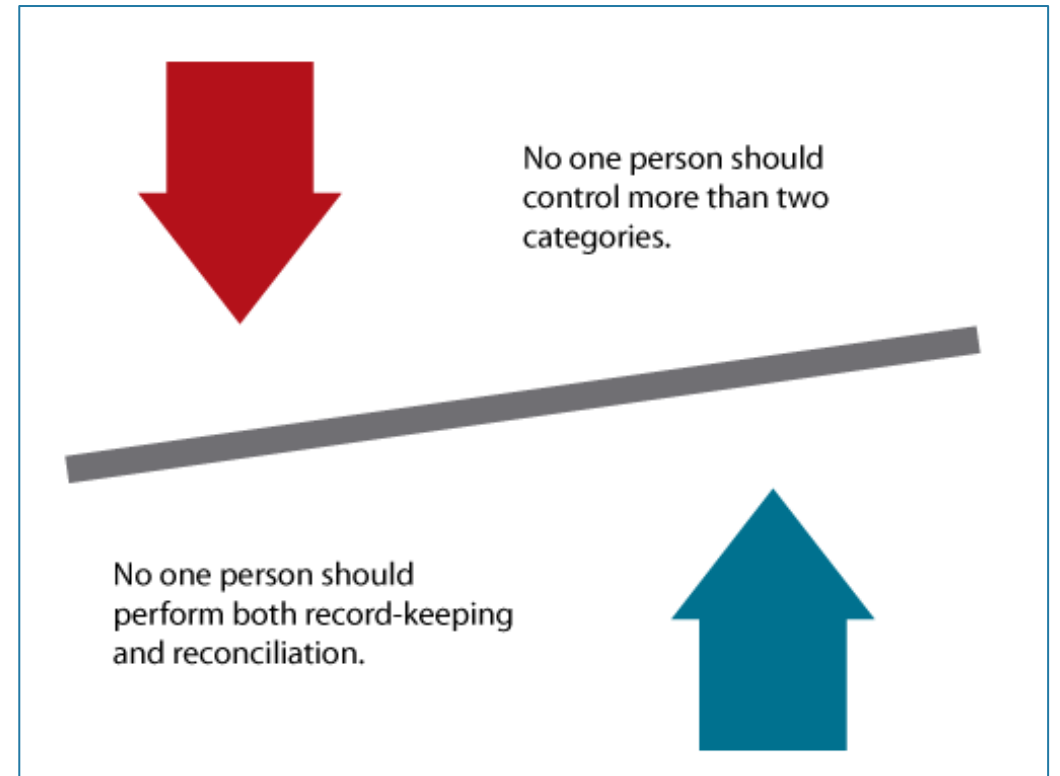
Separate responsibilities to ensure that no single person has control of a transactional process

Authorization

Custody

Record-Keeping

Approval/Reconciliation



	Authorization	Custody	Record-keeping	Reconciliation
Signing of checks	Joe			
Mailing of checks		Lisa		
Approval of debit memos	Joe			
Approval of access to master vendor files	Joe			
Sub-ledger and account reconciliation				Lynn
Approval of Journal entries	Joe			
Recording of Journal Entries			Lynn	
Posting of Debit Memos			Lynn	

Which of Lynn's duties are incompatible?

Compensating Controls for Small Units

- Board member spot-checks transactions and reviews supporting documents
- Board member to review account reconciliations
- Rotate duties!



NORTH CAROLINA
DEPARTMENT OF STATE TREASURER
STATE AND LOCAL GOVERNMENT FINANCE DIVISION
AND THE LOCAL GOVERNMENT COMMISSION

JANET COWELL
TREASURER

GREGORY C. GASKINS
DEPUTY TREASURER

Memorandum #2015-15 (Revision of Memo #568 and #569)

TO: Finance Officers of Small North Carolina Governments and Public Authorities

FROM: Sharon Edmundson, Director, Fiscal Management Section

SUBJECT: Internal Controls for a Small Unit of Government

DATE: April 30, 2015

Included in this memo is information that will help smaller units strengthen their internal controls. Elected officials and governmental employees are accountable for resources entrusted to them and for ensuring that programs and services are administered effectively and efficiently. A significant component in fulfilling this responsibility is ensuring that an adequate system of internal control exists within each governmental unit. Whether a unit of government has strong or weak internal controls directly affects the reliability of the accounting records and financial statements. Strong internal controls aid in the prevention of fraud and the detection of accidental errors in the accounting process. Internal controls provide greater assurance of the accuracy of financial reporting, compliance with laws and regulations, and effective and efficient operations.

One method that a unit can use to enhance its internal control is through proper segregation of duties. The fundamental premise of segregation of duties is that an individual or small group of individuals should not be in a position to initiate, approve, undertake, and review the same action. Without proper segregation of duties, it is impossible to have an effective system of internal control. There are two main advantages to implementing segregation of duties: the first is that fraud is more difficult to perpetrate when proper segregation of duties are in place because it would require collusion of two or more individuals; second, if duties are adequately separated, innocent errors are more likely to be found and corrected.

Extensive separation of duties is not always possible for smaller units of local government. In such cases, the duties should be separated as much as possible and alternative controls used to compensate for lack of separation. Members of the governing board must be called upon to provide some of these controls; they are generally very familiar with operations and 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 transactions are valid.

This memo is addressed specifically to the smaller units where internal controls may not be as

Which of the following is an example of a compensating control?

- a. The employee's supervisor approved a time sheet of hours worked.
- b. The clerk prepares a check and the manager and finance officer sign it.
- c. A board member reconciles bank statements with the general ledger each month.

C



Authorization & Management Review



Authorization is the process of granting formal approval to perform a specific function. Management determines which activities require approval.

- Approval of access to accounting systems
- Approval of purchases



Documentation & Record Retention

- Establish documentation and record-keeping system to ensure that accounting records and supporting documentation is retained for the time required by law.
- Use standard forms, templates, and contracts

Physical & IT Controls

- Restrict access to cash, inventory, and buildings
- Install necessary firewalls
- Terminate system access after an employee leaves
- Require passwords to be changed periodically





#4: Information and Communication

All staff must understand their internal control responsibilities

Information & Communication

For internal controls to be effective, information must flow up, down, and across the organization

Communication explains:

Policies and procedures

Specific goals and objectives

Importance of Internal Controls

Expectations for behaviors

Channels of communication

Communication must be:

Appropriate

Accurate

Timely

Accessible



#5: Monitoring

The review of a unit's internal control activities

#5 Monitoring

- The agency selects, develops, and performs ongoing evaluations to ascertain whether internal controls are present and functioning.
- Employees communicate internal control deficiencies promptly to parties responsible for taking corrective action



Implementing a System of Internal Control





Exercise #3

Which internal control component is most important?

- Control Environment
- Risk Assessment
- Control Activities
- Information and communication
- Monitoring