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MEMORANDUM

To: Municipal Officials

From: Karen Horn, Director, Public Policy and Advocacy; and
Abby Friedman, Director, Municipal Assistance Center

CC: VLCT Board of Directors Financial Responsibility Committee

Date: January 17, 2012

RE: Internal Controls for Municipalities

The integrity and transparency of a municipality's financial systems are of paramount importance to the overall health of Vermont's towns. Last spring, the VLCT Board of Directors appointed the VLCT Financial Responsibility Committee to advise on ways to ensure that integrity. The committee recommended developing guidance to complement the Vermont State Auditor's Internal Control Checklist for Vermont Towns. After further research and in consultation with the State Auditor, we developed a new Municipal Internal Control Checklist that not only complies with current professional standards, but will also meet the needs of our municipalities as they work to improve their own financial controls.

This memo includes an introduction to internal financial controls, the Municipal Internal Control Checklist, and guidelines for completing the checklist. As described below, an internal controls checklist is only one component of a comprehensive set of internal control activities. VLCT, with the support of VLCT Property and Casualty Intermunicipal Fund (PACIF) is committed to help municipalities build and maintain sound financial management systems. We plan to pilot test the Municipal Internal Control Checklist with a few municipalities and incorporate the results along with a more in-depth guidebook on the full spectrum of municipal internal controls.

For more information, please contact Abby Friedman at afriedman@vlct.org or (800) 649-7915.

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What are Internal Controls and Why are they Important?

At the time of this writing, the number of cases of municipal embezzlement and faithful performance errors in Vermont is on the rise. These losses to taxpayers amount to millions of dollars that insurance does not always cover in full. What these cases have in common is a serious lack of internal controls over financial management and accounting transactions. Beyond preventing embezzlement, a good system of internal controls will also help detect accidental mistakes that may result in the preparation of inaccurate and misleading financial information. In recent months, we have noted an increase in interest among municipalities in establishing or improving the internal controls over their financial management.

Internal controls will vary from municipality to municipality. Controls in small towns with few employees will naturally be different from controls in larger towns that have more employees in the financial function. However, the standards of any internal control system are generally the same. These standards are not new ideas. Many of the concepts are already part of many municipalities' existing operations.

According to the Committee of Sponsoring Organizations (COSO), a joint initiative of five private sector organizations:

Internal control is a process, affected by an entity's board of directors, management, and other personnel, designed to provide reasonable assurance regarding the achievement of objectives in three fundamental categories:

- *Effectiveness and efficiency of operations,*
- *Reliability of financial reporting, and*
- *Compliance with applicable laws and regulations.*

Internal controls ensure that financial statements accurately present the operating results of the organization; that public funds are administered and expended in compliance with applicable statutes and regulations; and that funds are used for the purposes for which they were authorized and intended.

The Five Elements of Internal Control

COSO identifies five elements of internal control briefly described below. VLCT will provide more comprehensive information, training, and tools on internal controls later this year.

1. The **Control Environment** in a municipality should be one in which the elected officials and appointed managers support strong controls and show a commitment to maintaining competence through good hiring practices and training. In addition, the municipality should have a clear and unambiguous organizational structure with appropriate policies and procedures. VLCT's *Model Financial Policies Handbook* contains five policies particularly applicable to internal controls: Model Accounting, Auditing, and Financial Reporting Policy; Model Purchasing Policy; Model Cash Receipts, Petty Cash, and Returned Check Policy; Model Credit Card Policy; and Model Fraud Policy. The Model Fraud Policy explains fraudulent activities and the role of employees who discover them. In addition, our model

conflict of interest policy can help manage conflicts of interest. The handbook is archived at www.vlct.org/assets/Resource/Handbooks/VLCT_Model_Financial_Policies_Handbook.pdf.

2. **Risk Assessment** is necessary in order for a municipality to understand what activities may create a risk for fraud and embezzlement. Evaluating risk allows you to put in place the control activities needed to eliminate or mitigate that risk. Contact VLCT to learn more about a fraud risk assessment service we offer to members.
3. **Control Activities** are specific actions municipalities can take to prevent or mitigate the risks they have identified in their operations. The Municipal Checklist for Internal Controls is a key component of determining appropriate control activities and the focus of this memo. The Municipal Checklist and guidelines explaining its components as a tool for government officials in improving their internal controls follow below.
4. **Information and Communication** between staff and elected officials is an important element because it ensures that reporting to the selectboard and citizens is timely and accurate, policies and procedures are documented and accessible, and control effort are transparent.
5. The final element, **Monitoring**, is the municipality's activities and transactions to assess the quality of performance over time and to determine whether controls are effective.

The following guide provides both an explanation of the various categories of control activities as well as a checklist for municipalities to use in determining what controls are currently in place.

Guide to the Municipal Checklist for Internal Controls

The Municipal Checklist for Internal Controls is a modified version of the Vermont State Auditor's Internal Control Checklist for Vermont Towns. Each section of the checklist is described below.

A. General Controls

It is important for local officials to spend sufficient time to establish a system of internal controls appropriate for their municipality. This system should address all five elements of internal control: the control environment, risk assessment, control activities, information and communication, and monitoring. Adopting appropriate financial policies such as a code of conduct and a fraud prevention policy will go a long way in preventing undesirable events from occurring, or detecting them if they do occur.

Train your employees. Good internal controls include a commitment to competence. To make sure that municipal financial systems are functioning properly, it is important that local officials and staff have the opportunity to get the training they need to maintain and improve their skills.

Document policies, procedures and practices. A municipality should have proper documentation – such as a personnel manual – that supports its policies, procedures, and control practices. This manual will make clear the duties and responsibilities of each employee in the organization and how they interrelate with one another. Among the policies that a town should consider adopting are an accounting, auditing, and financial reporting policy; a purchasing policy; and a cash receipts policy. When policies, procedures, and control activities are in writing, employees will know what is expected of them as they carry out their duties. In addition, written procedures will be indisputable in the case of employee absences or when a new employee is hired.

Take steps to reduce the opportunity to commit fraud. Personnel who are involved in the accounting function should be required to take annual vacations, and other employees should perform their functions in their absence. Routine cross-training among positions will facilitate this process. It is often when someone else performs an accounting function that an incidence of fraud is discovered.

Selectboards, managers, and other elected officials must make employees aware that they are paying attention to the financial affairs of the municipality. Employees should be properly supervised and their work regularly reviewed. Reports should be regularly prepared and distributed, and managers should review any unusual issues with accounting staff. Employees are less likely to commit fraudulent activities if they think they might be caught.

Selectboards and town managers should regularly review budgets and projections and compare actual results to expectations. An employee who commits a fraudulent act typically needs to manipulate the accounting records to hide the action. In many cases, a careful review of the accounts will expose that kind of activity.

Elected officials and employees who handle municipal funds should be appropriately bonded to ensure that the taxpayers do not absorb the cost of embezzlement if it does occur.

B. Controls over Financial Records

Establish and maintain adequate systems and processes for accounting and reporting. Municipalities should maintain an accounting system that allows financial transactions to be recorded, easy retrieval of the data for analysis, and generation of timely reports to maintain accountability for the organization's assets. The system should include detailed cash receipts and cash disbursements journals, as well as a detailed general ledger and subsidiary ledgers where appropriate. A subsidiary ledger (a detailed list of outstanding taxes receivable, for example) should be regularly reconciled with the general ledger to ensure that transactions were recorded properly and that all transactions have been included. All general journal entries should be approved by management.

No single individual should perform all related elements of an individual transaction. No employee should be able to (a) authorize a transaction, (b) record the transaction in the accounting records, and (c) maintain custody of the assets resulting from the transaction. For example, individuals responsible for the data entry of accounts payable should not be able to

authorize transactions. For a small town, this may simply mean that the limited number of staff will have to alternate certain duties to ensure that there is a second set of eyes for each type of transaction.

Bank reconciliations should be performed by someone who is not involved in the cash receipt or cash disbursement process. Reconciliations should be prepared on a timely basis, preferably immediately on receipt. A responsible and knowledgeable official other than the preparer should review the completed bank reconciliation.

In addition to the bank reconciliation, other reconciliation procedures should be performed monthly. Regularly reconcile accounts receivable balances to the original invoices and accounts payable balances with actual invoices. Reconcile payroll withholdings with payroll reports and invoices for benefits, and reconcile property tax receivable balances with property tax receipts. These reconciliations will indicate if the subsidiary information contains errors or irregularities.

All financial recording documents (checks, receipts, purchase orders, etc.) should be pre-numbered, and all forms should be accounted for. Issue receipts for all cash transactions.

Safeguard accounting records against fire, theft, and manipulation. Records should remain on town property, preferably in a safe or vault.

C. Controls over Cash

Establish adequate processes for safeguarding receipts. The municipality should adopt a cash receipts policy specifying which officials and employees are authorized to accept payments on behalf of the municipality. Remit all funds collected by persons other than the treasurer to the treasurer promptly. Do not make any expenditures from cash collected and do not cash any checks from funds collected.

Checks should be restrictively endorsed (“for deposit only”) immediately upon receipt. Cash receipts should be physically safeguarded until deposit. Make deposits on a timely basis to avoid accumulating large amounts of cash that may provide an opportunity for theft.

Prepare duplicate receipts for all transactions. Compare receipts to cash journals during the reconciliation process.

Establish adequate processes for controlling cash disbursements. All disbursements, except for occasional small petty cash items, should be made by check or direct deposit transactions. Checks should be pre-numbered, and unused checks should be stored in a secure location. Checks should be made payable to a specific individual, never to “cash.”

Selectboard orders must be prepared for all purchases and signed by a majority of the board before payment is made.

Handle petty cash funds on an imprest (replacing only what is spent), or fixed amount, basis. The amount of cash on hand, plus receipts for cash items paid out, must at all times equal the total of the fund.

D. Controls over Accounts Receivable and Collections

Establish and maintain processes that will ensure that account balances are accurate. Duties involving accounts receivable should be separate from those involving cash receipts. Persons involved in the collection process should not also be responsible for the billing process or the credit/adjustment process.

Record all receivables (taxes, utility charges, other miscellaneous receivables) in the general ledger. Subsidiary ledgers should be reconciled to the general ledger control account on a regular basis.

Establish and maintain processes that will ensure that outstanding amounts due are collected. Forward invoices prepared by various town departments to the finance office for entry into the accounts receivable ledger so that action can be taken on unpaid balances. The accounts receivable system must be capable of preparing an aged listing of outstanding accounts receivable.

Send periodic statements to all customer accounts showing any unpaid amounts as well as recent payments. Charge penalties and interest on all overdue accounts.

E. Controls over Purchasing and Disbursements

Establish and maintain processes that ensure adequate oversight. The town should adopt a purchasing policy that describes the lines of authority for approving purchases and indicates when to use competitive bidding. No one person should be involved in the purchasing, receiving, and payment functions.

Adopt a purchase order system to document purchasing details and demonstrate that policies were adhered to. Submit a copy of the purchase order and all receiving documents for payment and maintain it in your files.

An appropriate authority must approve all invoices before payment.

Put in place procedures to detect fictitious vendors and prevent duplicate payment of invoices. Review activity for vendors regularly to detect any suspicious activity.

F. Controls over Payroll

Establish and maintain adequate systems for ensuring accuracy and oversight. Maintain a personnel file for each employee that includes hiring and compensation information and authorization for all deductions taken. The selectboard must annually adopt salary and wage information for all employees.

Use direct deposit for payment of net pay.

All payroll additions, removals, or changes should be authorized by someone other than the employee who processes payroll.

The selectboard must adopt leave policies. Adequate records must be maintained to document the accumulation and use of leave time.

G. Controls over the Grand List and Tax Records

Establish and maintain adequate processes to ensure that records are accurate. A system should be in place to make certain that all taxable property is included in the grand list. A record of all changes to values should be maintained and reconciled on a regular basis.

Reconcile tax receivables with tax receipts and tax adjustments on a monthly basis.

Adopt policies concerning collection actions on late and delinquent taxes. Add interest and penalties, and regularly follow up on all outstanding amounts. Hold tax sales when appropriate.

An individual other than the tax collector (current and/or delinquent) should reconcile taxes.

H. Controls over Property and Equipment

Establish and maintain adequate systems and processes to ensure that schedules are accurate and inventory is secure. Prepare fixed asset schedules to maintain control over significant assets. Conduct and compare periodic inventories with the fixed asset schedule.

Maintain proper security – such as locks and the use of security cameras and alarm systems – over all property and equipment.

Periodically review insurance coverage to determine its adequacy.

I. Controls over Information Systems

Establish and maintain adequate systems and processes to ensure that data is secure. To prevent accidental or intentional changes to data, limit access to financial records to those who require specific access.

Back up computer records daily, and store the back-up copy off-site. Use passwords to protect all financial information. Do not share passwords with other employees, and change them on a regular basis.

MUNICIPAL CHECKLIST FOR INTERNAL CONTROLS

Question	Yes	No	Don't Know	Comments
A. GENERAL CONTROLS				
Does management understand that an adequate system of internal controls is its responsibility?				
Has management performed a risk assessment and adopted the appropriate compensating controls?				
Does the municipality have written documentation of its accounting procedures?				
Are the duties of officials and employees clearly defined and in writing?				
Are municipal officials bonded or covered by liability insurance?				
Does the municipality have an independent professional audit done on an annual basis?				
Is a budget system used to monitor revenues and expenses?				
Does the selectboard receive monthly financial reports?				
Do the selectboard members read and understand the reports?				
Does the municipality have a fraud policy and has it been communicated to the employees during the last year?				
Does management and staff understand what is meant by segregation of duties?				
Are duties properly segregated so that no individual is able to perform all related elements of a transaction?				
Are all employees required to take annual vacations, and are their accounting functions performed by other employees when they are on vacation?				
B. CONTROLS OVER FINANCIAL RECORDS				
Has the municipality adopted an accounting, auditing, and financial reporting policy?				
Does the municipality have a useful and descriptive chart of accounts?				
Does the municipality maintain its financial records using a computerized accounting system?				
Does the accounting system allow for timely recording of financial transactions, easy viewing of transaction data, and timely creation of financial reports?				
Are detailed cash receipts journals and cash disbursements journals maintained?				
Are subsidiary ledgers (e.g., taxes receivable, accounts payable) regularly reconciled with the general ledger?				
Are account reconciliations and account analysis regularly performed and reviewed by a knowledgeable person other than the preparer?				
Are all adjusting journal entries approved in writing by someone in management?				

Question	Yes	No	Don't Know	Comments
Are financial recording documents (checks, receipts, purchase orders) in duplicate and pre-numbered?				
Are all forms regularly accounted for as issued or voided?				
Are all accounting records adequately protected against fire, theft and manipulation?				
C. CONTROLS OVER CASH				
Has the municipality adopted a cash receipts policy and an investment policy?				
Does the municipality use a pooled cash account (one bank account) for most receipts?				
Does the municipality allocate monthly interest to the various funds using the pooled cash account?				
Are bank accounts covered by FDIC insurance or otherwise collateralized?				
Are receipts issued for cash transactions?				
Are receipts turned over to the treasurer daily and deposited on a timely basis?				
Are all cash receipts deposited intact?				
Are checks restrictively endorsed when received?				
Are receipts recorded in the accounting system in a timely manner?				
When funds cannot be deposited daily are they securely stored?				
Does the same employee accept funds, document or deposit them, and post the activity in the accounts?				
Are all disbursements, except for small petty cash items, paid by check or direct deposit?				
Are checks produced using an automated accounting system?				
Are checks pre-numbered and used consecutively?				
Are unused checks controlled and adequately protected from misuse?				
Are voided checks accounted for?				
Are checks prepared by a separate person from the signer?				
Does the employee who writes checks open the bank statement?				
Is petty cash controlled through an imprest petty cash system?				
D. CONTROLS OVER ACCOUNTS RECEIVABLE AND COLLECTIONS				
Are all accounts receivable recorded in the general ledger?				
Are billing, collection and posting performed by separate employees or departments?				
Does the municipality have a policy regarding adding penalties and interest to delinquent accounts other than taxes?				
Do taxpayers or ratepayers receive regular statements for outstanding balances due or overpayments?				

Question	Yes	No	Don't Know	Comments
Does the municipality have a policy regarding writing off delinquent accounts?				
Are accounts receivable reconciled to detailed invoices?				
E. CONTROLS OVER PURCHASING AND DISBURSEMENTS				
Does the municipality have a purchasing policy?				
Are the functions of purchasing, receipt of goods, and payment of invoices performed by different people?				
Does the municipality maintain an approved vendors list and perform procedures to detect fictitious vendors?				
Does the municipality use purchase orders?				
Are all expenditures supported by original invoices and other related supporting documentation?				
Are all expenditures approved by the appropriate employees and officials before payment is made?				
F. CONTROLS OVER PAYROLL				
Are personnel records maintained for all employees?				
Does the municipality have an employee manual?				
Are salary and wage rates approved by the selectboard?				
Does the municipality accurately accumulate time and record absences of employees?				
Are withholding taxes remitted promptly?				
Are payroll withholdings reconciled to payroll reports?				
Are fees paid to elected officials disclosed in the municipality's accounting records and reported to the IRS?				
G. CONTROLS OVER THE GRAND LIST AND TAX RECORDS				
Does the municipality have a system to make sure that all taxable property is included in the grand list?				
Is a reconciliation regularly performed to assure that changes to values are properly recorded?				
Are tax receipts reconciled to tax receivables, and are tax receivables reconciled to the grand list?				
Does the municipality have a policy concerning collection actions on late and delinquent taxes?				
H. CONTROLS OVER PROPERTY AND EQUIPMENT				
Are fixed asset schedules maintained for municipal property and equipment?				
Are periodic inventories taken and compared with such schedules?				
Is all property and equipment properly secured?				
Is insurance coverage reviewed regularly to determine its adequacy?				
I. CONTROLS OVER INFORMATION SYSTEMS				
Is financial information protected by the use of passwords?				
Are passwords regularly changed?				
Are computer records regularly backed up, and are back up copies stored off site?				