

2015

Internal Control Guidelines



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California
Local
Agencies

FOREWORD

California Government Code (GC) section 12422.5¹ requires the State Controller to develop internal control guidelines applicable to each local agency. The intent of the legislation is to assist local agencies in establishing a system of internal control to safeguard assets and prevent and detect financial errors and fraud. However, there is no requirement that the tools developed must be used in the form provided.

A local agency includes a city, county, city and county, special district or any other local government entity, except a school district. In this document, these entities are referred to as local governments.

The California Society of Certified Public Accountants took a lead role in developing the internal control guidelines based on standards adopted by the American Institute of Certified Public Accountants (AICPA). The State Controller's Office worked closely with the California Society of Certified Public Accountants and received valuable input from organizations representing the interests of local governments, (i.e. League of California Cities, California State Association of Counties, California Special Districts Association, California State Association of County Auditors, and California Common Sense to complete the internal control guidelines.

Although GC section 12422.5 specifically cites the AICPA standards, the internal control guidelines incorporate or reference other internal control standards and practical guidance (i.e. U.S. Government Accountability Office [GAO], Office of Management and Budget [OMB], Committee of Sponsoring Organizations of the Treadway Commission [COSO] Internal Control Standards, Institute of Internal Auditors [IIA], Government Finance Officers Association Best Practices, etc.). For additional information on Internal Controls please refer to the following:

GAO - <http://www.gao.gov/greenbook/overview>

GAO - <http://www.gao.gov/products/GAO-01-1008G>

GAO - <http://www.gao.gov/yellowbook/overview>

OMB - <http://www.whitehouse.gov/omb>

COSO - <http://www.coso.org/IC.htm>

¹ (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.

(c) On or before January 1, 2015, the Controller shall post the completed internal control guidelines on the Controller's Internet Web site to assist a local agency, as defined in subdivision (e), in establishing a system of internal controls to safeguard assets and prevent and detect financial errors and fraud.

(d) The Controller shall, with input from the agencies listed in subdivision (b), update the internal control guidelines, as he or she deems necessary, and maintain a current version on the Internet Web site.

(e) For purposes of this section, "local agency" means a city, county, city and county, special district, or any other local governmental entity, except a school district.

IIA - <https://na.theiia.org/standards-guidance/Pages/Standards-and-Guidance-IPPF.aspx>

GFOA - <http://www.gfoa.org/best-practices>

These guidelines do not include an “Internal Control Questionnaire” or an “Internal Control Checklist”; however, we recommend using the GAO’s Internal Control Standards, Internal Control Management and Evaluation Tool (<http://www.gao.gov/products/GAO-01-1008G>). The tool provides useful guidance for evaluating an agency’s internal control and is intended to help management determine how well an agency’s internal control is designed and functioning and how improvements can be implemented. We also recommend using COSO’s Internal Control – Integrated Framework 2013. The framework defines internal control, describes requirements for effective internal control including components and relevant principles, and provides direction for all levels of management to use in designing, implementing, and assessing its effectiveness. The Executive Summary can be downloaded from COSO’s website <http://www.coso.org/IC.htm>, however the Framework and Appendices, and Illustrative Tools for Assessing Effectiveness of a System of Internal Control (three-volume set) can be purchased.

The internal control guidelines are posted on the State Controller's Office website and will be updated periodically, as he or she deems necessary.

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Introduction

The American Institute of Certified Public Accountants' (AICPA's) Auditing Standard AU-C §315.04 defines internal control based on the definition and description contained in *Internal Control – Integrated Framework*, published by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) as follows:

A process effected by those charged with governance, management, and other personnel that is designed to provide reasonable assurance about the achievement of the entity's objectives with regard to the reliability of financial reporting, effectiveness and efficiency of operations, and compliance with applicable laws and regulations. Internal control over safeguarding of assets against unauthorized acquisition, use or disposition may include controls relating to financial reporting and operations objectives.

Internal control is comprised of five components that work together in an integrated framework:

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

The objectives of the five components are defined below along with examples of methods that may be used by a local government to address each component. However, these are guidelines and it is important to note that the actual methods implemented to address the components of internal control need to be scaled to each particular local government and expanded or contracted based on the local government's organizational structure, staffing levels, programs, and resources. It is not expected that all local governments will use all of the example methods of implementation that have been identified for each component. In addition, some local governments may use other policies or procedures in their system of internal control in lieu of the examples provided in these guidelines.

Control Environment

The Objectives of Control Environment:

The AICPA's Auditing Standard AU-C §315.A71 defines control environment as:

The control environment includes the governance and management functions and the attitudes, awareness, and actions of those charged with governance and management concerning the entity's internal control and its importance in the entity. The control environment sets the tone of an organization, influencing the control consciousness of its people. It is the foundation for all other components of internal control, providing discipline and structure.

The control environment is the set of standards, processes, and structures that provide the basis for carrying out internal control across the entity. The governing board and management 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. The control environment extends beyond the idea of culture and comprises the following:

- The organization's integrity and ethical values;

- The governing board's oversight responsibilities;
- The assignment of authority and responsibility;
- The process for attracting, developing, and retaining employees; and
- The measures, incentives, and rewards to drive accountability for performance.

A local government's control environment is influenced by a variety of factors including its history, values, market, and the competitive and regulatory landscape. Also, a local government that establishes and maintains a strong control environment positions itself to be more resilient in the face of internal and external pressures.

Examples of Methods That May be Used by a Local Government to Address Control Environment:

Below are examples of how a local government might establish its control environment process. These are only examples and some local governments might use other methods to meet the objectives of control environment:

Local governments may use policies and procedures to promote and maintain a proper control environment. In some cases these policies and procedures are established as a matter of practice. In other cases, these policies and procedures are in writing, perhaps in the form of a policy manual or an electronic library of documents to aid the local government in providing a basis for training personnel, communicating and providing a source of reference to approved policies, and maintaining consistency of recording financial transactions.

A local government's policies and procedures should include some or all of the following elements:

Organization'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 to management personnel the importance of integrity and ethical values.
4. Ensure that the board and management receive and update their ethics training as required by AB 1234

Governing Board's Oversight Responsibilities

1. Identifies and accepts its oversight responsibilities.
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.
4. Ensures the completion of periodic risk assessments.
5. Follows up on the status of audit findings.
6. Establishes an audit committee.

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.
 - a. The governing board should retain authority over significant decisions and review management assignments and any limitations of management's authority and responsibilities.
 - b. Management should establish directives, guidance, and control to enable management and other personnel to understand and carry out their internal control responsibilities.
 - c. 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.

Process for Attracting, Developing, and Retaining Employees

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.
 - a. **Attract** – Seek out candidates who fit the organization's needs and possess the competence for the position.
 - b. **Develop** – Enable individuals to develop competencies appropriate for assigned roles and responsibilities. Establish expectations and tailor training based on roles and needs.
 - c. **Mentor** – Guide employee performance toward expected standards of conduct and competence, and align the employee's skills and expertise with the organization's objectives.
 - d. **Evaluate** – Measure the performance of employees in relation to achievement of objectives and demonstration of expected conduct.
 - e. **Retain** – Provide incentives to motivate and reinforce expected performance.
4. Develop contingency plans to ensure that candidates for succession are trained and coached for assuming the target role so that internal controls do not lapse.

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 incentives appropriate for responsibilities at all levels of the organization.

3. Perform evaluations timely and align incentives with the fulfillment of internal control responsibilities.

Risk Assessment

The Objectives of Risk Assessment:

The AICPA's Auditing Standard AU-C §315.A81 defines risk assessment as:

An entity's risk assessment process for financial reporting purposes is its identification, analysis, and management of risks relevant to the preparation and fair presentation of financial statements.

A local government's risk assessment process includes how management identifies risks (including fraud risk) relevant to the preparation and fair presentation of financial statements in accordance with the local government'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 a local government's ability to initiate, authorize, record, process, and report financial data consistent with the assertions of management.

Examples of Methods That May Be Used by a Local Government to Address Risk Assessment:

Below are examples of how a local government might manage its risk assessment process. These are only examples and some local governments might use other methods to meet the objectives of risk assessment:

1. Some local governments 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.
2. Other local governments may have a more formal risk assessment process that includes one or more of the following elements:
 - a. 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.
 - b. When errors or violations of policy occur or are identified, the local government 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.
 - c. The local government should report to department heads after each governing board 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.
 - d. Finance personnel should attend accounting training sessions to become aware of new accounting pronouncements and emerging issues in order to further identify and manage risks associated with proper financial reporting.

- e. 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 that they manage. These persons should disseminate this information to other persons in their department.
- f. The Information Technology (IT) department should periodically identify and communicate risks for which employees should be particularly vigilant.
- g. Changes in software should be subject to extensive evaluation and testing in order to identify and manage risks associated with use.
- h. The budget should be used as a means to anticipate, identify, and react to changes in conditions that may increase the risk of misstatement.
- i. During the year end closing process, the local government 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 nonstandard transactions that merit special consideration or consultation to ensure that all aspects of generally accepted accounting principles associated with those transactions are properly attended to.
- j. Management should identify for its staff those parties that have transactions with the local government for which there is a potential conflict of interest due to members of management or elected officials having a relationship with those parties.
- k. Throughout the year, management maintains 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 local government'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, new responsibilities for pollution remediation, 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 Objectives of Control Activities:

The AICPA's Auditing Standard AU-C §315.A91 defines control activities as:

Control activities are the policies and procedures that help ensure that management directives are carried out. Control activities, whether within IT or manual systems, have various objectives and are applied at various organizational and functional levels. Examples of specific control activities include those relating to the following:

- *Authorization*
- *Performance reviews*
- *Information processing*
- *Physical controls*
- *Segregation of duties*

Local governments should establish policies and procedures to implement control activities that achieve management directives and respond to identified risks in the internal control system. Control activities can be categorized as policies and procedures that pertain to the following:

Authorization – activities should be authorized in accordance with the local government's policies and procedures.

Performance Reviews – local government should perform analyses of financial data, including comparing actual results to budget forecasts and historical data, to ensure variances are in accordance with expectations, considering internal and external factors.

Information Processing – two aspects, Application Controls and General IT Controls, which relate to the overall effectiveness of IT controls to ensure the proper operation of the local government'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 includes the structure, policies, and procedures that apply to the agency's overall computer operations. It applies to all information systems: mainframe, minicomputer, network, 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.

Physical Controls – include ensuring the safeguarding of both tangible and intangible assets. The local government 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.

Segregation of Duties – the functions of authorization, recording or reconciling, and maintaining custody of assets should be segregated.

When designing policies and procedures to address control activities, the local government should keep in mind that the cost of implementing certain control activities should not exceed the benefit derived from the control activities.

For some small local governments, segregation of duties may be a challenge. Review and approval by an appropriate second person may be the most important control activity. That second person may be a member of the governing body in a review or approval role.

Examples of Methods That May be Used by a Local Government to Address Control Activities:

Below are examples of how a local government might implement control activities in specific areas. Each local government will need to identify control activities and areas of risk specific to the local government. These are only examples of key controls in the areas noted and some local governments might use other policies or procedures to meet the objectives of control activities in these and other areas.

1. Cash Deposits

- a. Bank reconciliations are effective tools to detect mistakes, errors, or embezzlements if they are prepared timely, reviewed in detail, and approved by a second person.
- b. Transfers between accounts involve two people (one to initiate and one to approve), to prevent misappropriation of assets.
- c. To ensure proper segregation of duties, the person involved with the bank reconciliation should be prohibited from performing the following duties:
 - i. Collection of cash receipts in any form (cash, check, wire, electronic, credit card, etc.);
 - ii. Deposit of cash collections with the bank;
 - iii. Disbursements; and
 - iv. Authorized signer on the account(s).

2. Investments

- a. The purchase or sale of investments should require authorization prior to execution, to ensure the transactions are in compliance with the local government's investment policy, the Government Code, or any other authoritative guidance regulating the purchase or sale.
- b. To safeguard investments, an investment safekeeper should be utilized.
- c. Performance of the investment portfolio should be reviewed periodically to ensure it is meeting the objectives and expectations of the local government.

3. Payroll (Compensation-related Disbursements)

- a. To ensure proper segregation of duties, access to the human resources module (add, delete, and modify employee data) should be segregated from access to the payroll module (payroll processing).
- b. To ensure accuracy and authorization, a second person should be required to review and approve the following:
 - i. Timesheets;
 - ii. Addition or deletion of employees;
 - iii. Changes to the payroll data (existing employees);

- iv. Time entry; and
 - v. Payroll register.
 - c. Internal financial reports should be reviewed and compared to budget on a periodic basis and variances should be investigated.
4. Non-compensation-related Disbursements/Procurement
- a. To ensure proper segregation of duties, access to the vendor database (add, delete, and modify vendor data) may be segregated from access to the accounts payable module (disbursements processing).
 - b. Invoices should be checked for mathematical accuracy and approved for payment prior to processing.
 - c. Check/warrant registers should be reviewed for accuracy by a person independent from the accounts payable process and approved prior to finalization.
 - d. Purchasing guidelines should be established that detail authorization limits, when contracts are required, and 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.
 - e. Positive pay, or a similar procedure, should be employed.
 - f. Internal financial reports should be reviewed and compared to budget on a periodic basis and variances should be investigated.
5. Capital-related Expenditures
- a. Procedures should be established to ensure capital expenditures are authorized, identified, and capitalized.
 - b. Policies and procedures should be established to ensure that capital assets are safeguarded against misuse or theft.
 - c. Periodic physical inventories should be performed to ensure that the records are accurate and differences investigated/explained. Inventory counts should be performed by a person that is not responsible for safeguarding the assets and differences investigated/explained.
 - d. Grant funded capital assets must be inventoried and maintained in accordance with applicable grantor requirements.
6. Revenue
- a. To ensure proper segregation of duties, the person responsible for the collection of customer payments should be prohibited from being involved with, or having access to, the following:
 - i. Producing customer bills or reimbursement requests;
 - ii. Customer database (add, delete, and modify customer or rate data);

- iii. Approving voided transactions; and
 - iv. Posting receipts to the general ledger.
- b. Bills should be reviewed by a second person prior to issuance, on a sample basis at a minimum.
 - c. When subsidiary ledgers are used, the detailed ledgers should be reconciled to the general ledger on a periodic basis and any differences investigated.
 - d. Internal financial reports should be reviewed and compared to budget on a periodic basis and variances should be investigated.
7. Debt
- a. 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.
 - b. Procedures should be established to ensure timely repayment and compliance with on-going debt covenants.
 - c. To ensure compliance with limitations on use, the use of debt proceeds should be subject to review and approval.
 - d. Trustee or bank accounts should be reconciled by a person not involved with the authorization for the disbursement of debt proceeds.
8. Financial Reporting
- a. A policy should be used to establish budgetary control and approval required for budget amendments.
 - b. Financial reports should be reviewed for accuracy.
 - c. Financial reports should be periodically produced and distributed or made available to departments and the governing body for review.
 - d. Analyses of financial data, including comparing actual results to budget forecasts and prior year actuals, should be performed to ensure variances are in accordance with expectations, considering internal and external factors. Any unexpected variances should be investigated.

Information and Communication

The Objectives of Information and Communication:

The AICPA's Auditing Standard AU-C §315.A84 defines the information system as:

The information system relevant to financial reporting objectives, which includes the accounting system, consists of the procedures and records designed and established to:

- *initiate, authorize, record, process, and report entity transactions (as well as events and conditions) and maintain accountability for the related assets, liabilities, and equity;*
- *resolve incorrect processing of transactions (for example, automated suspense files and procedures followed to clear suspense items out on a timely basis);*

- *process and account for system overrides or bypasses to controls;*
- *transfer information from transaction processing systems to the general ledger;*
- *capture information relevant to financial reporting for events and conditions other than transactions, such as the depreciation and amortization of assets and changes in the recoverability of accounts receivables; and*
- *ensure information required to be disclosed by the applicable financial reporting framework is accumulated, recorded, processed, summarized, and appropriately reported in the financial statements.”*

The AICPA's Auditing Standard AU-C §315.A89 defines communication as:

Communication by the entity of the financial reporting roles and responsibilities and significant matters relating to financial reporting involves providing an understanding of individual roles and responsibilities pertaining to internal control over financial reporting. It includes such matters as the extent to which personnel understand how their activities in the financial reporting information system relate to the work of others and the means of reporting exceptions to an appropriate higher level within the entity. Communication may take such forms as policy manuals and financial reporting manuals. Open communication channels help ensure that exceptions are reported and acted on.

Information is necessary for an entity to carry out internal control responsibilities to support the achievement of its objectives. Management obtains or generates and uses 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.

Information is the data that is combined and summarized based on relevance to information requirements. Information requirements are determined by the on-going functioning of the other internal control components, taking into consideration the expectations of all users, both internal and external. Information systems support informed decision making and the functioning of the other components of internal control by processing relevant, timely, and quality information from internal and external sources.

An information system is the set of activities, involving people, processes, data and/or technology, which enable the organization to obtain, generate, use, and communicate transactions and information to maintain accountability and measure and review the entity's performance or progress toward the achievement of 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. Management should establish communication channels that: provide timely information; can be tailored to individual needs; inform employees of their duties and responsibilities; enable the reporting of sensitive matters; enable employees to provide suggestions for improvement; provide the information necessary for all employees to carry out their responsibilities effectively; convey management's message that internal control responsibilities are important and should be taken seriously; and convey and enable communication with external parties.

Communication is not an isolated internal control component. It affects every aspect of an organization's operations and helps support the system of internal control. The feedback from this communication network can help management evaluate how well the various components of the system of internal control are working.

Examples of Methods That May Be Used by a Local Government to Address Information and Communication:

Below are examples of how a local government might manage its information and communication. These are only examples and some local governments might use other methods to meet the objectives of information and communication:

1. Local governments may have management-authorized job descriptions for all personnel.
2. Local governments 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.
3. Local governments 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.
4. Management should periodically review pertinent policies with key employees charged with entering transactions into the financial system.
5. 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. Local governments should have monthly or quarterly reports distributed to department managers.
6. 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.
7. A mid-year financial report, or quarterly financial reports, should be submitted to the governing board for its review. This report of financial data can take various forms, including standard reports produced by that local government's accounting system or a high-level budget-to-actual comparison for selected key funds. An annual financial report, such as a Comprehensive Annual Financial Report (CAFR), is presented to the Audit Committee, if applicable, for its review and then presented to the governing board.
8. Financial reports prepared for external distribution may be reviewed by management prior to distribution.
9. Local governments adopt annual or biennial budgets and maintain processes for preparing and communicating budget revisions.
10. Management may use intranet and internet sites to communicate important information to employees, the governing board, and the public. Information provided on internet sites could include annual financial reports, adopted budgets, and summaries of governing board actions.

11. Local governments should monitor events at the state and national levels for pertinent legislative or regulatory actions.
12. Meetings of management personnel should be conducted to review governing board agenda items, new initiatives, budget updates, and other important information.
13. Staff meetings provide an opportunity for information sharing up, down, and across the organization.
14. Local governments 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

The Objectives of Monitoring:

The AICPA's Auditing Standard AU-C §315.A.102 defines monitoring as:

Monitoring of controls is a process that is used by management to assess the effective operation of internal controls over time.

Monitoring involves evaluating the effectiveness of controls on an on-going basis and taking remedial actions when necessary. On-going monitoring activities often are built into the normal recurring activities of a local government and include regular management and supervisory activities. Management's monitoring of controls includes considering whether they are operating as intended and that they are modified as appropriate for changes in conditions.

Examples of Methods That May Be Used by a Local Government to Address Monitoring:

Below are examples of how a local government might manage its monitoring responsibilities. These are only examples and some local governments might use other methods:

1. When employees are supervised and evaluated by management, local governments 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.
2. A local government might use periodic meetings with personnel of the finance department 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.
3. Local governments may receive information from on-site reviews of regulatory and funding agencies that comment on the effectiveness of internal controls in certain areas. A local government'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.

4. A local government 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 local government.
5. A local government should respond to information received from employees regarding the accuracy of their payroll checks in order to give the local government information about the quality of the internal controls associated with the payroll process.
6. A local government should respond to information received from vendors regarding the accuracy of payments made on vendor invoices in order to give the local government information about the quality of the internal controls associated with the accounts payable process.
7. A local government should respond to information received from customers regarding the accuracy of utility billings in order to give the local government information about the quality of the internal controls associated with the utility billing system.
8. Some local governments may establish audit committees and/or use internal auditors to monitor the on-going effectiveness of internal controls.
9. When a material amount of the local government's transactions are processed by vendors or service organizations, some local governments control the risk of fraud and misstatement associated with those transactions by having a high degree of interaction with the vendor or service organization (e.g., authorizing and reviewing those transactions, etc.) as provided by the AICPA's Auditing Standard AU-C §402.A.7. In other cases, the local government may require that the 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).
10. Some local governments include in their monitoring activities a periodic consideration of the continued appropriateness of the organizational structure of the local government to effectively manage the financial reporting risks of the local government.
11. Some local governments 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.