General
Internal Control

CHAPTER II

GENERAL INTERNAL CONTROL

A. INTRODUCTION

Chances are that if $300 was missing from a corporation in your county, it would not be reported in the media unless there was something significant surrounding the missing money (e.g., a prominent citizen was involved or a robbery was made at gunpoint). However, if it appears that $300 is missing from a justice court, county clerk's office, or district clerk's office, it generally will get media coverage—and often, significant coverage.

The public expects and deserves sound financial management from county officials and employees. And county officials and employees deserve to work in an environment that protects them if they do their jobs correctly. Chances for errors and other irregularities should be minimal. All too often, it is not a situation where money is actually missing that causes an office problems, but rather a situation where someone thinks money may be missing and the financial management system in the office cannot show otherwise.

There are basic principles and guidelines, which when followed, provide the framework around which a justice court, county clerk's office, or district clerk's office should be organized and operated. A sound financial management system will:

- help ensure the safeguarding of assets;
- help ensure the reliability and timeliness of bookkeeping and accounting reports and data;
- promote operational efficiency; and
- encourage adherence to prescribed laws, regulations, policies, and procedures.

Specifically, when it comes to money and other property, a court or clerk's office should show four things:

- they have collected all the money or other property to which they are entitled;

- the money collected is properly remitted to the appropriate party;
- all money and other property is properly managed; and
- all money and other property is properly expended, properly accounted for, and properly reported.

Many courts and clerk offices do not have adequate staff and resources to operate according to textbook guidelines. However, each court and clerk's office should have a goal to do the best they can with the resources they have. In fact, some extra precautions and steps should be taken in those situations where there is a lack of adequate staff and other resources, because the chances for problems are higher.

One of the purposes of this handbook is to provide a framework for sound financial management that provides both accountability to the public and protection for those who do their jobs and do them right.

In this chapter, internal control will be looked at in general terms—a definition and description will be given, the basic principles of internal control will be provided, segregation of duties will be discussed, and the preparation of a financial management procedures manual will be addressed. More detailed and specific controls relating to specific subject areas will be covered in subsequent chapters (e.g., internal controls relating to receipts will be covered in Chapter III).

B. INTERNAL CONTROL DEFINED AND DESCRIBED

Although more technical definitions exist, a practical definition of internal control (as used in this handbook) is:

Internal Control: the plans and procedures implemented in a justice court or county or district clerk's office which are designed to provide **reasonable** assurance of: (1) reliable financial information; (2) compliance with applicable laws and regulations; and (3) effective and efficient operations.

One easy way to think of internal control is as a set of financial management checks and balances. A sound system of internal control should:

- minimize the possibilities for errors and misuse of funds;
- provide a clear audit trail (show who did what and when they did it); and
- provide for earlier detection of errors and/or irregularities than would otherwise be the case.

Good controls make the work of both the county auditor and outside auditor easier and less time–consuming. However, keep in mind that good internal control provides "reasonable" (see the definition above), not "absolute" assurance that operations are as they should be.

Internal control used to be primarily something that only auditors and accountants talked about. But the frequency of publicized wrongdoing in governmental financial management has increased the need for awareness and understanding of internal controls at all levels of government. In addition to actual monetary losses that can result from poor controls, perhaps the biggest loss is the decline in the public's perception of and confidence in government.

The importance of internal control relates to both money and people. The people component, which in the long run can prove more important than the money side of internal control, is often overlooked. An internal control system should protect the people who do their jobs and do them right. The vast majority of people who are not involved in errors and irregularities deserve to work in an office that can show their innocence when errors and/or irregularities do occur. They do not deserve to be clouded with unnecessary suspicion.

Not protecting honest employees from unnecessary suspicion or improperly accusing them of errors and/or irregularities can have disastrous long-term results. An employee may feel he/she might as well take money since everyone seems to think he/she did so anyway, or the employee's performance may take a nose dive.

Most internal controls are not complicated. They are, however, frequently overlooked because officials and employees focus on what they consider to be the primary function(s) of their office. For example, a district clerk generally thinks in terms of duties related to the district court(s), rather than financial management duties and internal controls.

When it comes to financial management, an individual should not want someone to just trust him/her. Rather, he/she should want a set of procedures that are followed, and that will show he/she did the right thing should a question ever arise concerning county money.

One of the things that makes sound financial management so important is the realization that something only has to go wrong once and it can plague someone for a long time.

One quick way to determine if there may be some internal control weaknesses in an office is for everyone to take a "Blank Paper Test." Simply have each person in the office (the official included) write down the things that could cause him/her to be accused or unnecessarily suspected of wrongdoing, even if he/she did things right.

For example, assume three people all work from the same cash drawer, and there is $50 missing from the drawer at the end of a day. It does not matter whether it was intentional or unintentional. Any one of the three could be at fault. This means that the two innocent people will probably be unnecessarily suspected. A sound system of internal control would pinpoint responsibility for the missing money, preventing those who did not have anything to do with it from being unnecessarily suspected.

Other examples include: (1) not getting a receipt when turning in money to someone; (2) not using official, chronologically, pre-numbered receipts for intakes of money; or (3) not balancing out receipts before turning money and receipts over to someone else.

Finally, one additional matter should be kept in mind concerning internal control—and that is the "Cost Benefit Rule." This rule simply provides that, in general, the cost of internal controls should not exceed the expected benefit. For example, $10,000 should not be spent to protect $500. The rule takes into account that funds should be spent efficiently and effectively.

C. BASIC PRINCIPLES OF INTERNAL CONTROL

(The materials on pages II-6 through II-8 were adapted from the *Justice of the Peace Manual (1994)* - a Texas Comptroller of Public Accounts publication.)

There are four basic principles of internal control. Every good system of internal control has all four principles, not just two or three. The principles are:

1. Appropriate division of duties;
2. Qualified personnel;
3. Sound, written procedures for authorizing, recording, and reporting transactions; and
4. Actual performance consistent with the first three principles.

1. Appropriate Division of Duties

If possible, the following three basic functions should be performed by three different people within an office:

- authorization (approval) of transactions;
- recording of transactions; and
- custody of assets (money and other property).

For example, a clerk making collections and issuing receipts (having custody of assets) should not be the person to balance and prepare the bank deposit (approving the day's receipts), and neither of these persons should record the day's receipts in the cash receipts journal.

If one person does perform two, or all three of these functions, there is no independent check for mistakes. Consequently, errors are more likely to go undiscovered for long periods of time. Fraud is also much easier if, for example, the same person collects cash, prepares the bank deposit, and/or records the receipts in the books.

Refer to Page II-9 for additional information on the division of duties.

In many offices, it is often not practical to maintain a strict division of duties due to a limited staff size. If such is the case, other means will have to be used to help assure reliable internal control. For example:

- rotation of duties among personnel;
- more strict supervision;
- special double-checking of work;
- enforced vacations;
- additional training to improve quality of personnel; and
- more frequent internal audits.

The six items above are important regardless of staff size—they just take on added importance in offices with fewer personnel.

The basic point to remember is that **no single person should handle a transaction from beginning to end**. This means if there are at least two people in an office on any given day, there can be some division of duties.

2. Qualified Personnel

Staff positions should naturally be filled with the most qualified and competent persons possible. Under-qualified persons tend to be less able to perform their duties without undue errors. Special training may help here.

A surprising number of people are dishonest on applications and resumes. Employers who hire the "wrong" person often do so because they failed to take time to verify information given by applicants. If an official is interested in hiring someone, it is imperative they verify educational background, prior employment, skills, and check with references and prior supervisors.

All personnel should know clearly what they are supposed to do and how they are supposed to do it. Additionally, personnel should understand how their duties fit in with the duties of others in the office, and with the duties of other offices and departments in the county.

3. Sound Procedures for Authorizing, Recording, and Reporting Transactions

All offices should have logical, consistent procedures that describe in detail the duties that must be performed, how they are to be performed, and who is to perform them. If personnel clearly understand what is expected of them, they will tend to do a better, more accurate job. Also, errors will be fewer and chances of fraud will be less, if each person understands what he/she should be doing.

Procedures should provide for:

- use and control of pre-numbered forms and documents (e.g., receipts, checks);
- cross-referencing of documents (e.g., citation numbers, docket numbers, receipt numbers);
- periodic reconciliation of subsidiary records to control totals (e.g., payout information);
- proper authorization of transactions (e.g., remittances, disbursements, requisitions);
- effective, timely reporting of transactions (e.g., monthly reports);
- safeguarding of assets (money and other assets);
- appropriate flow of documents (e.g., citations, complaints, receipts, deposit/remittance forms, warrants);
- reasonable amount of checking work of others; and
- bonding of all employees with access to money and other valuables.

These procedures should be developed in cooperation with the county auditor and county treasurer.

4. Actual Performance Consistent With the First Three Principles

A good system of division of duties, qualified personnel, and sound, written procedures will not guarantee good internal control—the system must be followed. Results must be periodically monitored to see if the system is working as it should be. In other words, just having good people, good procedures, and a good plan for distribution of the workload is not enough.

Checking to see if performance is appropriate is part of the county auditor's internal audit functions. However, this does not relieve an official of the responsibility for checking the performance in his/her own office. In fact, it can be argued that an official's attitude and desire for good internal control in his/her office is the most important part of a good system. In other words, if an official does not think internal control in his/her office is important, it is not likely his/her employees will either.

D. DIVISION OF DUTIES WORKSHEET

An appropriate division of duties is the first basic principle of internal control (see page II-6). Remember, the basic point is that **no single person should handle a transaction from beginning to end**. The primary reason is to prevent an individual from having enough control over a transaction to where errors and/or irregularities can occur and go undetected for extended periods of time. An appropriate division of duties should also produce warning signals when errors and/or irregularities do occur.

It is important to keep in mind that a good division of duties does not guarantee that things will operate as they should. This is because two or more people can be involved in wrongdoing (i.e. collusion). Unannounced rotation of job duties and surprise audits can help reduce the chances of collusion.

In offices without an adequate staff size to properly divide duties, the additional procedures listed on page II-7 will help ensure reliable internal control.

The worksheet on the next page should assist in determining if there is a proper division of duties in an office. The worksheet comes from the December 1998 issue of *City and County Financial Management Systems*, a Texas Comptroller of Public Accounts publication.

Division of Duties Worksheet

Place a check by the duties for each person in your office. Add additional columns if your office has more than five employees. Also, if your office has any additional duties/responsibilities that are not listed on the worksheet, add those. Remember, that ideally, no one person should be involved in more than one type of duty. In other words, someone with custody duties should not also have recording duties. If, upon completing the worksheet, you discover conflicting duties in your office, reallocate the duties in a manner that results in a more appropriate division. The county auditor can help here. If duties cannot be properly divided because of staff size, then, where possible, limit a person to only two types of duties. If it is not possible to limit a person's duties to two types, then be sure to use the additional procedures listed on page II-7.

Duty/Responsibility	Type	Person A	Person B	Person C	Person D	Person E
Involving Money:						
Receive money/issue receipts	Custody					
Open and list mail receipts	Custody					
Prepare bank deposits/remittances	Custody					
Review/approve bank deposits/ remittances	Approve					
Record receipts	Record					
Access to unused receipts	Custody					
Take inventory of unused receipts	Record					
Prepare disbursements	Record					
Sign checks	Approve					
Record disbursements	Record					
Access to unused checks	Custody					
Take inventory of unused checks	Record					
Prepare billings and delinquency letters	Record					
Approve billings and delinquency letters	Approve					
Reconcile bank statements	Record					
Review/approve bank reconciliations	Approve					
Prepare monthly reports	Record					
Review/approve monthly reports	Approve					
Not Involving Money:						
Use of furniture, equipment, vehicles and other physical assets	Custody					
Take inventory of physical assets	Record					
Review/approve inventory of physical assets	Approve					
Fill out own time cards	Custody					
Review/approve time cards	Approve					
Use time cards to calculate payroll	Record					

E. PROCEDURES MANUAL

(The materials on pages II-11 and II-12 were adapted from the *Justice of the Peace Manual (1984)* - a Texas Comptroller of Public Accounts publication.)

1. Procedures Manual Defined

A procedures manual is a detailed, written description of each duty and function in an office and how they are to be performed. A good manual should include the following:

- organization chart;
- list of employee positions, including job requirements and responsibilities;
- description of each function in the office, including all steps involved in performing the function;
- description and sample of each form and document used in the office;
- description of collecting, processing, and depositing/remitting payments;
- description of the bookkeeping system to be used, and how it is to be maintained;
- description of the reports to be completed, who is to complete them, how they are to be completed, and where and when to send them;
- internal controls within the office; and
- any other information useful in carrying out the duties and responsibilities of the office effectively and efficiently.

When possible, flowcharts should be used to enhance understanding of the procedures.

2. Preparing a Financial Management Procedures Manual

A quick and often effective way of getting started on a financial management procedures manual is to let the employees do it themselves. They know better than anyone what they do, and how they do it. Simply have them list their duties and responsibilities and describe step-by-step specifically what they do.

Depending upon the size of the office, one individual or a procedures manual team should be responsible for preparing a complete, initial draft of the manual. A review process should be established and followed to ensure correctness, consistency, and completeness. Legal aspects of the manual should be reviewed by the county attorney's office.

Upon completion, a copy should be given to each office employee, if possible. Limited copies usually means limited use. If possible, update the manual whenever there are changes to laws, regulations, policies, or procedures. At a minimum, review and update the manual annually.

3. Benefits of a Good Financial Management Procedures Manual

Even though Texas law does not require justice courts, county clerk offices, or district clerk offices to have a financial management procedures manual, it is an essential part of a sound system of internal control. A good procedures manual has the following important benefits:

- guides employees in performing their jobs correctly;
- guides employees in performing the duties of absent staff;
- helps train new employees;
- helps safeguard assets;
- helps auditors familiarize themselves with office operations *(without this tool, they may have to spend costly time learning how the office works)*; and
- helps inform the budget officer and commissioners court of the operations of the office *(which can be particularly helpful during budget hearings).*

Operating without written procedures decreases efficiency and weakens the internal controls of the office and the county.