



NORTH CAROLINA  
DEPARTMENT OF STATE TREASURER  
STATE AND LOCAL GOVERNMENT FINANCE DIVISION  
AND THE LOCAL GOVERNMENT COMMISSION

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**Memorandum #2015-15 (Revision of Memo #568 and #569)**

**TO:** Finance Officers of Small North Carolina Governments and Public Authorities

**FROM:** Sharon Edmundson, Director, Fiscal Management Section

**SUBJECT:** Internal Controls for a Small Unit of Government

**DATE:** April 30, 2015

Included in this memo is information that will help smaller units strengthen their internal controls. Elected officials and governmental employees are accountable for resources entrusted to them and for ensuring that programs and services are administered effectively and efficiently. A significant component in fulfilling this responsibility is ensuring that an adequate system of internal control exists within each governmental unit. Whether a unit of government has strong or weak internal controls directly affects the reliability of the accounting records and financial statements. Strong internal controls aid in the prevention of fraud and the detection of accidental errors in the accounting process. Internal controls provide greater assurance of the accuracy of financial reporting, compliance with laws and regulations, and effective and efficient operations.

One method that a unit can use to enhance its internal control is through proper segregation of duties. The fundamental premise of segregation of duties is that an individual or small group of individuals should not be in a position to initiate, approve, undertake, and review the same action. Without proper segregation of duties, it is impossible to have an effective system of internal control. There are two main advantages to implementing segregation of duties: the first is that fraud is more difficult to perpetrate when proper segregation of duties are in place because it would require collusion of two or more individuals; second, if duties are adequately separated, innocent errors are more likely to be found and corrected.

Extensive separation of duties is not always possible for smaller units of local government. In such cases, the duties should be separated as much as possible and alternative controls used to compensate for lack of separation. Members of the governing board must be called upon to provide some of these controls; they are generally very familiar with operations and likely to spot unfamiliar vendors and transactions. Also, due to knowledge of unit and community, they will be able to determine if explanations for unusual transactions are valid.

This memo is addressed specifically to the smaller units where internal controls may not be as effective due to the limited number of personnel. For a more comprehensive discussion of internal controls, please refer to the [internal controls section of the policy manual](#).

Memo #2015-15  
Internal Controls for a Small Unit of Government  
April 30, 2015  
Page 2

The Local Government Commission encourages local units to review their internal controls on a periodic basis. After reviewing their controls, a careful reading of the procedures attached may aid units in strengthening their controls.

The control procedures that each unit implements should include controls that safeguard assets, ensure that financial information is accurate and reliable and that each unit complies with applicable laws and regulations. The procedures should be reviewed carefully and the cost effectiveness measured before being implemented by a local unit.

Note that internal controls, no matter how well designed and operated, can only provide reasonable assurance that the operations of the governmental entity are followed, that financial reporting is accurate, and that laws and regulations are complied with. Certain limitations are inherent in all internal control systems.

1. **General Controls** – Those that can be applied to all areas of a governmental unit.
  - a. Written organization plan – A plan of organization should be developed and communicated to all parties involved (governing body, mayor, city manager, finance officer, and anyone else elected or employed). This plan should include (at least):
    - Clear lines of authority and responsibility
    - Up-to-date job descriptions
    - Criteria to be observed by employees in initiating transactions (approval authority and amount limitations)
  - b. Governmental units should employ personnel with the ability and experience required to perform satisfactorily the responsibilities assigned to them. This includes continuing education for present employees.
  - c. In smaller units, active participation by the governing body in key functions is necessary for good internal controls.
  - d. Monthly financial reports must be presented to and reviewed by the Board. These reports at a minimum should reflect the budget and actual revenues and expenditures.
  - e. All employees should be required to take annual vacations. The duties should be performed by another employee during their absence. This will reduce the likelihood of fraud since employees are aware that at any given time, someone else could perform their duties.
  - f. Unit should consider implementing a written code of conduct or ethics that is communicated to their employees in writing.
2. **Controls in the Accounting System**
  - a. All journals, ledgers and other accounting records should be kept up-to-date at all times and should be balanced.
  - b. All subsidiary records should be periodically reconciled to the control accounts and should be reconciled in a timely manner.
  - c. Duties should be segregated as much as possible between custody of assets and recording of the transactions.
  - d. System should be in place to make sure that the preaudit process is functioning properly.
  - e. All expenditures made in excess of appropriations should be investigated and resolved.
  - f. Each unit should maintain and follow records filing, retention and disposal policies in compliance with the Public Records Laws, G.S. Chapter 132 and the guide lines published

by the Department of Cultural Resources. Detailed information can be found on the department website, [Local Government Schedules](#).

**3. Controls- Statutory**

- a. All minutes of the governing body should be maintained in final form in the permanent records of the unit.
- b. All funds remaining unclaimed after one year should be escheated to the State as required by G.S. Chapter 116B.
- c. The unit should develop, adopt and approve its budget according to G.S. 159-13.
- d. All employees who handle public moneys or have access to inventories must be bonded either individually or under a blanket bond (G.S. 159-29).
- e. The Finance Director must be individually bonded for at least \$50,000 (G.S. 159-29). The tax collector (if applicable) must be individually bonded at an amount set by the governing board.
- f. A complete schedule of insurance coverage and limits should be maintained, showing expiration dates, premiums, and other essential information.

**Specific Controls** – Those that can be applied to the various functions within a unit.

Units of government have various accounting functions. We will address the major functions and the related internal controls. The procedures used in each function are outlined, followed by suggestions on how to divide duties between staff members for more effective internal control.

The major functions addressed in this memo are:

Cash Receipts	Cash Disbursement Nonpayroll	Accounts Payable and Expenditures
Financial Institutions	Cash Disbursement –Payroll	Purchasing and Contracting
Petty Cash	Accounts Receivable	Inventories
Revenue-(including tax revenues	Investments	Capital Assets

**1. Internal Controls – Cash Receipts**

- a. All cash receipts received should be recorded on a Daily Collection Report, noting the name of the payer, date, amount and the form of payment. All checks should be endorsed and prenumbered receipts prepared for all payments.
- b. A staff or board member should receive the payments and the Daily Collection Report and prepare the deposit slip in duplicate. Bank deposits should be made in accordance with G.S.

159-32. Ideally, deposits should be taken to the bank by someone other than the person who prepared the deposit. All deposits should be made in official depositories.

- c. The activity on the duplicate deposit slip (which should show validation by the bank) is compared to the Daily Collection Report to verify that all cash that was received has been deposited. The person performing this task should initial the deposit slip.
- d. The activity on the Daily Collection Report is recorded in the General Ledger.
- e. Funds not deposited, such as cashier's change drawer or petty cash should be located in a safe location, such as a safe on the premises and access to this safe should be controlled.

## **2. Internal Controls – Financial Institutions**

- a. All deposits should only be in institutions authorized by the governing body of the unit.
- b. The financial institutions that hold the unit's funds should be instructed to notify appointed person, of any unusual items or transactions occurring on the account, such as insufficient funds notices or checks made payable to cash.
- c. Current signature cards should be maintained on file with the unit's financial institution at all times. Terminated employees should be removed from signature cards immediately.
- d. All bank statements should be reconciled promptly upon receipt to help identify any errors or discrepancies. Any discrepancies should be investigated immediately and acted upon accordingly.

## **3. Internal Controls – Petty Cash**

- a. If a unit can offer reimbursement to employees in a reasonable time frame, there is no need for a petty cash fund. A unit should carefully evaluate the need for these funds.
- b. Petty cash funds should be maintained on the imprest basis at the least amount for the fund to be effective. One individual should be responsible for the fund and should maintain sole control over it.
- c. Petty cash should only be used to reimburse employees for small purchases. Employees seeking reimbursement should present a receipt that documents what was bought, the purpose and the amount, and should sign the receipt in exchange for being reimbursed.
- e. All petty cash funds should be subject to a surprise cash audit from time to time.

## **4. Internal Controls – Revenues/Billing**

- a. There should be, to the greatest extent possible, a separation of duties between the collections, billing, and receivable functions.

- b. All subsidiary records should be reconciled with the control accounts on a monthly basis.
- c. All delinquent accounts should be periodically reviewed by an appropriate official outside of the collection function.
- d. Billings for enterprise and other service revenues should be based on usage as determined by accurate and timely information, such as meters for water usage.
- e. For applicable enterprise revenues, meter readers assignments should be periodically rotated on a surprise basis.

**5. Internal Controls –Tax Revenues**

- a. The unit should take necessary steps to verify that all the property has been included in the levy.
- b. All taxes must be levied within statutory limitations and for purposes permitted by the statutes (counties G.S. 153A-149; municipalities G.S. 160A-209).
- c. The tax scrolls must be adequately maintained and balanced periodically with the control accounts.
- d. All releases, refunds, and write-offs of taxes must be authorized by the governing in its minutes as permitted by law (G.S. 105-325(b)).
- e. All discoveries should be properly recorded as part of the current year's levy.
- f. All uncollected delinquent taxes more than ten years old should be written off the books, unless collection proceedings are underway.

**6. Internal Controls –Cash Disbursements (Non-Payroll)**

- a. Prenumbered checks should be used for all disbursements paid by check.
- b. The unused check supply should be locked up all times.
- c. Voided checks should be indicated in the check register. The checks themselves should be sufficiently defaced so that no one else could use them. Voided checks should be maintained on file in numerical order.
- d. Blank checks should never be signed in advance.
- e. Checks should never be made payable to cash.
- f. Checks should be prepared by someone who is not authorized to sign them.

- g. Check signers should review supporting documentation for disbursements prior to signing the checks. (Note that in this age of electronic invoicing, original invoices may not be as strong as a control for documentation. One method to mitigate this is to have two independent persons verify that the goods or services were received).
  - h. All purchase orders (if used), contracts, or checks and warrants should have a properly signed pre-audit certificate (G.S. 159-28).
  - i. If applicable, purchase orders and receiving reports should be initialed by an authorized individual when goods are received and matched to the purchase order. The purchase order will eventually be matched to the invoice for payment.
  - j. Two signatures are required on all checks per G.S. 159-25(b). The second signatory should be someone who does not have access to the accounting records. The governing board may waive the dual signature requirements if the board determines that satisfactory internal controls are in place. Maintaining the two signature requirement strengthens internal controls.
  - k. All checks should be mailed or distributed by someone other than the person who prepared the checks.
  - l. Disbursements should only be made to authorized vendors.
  - m. All items that are outstanding for a lengthy period of time should be investigated; anything outstanding more than one year should be escheated. See [Holders of Unclaimed Property](#) on the Unclaimed Property's website.
  - n. All wire or other electronic transfers should be made by persons authorized by the governing body.
7. **Internal Controls –Cash Disbursements (Payroll)-The following procedures apply specifically to payroll, in addition to the other procedures for cash disbursements**
- a. Each employee should have a secure personnel file that includes, at a minimum, the following:
    - hiring authorization,
    - salary history,
    - hours authorized to work,
    - federal and state withholding forms,
    - health insurance and retirement deduction information, and
    - authorization for all other payroll deductions.
  - b. Payroll checks should be handled like other cash disbursements except that a time record will be the supporting documentation (either electronic or hard-copy).
  - c. Units should have written personnel policies prohibiting employment practices resulting in nepotism, conflicts of interest or discrimination.

- d. In units with appropriate staff, the functions of payroll, additions and deletions to payroll, and timekeeping functions should be segregated.

**8. Internal Controls –Accounts Receivable- Duties should be separated as much as possible between the three sectors of the revenue cycle-billing, collections, and maintenance of the receivable records**

- a. On a periodic basis (at least monthly), a list of delinquent accounts should be prepared. For utility services, a written “cut-off” policy should be in place to terminate services to all delinquent customers.
- b. Daily posting of receipts to accounts receivable ledgers should be done by someone other than the staff member responsible for cash receipts.
- c. Subsidiary ledgers should be reconciled at least monthly with the control ledgers.

**9. Internal Controls –Investments-Per G.S. 159-30(a), the finance officer is responsible for managing investments subject to the law and to whatever additional restrictions and directions the governing board may impose.**

- a. All investments should be in compliance with G.S. 159-30.
- b. A written cash management and investment policy, approved by the governing board, should be on file.
- c. Electronic access to securities and brokerage accounts should be limited to personnel authorized by the governing board. Any securities physically held by the unit should be maintained under strict dual control.
- d. Any approvals required by the unit’s written cash management policy for purchases, sales or other investment activities should be obtained, with written evidence of such approval provided.
- e. A system should be in place to insure that all interest is credited as due for the proper amount and to the proper funds.
- f. If unit uses on-line banking, proper controls need to be maintained in the banking application. Wires and Automated Clearing House (ACH) transactions should require dual authorizations.

**10. Internal Controls –Accounts Payable and Expenditures-Internal controls in the accounts payable and expenditure areas should ensure that all expenditures are properly documented and made in accordance with the authorized budget.**

- a. Expenditures should be controlled using the budget ordinance. For any budgeted fund, all expenditures must be budgeted.

- b. All budget appropriations should be recorded in the appropriate expenditure account.
- c. An effective year-end cut-off policy should be in place for all liabilities, including accounts payable.
- d. All accounts payable subsidiary ledgers should be reconciled to the general ledger on a monthly basis by someone who does not have access to the subsidiary records.
- e. Any debit balances in accounts payable should be investigated thoroughly.

**11. Internal Controls –Purchasing and Contracting**

- a. Units should have a written procurement and contracting policy that clearly outlines levels of authorization and approvals necessary for all purchasing and contracting transactions.
- b. Prenumbered purchase orders should be used for purchases. Voided purchase orders should be recorded as such and maintained on file.
- c. The preaudit certificate (G.S. 159-28) should be present on purchase orders and invoices and signed by the finance officer or designated deputy.
- d. Invoices and other supporting documentation should be thoroughly reviewed prior to the invoice being approved.
- e. Department heads should be provided a detailed list of revenues and expenditures with comparisons to the budget at least monthly.
- f. Those contracts requiring public bids per G.S. 143-128 through G.S. 143-133 should be handled as required by the statutes.
- g. A unit of government might allow by written policy, board-approved small or routine purchases to be made outside the purchase order or contract control process.
- h. Accommodation purchases for employees should be expressly prohibited. These include purchase of goods made for employees for their personal use from vendors at the unit's contract price.
- i. The person that sets up new vendors in the accounting system or edits information on existing vendors, should not be the same as the person writing the checks.

**12. Internal Controls –Inventories-Note that some of the procedures listed below may not be applicable to insignificant inventories as they are not cost effective. The costs of tracking inventory should be weighed against the potential benefits**

- a. A unit should inventory and control in its general ledger all major classes of materials and supplies, if material.
- b. Perpetual inventory systems should be maintained for all major classes of inventory.
- c. Custodial responsibilities should be clearly defined.
- d. Inventory should be controlled with physical barriers, such as locked cabinets or storehouses.
- e. Keys to inventory should be controlled in such a manner that does not inhibit day-to-day operations. For utility departments, the engineer must have a key to the inventory. Ideally, no one else should have a key, so the inventory stays under the strict control of one person. However, a backup key should be maintained under dual control in case the engineer is unexpectedly absent.
- f. Physical inventory counts should be made once a year at a minimum. The count should be made by an independent staff member(s).
- g. Records should be maintained showing all additions, withdrawals and transfers of inventory.
- h. Significant inventories should be insured against loss.
- i. Persons having control of inventory should not have access to the accounting records.

**13. Internal Controls –Capital Assets**

- a. Adequate accounting records should be maintained that identify and classify all capital assets, with special attention to capital assets purchased with grant funds.
- b. Adequate guidelines should be established and followed to distinguish between expensed items and capital additions.
- c. Physical inventories of capital assets should be taken on an annual basis by independent parties.
- d. All capital assets should be tagged or identified in the accounting records by a control number, as applicable. Tags should be affixed in a permanent manner.
- e. All property, buildings, titled equipment and vehicles, and other items should be held in the name of the unit.
- f. All capital assets purchased, transferred, sold, scrapped or destroyed should be recorded as such in a timely manner in the accounting system.
- g. All sales of surplus property should be conducted in accordance with G.S. Chapter 160A, Article 12 (municipalities) or G.S. 153A-176 (counties).

- h. Significant inventories should be insured against loss.
- i. Persons having control of inventory should not have access to the accounting records.

**14. Internal Controls –Electronic Banking**-This section has been included in recognition of the growth of electronic activities (Electronic Funds Transfers, Automated Clearing House transactions, direct deposits, etc.) Because connecting to the internet is a necessary part of the electronic banking process, units must recognize and anticipate vulnerabilities inherent in electronic activities.

- a. Units are encouraged to create and implement comprehensive written policies for electronic banking operations and regularly review them to ensure they remain current.
- b. Units must maintain adequate separation of duties so no one individual can control an electronic activity from start to finish.
- c. Apply dual controls to riskier transactions (such as wire transfers) so that more than one individual approves the transaction. (Wire transfers are particularly risky since they can be transferred almost immediately to anywhere in the world). Also, there should be restrictions such as maximum dollar amounts allowed, or what vendors are allowed to receive wire transfers.
- d. Employee access to electronic banking transactions should be limited based on job responsibilities and business need.
- e. Consider the use of a Positive Pay system. This allows the bank to compare checks presented against a unit's account to a list of checks authorized and issued by the unit. It will uncover instances where the amount has been altered, a counterfeit has been created using a different check number, or the payee name does not match.
- f. Employees should be prohibited from sharing logon and password information with other employees.
- g. Ideally, one highly secured computer should be used for electronic banking and for that purpose only. This reduces the risk of malicious software being installed through fake email messages or infected websites.
- h. Employee access to the electronic banking system should be revoked or modified based on personnel changes. Employees that terminate employment for whatever reason must have passwords deactivated immediately upon termination.

This memo includes an appendix that illustrates how to divide duties (for most functions) with a staff of one or two accounting personnel. Again, these procedures should be reviewed carefully and the cost effectiveness measured before being implemented.

**Appendix A**  
**Division of Duties between Staff Members**

**Cash Receipts-One Accounting Position**

<b>Task</b>	<b>Performed By</b>
Prepare deposit slip	Mayor/Board Member
Prepare Daily Collection Report	Mayor/Board Member
Make the deposit	Finance Officer
Compare activity listed on the deposit slip to the Daily Collection Report	Finance Officer
Record activity on Daily Collection Report in the general ledger	Finance Officer
Properly secure any undeposited funds	Finance Officer

**Cash Receipts-Two Accounting Positions**

<b>Task</b>	<b>Performed By</b>
Prepare deposit slip	Mayor/Board Member
Prepare Daily Collection Report	Mayor/Board Member
Make the deposit	Finance Officer
Compare activity listed on the deposit slip to the Daily Collection Report	Accounting Technician
Record activity on Daily Collection Report in the general ledger	Accounting Technician
Properly secure any undeposited funds	Finance Officer

**Financial Institutions-One Accounting Position**

<b>Task</b>	<b>Performed By</b>
Make sure that deposits are in institutions authorized by the Board	Finance Officer
Maintain signature cards	Finance Officer
Receive notification of any unusual items or transactions	Mayor/Board Member
Reconcile bank statements	Finance Officer

**Financial Institutions-Two Accounting Positions**

<b>Task</b>	<b>Performed By</b>
Make sure that deposits are in institutions authorized by the Board	Finance Officer
Maintain signature cards	Finance Officer
Receive notification of any unusual items or transactions	Mayor/Board Member
Reconcile bank statements	Accounting Technician

### Petty Cash-One Accounting Position

Task	Performed By
Maintain control and responsibility over the fund	Finance Officer
Verify the documentation used to request any reimbursements	Finance Officer
Perform a surprise cash audit	Mayor/Board Member

### Petty Cash-Two Accounting Positions

Task	Performed By
Maintain control and responsibility over the fund	Finance Officer
Verify the documentation used to request any reimbursements	Accounting Technician
Perform a surprise cash audit	Mayor/Board Member

### Revenue/Billings-One Accounting Position

Task	Performed By
Prepare bills and review for reasonableness	Finance Officer
Mail bills	Mayor/Board Member
Collect payments	Finance Officer
Prepare deposit slip	Mayor/Board Member
Make deposit	Finance Officer
Post payment to the general ledger	Mayor/Board Member
Reconcile subsidiary ledgers with the control account	Finance Officer
Periodically review delinquent accounts	Mayor/Board Member

### Revenue/Billings-Two Accounting Positions

Task	Performed By
Prepare bills and review for reasonableness	Finance Officer
Mail bills	Mayor/Board Member
Collect payments	Accounting Technician
Prepare deposit slip	Finance Officer
Make deposit	Accounting Technician
Post payment to the general ledger	Finance Officer
Reconcile subsidiary ledgers with the control account	Accounting Technician
Periodically review delinquent accounts	Mayor/Board Member

**Tax Billings (for units that collect their own ad valorem taxes-  
 One Accounting Position)**

<b>Task</b>	<b>Performed By</b>
Compute and prepare tax bills	Finance Officer
Reconcile information on tax bill to information received from the County	Mayor/Board Member
Mail bills	Finance Officer
Receive payments	Tax Collector
Prepare deposit slip	Finance Officer
Post payments to the general ledger	Finance Officer
On a sample basis, trace billings to the taxes receivable ledger to see if they have been posted	Finance Officer
On a sample basis, trace deposits into taxes receivable ledger	Finance Officer
Prepare a list of delinquent accounts and review. The amount for delinquent accounts should match the amount in taxes receivable.	Tax Collector

**Tax Billings (for units that collect their own ad valorem taxes-  
 Two Accounting Positions)**

<b>Task</b>	<b>Performed By</b>
Compute and prepare tax bills	Finance Officer
Reconcile information on tax bill to information received from the County	Accounting Technician
Mail bills	Finance Officer
Receive payments	Tax Collector
Prepare deposit slip	Finance Officer
Post payments to the general ledger	Accounting Technician
On a sample basis, trace billings to the taxes receivable ledger to see if they have been posted	Finance Officer
On a sample basis, trace deposits into taxes receivable ledger	Accounting Technician
Prepare a list of delinquent accounts and review. The amount for delinquent accounts should match the amount in taxes receivable.	Tax Collector

### Cash Disbursements (Nonpayroll)-One Accounting Position

Task	Performed By
Prepare purchase order (if applicable)	Finance Officer
Review and approve purchase order and sign preaudit certification	Finance Officer
Compare copy of purchase order to receiving report or to the actual goods received (if applicable)	Finance Officer
Match copy of the purchase order to the invoice (if applicable)	Finance Officer
<b>Review documentation, prepare and sign check</b>	Finance Officer
Second check signer reviews documentation and signs check	Mayor/Board Member
Mail check	Mayor/Board Member

### Cash Disbursements (Nonpayroll)-Two Accounting Positions

Task	Performed By
Prepare purchase order (if applicable)	Accounting Technician
Review and approve purchase order and sign preaudit certification	Finance Officer
Compare copy of purchase order to receiving report or to the actual goods received (if applicable)	Accounting Technician
Match copy of the purchase order to the invoice (if applicable)	Accounting Technician
Review documentation and prepare check	Accounting Technician
Review documentation and sign check	Finance Officer
Second check signer reviews documentation and signs check	Mayor/Board Member
Mail check	Finance Officer

**Cash Disbursements (Payroll)-One Accounting Position\***

Task	Performed By
Maintain personnel files and update as necessary	Finance Officer
Review and approve time sheets (if applicable) and leave records	Finance Officer
Prepare checks	Finance Officer
Review payroll for reasonableness and sign check	Finance Officer
Obtain second check signature	Mayor/Board Member
Distribute checks	Mayor/Board Member

\*In addition to the procedures above, the procedures listed in the nonpayroll section for cash disbursements should be carried out as well.

**Cash Disbursements (Payroll)-Two Accounting Positions\***

Task	Performed By
Maintain personnel files and update as necessary	Finance Officer
Review and approve time sheets (if applicable) and leave records	Finance Officer
Prepare checks	Accounting Technician
Review payroll for reasonableness and sign check	Finance Officer
Obtain second check signature	Mayor/Board Member
Distribute checks	Mayor/Board Member

\*In addition to the procedures above, the procedures listed in the nonpayroll section for cash disbursements should be carried out as well.