# INTERNAL CONTROLS

FINANCE POLICY SERIES

CITY OF
FLORENCE

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## TABLE OF CONTENTS

## ACRONYMS

ACFR – Annual Comprehensive Financial Report

COSO – The Committee of Sponsoring Organizations of the Treadway Commission

IT – Information Technology

GAAP – Generally accepted accounting principles

## INTRODUCTION

The purpose of this policy is to assist the management of City Departments in establishing effective systems of internal controls.

Departments of the City are responsible for establishing a system of internal controls designed to prevent losses of public funds arising from fraud, employee error, misrepresentation by third parties, unanticipated changes in financial markets, or imprudent actions by employees and officers of the City.

The internal control process is designed to provide reasonable assurance about the achievement of the City's objectives with regard to the reliability of financial reporting, effectiveness and efficiency of operations, compliance with applicable laws and regulations, safeguard assets against unauthorized purchases, and prevent/detect financial errors and fraud.

## *COSO Framework:*

The Committee of Sponsoring Organizations of the Treadway Commission (COSO) issued the Internal Control – Integrated Framework report to define internal control and help businesses and other entities assess and enhance their internal control systems.  The COSO framework has since been incorporated into policy, rule, and regulation, and used by thousands of enterprises to better control their activities in moving toward achievement of their established objectives.

The Framework provides for three categories of objectives—effectiveness and efficiency of operations, reliability of financial reporting, and compliance with applicable laws and regulations—and five integrated components of internal control—control environment, risk assessment, control activities, information and communication, and monitoring activities. Each of the five components of internal control is important to achieving the entity's objectives.

Determining whether a city's internal control over financial reporting is effective involves judgment. The actual methods implemented to address the components of internal control need to be scaled to each particular entity, and expanded or contracted based on the operation's organizational structure, staffing levels, programs, and resources. It is not expected that the City will use every method of implementation that has been identified for each component. In addition, the City may use other policies or procedures in their system of internal control in lieu of the examples provided in the Internal Control Policy document.

## *Control Environment:*

The first internal control standard addresses the control environment. The City's control environment should include a set of standards, processes, and structures that provide a basis for carrying out internal control across the entity. The governing body and management should establish the "tone at the top" regarding the importance of internal control, including expected standards of conduct, which then cascade down throughout the various levels of the organization and have a pervasive effect on the overall system of internal control. There are several key factors that affect the accomplishment of this goal. Managers and evaluators should consider each of these control environment factors when determining whether a positive control environment has been achieved. The factors that should be focused on are listed below. These are only examples and some departments might use other methods to meet the objectives of their control environments.

a)  The City's integrity and ethical values;

   1)  Develop, widely distribute, and practice a code of conduct
   2)  Establish the values and operating style for the organization and communicate to all employees through various methods, such as by example, the code of conduct, policies, and procedures
   3)  Consistently communicate the importance of integrity and ethical values to all personnel

b)  The City's governing body oversight responsibilities;

   1)  Identifies and accepts its oversight responsibilities related to financial reporting and related internal control
   2)  Ensures that management has the skills, knowledge, and experience necessary for their job duties
   3)  Applies skepticism and is objective in evaluating management and when making decisions

c)  The assignment of authority and responsibility;

   1)  Consider the structure of the organization in terms of its size and the nature of its operation
   2)  Establish reporting lines to enable execution of authorities, responsibilities, and flow of information to manage the activities of the organization

3) Use appropriate processes and technology to assign responsibility and segregate duties as necessary at all levels of the organization

    i. The governing body should retain authority over significant decisions and review management assignments and any limitations of management's authority and responsibilities

    ii. Management should establish directives, guidance, and control to enable management and other personnel to understand and carry out their internal control responsibilities

    iii. Personnel should understand the organization's operational style and the code of conduct and carry out management's plan of action to achieve the objectives

d) The process for attracting, developing, and retaining employees; and

    1) Establish policies and practices reflecting expectations of competence
    2) Evaluate competence across the organization
    3) Provide the mentoring and training needed to attract, develop, and retain sufficient and competent personnel

    i. *Attract* – Seek out candidates who fit the organization's needs and possess the competence for the position

    ii. *Develop* – Enable individuals to develop competencies appropriate for assigned roles and responsibilities. Establish expectations and tailor training based on roles and needs.

    iii. *Mentor* – Guide employee performance toward expected standards or conduct and competence, and align the employee's skills and experience with the organization's objectives

    iv. *Evaluate* – Measure the performance of employees in relation to achievement of objectives and demonstration of expected control

    v. *Retain* – Support employees to motivate and reinforce expected performance

e) The measures, incentives, and rewards to drive accountability for performance

    1) Establish mechanisms to communicate and hold individuals accountable for performance of internal control responsibilities across the organization and implement corrective actions as necessary
    2) Establish performance measures and goals appropriate for responsibilities at all levels of the organization
    3) Perform timely evaluations and align incentives with the fulfillment of internal control responsibilities

## *Risk Assessment:*

The second internal control standard addresses risk assessment. The City's risk assessment process should include how the City's management identifies risks relevant to the preparation and fair presentation of financial statements in accordance with the entity's applicable financial reporting framework, estimates the significance of each risk, assesses the likelihood of the occurrence, and decides upon actions to respond to and manage them and the results thereof. Risks relevant to reliable financial reporting include external and internal events, as well as transactions or circumstances that may occur and adversely affect the City's ability to initiate, authorize, record, process, and report financial data consistent with the assertions of management.

Below are examples of how the City might manage its risk assessment process. These are only examples and some departments might use other methods to meet the objectives of risk assessment.

a) The City should address risk assessment in conjunction with the supervision of personnel. When providing direction to personnel in the performance of their duties, management may identify information as to the types of errors, policy violations, fraud, or noncompliance to which they should be attentive in the performance of their duties.

b) The City may also have a more formal risk assessment process that includes one or more of the following elements:

1) The identification of objectives relevant to the reduction of errors, policy violations, fraud or noncompliance. This is sometimes communicated to employees by means of the posting of certain organizational policies and procedures.

2) When errors or violations of policy occur or are identified, the City should respond to this increase in risk by communicating to appropriate persons within the organization the need to be vigilant with respect to these identified areas of risk.

3) The City should report to department heads after each governing body meeting to communicate new or changed risks, conditions, actions, or events that may impact the ability of departments to manage the risks relevant to the operation

4) Finance personnel should attend accounting training sessions to become aware o new accounting pronouncements and emerging issues in order to further identify and manage risks associated with proper financial reporting

5) Operating departments should send staff to conferences and program training sessions for the purpose of identifying likely risks of noncompliance, fraud, and error relevant to the programs they manage. These persons should disseminate this information to others in the department.

6) The Information Technology Department (IT) should periodically identify and communicate risks for which employees should be particularly vigilant

7) Changes in software should be subject to extensive evaluation and testing in order to identify and manage risks associated with use

8) The budget should be used as a means to anticipate, identify, and react to changes in conditions that may increase the risk of misstatement

9) During the year-end closing process, the City should identify for those personnel involved in the closing process the objectives of financial reporting and the likely errors that are associated with each individual's role in that process. This would include identifying the types of non-standard transactions that merit special consideration or consultation to ensure that all aspects of generally accepted accounting principles (GAAP) associated with those transactions are properly attended to.

10) Management should identify for its staff those parties that have transactions with the City for which there is a potential conflict of interest due to members of management or elected officials having a relationship with those parties

11) Throughout the year, management maintains a list of conditions, transactions, and events that may increase the risk of accounting error or fraud in order to evaluate the effects of such matters and to properly communicate these matters to the City's independent auditors. These include new laws or legislation, major changes in government operations, major or unusual transactions, actions of the governing board, new agreements, new joint ventures, asset impairments, major changes in executive management, staff reductions that might affect internal controls, major changes in the government's service area, the acquisition of utility systems, new material revenue sources or fee structures, changes in the collectability of loans made to others, regulatory inquiries or audits, significant intra-entity transactions, major changes in the local economy, etc.

## *Control Activities:*

The third internal control standard addresses control activities. Internal control activities are the policies, procedures, techniques, and mechanisms that help ensure that management's directives to mitigate risks identified during the risk assessment process are carried out. Control activities are an integral part of the entity's planning, implementing, and reviewing. They are essential for proper stewardship and accountability for government resources and for achieving effective and efficient program results. When designing policies and procedures to address control activities, the City should keep in mind that the cost of implementing certain control activities should not exceed the benefit derived from the control activities.

Controls can either be preventive or detective. Preventive controls attempt to deter or prevent undesirable events from occurring but detective controls attempt to detect undesirable acts that may have already occurred. Control activities can be categorized as policies and procedures that pertain to the following:

a) *Authorization (Preventive)* – Activities should be authorized by the appropriate personnel and in accordance with the City's policies and procedures

b) *Segregation of Duties (Preventive)* – Key duties and responsibilities are divided or segregated among different people to reduce the risk of error, waste, or fraud. The functions of authorization, recording, or reconciling, and maintaining custody of assets should be segregated. Consider the following:

1) No one individual is allowed to control all key aspects of a transaction or event
2) Responsibilities and duties involving transactions and events are separated among different employees with respect to authorization, approval, processing and recording, making payments or receiving funds, review and auditing, and the custodial functions and handling of related assets
3) Duties are assigned systematically to a number of individuals to ensure effective checks and balances exist
4) Where feasible, no one individual is allowed to work alone with cash, negotiable securities, or other highly vulnerable assets
5) The responsibility for opening mail is assigned to individuals who have no responsibilities for or access to files or documents pertaining to accounts receivable or cash accounts
6) Bank accounts are reconciled by employees who have no responsibilities for cash receipts, disbursements, or custody
7) Management is aware that collusion can reduce or destroy the control effectiveness of segregation of duties and, therefore, is especially alert for it and attempts to reduce the opportunities for it to occur
For some small city entities, segregation of duties may be a challenge. Review and approval by an appropriate second person may be the most important control activity.

c) *Performance Reviews (Detective) – The* City should perform analyses of financial data to ensure variances are in accordance with expectations, considering internal and external factors. This includes comparing current year actuals to budget, historical trends, and any forecasts of future performance available

d) *Information Processing (Preventive)* - two aspects, Application Controls and General Information Technology (IT) Controls, which relate to the overall effectiveness of IT controls to ensure the proper operation of the City's information systems.

*Application Controls* are those related to procedures to check the accuracy of the output data, including follow-up on exceptions. Application controls are designed to help ensure completeness, accuracy, authorization, and validity of all transactions during application processing. It includes both the routines contained within the computer program code as well as the policies and procedures associated with user activities, such as entering data and producing or reporting results.

*General IT Controls* involve maintaining control procedures to restrict the access to the program data and the ability to make modifications to the data, including software updates and back-up or disaster recovery procedures, to ensure the continued operation of the information systems. General controls are needed to ensure the function of application controls, which depend on computer processing, and include the structure, policies, and procedures that apply to the entity's overall computer operations. It applies to all information systems: mainframe, minicomputer, network, cloud applications, and end-user environments, and can include controlled processes for system access, computer center or server operations, change management, incident response, business continuity, and backup and storage.

e) *Physical Controls (Preventive and Detective)* - include ensuring the safeguarding of both tangible and intangible assets. The City should have policies that ensure the physical security over all assets, whether they be capital assets, cash and investments, or other assets, and procedures to periodically count or reconcile the assets to the records. In addition, access to computer programs or data files should be restricted to appropriate personnel.

### *Information and Communication:*

According to the fourth internal control standard, information is necessary for each city entity to carry out internal control responsibilities to support the achievement of its objectives. The City management at all levels should obtain, or generate, and use relevant and quality information from both internal and external sources to support the functioning of other components of internal control. Communication is the continual, iterative process of providing, sharing, and obtaining necessary information. Internal communication is the means by which information is disseminated throughout the organization, flowing up, down, and across the entity. It enables personnel to receive a clear message from management that control responsibilities must be taken seriously. External communication is twofold as it enables inbound communication of relevant external information and provides information to external parties in response to requirements and expectations.

Below are examples of how a department might manage its information and communication. These are only examples of key controls in the areas noted some departments might use other methods to meet the objectives of information and communication:

a) Cities should have management-authorized job descriptions for all personnel

b) Cities may adopt policies and procedures to communicate important information about management's expectations for each process. Policies should be deployed thoughtfully and conscientiously to ensure that required actions are reasonable. Procedures should articulate the distinct responsibility and accountability of each individual involved in the process. Procedures lose effectiveness unless they are performed consistently, by qualified personnel who have been properly trained, and with a continuous focus on the risks to which they are directed.

c) Cities should adopt a written ethics policy or code of conduct and communicate management's message to employees concerning ethics through their daily words and actions

d) Management should periodically review pertinent policies with key employees charged with entering transactions into the financial system

e) Management should have access to viewing and reporting within the financial system and are encouraged to review their department's revenue, expenses, and budget-to-actual reports. The City should have monthly or quarterly reports distributed to department managers.

f) Management should provide written instructions to all financial personnel with a role in the budget development and year-end close processes. Instructions for the year-end close process should include the objectives of financial reporting and information about new accounting and financial reporting guidance.

g) A mid-year financial report, or quarterly financial reports, should be submitted to the governing body for its review. This report of financial data can take various forms, including standard reports produced by that entity's accounting system or a high-level budget-to-actual comparison for selected key funds. An annual financial report, such as an Annual Comprehensive Financial Report (ACFR), is presented to the governing body.

h) Financial reports prepared for external distribution may be reviewed by management prior to distribution

i) The City should adopt annual/biennial budgets and maintain processes for preparing and communicating budget revisions

j) Management may use intranet and internet sites to communicate important information to employees, the governing body, and the public

k) Information provided on internet sites could include annual financial reports, adopted budgets, and summaries of governing body actions

l) Cities should monitor events at the state and national levels for pertinent legislative or regulatory actions

m) Meetings of management personnel should be conducted to review governing body agenda items, new initiatives, budget updates, and other important information

n) Staff meetings should be conducted to provide an opportunity for information sharing up, down, and across the organization

o) Cities should establish and communicate to their employees a whistleblower hotline to provide a channel for reporting potential wrongdoing. The reporting channel should allow for anonymity and be separate from management's reporting structure to prevent any potential barriers to the reporting of wrongdoing.

### *Monitoring Activities:*

Monitoring is the fifth and final internal control. Monitoring involves evaluating the effectiveness of City controls on an on-going basis and taking remedial actions when necessary. On-going monitoring activities should be built into the normal recurring activities of the City, including regular management and supervisory activities. Management's monitoring of controls should include consideration of whether they are operating as intended and that they are modified as appropriate for changes in conditions. Below are examples of how the City might manage its monitoring responsibilities. These are only examples and the City might use other methods when appropriate.

a) When employees are supervised and evaluated by management, cities should use that process to address issues of internal control that are associated with that employee's duties. This allows management to ascertain the effectiveness of those internal controls over the period that the employee performs his or her duties. As a part of the supervision process, management should communicate management's expectations to the employee with respect to those internal controls. This provides a measure by which management judges the effective operation of those controls.

b) The City might use periodic meetings with personnel of its independent auditor to identify issues that affect the quality and timeliness of key controls (monthly cash reconciliations, reconciliations of accounts receivable balances to subsidiary ledgers, updating of capital asset records, etc.). Such meetings might include discussion regarding internal control deficiencies identified by finance department employees in the performance of their duties (such as violations of purchasing requirements by other departments, etc.) and an appropriate response to those deficiencies.

c) The City may receive information from on-site reviews of regulatory and funding agencies that comment on the effectiveness of internal controls in certain areas. The City's monitoring activities may include a consideration of the information provided by these reviews and the development and implementation of actions to correct any deficiencies noted.

d) The City should use its review of budget-to-actual reports to ascertain the on-going quality of the accounting controls that are used to produce reliable and consistent financial information about the City.

e) The City should respond to information received from employees regarding the accuracy of their payroll checks in order to give the City information about the quality of the internal controls associated with the payroll process.

f) The City should respond to information received from vendors regarding the accuracy of payments made on vendor invoices in order to give the City information about the quality of the internal controls associated with the accounts payable process.

g) The City should respond to information received from consumers regarding the accuracy of billings in order to give the City information about the quality of the internal controls associated with the billing system.

h) The City may include in their monitoring activities a periodic consideration of the continued appropriateness of the organizational structure of the city to effectively manage the financial reporting risks of the city.

i)  The City may establish a practical mechanism (e.g., hotline) to permit the anonymous reporting of concerns about fraud or abuse and questionable accounting or auditing practices to the appropriate parties.

## CHAPTER III – EVALUATING INTERNAL CONTROLS

Once an internal control framework has been designed and properly implemented, periodic monitoring and improvements are essential. Consider the following:

a)  If the control was not valid, then it should be redesigned

b)  If the control was not properly established then it should be re-communicated to the proper parties

c)  If the control was not effective, that is, was not operating as intended then the cause should be identified and eliminated

d)  If the control was not efficient then it should be modified to ensure that the benefit outweigh the cost Control activities are often interrelated and the combined effect of a group of control activities may be greater than the sum of the effects. Optimum improvement often requires considering groups of controls rather single control activities. Consequently, the best way to improve internal control after an evaluation is to develop a plan for improvement that packages the modified and new controls into congruent groups of activities, rather than trying to fix each internal control separately.

If you have any questions or would like additional guidance, please contact the Administrative Services Department.