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California State Controller

PRESENTED BY:

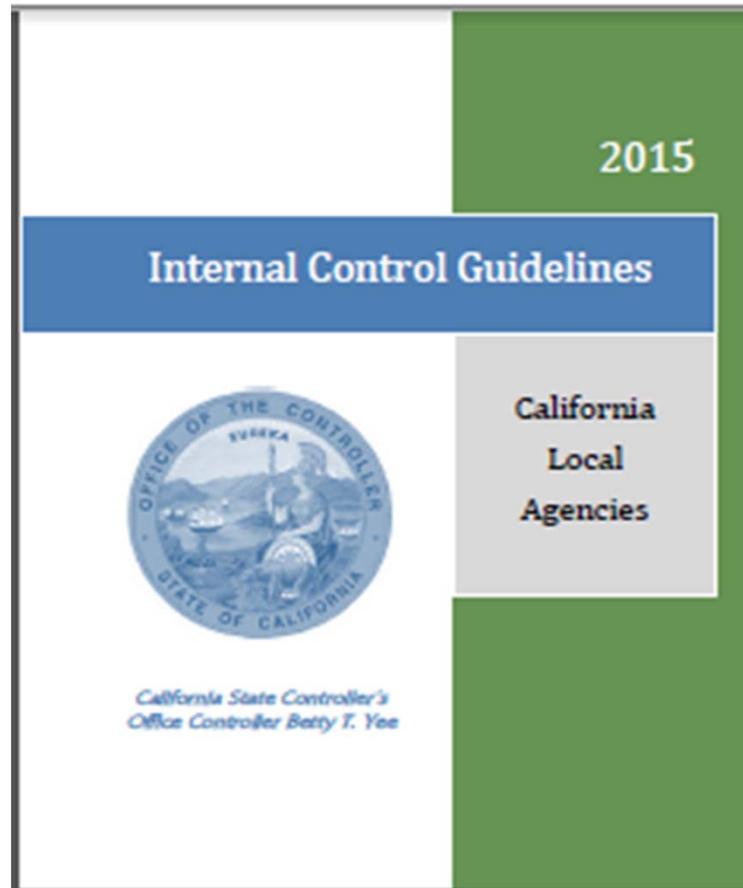
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SCO Internal Control Guidelines for California Local Agencies



[www.sco.ca.gov/Files-AUD/2015 internal control guidelines.pdf](http://www.sco.ca.gov/Files-AUD/2015_internal_control_guidelines.pdf)

SCO Internal Control Guidelines for California Local Agencies

- Background
- SCO's Internal Control Review of an LGA
- SCO's Internal Control Guidelines
- Questions?

Background

- Lack of internal controls found on a series of SCO audits of various Local Government Agencies (LGA)
- Assembly Bill 1248
 - Sponsored by the SCO
 - Introduced by Assembly Member Ken Cooley on February 22, 2013
 - Became law on August 28, 2013

Background

Legal Requirements

California Government Code Section 12422.5:

- (a) On or before January 1, 2015, the Controller shall develop internal control guidelines applicable to each local agency to prevent and detect financial errors and fraud.
- (b) The Controller shall develop the internal control guidelines based on standards adopted by the American Institute of Certified Public Accountants and with input from any local agency and organizations representing the interests of local agencies, including, but not limited to, the League of California Cities, the California State Association of Counties, the California Special Districts Association, and the California State Association of County Auditors.

Background

Development Process

- SCO and California Society of Certified Public Accountants (CalCPA)
- CalCPA – took a lead role in developing the guidelines
- Input from:
 - League of California Cities
 - CA State Association of Counties
 - CA Special Districts Association
 - CA State Association of County Auditors
 - California Common Sense
- Timelines
 - July 2014 – Draft Guidelines sent out for review and comment
 - January 2015 – Final Guidelines posted on the SCO website

SCO's Internal Control Review of a LGA

Internal Control Review

- Evaluate whether a LGA has sound internal control policies and procedures sufficient to ensure:
 - Accuracy and reliability of the financial data submitted to the SCO;
 - Claims against the state are correct, legal, and in compliance with applicable funding provisions.

SCO's Internal Control Review of a LGA

Internal Control Review

- Evaluation of a LGA's internal controls:
 - Past and current reviews
 - Assessment of Elements of Internal Control based on:
 - ✓ GAO's 2001 Internal Control Management and Evaluation Tool
 - Future reviews
 - Assessment of Components, Principles, and Attributes of Internal Control based on:
 - ✓ COSO's 2013 Framework
 - ✓ GAO's 2014 Standards
 - ✓ SCO's 2015 Guidelines

Internal Control

Why is it important?

- It helps ensure:
 - Effectiveness and efficiency of operations;
 - Reliability of financial reporting;
 - Compliance with applicable laws and regulations; and
 - Adequate safeguard of resources.
- It affects everyone

Guidelines Were Organized Into the Five Elements of Internal Control (COSO Standards)

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

Examples Listed in Guidelines

- Not minimum requirements
- Your agency does not need to incorporate all of the examples listed
- Different agencies will use different combinations of the examples listed
- The guidelines are meant to be an aid to help agencies
- The guidelines can help agencies identify what they are already doing to address internal control objectives

You Should Document How Your Agency Has Addressed Each of the Five Elements

- “Documentation” can be a simple write-up that describes what your agency does to address the objectives of each of the five elements of the COSO framework
- Your auditors will expect that your agency has thoughtfully considered each of the five elements
- The examples listed in the guidelines might be relevant to your organization
- Your organization might use other methods to address internal control objectives that are different from those listed in the guidelines
- You should have a separate write-up for each of the five elements
- As you describe what your agency does, your write-up should clearly describe how the matters described in your documentation contribute toward the objective of the element that is addressed in the write-up

Control Environment

- What is it:
 - The governance and management functions and the attitudes, awareness, and actions of those charged with governance and management that:
 - Sets the tone of an organization
 - Serve as the foundation for all other components of internal control, providing discipline and structure.

Source: AICPA Auditing Standards AU-C 315.A71

Control Environment - Examples

Any combination of the following:

- Ethics policy
- Fraud hotline
- Annual email from City Manager emphasizing the values of the agency and the importance of following policies and procedures
- Serious consequences for policy violations
- Use of an audit committee
- Describe in the “control environment” document how the governing board promotes a strong ethical culture
- HR’s use of procedures to ensure that individuals with strong ethical values are hired and HR’s use of training programs to promote best practices
- Appropriate follow-up on negative matters noted in staff performance reviews

Risk Assessment – What is it

- “An entity’s identification, analysis, and management of risks relevant to the preparation and fair presentation of financial statements” – AICPA Auditing Standards AU-C 315.A91
 - You are probably already performing risk assessment activities without realizing it
 - In your written document, you should acknowledge how those activities qualify as risk assessment

Risk Assessment Process

- Identifies risks (including unintentional error, fraud, noncompliance)
- Estimates the significance of each risk
- Assesses the likelihood of the occurrence of the error, fraud, or noncompliance associated with the risk
- Decides upon the actions to respond to and manage those risks and the results thereof

Risk Assessment - Example (Department Head Meetings)

You may want to acknowledge in your risk assessment documentation the following:

- The use of bi-weekly department head meetings to receive information from the City Manager. When this information affects the proper recording of transactions, this information is identified and communicated. You will want your written description of the risk assessment process to explain how this plays out in your agency toward the management of risk

Risk Assessment – Example (Inventory of Risks)

- A part of your risk assessment might involve a more formal process
- You might ask each person in the Finance Department to provide you with a list of the types of errors that they (or other departments of the agency) might create or fraud that might occur that is associated with their tasks at the agency

Risk Assessment – Example (Employee Supervision)

You may want to acknowledge in your risk assessment documentation of the following:

- Your identification of risks associated with financial reporting might be a bi-product of your **employee supervision and performance evaluation** process.
- If so, this should be acknowledged in the written description of your risk assessment process.
- You should describe how information noted during employee supervision and review results in the identification of risks that are evaluated to require further attention.
- The written description of the process should describe how your agency develops a response to those risks, perhaps giving examples of such responses to assist staff when executing the risk assessment process that is described in your process documentation.

Risk Assessment – Example (Accumulation of Information for Auditors)

- Throughout the year, management might maintain a list of information, 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 agency's independent auditors.

Control Activities – What Are They

- “Control activities are the policies and procedures that help ensure that management directives are carried out” – AICPA Auditing Standards AU-C 315.A91
- Control activities generally include elements of:
 - **Authorization** – review and approval
 - **Performance Reviews** – analyzing data by comparing data to expected values based on budgets, forecasts, historical data, etc.
 - **Information Processing** – IT application controls and IT general controls
 - **Physical Controls** – safeguarding assets
 - **Segregation of Duties** – the persons with functional access to assets (data entry for cash disbursements, etc.) should be different from those that approve the activity and record or reconcile the activity.

Control Activities – Example (Payroll)

- Only Human Resources (not payroll) has the system access rights to establish or remove an employee from the system
- Or someone other than the payroll clerk must run a system report that lists all payroll master file changes and compares such changes to properly approved personnel action forms
- The most material payroll frauds involve the creation of fictitious employees (or leaving a separated employee in the system, but then changing the direct deposit bank account to an account that is under the control of the payroll clerk).
- Simply altering pay rates for selected employees is less likely to produce material amounts of fraud.

Control Activities – Example (Collections Outside of Finance)

Consider money collected outside of the Finance Department:

- Gold standard – use of cash registers (avoid the use of other “documents” that might satisfy the payors expectation for a receipt without the transaction being ran through the cash register)
- Don’t just focus on currency
- The most material skimming frauds have involved an employee depositing checks made out to the agency into a bank account in the name of the agency that was established by that employee
- An effective control might involve two individuals in that department reconciling the money received to some evidence of services rendered (a print out of recreation class registrations, etc.) – both “reconciler” should sign this daily reconciliation

Control Activities – Example (Control Over Interbank Transfers)

- During the bank reconciliation, the independent reconciler should trace all interbank transfers to evidence of approval by an authorized initiator and a second approver (other than the initiator)
- The reconciler of the bank accounts should not be involved in data entry for cash disbursements, the handling of bank deposits, or the execution of interbank transfers (including investment purchases)

Control Activities – Example (Procurement/ Contract Management/Accounts Payable)

- Access to the vendor database may be segregated from access to the accounts payable module.
 - Do you have a vendor table policy? Written procedures?
- Invoices should be checked for mathematical accuracy and approved for payment prior to processing.
 - Do you have an accounts payable policy? Who in the process is responsible for what? Written procedures?
- Check/warrant registers should be reviewed for accuracy by a person independent from the AP process and approved prior to finalization.
 - Do you have written procedures? Have you reviewed your procedures for effectiveness based on changes in technology?

Control Activities – Example (Procurement/ Contract Management/Accounts Payable)

- Purchasing guidelines should be established that detail:
 - authorization limits
 - when contracts are required
 - when purchases are subject to bidding or informal quotes
- [Otherwise, the applicable contract procurement sections of the Government Code, or other authoritative guidelines, should be followed.]
- Positive pay, or a similar procedure, should be employed.
 - Are you talking with your bank about fraud prevention controls?
- Internal financial reports should be reviewed and compared to budget on a periodic basis and variances should be investigated.
 - By Finance Department
 - By other departments

Control Activities – Example (Debt Management)

- Policies should be established to define when the governing body or staff may authorize the issuance of long-term debt, including bonds, capital leases, loans, lines of credit, etc.
- Procedures should be established to ensure timely repayment and compliance with on-going debt covenants.
- To ensure compliance with limitations on use, the use of debt proceeds should be subject to review and approval.
- Trustee or bank accounts should be reconciled by a person not involved with the authorization for the disbursement of debt proceeds.

Control Activities – Debt Management

- Task Force on Bond Accountability Final Report issued in December 2015:
 - Internal Control practices common to public agencies
 - Lessons learned from observed internal control practices of issuers
 - 20 Observations based on task force research and lessons learned
 - 17 Bond Accountability Best Practice Guidelines
 - Debt Issuance and Management Review Checklist
 - Internal Control System Checklist

Information and Communication

- AICPA Auditing Standards AU-C 315.A84 and 315.A89
- Information is necessary for an entity to carry out internal control responsibilities to support the achievement of its objectives.
- A communication system consists of methods and records established to identify, capture, and exchange useful information.
- Information is useful when it is timely, sufficiently detailed, and appropriate to the user.

Information and Communication - Examples

- Management-authorized job descriptions for all personnel
- Policies and procedures to communicate important information about management's expectations for each process.
- Written ethics policy or code of conduct
- Communicate management's message to employees concerning ethics through their daily words and actions.

Information and Communication Examples

- Management should periodically review pertinent policies with key employees.
- 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.
- 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.

Information and Communication Examples

- A mid-year financial report, or quarterly financial reports, should be submitted to the governing board for its review.
- Financial reports prepared for external distribution may be reviewed by management prior to distribution.
- Local governments adopt annual or biennial budgets and maintain processes for preparing and communicating budget revisions.

Information and Communication Examples

- Management may use web sites to communicate important information to employees, the governing board, and the public.
- Meetings of management personnel should be conducted to review governing board agenda items, new initiatives, budget updates, and other important information.
- Staff meetings provide an opportunity for information sharing up, down, and across the organization.
- Local governments should establish and communicate to their employees a whistleblower hotline to provide a channel for reporting potential wrongdoing.

Monitoring

- “*Monitoring of controls is a process that is used by management to assess the effective operation of internal controls over time.*” – AICPA Auditing Standards AU-C 315.A91

Monitoring Examples

- Use performance evaluations to address issues of internal control that are associated with that employee's duties.
- Use periodic meetings with personnel of the finance department to identify issues that affect the quality and timeliness of key controls.
- Consider information from on-site reviews of regulatory and funding agencies that comment on the effectiveness of internal controls in certain areas.

Monitoring Examples

- Use review of budget-to-actual reports to monitor the on-going quality of the accounting controls that are used to produce reliable and consistent financial information.
- In order to give the local government information about the quality of the internal controls associated with the following processes:
 - Respond to information received from employees regarding the accuracy of their payroll checks
 - Respond to information received from vendors regarding the accuracy of payments made on vendor invoices
 - Respond to information received from customers regarding the accuracy of utility billings
- Some local governments may establish audit committees and/or use internal auditors to monitor the on-going effectiveness of internal controls.

Monitoring

- Maintain a high degree of interaction with vendors or other service providers that process a material amount of the local government's transactions and/or require that the vendor (service organization) provide an independent auditor's report on the effectiveness of the service organization's controls over the processing of those transactions (i.e., a SOC 1 – Type 2 report).
- Establish a hotline to permit anonymous reporting of concerns about fraud or abuse and questionable accounting practices.

GFOA Best Practices

- Documenting Accounting Policies and Procedures (2007)
- Encouraging and Facilitating the Reporting of Fraud and Questionable Accounting and Auditing Practices (2007)
- Getting Management Involved in Internal Control (2008)
- Framework for Entity-wide Grants Internal Control (2015)
- Establishing a Comprehensive Framework for Internal Control (2015)
- Framework for Internal Control: The Control Environment (2016)

Questions

