

DEPARTMENT OF STATE TREASURER POLICIES MANUAL
INTERNAL CONTROLS POLICY
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Synopsis

- 1) Internal control means a process, effected by an entity's governing board, management, and other personnel, designed to provide reasonable assurance regarding the achievement of objectives in the following categories: a) reliability of financial reporting, b) effectiveness and efficiency of operations, and c) compliance with applicable laws and regulations. Internal controls should be in force in all units of government.
- 2) Internal control consists of five interrelated components, which are: 1) Control environment; 2) Risk assessment; 3) Control activities; 4) Information and communication; and 5) Monitoring.
- 3) OMB Circular A-133, "Audits of States, Local Governments, and Non-Profit Organizations", defines internal control pertaining to the compliance requirements for federal programs as a process designed to provide assurance that transactions are properly recorded and accounted for, transactions are executed in compliance with laws and regulations, and assets are safeguarded against loss and unauthorized use.
- 4) 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.
- 5) Internal control in small units of government presents a problem in that there are not enough financial management staff members to adequately segregate duties. Compensating measures, usually involving the board, must be taken to keep the system of internal controls functioning properly.
- 6) Internal control, no matter how well designed, has its limitations. These include human judgement in decision making, collusion, and costs. In most cases the cost of an entity's internal control should not exceed the expected benefits. However, adequate controls are necessary, regardless of cost, to ensure compliance with applicable laws and regulations.
- 7) There are specific procedures that must be followed to maintain adequate internal control over certain areas of operation within a unit of local government. Most of these revolve around adequate segregation of duties among the staff while performing day-to-day tasks.

Introduction

A system of internal control consists of many specific policies and procedures, which are often called controls. Internal control is defined as a process - effected 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 78 para. 6). 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. The following discussion defines three objectives of management in the development of a system of internal control for all governments and public authorities.

Control Objectives

The three categories of control objectives described previously 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.** Management of the local government or public authority is responsible for preparing financial statements. Management has both a legal and professional responsibility to be sure that the information is fairly prepared in accordance with generally accepted accounting principles (GAAP). Information concerning the operations and financial condition of the unit must be accurate in order to be useful.
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.

The physical assets of an entity can be stolen, misused, or accidentally destroyed unless they are protected by adequate controls. The same is true for other assets such as accounts receivables, records (e.g. general ledger, tax scrolls, journals etc.) and other important documents (e.g. grant agreements). Safeguarding information stored electronically has also become increasingly important. With the expansion of electronic commerce, citizens' expectations for "electronic government" will be raised. The subsequent increase in electronic transactions and "electronic access" will require increased security for electronic information resources.

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 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. 159), other general statutes, and grant agreements applicable to local units of government.

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 by the following:

- a. Integrity and Ethical Values. 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.
- b. Commitment to Competence. 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.
- 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 effect 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 board's complaints and/or recommendations to help locate problem areas or inefficient activity. This is especially true in small units of government because of the inherent problem created by the limited staff size.

- d. Management's Philosophy and Operating Style. Management's philosophy and operating style effects 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.

- e. Organizational Structure. 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).

- f. Assignment of Authority and Responsibility. In addition to the structural aspects already mentioned, a system of internal control establishes formal methods of communication (e.g. organizational and operating plans, employees' job descriptions, and related policies) concerning the assignment of authority and responsibility for operating activities, and on the establishment of reporting relationships and levels of authorization. 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.

Also included are policies and directives concerning appropriate operating procedures, knowledge and experience levels of key staff, and the means available to perform one's duties. These

policies and directives should encompass the entity's objectives in a format understandable to all staff. Each staff member should be made aware of how their performance effects those objectives, and how their performance will be measured.

- g. Human Resource Policies and Practices. The formal human resource policies and more importantly, how they are put into practice, reveal an entity's commitments, values, managerial philosophy, and other qualities which factor into the control environment. The manner in which human resource activities are carried out, from recruitment, to training, to remediation, to retirement, also effect 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.

2. Risk Assessment

Risk assessment with respect to the financial statements is management's identification and analysis of risks that effect 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 that can 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.

Some of the factors effecting risks are:

Internal Factors

- Staff turnover. Changes of key employees, either line or management, can result in changes in attitudes and knowledge of the entity's internal control.
- 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.
- 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.

External Factors

- Operating environment. Changes in economic, political, and regulatory conditions may put additional stresses on management which could compromise internal control procedures.
- Accounting statements. New or changing statements may require changes in financial reporting and thus effect any associated risks.

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. The following policies and procedures can be considered control activities:

- Performance reviews. This includes the analysis of operating results with respect to budgets, prior periods, and applicable benchmarks. Both fraudulent and unintentional misstatement 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.

- 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.
- 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.
- 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 \$10,000, and not more than \$250,000. The tax collector and 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 (with Local Government Commission approval), 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.

- 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 limited 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). These guidelines are discussed below:

- a. 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 with a programming or input function in an EDP environment would have access to the accounting records, he/she should not have access to assets because the same type of misuse and cover-up could occur.
- b. 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 distribute paychecks.
- c. Segregation of duties within the accounting function. One person should never be responsible for recording a transaction from its origin to its posting to the general ledger. Posting to the journals should be separated from posting to the related subsidiary ledgers.
- d. 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. Centralized accounting normally fulfills this requirement.
- e. 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.

- 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, and therefore may detect fraud being committed. As an extra benefit, employees become cross-trained in other job functions, which increases overall efficiency. 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.

For each class of transactions, the accounting system must identify the following objectives:

- 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.
- 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.

Adequate documentation is essential to a good system of internal control. Fraudulent activity may be deterred if substantial 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.

- a. Well-designed and properly used documents increase the effectiveness of internal control.
 1. Whenever possible, documents should be prenumbered consecutively to help account for missing documents. Prenumbered 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 prenumbered include: all receipts for payment of funds to the unit, purchase orders, bills or invoices, and checks.
 2. Transactions should be documented in a timely manner (e.g., at the point of transaction when possible).
 3. 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.
 4. Documents should be designed for multiple use 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.

- b. 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 general public and other financial statement users. The classifications should assist the unit's governing board in its decision-making. If the chart of accounts is complete and thorough, it also assists in detecting misclassification errors. For additional information, see the "Chart of Accounts" section of this manual.)
- c. 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. Open communication channels in a system of internal control facilitates the reporting of exceptions along with appropriate follow-up action.

Policy and procedures manuals, accounting and financial reporting guides, and memoranda are forms of communication. For smaller units of government, communications can be made orally and through active involvement of the governing board.

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.

Monitoring deals with ongoing periodic assessment of the quality of internal control performance by the unit of government to determine that controls are operating as intended and that they are modified as appropriate for

changes in conditions. The information for assessment and modification comes from a variety of sources including study of existing internal controls, internal auditor reports, exception reports and unit letters received from the Local Government Commission (LGC), feedback from personnel and complaints from citizens.

Monitoring is ongoing. It should be part of the normal routine in an entity's operations and include regular activities performed by management. 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 or personnel performing similar functions who assist, via independent assessments, with the monitoring of an entity's activities. These assessments report on the functioning of internal control, especially in the evaluation of its design and operation. They inform management of the strengths and weaknesses and make recommendations for improvements.

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.

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 Circular A-133, "Audits of States, Local Governments, and Non-Profit Organizations" (dated 6/24/97), defines internal control over federal programs as pertaining to the compliance requirements for federal programs (internal control over federal programs). It is a process - effected by an entity's management and other personnel - designed to provide reasonable assurance regarding the achievement of the following objectives for federal programs:

1. Transactions are properly recorded and accounted for to:

- a) Permit the preparation of reliable financial statements and federal reports;
 - b) Maintain accountability over assets; and
 - c) Demonstrate compliance with laws, regulations, and other compliance requirements;
2. Transactions are executed in compliance with:
 - a) Laws, regulations and the provisions of contracts or grant agreements that could have a direct and material effect on a federal program; and
 - b) 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.

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:

- a) **Program operations:** controls over program operations includes policies and procedures that management has implemented to reasonably ensure that a program meets its objectives.
- b) **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 management that it is getting valid and reliable information about whether programs are operating properly.
- c) **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.

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.

Internal Control in Small Units of Government

Segregation of duties, a fundamental part of internal control, has always posed a problem for small units of government. 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 act as an employee 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.

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 judgement 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.

Internal Control in Specific Areas of Operations

(Note: 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 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.)

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.

1. Each unit should have an organization chart that clearly defines the lines of authority and responsibility.
2. Up-to-date job descriptions should be on file for each position within the unit of government.
3. The governing body should participate closely in the day-to-day operations of a unit, especially a unit with a small accounting staff.
4. Monthly financial reports should be prepared on a timely basis and should be reviewed and understood by management and the governing body.
5. All employees should take annual, uninterrupted vacations. Other adequately trained employees should perform the tasks of those employees on vacation.
6. All personnel performing fiscal functions must be adequately trained. Any staff member in this area who is not adequately trained should be currently enrolled in the proper course(s) to ensure that any deficiencies are eliminated.
7. The internal audit staff should be adequately trained and have the proper resources and authority to effectively evaluate a unit's policies and procedures.
8. Management and the governing body should take steps, in a timely manner, to implement suggestions for

improvement made by the auditor and/or internal audit staff.

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.

1. All journals, ledgers, and other accounting records should be kept up-to-date at all times and should be balanced.
2. All subsidiary records should be periodically reconciled to the control accounts. This reconciliation should be documented and maintained on file.
3. Each unit should maintain a written accounting procedures manual. This manual 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; and guidelines for controlling expenditures, such as purchasing requirements and travel authorizations.
4. All journal entries should be approved, explained, and properly supported with the correct documentation.
5. The unit should maintain the minimum number of funds possible to meet legal and operating requirements.
6. Duties should be segregated as much as possible between custody of the assets and recording of the transactions.
7. Each unit should maintain and follow records filing, retention, and disposal policies in compliance with the Public Records Laws, G.S.132, and the guidelines established by the Record Services Branch, Division of Archives and History, Department of Cultural Resources. Detailed information can be found on their website, www.ah.dcr.state.nc.us/sections/archives/rec.
8. All accounting records should be maintained in a secure place. Computerized accounting systems should be controlled with the use of passwords and other safeguarding procedures.
9. All expenditures made in excess of appropriations and other deviations from the adopted budget should be investigated and resolved.
10. Reserves should be established for the following:
 - a. encumbrances
 - b. interfund receivables for which cash is not available in the debtor fund or which are not expected to be repaid promptly
 - c. inventories and other assets, including non-current receivables
 - d. restricted revenues
 - e. fund balance reserved by State Statute (G.S. 159-8)
 - f. any other reserves required by the governing body

Internal Control Procedures - General and Statutory

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

1. The following transactions should always be approved in the minutes of the meetings of the governing body:
 - a. contracts to buy or rent land or other real estate
 - b. continuing contracts
 - c. construction contracts
 - d. purchase orders for major purchases
 - e. intergovernmental agreements
 - f. contracts of an unusual nature
 - g. any other major contract
2. All minutes of the governing body should be maintained in final form in the permanent records of the unit.
3. The unit's official records should be maintained in a fireproof location after regular business hours.
4. All funds remaining unclaimed for five years should be escheated to the State as required by G.S. 116B.
5. 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.
6. All taxes should be distributed according to the statutes (G.S. 159-27).
7. 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).
8. The following persons must be bonded for at least \$10,000 and not more than \$250,000 according to the referenced statutes: the finance officer (G.S. 159-29) and the tax collector [G.S.105-349(c)].
9. A complete schedule of insurance coverage and limits should be maintained, showing expiration dates, premiums, co-insurance clauses, and other essential information.
10. 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.

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.

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:

- 1) Separate accounts for identifying receipts and expenditures by grant.
- 2) Budget categories for grant receipts and expenditures by grant.
- 3) Documentation of a time schedule for filing financial reports with grantors.
- 4) Reconciliation of grant financial reports that have been prepared, reviewed, and approved by a responsible official before filing with supporting account records.
- 5) Review of eligibility determination.
- 6) Written notification to employees when grant provisions or related regulations impose requirements that differ from the governmental unit's normal policies and procedures.
- 7) If applicable, monitoring the indirect cost allocation plan and approval of allocations and requests for reimbursements.

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:

- 1) 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.
- 2) 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.
- 3) 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 performance goals are achieved.
- 4) Ensure that subrecipients expending \$300,000 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.
- 5) 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.
- 6) 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.

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:

- 1) 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/or state requirements set by the federal and/or state agency.
- 2) Establishing internal control over compliance to provide reasonable assurance that-
 - Funds are disbursed to subrecipients only on an as-needed basis
 - 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.
 - 3) Reviewing financial and technical reports, to evaluate them for completeness and for compliance with applicable laws and regulations.
 - 4) Evaluating audit findings; issuing appropriate management decisions, if necessary; and determining if an acceptable plan for corrective action has been prepared and implemented.
 - 5) Reviewing previously detected deficiencies and determining that corrective action was taken

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

1. 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 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.

If there is only a finance officer position, he/she should perform these duties.

2. 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. 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).
3. Cash collection should be centralized to the maximum extent possible without hindering operations.
4. The staff members and/or 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 not be destroyed.) Unissued receipts should be controlled by the staff member(s) 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.
5. An accounting staff member should receive the checks and control listings from the person opening the mail and from the cashier(s), 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.
6. 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.
7. 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 be required. **In small units**, the finance officer should assume these responsibilities.

8. 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.
9. 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 records of each reconciliation bearing their signatures as evidence that the reconciliation was performed. 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.

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.

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 the finance officer must be prepared as a part of his/her stewardship responsibilities over public funds to ensure the accuracy of such records.

Critical Internal Control Procedures for Deposits in Financial Institutions

1. All deposits should only be in institutions authorized by the governing body of the unit.
2. All funds held by financial institutions must either be insured by the FDIC or fully collateralized in accordance with G.S. 159-31(b).
3. 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.
4. 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.
5. 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. In performing the reconciliations, the staff member should check for the following:
 - A. Deposits
 1. Compare dates and amounts of daily deposits as shown on the bank statements with the cash receipts journal.
 2. Investigate bank transfers to see that both sides of the transaction have been recorded in the unit's financial records.

B. Disbursements

1. Account for all check numbers, including voided checks.
2. Examine cancelled checks for authorized signatures, irregular endorsements, and alterations.
3. 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. (See the "Cash" policy for a more complete discussion of bank reconciliations.)

In small units, a board member may perform the bank 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.

Internal Control in 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.

Critical Internal Control Procedures for Petty Cash Funds

1. 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.
2. Petty cash vouchers should be required for all petty cash disbursements. These vouchers should be signed by the payee and should be approved by the payee's supervisor.
3. All petty cash funds should be replenished at month-end at a minimum. All petty cash vouchers should be cancelled by someone other than the fund custodian when the fund is replenished.
4. All petty cash funds should be subject to a surprise cash audit from time to time.

Internal Control in 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. These are identified in the following discussion.

Critical Internal Control Procedures for Revenues

1. The organization and integration of the records for collections should identify probable taxpayers as a result of license purchases or other contacts with the unit.
2. Records should be updated on a timely basis to prevent incorrect billing of amounts due to the unit.
3. There should be, to the greatest extent possible, a separation of duties between the collections, billing, and receivables functions.
4. All payments in lieu of taxes from the U.S. Forest Service must be used for public schools according to State and federal laws.
5. 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.
6. All subsidiary records should be reconciled with the control accounts on a monthly basis.
7. All delinquent accounts should be listed periodically and reviewed by the appropriate official.
8. Billings for enterprise and other service revenues should be based on usage as determined by accurate and timely service meter readings.
9. For enterprise revenues, assignments of meter readers should be periodically rotated on a surprise basis.
10. For service revenues, procedures should be in place to identify irregular service patterns. Any irregularities identified in this manner should be thoroughly investigated.

Critical Internal Control Procedures Specific to Tax Collections

1. 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).
2. There should be a clear separation of duties between the tax collector and the tax assessor. If there is not a separation of duties over these two functions, there should be compensating controls over the tax scrolls and receipts.
3. Taxes receivable must be reconciled periodically to the control accounts.
4. The tax scrolls must be adequately maintained and balanced periodically with the control accounts.
5. 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)].
6. All discoveries should be properly recorded as a part of the current year's levy.
7. All uncollected delinquent taxes more than ten years old should be written off the books, unless collection proceedings are underway.

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

1. Prenumbered checks should be used for all disbursements.
2. 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.
3. 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/or 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.

4. Blank checks should never be signed in advance.
5. Checks should never be made payable to cash.
6. A check protector should be used at all times to imprint checks issued manually. 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. If an accounting clerk also is on staff, that person should prepare the checks.
7. Check signers should review documentation supporting the disbursements prior to signing the checks. Check signers should review documentation for the following:
 - a. Amounts and payees on documentation (purchase orders and invoices) should agree to the checks.
 - b. Documentation should be stamped "paid" to prevent duplicate payments. Only original invoices should be paid - photocopies should not be accepted.
 - c. 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.
 - d. All purchase orders and contracts or checks and warrants should have properly signed pre-audit certificates (G.S. 159-28).
8. Purchase orders 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.
9. 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 facsimile. If the facsimile is two signatures, the plate should be under dual control at all times. Any employee having access to facsimile signature dies should be properly bonded. The governing board may waive the dual signature requirements if the board determines that satisfactory internal control procedures are in effect. **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.

10. Employee expense reports should be properly completed prior to payment. Reports should be signed by the employee, approved by the appropriate person(s) as required by the policy (see the "Travel Policy" section of this manual), and supported by all required documentation.
11. 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.
12. Disbursements should only be made to authorized vendors. Purchasing officers should avoid vendors that use high pressure sales tactics. An out-of-state vendor should only be utilized after the governing body has given its specific approval.
13. Prior to making disbursements to a vendor, a unit should obtain the necessary IRS Form 1099 information, if needed.
14. 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.
15. 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.

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.

1. Each employee should have a personnel file that includes the following at a minimum:

- a. hiring authorization
- b. salary history
- c. hours authorized to work
- d. federal and State withholding forms
- e. hospital and retirement deduction information
- f. authorization for all other payroll deductions

Any changes in an employee's status should be supported by the appropriate documentation in the employees' personnel file.

2. 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 if the check used to deposit payroll funds to the account on which the payroll checks are drawn contained a signed certificate. **In small units**, the finance officer and a board member should sign all payroll checks, and the board member should distribute them.
3. A separate payroll checking account should be maintained on an imprest basis (see "Payroll" policy).
4. 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.
5. Units should have written personnel policies prohibiting employment practices that result in nepotism, conflicts of interest, or discrimination.

Critical Internal Control Procedures Specific to Travel Expenditures

1. There should be a definite, written policy for requesting travel advances, reporting travel expenses, and reimbursing the unit for unexpended advances.
2. All travel advances should be approved by a department head and effectively controlled.
3. All employees should be required to give an adequate accounting of actual expenses incurred subsequent to the issuance of a travel advance.

4. All reimbursed travel expenses should be made in accordance with the travel policy as adopted by the unit. (See the "Travel" section of this manual for more information.)

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. 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

1. 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.
2. 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.
3. 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.

Internal Control in 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 protected from 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.

Critical Internal Control Procedures for Investment Management

1. All investments should be in compliance with G.S. 159-30.
2. 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 policy can be found in the "Cash Management" section of this manual.
3. 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.
4. 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 "Cash" section of this manual for a more detailed discussion of custody and investment policies.)
5. 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.

6. Securities should be adequately safeguarded in locked, fireproof compartments.
7. 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. Statements provided by safekeeping agents also should be reconciled to the investment records on a periodic, surprise basis, again by a staff member 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.
8. 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/sale price, and purchase/sale date. Written evidence should be provided of such reconciliations. A board member should perform these reconciliations **in a small unit**.
9. 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.
10. 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.
11. 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.
12. Investments should be reported in compliance with GASB 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. This statement requires governmental entities, including governmental external investment pools, to report investments at fair value on the balance sheet. Fair value is the amount at which a financial instrument could be exchanged in a current

transaction between willing parties, other than in a forced or liquidation sale. Governmental entities are permitted to report certain short-term money market investments at amortized cost when certain criteria are met, i.e. remaining maturity at time of purchase of one year or less. These investments include commercial paper, bankers' acceptances, U.S. Treasury obligations and agency obligations. Asset-backed securities, derivatives, and structured notes are not included. Certain financial institution deposits and repurchase agreements also are recorded at cost in most situations. For additional information, refer to this manual's "Cash Management" section.

13. All underlying securities in repurchase agreement transactions should be held by a third party safekeeping agent. (Note: The selling bank's trust department does not qualify as a third party.)

Internal Control in Accounts Payable, Expenditures, Encumbrances, Purchasing, and Contracting

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

1. Expenditures should be controlled using the budget ordinance. For any annually budgeted fund, all expenditures must be budgeted, and there must be sufficient budgeted revenues or available fund balance to cover each expenditure. (See the "Budgeting Policy" for more details on this area.)
2. All budget appropriations in the current year should be recorded in the appropriate expenditure account.
3. All expenditures must be charged against an appropriation account. The exact timing of the accounting entry will vary depending on the type of transaction.
4. An encumbrance system must be used by:
 - a. counties with populations of 50,000 or more.
 - b. cities and towns with populations of 10,000 or more.

- c. 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)] and in fact even small governments commonly use an encumbrance accounting system. (See the "Purchasing" section of this manual for more information on encumbrance accounting.)

5. An effective year-end cut-off policy should be in place for all liabilities, including accounts payable.
6. 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.
7. 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.
8. Any debit balances in accounts payable should be investigated thoroughly.

Critical Internal Control Procedures for Purchasing and Contracting

1. Prenumbered purchase orders should be used for all purchases. Voided purchase order forms should be recorded as such and copies maintained on file.
2. 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. Facsimile signatures are used in automated systems where purchase orders cannot be issued without adequate unencumbered balances available.
3. 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 and billed as ordered.
4. An open file for outstanding purchase orders should always be maintained to facilitate monitoring of outstanding orders.
5. All department purchases should be requisitioned or approved by the department head prior to purchase. This approval should be in writing. In small units where there is more than one accounting staff member, the finance officer should initiate the purchases. In units with only a finance officer and no other accounting staff, a board member should approve all purchases.

6. Department heads should be provided a detailed list of expenditures, with comparisons to the budget at least on a quarterly basis, and preferably on a monthly basis. Not only will this allow the managers to keep track of their budgets, but it serves as a good check for errors.
7. Those contracts requiring public bids per G.S. 143-128 through 133 should be handled as required by the statutes. Complete documentation should be maintained on the bids and the awarding of the contract. (See the "Purchasing" section of this manual for more details on purchasing and contracting requirements.)
8. The governing board may grant blanket authorizations to staff members to enter into contracts to purchase goods. These authorizations should be very specific as to the maximum dollar amount, type of assets being purchased, and other terms of such contracts. Any contract not meeting the specifications of the blanket authorizations should be approved by the board.
9. If a unit uses open-ended purchase orders and/or procurement cards, specific controls are required to ensure compliance with the preaudit statute, G.S. 159-28 (see the "Purchasing" section of this manual for additional information). Department heads should review these purchases made by their staff on a monthly basis. This review should be incorporated in the processing of accounts payable.
10. 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.
11. 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.

Internal Control in Inventory and Fixed Asset Management

It is essential that all inventories and fixed assets be adequately controlled to prevent their 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. (See the "Inventory" and "Fixed Assets" sections of this manual for more information on these areas.)

Critical Internal Control Procedures for Inventory Management

1. A unit should inventory and control in its general ledger all major classes of materials and supplies, if material.
2. Perpetual inventory systems should be maintained for all major classes of inventory.
3. Custodial responsibilities should be clearly defined. For areas with significant inventories, this responsibility should be included in the appropriate job descriptions.
4. Inventory should be controlled with physical barriers, such as locked cabinets or storehouses.
5. 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.
6. 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. If there are two accounting or finance staff members, the finance officer may take the inventory.
7. 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.

8. 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.
9. Significant inventories should be insured against loss.
10. Persons having control of inventory should not have access to the accounting records.
11. Provisions should be made for obsolete or inactive inventory. Periodic reports should be made to the governing body concerning obsolete items.
12. A workable system should be in place to maintain optimum quantities of inventory at all times.

Critical Internal Control Procedures for Fixed Asset Management

1. Adequate accounting records should be maintained that identify and classify all fixed assets.
2. Adequate guidelines should be established and followed to distinguish between expensed items and capital additions.
3. 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.
4. All fixed assets should be tagged or identified in the accounting records by a control number, as applicable. (See the "Fixed Assets" section of this manual.) 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.
5. 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.
6. 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.

7. All sales of surplus property should be conducted in accordance with G.S. 160A, Article 12 (municipalities) or G.S. 153A-176 (counties).
8. All purchases made with federal grant funds should be identified as such and accounted for by the source of the funds.
9. Adequate insurance coverage must be maintained on all real and personal property. An independent review of insurance coverage should be conducted at least every three years.

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 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

1. 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:
 - a. funds to account for taxes specifically voted by the people
 - b. funds to account for taxes or other revenues collected for others
 - c. public assistance funds
 - d. school funds
 - e. reappraisal fund [G.S. 159-13(b)(17)]
2. All transfers and loans from the following funds should be checked for legality and propriety:
 - a. capital reserve fund (G.S. 159-22)
 - b. capital project fund for bond issue proceeds[G.S. 159-13(b)(19)]
 - c. debt service funds
 - d. enterprise funds [G.S. 159-13(b)(14)]
 - e. 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.
 - f. service district funds [G.S. 159-13(b)(18)]
3. 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 (see

the "Budgeting" section of this manual for more information). Authorization for interfund loans should include provisions for the method and time of payment.

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

1. Detailed records of all outstanding contracts should be maintained.
2. All amounts withheld from contract payments upon completion of a project should be reflected on the books (retainage).
3. 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.

Critical Internal Control Procedures for Bonds Payable

1. 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).
2. All proceeds from a bond issue must be used in accordance with the stated purpose of the issue.
3. Separate accounting records should be maintained for each bond order as required by G.S. 159-26(b)(6).
4. All debt service and other fiscal requirements of revenue bond resolutions should be complied with.
5. All bond order and secondary market disclosure requirements should be complied with and appropriate IRS forms (8038-G or 8038-GC) filed.
6. 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.

Critical Internal Control Procedures for Other Long-Term Debt

1. 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.

2. 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).
3. The unit should be meeting the arbitrage rebate requirements for all tax-exempt financing.

Internal Control in a Small System EDP Environment

There are several internal controls that are essential in the small system EDP environment. 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 virtually impossible in a small system environment; other checks and controls must be implemented to compensate for the lack of segregation.

Critical Control Procedures in a Small System EDP Environment

1. All computer hardware should be included in the fixed asset inventory (see "Fixed Assets" section of this manual). All hardware should be clearly identified as property of the unit and should be tagged.
2. 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.
3. 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.
4. 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.
5. 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.
6. Back-up copies of all data files should be maintained. Off-site storage of critical data is necessary for full protection against loss.

7. All back-ups maintained on-site should be kept in fireproof facilities. Data files and software should be adequately protected against damage. Diskettes should be properly stored when not in use - protected from extreme temperature changes, dust, and magnetic fields. In addition, all diskettes should be properly labeled.
8. Diskettes containing sensitive data should be maintained under the control of the staff member responsible for the related function.
9. Access to the equipment, software, and data should be controlled. Diskettes can be locked away; some keyboards also have a lock function. An independent verification should be made from time to time to ensure that computers and/or software are not being used for personal business without express authorization.
10. 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 should be coordinated with the unit's overall emergency management operations.
11. An independent verification should be made periodically to ensure that application programs are functioning properly.
12. 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.

References

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



State of North Carolina
Department of State Treasurer

HARLAN E. BOYLES
TREASURER

*State and Local Government Finance Division
and the Local Government Commission*

ROBERT M. HIGH
DEPUTY TREASURER

April 9, 1984

TO: Finance Officers of Small Governmental Units
FROM: Robert M. High
SUBJECT: Internal Controls

The Local Government Commission has gathered information that will help smaller units strengthen their internal controls. Elected officials have a responsibility to provide taxpayers with reasonable assurance that governmental finances are adequately controlled. Whether a unit of government has strong or weak internal controls directly reflects 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.

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. The governing board members must be called upon to provide some of these controls.

This bulletin is addressed specifically to the smaller units where internal controls are weak due to the limited number of personnel. These internal control procedures are not complete and your Uniform Accounting Systems Manual should be consulted for further guidance. The Local Government Commission encourages local units to review their internal controls. After reviewing their controls, a careful reading of the procedures attached may aid the unit in strengthening their controls. We have also included an illustration on how to divide duties with a staff of one or two. The procedures should be reviewed carefully and the cost effectiveness measured before being implemented by a local unit.

80-A-1

GENERAL CONTROLS – Those that can be applied to all areas of a governmental unit.

- A. Plan of organization – A plan of organization should be developed and communicated to all parties involved (governing body, mayor, city manager, finance officer, and anyone else elected or employed). This plan should include:
 - 1. Clear lines of authority and responsibility
 - 2. List of positions
 - 3. Duties of each position
 - 4. Criteria to be observed by employees in initiating transactions
- B. Governmental units should employ personnel with the ability and experience required to perform satisfactorily the responsibilities assigned to them. This includes continuing education for present employees.
- C. Active participation by the governing body in key functions is necessary for good internal controls. Personal investigation of complaints may help locate problems or areas needing improvement.
- D. Monthly reports must be presented to the Board and reviewed by the Board. These reports at a minimum should reflect the budget and actual revenues and expenditures.
- E. All employees should be required to take annual vacations. During their absence, their duties should be performed by another person.

SPECIFIC CONTROLS – Those that can be applied to the various functions within a unit.

Units of government have various accounting functions. We will address the major functions and the related internal controls. The procedures used in each function are outlined, followed by suggestions on how to divide duties between staff members for more effective internal control. The major functions addressed in this memo are:

Major Functions

Investment Management
Inventory Management
Cash Management
Cash Disbursement – Nonpayroll
Cash Disbursement – Payroll
Billing and Receipting – Utilities
Billing and Receipting – Taxes

A. INVESTMENT MANAGEMENT

Procedures

1. Units should make sure their investments are in compliance with G.S. 159-30.
2. Local units should have physical custody of securities.
3. Access to securities should be restricted to personnel authorized by the governing body.
4. Investments should be adequately safeguarded.
5. Securities should be in the name of the unit.

Duties

“The finance officer shall manage investments subject to whatever restrictions and directions the governing board may impose. The finance officer shall have the power to purchase, sell, and exchange securities on behalf of the governing board. The investment program shall be so managed that investments and deposits can be converted into cash when needed.” G.S. 159-30 (a)

B. INVENTORY MANAGEMENT

Inventories needed to have adequate controls. They need to be accounted for and have physical safeguards. The water and sewer fund could possibly have a material amount of chemicals and plumbing fixtures on hand at any period of time.

Procedures

1. Clearly define custodial responsibilities.
2. Units should have physical barriers (locked doors, cabinets and fences).
3. Control keys.
4. Maintain a list of additions to inventory and withdrawals from inventory initialed by the person receiving the inventory.
5. Units should take physical inventories at least once a year.

Duties

1. Control of keys
2. Physical inventory

Separation of Duties

1. Engineer must have access to keys.
2. Physical inventories should be performed by Accounting Clerk and/or Finance Officer (someone other than engineer).

C. CASH MANAGEMENT

Procedures

1. All bank accounts should be authorized by the governing body.
2. Bank accounts should be properly collateralized in accordance with G.S. 159-31(b).
3. Bank accounts should be reconciled promptly after the end of each month by someone who does not participate in other cash procedures including handling currency, receipts or signing of checks.
4. Unopened bank statements should be delivered directly to the individual making the reconciliation.
5. The bank should be instructed to contact an authorized official who is independent of the recordkeeping and cash receipting functions for unusual items such as insufficient funds notice.
6. All wire transfers should be authorized by a responsible official.

Duties

1. Board member should be notified by the bank for unusual items, such as insufficient funds.
2. Make all wire transfers.
3. Review bank accounts for proper collateralization.
4. Receive unopened bank statement.
5. Perform bank reconciliation every month and check for the following:
 - A. Deposits
 - (1) Compare dates and amounts of daily deposits as shown on the bank statement with the cash receipts journal.
 - (2) Investigate bank transfers to determine that both sides of the transaction have been recorded on the books.
 - B. Disbursements
 - (1) Account for sequence for check numbers including all voided checks.
 - (2) Examine cancelled checks for authorized signatures.
 - (3) Examine cancelled checks for irregular endorsements.
 - (4) Examine cancelled checks for alterations.

(Note: Uniform Accounting System Manual, procedure 37-09 for detail procedures on bank account reconciliation.).

Separation of Duties

One position:

Finance Officer

(2) (3)

Board Member
Who does not sign checks

(1) (4) (5)

Two positions:

Accounting Clerk

(4) (5)

Finance Officer

(2) (3)

Board Member

(1)

D. CASH DISBURSEMENTS - NONPAYROLL

Procedures

1. Prenumbered checks should be used for all disbursements.
2. The supply of unused checks should be adequately controlled and safeguarded.
3. Voided checks should never be destroyed or thrown away. The signature space should be cut off the voided check. All copies of the check should be filed in numerical order with check copies.
4. All paid invoices and vouchers effectively stamped "paid" to prevent re-use.
5. Payment of photocopied invoices or statements should be prohibited; pay only from original invoices.
6. The practice of signing blank checks in advance should be prohibited.
7. The practice of making checks to the order of "cash" should be prohibited.
8. The proper authority should approve all expense reports.
9. The local unit needs to maintain effective control over mailing or distribution of checks after they are signed. (Checks should not be handed back to persons who prepared checks for distribution; person signing checks should distribute.)
10. Local unit should require a second signature of an official or employee who does not have access to the accounting records on all disbursements. (The purpose of this internal control procedure is defeated if one employee or official possesses a stamp or signature plate of the other individual required to sign checks.)

Duties

1. Initiate purchase.
2. Type purchase order (at least original and one copy).
3. Review and approve purchase order by signing preaudit certification. [G.S. 159-28 (a)].
4. Sign off on copy of purchase order for receipt of goods after comparing purchase order to goods received.
5. Match invoice to copy of purchase order and compare goods received report to invoice (mathematical check of footings).
6. Prepare and review check.
7. Review documentation and sign check.

8. Present purchase order, receipt report, invoice, check and addressed and stamped envelope for second signature.
9. Review supporting documentation, sign check, mail check to vendor, and return supporting documentation to accounting clerk.

Separation of Duties

One position:

<u>Finance Officer</u>	<u>Board Member</u>
(2) (3) (4) (5) (6) (7) (8)	(1) (9)

Two positions:

<u>Accounting Clerk</u>	<u>Finance Officer</u>	<u>Board Member</u>
(2) (4) (5) (6)	(1) (3) (7) (8)	(9)

E. CASH DISBURSEMENTS - PAYROLL

Procedures

1. Every employee should have a personnel file which includes authorization for hiring, salary history, hours authorized to work, federal and state withholding forms, hospital and retirement information and support for any other payroll deduction.
2. All paychecks should be supported by time sheets which are reviewed and approved by signature.

Duties

1. Hire personnel and set salary and working hours.
2. Prepare personnel file form authorization papers and updates.
3. Review and approve (by signature) time sheets and leave records.
4. Prepare checks from authorized salary and time sheets and review work.
5. Review payroll for reasonableness and sign checks – first signature.
6. Review payroll and sign checks – second signature.
7. Distribute checks.

Separation of Duties

One position:

<u>Finance Officer</u>	<u>Board Member</u>
(2) (3) (4) (5)	(1) (6) (7)

Two positions:

<u>Accounting Clerk</u>	<u>Finance Officer</u>	<u>Board Member</u>
(2) (4)	(3) (5) (7)	(1) (6)

F. BILLING AND RECEIPTING – UTILITY

Procedures

1. The meter readings should be taken by someone other than the normal reader at least once a year. The meter reader should not have any financial duties.
2. Total gallons billed should be reconciled to total gallons pumped and/or kilowatts produced to kilowatts billed.
3. Before mailing, all bills should be reviewed for reasonableness.
4. Billing procedures should provide that a return portion of bill be submitted with payment.
5. Receipt of payment should be separated from recording transactions. The person who receives payment should not be posting to the accounts receivable ledger.
6. Responsible official reviews the ordering of prenumbered receipt books for proper number sequencing.
7. Prenumbered receipts should be issued for all cash receipts. (Separate books for major functions: Tax receipt book, Water and Sewer receipt book, and Miscellaneous receipt book).
8. Accounts receivable ledgers should be balanced with control accounts monthly.
9. Delinquent accounts should be listed periodically for review by an appropriate official.
10. Have an agreement with the bank that all checks with the unit of government as “payee” must be deposited, not cashed.

One of the most effective internal control procedures for receipting of cash is separation of duties for receipting cash and posting to accounts receivable ledger. In the smaller units where there is only one person in the office on a daily basis this could be a difficult task. One solution to this problem is for small units to negotiate with their banks to handle the receipting of monthly utility bills. A list of duties is presented below for this option. The separation of duties listed below is not ideal; however, under the circumstances it is the most practical solution.

Duties (Billing and Receipting – Utility)

1. Establish a policy for terminating services to delinquent customers.
2. Prepare bills and review work.
3. Reconcile total gallons/kilowatts billed to total gallons pumped or kilowatts used.
4. Post to accounts receivable ledger.
5. Mail bills.
6. Receive return portion of billing along with check or cash, write receipt, record amount received on return portion of billing, and endorse all checks “for deposit only” to unit account.
7. Prepare Daily Collection Report and reconcile to return portion of billing.
8. Prepare deposit slip and reconcile to Daily Collection Report.
9. Record receipt of cash to accounts receivable ledger.

10. Prepare a list of delinquent accounts.
11. On a sample basis, trace billings into accounts receivable ledger to see if they have been posted.
12. On a sample basis, trace deposits into accounts receivable ledger. (Take the return portion of the billings and trace to accounts receivable ledger; amount posted should equal amount deposited.)
13. Review of delinquent accounts. Determine that "cut-off" policy as established in #1 above is being adhered to by reviewing accounts receivable ledgers.

Separation of Duties

Units of government handling cash receipts

One position:

<u>Finance Officer</u>	<u>Board Member</u>
(2) (3) (4) (5) (6) (7) (8) (9) (10)	(1) (11) (12) (13)

Two positions:

<u>Accounting Clerk</u>	<u>Finance Officer</u>	<u>Board Member</u>
(2) (5) (6) (7)	(3) (4) (8) (9) (10)	(1) (11) (12) (13)

Units of government with banks handling cash receipts:

One position:

<u>[Bank]</u>	<u>Finance Officer</u>	<u>Board Member</u>
[(6) (7) (8)]	(2) (3) (4) (5) (9) (10)	(1) (11)*(12)* (13)

Two positions:

<u>[Bank]</u>	<u>Accounting Clerk</u>	<u>Finance Officer</u>	<u>Board Member</u>
[(6) (7) (8)]	(2) (4) (5) (9)	(3) (10) (11)* (12)*	(1) (11)* (12)* (13)

*These duties are not as critical to internal controls since the functions of cash receipting and posting to receivable ledger have been separated.

G. BILLING AND RECEIPTING TAXES

Procedures

The Uniform Accounting Systems Manual has specific procedures on the tax cycle. One procedure a small municipality may want to consider is contracting with the county to bill and collect taxes for the municipality. The municipality should evaluate the effect this procedure will have on tax collection rates, cost of collection, and efficiency of operations. Mr. Win Quakenbush with the LGC will be happy to discuss this procedure more thoroughly with all interested units.

The governing body of the municipality shall designate person or persons who shall compute and prepare the tax receipts for all taxes charged upon the tax records [G.S. 105-320 (b)]. No taxing unit shall adopt a tax receipt form until it has been approved by the Department of Revenue [(G.S. 105-320 (a)]. A tax receipt form that is becoming more popular is a postcard with a detachable portion to be mailed with payment. The portion kept by the taxpayer is the taxpayer's receipt. This style of form is gaining popularity as it saves: 1) cost of envelopes in mailing tax notices, 2) postage costs since postage required for postcards is less than envelopes, 3) cost of envelopes and postage used in mailing receipts to taxpayers, and 4) personnel time since this process is more efficient.

Duties (Units collecting their own taxes)

1. Prepare and compute the bills.
2. Reconcile property taxed from bills to tax records received from the county.
3. Post the taxes receivable ledger.
4. Mail bills.
5. Receive return portion of billing along with check or cash, record amount received on return portion of billing, and endorse all checks "for deposit only" to unit account. This person should be designated and bonded as "tax collector". (Note: Consult Uniform Accounting System Manual for receipt of partial payments, discounts, penalties and interest, and other unusual situations.)
6. Prepare Daily Collection Report and reconcile to return portion of billing.
7. Prepare deposit slip and reconcile to Daily Collection Report.
8. Record receipt of cash to tax receivable ledger.
9. Prepare a list of delinquent accounts.
10. On a sample basis, trace billings into taxes receivable ledger to see if they have been posted.
11. On a sample basis, trace deposits into taxes receivable ledger. (Take the return portion of the billings and trace to accounts receivable ledger; amount posted should equal amount deposited.)
12. Review of delinquent accounts. Delinquent accounts at January 6 should equal amount in Taxes Receivable account. Any abatements should be approved by the governing board. Advertise delinquent accounts specifying that any discrepancies should be brought to the attention of a designated board member.

Separation of Duties

One position:

Finance Officer

Board Member

(1) (3) (4) (5) (6) (7) (8) (9)*

(2)* (10) (11) (12)

Two positions:

Accounting Clerk

Finance Officer

Board Member

(1) (4) (5) (6) (7)

(2) (3) (8) (9)*

(10) (11) (12)

*If finance officer does this procedure then Board Member should review.



HARLAN E. BOYLES
TREASURER

State of North Carolina
Department of State Treasurer

*State and Local Government Finance Division
and the Local Government Commission*

MEMORANDUM #569

ROBERT M. HIGH
DEPUTY TREASURER

April 19, 1984

MEMORANDUM

TO: Elected Officials
FROM: J. D. Foust
SUBJECT: Internal Controls - - Small Units of Government

The Local Government Commission has gathered information that will help smaller units strengthen their internal controls. Elected officials have a responsibility to provide taxpayers with reasonable assurance that governmental finances are adequately controlled. Whether a unit of government has strong or weak internal controls directly reflects the reliability of the accounting records and financial statements. Strong internal controls aid in the prevention and detection of fraud and accidental errors in the accounting process.

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. The governing board members must be called upon to provide some of these controls.

This is a condensed version of Memo #568 Internal Controls – Small Units of Government which was mailed to finance officers and independent auditors. This bulletin addresses only the tasks needed to be performed by board members for more effective internal control. For more detailed information you may want to obtain a copy of Memo #568 from your finance officer or CPA.

The major functions addressed in this memo where a board member could improve internal controls are:

- 1) Cash Management
- 2) Cash Disbursements – Nonpayroll
- 3) Cash Disbursements – Payroll
- 4) Billing and Receipting – Utility
- 5) Billing and Receipting – Taxes

If the unit has more than one accounting employee only the items with an asterisk (*) should be completed by a board member.

80-B-1

I. Cash Management

- *A. Board member should be notified by the Bank for unusual items, such as insufficient funds.
- B. Receive unopened bank statement.
- C. Perform bank reconciliation every month.

II. Cash Disbursement - - Nonpayroll

- A. Initiate purchases.
- *B. Review supporting documentation, sign check, mail check to vendor, and return supporting documentation to accounting clerk.

III. Cash Disbursements - - Payroll

- *A. Hire personnel and set salary and working hours.
- *B. Review payroll and sign checks - - second signature.
- C. Distribute checks.

IV. Billing and Receipting - - Utility

- A. Establish a policy for terminating services to delinquent customers.
- B. On a sample basis, trace billings into accounts receivable ledger to see if they have been posted.
- C. On a sample basis, trace deposits into accounts receivable ledger. (Take the return portion of the billings and trace to accounts receivable ledger; amount posted should equal amount deposited.)
- D. Review of delinquent accounts. Determine that "cut-off" policy as established in #1 is being adhered to by reviewing accounts receivable ledgers.

V. Billing and Receipting - - Taxes

- A. Reconcile property taxed from bills to tax records received from the county.
- *B. On a sample basis, trace billings into taxes receivable ledger to see if they have been posted.
- *C. On a sample basis, trace deposits into taxes receivable ledger. (Take the return portion of the billings and trace to accounts receivable ledger; amount posted should equal amount deposited.)
- *D. Review of delinquent accounts. Delinquent accounts at January 6 should equal amount in Taxes Receivable account. Any abatements should be approved by the governing board. Advertise delinquent accounts specifying that any discrepancies should be brought to the attention of a designated board member.