

Internal controls

The integrity and accuracy of information produced by the accounting and financial reporting systems depend on the trustworthiness and reliability of those persons who authorize, record, reconcile, and ultimately report the financial data. Internal controls represent the network of policies and procedures that govern how financial data, and the assets they produce, are collected, processed, and documented. In larger local governments, an internal auditor, who typically reports to the manager, oversees and monitors this network.

Internal controls exist in every organization, small or large, public, for-profit, or not-for-profit. Maintaining and periodically verifying an inventory of personal computers (PCs), for example, is part of internal control. When a new PC arrives, a property label with an inventory number is attached. That documentation is used to track the PC's location, and an annual inventory review will verify that location and the current user.

Internal controls provide managers, accountants, and auditors with the assurance that procedures are being followed; that those procedures provide reasonable protection from fraud and theft of assets; and that if weaknesses in internal controls are identified, remedial action will be taken.

Internal control begins at the top, with the example set by the manager. How important is integrity to the manager? Does the manager model compliance with policies and procedures? Does the manager regularly communicate the importance of internal checks to department heads and other lower-level administrators? How does the manager handle violations of internal controls? No system is foolproof; every organization has vulnerabilities that enable the determined person "to beat the system." But a culture of compliance and integrity is foremost in any efforts to minimize the risk of such vulnerabilities.

Internal control has five components through which policies and procedures are most closely monitored and evaluated. The first component is **authorization**: internal policies must make clear who can authorize a transaction, whether that

transaction is the initiation of a purchase requisition, the issuance of a check, or the approval of a contract. Every document should have at least two signatures, at least one of which is from a supervisor of the person initiating the transaction.

The second component is the **design of documentation**, such as sequentially numbered purchase orders and checks. The destination of duplicate copies of documentation should be indicated on each form to ensure proper distribution.

The third component concerns the **proper security of assets and records**, such as inventory controls, custody of investment securities, and backup procedures for financial and personnel records.

The fourth component of an effective internal control system is the **segregation of sequential duties**. For example, the person who is responsible for opening utility payments received by mail or over the counter should not be the same person who records the payments in the accounting system, and neither of these persons should be the one responsible for making the daily deposit to the bank or reconciling the monthly bank statement with the cash ledger. In a smaller local government with a limited staff, segregation of duties becomes more difficult but just as essential; here, the manager may need to assume responsibility for verifying bank statements and other externally generated documentation against internal records.

The fifth component is **reconciliation and verification** of actual balances with those reported in the accounting records. Monthly bank statements should be reconciled with the cash balance reported in the general ledger. Inventory records should be verified at least annually by visual inspection of equipment and materials held in inventory. Personnel records need to be periodically verified with employees and their supervisors.

Internal controls provide a system of checks and balances that helps to ensure but cannot guarantee that transactions are being accurately recorded, that assets are protected from fraud, and that financial information is reliable.