



Financial Sustainability Program

Information Paper 21

Internal Financial Controls

April 2009



Introduction

Internal financial control, part of an organisation's broader internal control processes, is designed to assist the organisation in addressing risk of fraud and error and improving reliability of financial reporting and compliance with laws, regulations and policies. It focuses on Councils' financial processes and functions that deal with budgeting, financial reporting, transaction processing, financial delegations, treasury management, infrastructure management etc. This paper only deals with internal **financial** control. It does not address internal control in other areas such as business development, human resources, strategic management, etc which are also important.

The purpose of this information paper is to provide a practical approach to assist Councils when they are developing their internal financial controls and it presents:

- an implementation methodology;
- an action plan to implement changes to controls;
- a review process for key internal financial controls.

This paper should be read in conjunction with other information papers which highlight the increasing demands on Councils and the importance of efficiently managing the delivery of services.

Other information papers have been, or will soon be, prepared on the following topics:

- Financial Sustainability
- An Overview of Audit Mechanisms
- Audit Committees
- Scope of External Audit - Audit Specification
- Efficiency and Economy Audits
- Infrastructure and Asset Management (Policy and Planning)
- Service Delivery Framework including the Role of Shared Services
- Long-term Financial Plans
- Local Government Financial Indicators
- Debt Management
- Governance in Local Government
- Targets for Local Government Financial Indicators
- Model Framework for Council Annual Business Plans
- Model Work Program for Council Audit Committees
- Treasury Management
- Long-term Financial Plan - A Model Format for Financial Information
- Depreciation and Related Issues
- Financial Policies
- Audit Committee Reporting
- Funding Policies and Strategies
- Financial Governance
- *A New Approach to State-Local Resourcing (currently being prepared)*

A number of manuals, guidelines, templates, technical definitions, codes, standards and similar documents supporting this series of information papers are also being prepared by the LGA to provide practical assistance to Councils.

For an update on which information papers have now been completed or information about other documents and activities, including briefing and training sessions, please visit our website at: www.lga.sa.gov.au/goto/fsp.

What does Legislation require?

The Local Government Act 1999 and associated regulations spell out roles relating to internal controls for Councils (implementing and maintaining), audit committees (reviewing the adequacy) and external auditors (considering the adequacy of).

Section 125 of the Local Government Act 1999 states:

“A council must ensure that appropriate policies, practices and procedures of internal control are implemented and maintained in order to assist the council to carry out its activities in an efficient and orderly manner to achieve its objectives, to ensure adherence to management policies, to safeguard the council’s assets, and to secure (as far as possible) the accuracy and reliability of council records.”

Section 126 (4) (c) of the Local Government Act identifies one of the functions of an audit committee as:

“reviewing the adequacy of the accounting, internal control, reporting and other financial management systems and practices of the council on a regular basis.”

Local Government (Financial Management) Regulation 14 (2) states:

“In forming an audit opinion for a council under section 129(3) of the Act, the auditor must give due consideration to the adequacy of the council’s policies, practices and procedures of internal control under section 125 of the Act.”

In December 2008, the Minister for State/Local Government Relations advised of her intention to strengthen the current requirement in Financial Management Regulation 14 (2) in two ways¹:

- first, by prescribing the requirement in the Local Government Act itself rather than in the Regulations; and,
- second, by amending the Act to require external auditors to include in their reports to Councils a report on internal financial controls being exercised and, specifically, whether those controls are sufficient to provide a reasonable assurance that the financial activities of Councils have been conducted properly and in accordance with law.

What is internal financial control?

Internal financial control manages the risk to the organisation from error or fraud and therefore assists in the achievement of a Council’s objectives. It will not remove all risk but is a means of managing risk and reducing the likelihood and consequence of adverse events.

Internal financial control will be instrumental in:

- safeguarding the Council assets;
- ensuring reliability of both financial and non-financial reporting;
- complying with legislation and Council policies; and
- promoting the effectiveness and operational efficiency of Council.

A sound system of internal financial control is essential for a Council to ensure that its resources are allocated in the most appropriate manner to ensure that operational and financial objectives are being met and to comply with the accountability provisions of the Local Government Act. The benefits of a coordinated, systematic approach to risk management² include:

¹ See Local Government Accountability Proposals Paper, December 2008 available via LGA Circular 3.5 of 2009

² Financial Sustainability Information Paper 22: ‘Risk Management Framework’ encourages Councils to use a risk management approach consistent with the Australian Risk Management Standard AS/NZS 4360:2004. Internal financial controls are an integral part of a Council’s risk management framework.

- Council Members, the Audit Committee and senior management having a clear view on key risks facing the Council;
- agreement across Council Members, the Audit Committee and senior management on the priorities to manage the key risks;
- controls operating effectively to reduce risks to an acceptable level;
- cost-savings through an efficient controls environment; and
- Council being confident that its administration is operating effectively.

It is important that an internal control system addresses:

- adequate separation of duties in the financial operations;
- independent checks of changes to key master data files;
- regular key reconciliations (e.g. reconciliation of bank account balance to amount showing in general ledger) which are independently reviewed; and
- documentation and distribution of policies and procedures for all major activities.

Internal financial control framework

In 2002 the South Australian Local Government Financial Management Group Inc. commissioned Deloitte Touche Tohmatsu (Deloitte) to develop a 'Best Practice Model - Internal Financial Controls' The report encouraged Councils to adopt a risk management culture and outlined the following as essential elements of an internal financial control system:

- delegations of authority;
- documented policies and procedures;
- trained and properly qualified staff;
- information technology controls;
- process of review;
- regular liaison with statutory auditors and legal advisors;
- regular attestations from the leadership team that it has complied with Council's existing internal control policies and procedures; and
- documented risk identification and assessment.

The report identifies thirty-one business activities and business risks are identified for each activity. Examples of business activities are accounts payable, cash receipting, banking, payroll etc. For an example of a business risk refer to Attachment 1, which also provides the internal financial controls necessary to reduce the likelihood of that business risk occurring. The Deloitte report is available from the LGA web site by the following link:
http://www.lga.sa.gov.au/webdata/resources/Files/Finance_Internal_Financial_Controls_Best_Practice_Manual_2002.pdf2.pdf.

The majority of internal financial controls in the Deloitte Best Practice Model could be applied to all Councils, however it was recognised that each Council may require additional controls to fully meet its own requirements. A strong emphasis of the Model is the application of automated IT internal financial controls (i.e. system security) to strengthen the internal financial control environment. It also recommended the development of a culture of integrity, ethical values and competence as a method of reducing risk.

With the recent introduction of Audit Committees there has been a much stronger focus on the development of internal financial controls as a key part of the financial governance framework and many Councils are in the process of formalising improved internal financial controls.

In August 2008 the Local Government Association conducted a survey of South Australian Councils to identify the current position of internal financial controls. Less than 20% of responding Councils have internal controls based on the Deloitte Best Practice Model.

Councils that have developed their internal controls without the risk management methodology are open to serious risk.

It is recommended that Councils adopt the Deloitte Best Practice Model when developing or reviewing their internal financial controls.

Developing/reviewing internal financial controls

With over 400 internal financial controls spread over 31 business activities the Best Practice Model report is large. However, in practice Councils will need much less than 400 separate controls because many controls identified in the Best Practice Model address a number of business risks and are therefore effectively repeated. The majority of suggested internal controls are likely to be already built into Councils' current procedures and the number requiring development or review at any point in time is likely to be relatively small.

The following sets out a step by step process to assist Councils that may be reviewing (or developing) their internal controls:

1. Adopt the Deloitte Best Practice Model report as the base document for internal financial controls;
2. Identify problems and risks that have been raised by the external auditor, Audit Committee, etc and which could be covered by internal financial controls;
3. Consult with staff and Council Members regarding the objective of the review and provide an outline of the process - ensure that the senior management team is kept informed of progress;
4. Identify officers responsible for each of the 31 business activities and arrange for these to participate in the review;
5. Undertake an internal financial controls review for each of the 31 business activities to;
 - examine current procedures;
 - identify key risks threatening the achievement of Council's objectives;
 - identify existing internal financial controls;
 - assess current controls for effectiveness;
 - identify any new controls needed as well as existing controls requiring adjustment;
 - identify relevant officers for each internal control.

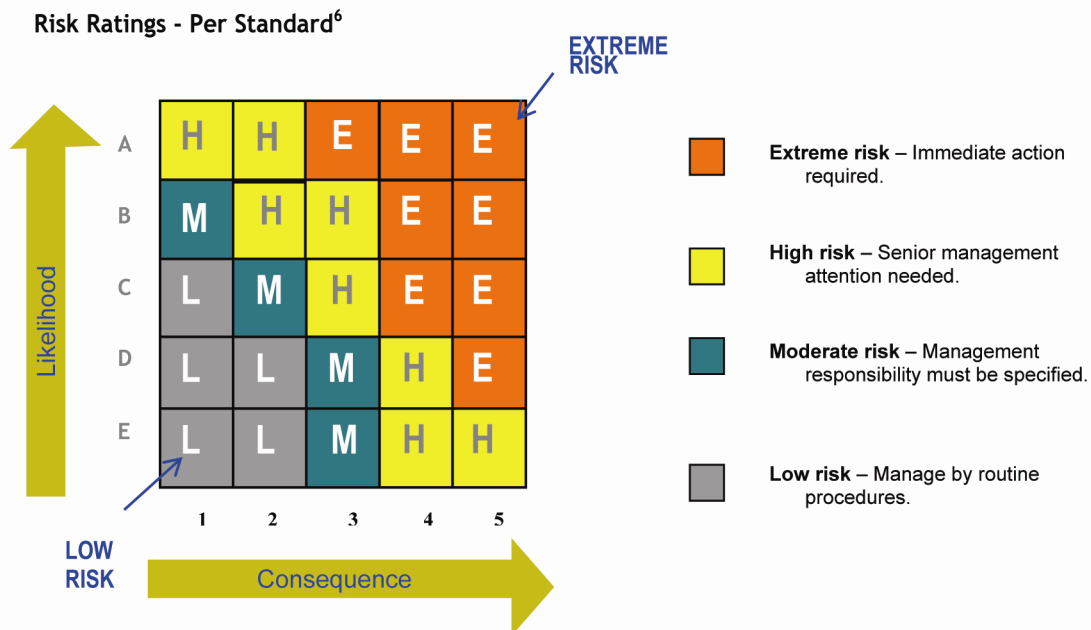
The review should not be seen as an audit of past transactions. Its objective is to identify and evaluate existing internal financial controls and recommend changes and/or new internal controls where necessary.

6. Establish a database of internal controls in accordance with the hierarchy presented at Attachment 2:
7. The following detail should be recorded for each internal financial control:

No:	Identification number of internal control for each risk
Description of Control:	Description of the internal financial control
Current Situation:	Current situation in regard to each internal control
Target Date:	Target date allocated to the implementation of the control
Responsible Officer:	Responsible officer for each internal control
Checking Officer:	Checking officer and/or if the internal control is included in the 'Spot Check' process (refer below in the Review Process)

8. For each risk identified an assessment of its likelihood and consequence should be undertaken according to the classifications included in Attachment 3 (Note: These measures need to be tailored to meet the needs of an individual organisation):
9. The final inherent risk is determined by using the two ratings above and applying these to the table below to identify overall risk as:

L Low Risk
 M Moderate Risk
 H High Risk
 E Extreme Risk.



Attachment 1 sets out an example of a business risk analysed according to the approach outlined above. The assessment process should not be considered to be an exact science however there is value in allocating time to considering the likelihood and consequence of each risk.

The strategy above may be implemented by Councils' own staff or by external consultants. However, regardless of who undertakes this work, it is important that the risks to Council are kept in mind and necessary internal controls, even if they are unpopular, are recommended. Resources required to implement new internal controls should be considered and an assessment of these costs against the ensuing benefits from the internal control should be made.

Plan of action

An outcome of an internal financial controls review will be a list of controls for implementation or refinement. It is likely that all staff will be affected by the internal financial controls, not just finance staff, and to receive the full benefit of the review it is important that Council's senior management team drive the process to ensure these controls are actioned.

In order to implement these controls Council should prepare an action plan (refer Attachment 4 for an extract example of a plan). This plan identifies the internal controls requiring action by each staff member responsible for specific tasks and includes deadlines for when each internal financial control is to be completed. The controls which are most critical as well as those requiring minimal work should be processed quickly and all timelines identified in the plan should be achievable.

This action plan should be agreed to by all staff members responsible for specific tasks within a month of preparation and should be a regular agenda item to the senior management team and Audit Committee meetings, until all controls have been completed.

Review process

Business risks faced by Council can and do change and a critical element of any comprehensive internal financial control model is regular monitoring and/or review to ensure the internal financial controls remain effective and are functioning properly.

In order to maintain confidence in their internal financial controls Councils should conduct regular spot checks on key controls. If spot checks are undertaken regularly the timing for a full review may be extended. Ideally an internal auditor would undertake such checks within an internal audit program but not all Councils have internal auditors. Alternatively a staff member responsible for specific tasks might be required to sign that the internal financial controls relating to his or her position are in place and are being adhered to.

Where a full review is scheduled, the key controls that will be subject to a 'spot check' should be identified (see the last column of the table in Attachment 1). These key internal financial controls may also be included in the full review process, or alternatively they can be removed or new controls added at any time.

If new systems are introduced, or when staff leave the organisation and are replaced, it is essential that any internal financial controls that are affected are reviewed.

What are the issues for Councils?

Elected Councils and Chief Executive Officers have a responsibility to ensure that the Councils' operations are conducted in compliance with appropriate laws, regulations and standards.

An effective suite of internal controls is a vital tool for Elected Councils and Chief executive officers to ensure that they carry out their activities in an efficient, compliant, reliable and transparent manner. Councils' Audit Committees and external auditors take account of internal control practices when forming their advice and opinions.

Councils should establish and maintain a robust and wide-spread internal control regime throughout their organisation. These internal controls should:

- reflect a co-ordinated and systematic approach to risk management;
- be embraced by management and the responsible officers within the organisation;
- be consistently recorded within a whole-of-organisation framework;
- have an associated plan of action to ensure that the controls are correctly implemented;
- include procedures for reporting immediately any significant control failings or weaknesses that are identified together with details of corrective action being undertaken; and
- be subject to periodic review at a frequency appropriate for each control.

Councils should embrace the Best Practice Model outlined in this paper to ensure a sound approach to the establishment and maintenance of their internal control framework. The approach should be embedded in the operations of the Council and form part of its culture.

Acknowledgements

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EXAMPLE OF A BUSINESS ACTIVITY RISK - ACCOUNTS PAYABLE

Risk No. 1: Accounts payable amounts are either inaccurately recorded or not recorded at all.

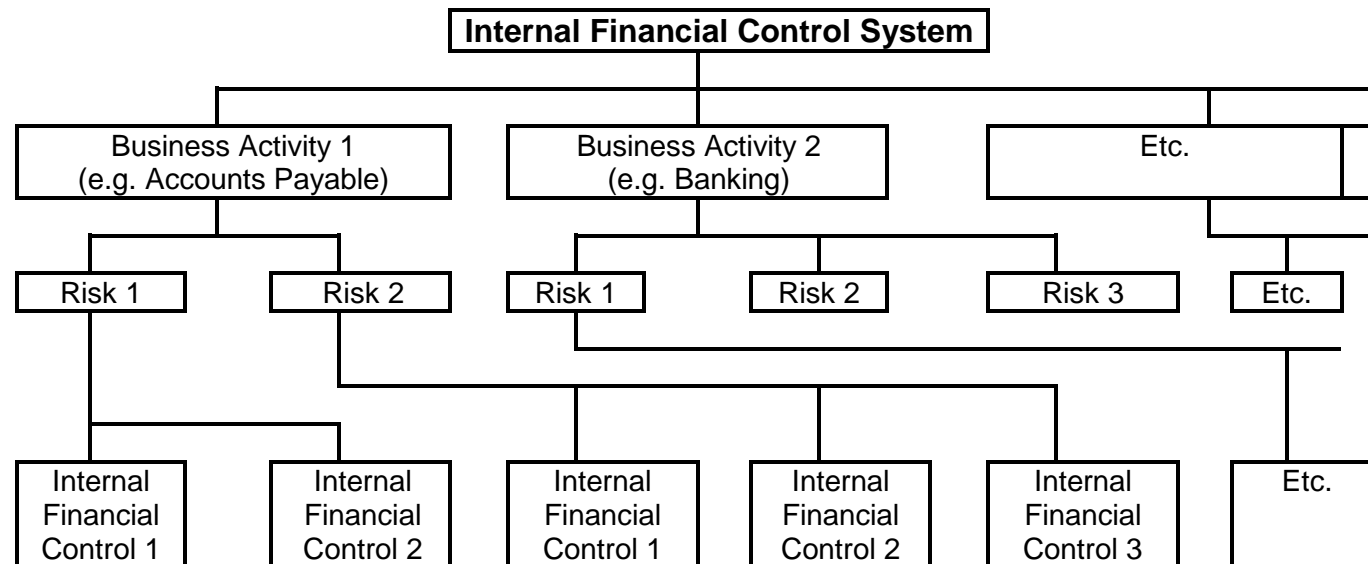
- If invoices are not entered accurately (e.g. amounts posted to incorrect creditors), accounts payable will be misstated, as will the relevant expense, inventory, or asset accounts. Also, erroneous payments may be made to vendors.
- If amounts posted to accounts payable do not represent goods or services received (due to invalid delivery address on purchase order), unauthorised payments might be made and the organisation might incur a financial loss.
- If accounts payable amounts are not recorded at all, accounts payable will be understated, as will the related inventory, expense, or asset accounts. Also, supplier payments will not be made, which may damage supplier relationships.

No	Description of Control	Current Situation	Target Date	Responsible Officer	Checking Officer
1	Statements received from suppliers are reconciled to the supplier accounts in the accounts payable sub-ledger regularly and differences are investigated.	Supplier statements are reconciled monthly as are the control accounts in the creditors system.	Monthly	Accounts Officer	
2	Actual expenditures are compared to budget regularly. Management reviews and approves significant variances.	Comparisons are made at the time of budget reviews.	Quarterly	All Managers	
3	Creditors batch listing is checked by independent officer prior to cheque (or EFT) generation for accuracy and credit note verification.	A batch listing report and supporting documentation is available for checking. Checking is required prior to EFT. When a checking officer checks the batch he/she should sign as confirmation that details have been checked.	Continual	Chief Executive Officer, Senior Finance Officer, Finance Officer, Manager Community Services, Manager Infrastructure	Spot Check
4	Invoices for services received are authorised and accompanied by appropriate supporting documentation.	Current practice.	Continual	Officers within Delegations of Authority	Spot Check

5	Where there are variances between Purchase Orders and Invoices, processing is suspended and released by Senior Finance Officer only after verification by the responsible officer.	Invoices are referred back to the relevant Manager for advice prior to processing.	Continual	All Managers	
6	Goods received are matched on-line or manually with purchase order details and/or invoices.	Goods received are matched manually with purchase orders.	Continual	Accounts Officer	
7	Bank statements are reconciled to the general ledger regularly.	Bank statements are reconciled weekly.	Weekly	Finance Officer	Spot Check
8	Cheques are endorsed by authorised officers separate to the preparer who ensures that they are paid to the specified payee.	Current practice.	Continual	Chief Executive Officer, Senior Finance Officer, Manager Community Services, Manager Infrastructure	
9	Individuals who process electronic funds transfers are authorised by management.	Only certain authorised officers can process electronic funds transfers. The Accounts Officer and Payroll Officer prepare the EFT run and completion is required by a Checking Officer.	Continual	Accounts Officer, Payroll Officer	Chief Executive Officer, Senior Finance Officer, Manager Community Services, Manager Infrastructure

Risk Assessment – With All Controls			
Likelihood	Consequence	Rating	Accept
D	2	L	Y

Internal Financial Control Database Hierarchy



Internal Financial Controls

Likelihood and Consequence Classifications

Likelihood

A	Almost certain	Is expected to occur in most circumstances
B	Likely	Will probably occur in most circumstances
C	Possible	Might occur at some time
D	Unlikely	Could occur at some time
E	Rare	May occur only in exceptional circumstances

Consequence

1	Insignificant	<ul style="list-style-type: none"> • Impact on operating result of \$X • Loss of business capability/failure to meet customer needs for X days • No adverse public/staff reaction and negative publicity • No breach of legislation • No physical injuries
2	Minor	<ul style="list-style-type: none"> • Impact on operating result of \$X • Loss of business capability/failure to meet customer needs for X days • Minor adverse public/staff reaction and negative publicity • Minor breach of legislation • First aid treatment
3	Moderate	<ul style="list-style-type: none"> • Impact on operating result of \$X • Loss of business capability/failure to meet customer needs for X days • Moderate adverse public/staff reaction and negative publicity • Moderate breach of legislation • Medical treatment required
4	Major	<ul style="list-style-type: none"> • Impact on operating result of \$X • Loss of business capability/failure to meet customer needs for X days • Major adverse public/staff reaction and negative publicity • Major breach of legislation • Extensive injuries
5	Catastrophic	<ul style="list-style-type: none"> • Impact on operating result of \$X • Loss of business capability/failure to meet customer needs for X days • Extreme adverse public/staff reaction and negative publicity • Extreme breaches of legislation • Death

Attachment 4

EXAMPLE – EXTRACT FROM ACTION PLAN

Senior Finance Officer

No.	INTERNAL CONTROL	ISSUES IDENTIFIED / COMMENTS	ACTION REQUIRED
By December 2008			
3	Senior Finance Officer to review aged payables listing quarterly and investigate where appropriate.		Planned for implementation next quarter.
74	Manually raised orders are periodically sampled to ensure completeness.	Training of staff to input clear descriptions of goods and services.	Current practice although the description of goods/services being purchased should be more detailed.
14	Annual Budgets are approved by the appropriate level of management and by Council, and in accordance with the Local Government Act.	This will require a more comprehensive Budget Schedule, which sets deadlines for the development of the Budget, etc and is strongly supported by management and Council.	Management present the annual budget to Council for adoption. The 2008/09 Budget was approved at the beginning of August. The Budget process will be streamlined to enable the 2009/10 Budget to be approved by the end of June 2009.
By March 2009			
4	Supplier master file data is periodically reviewed by management for accuracy and ongoing pertinence.	Reports available from the system may require upgrading.	To be reviewed by the Senior Finance Officer.
32	Management reviews debtors ageing profile on a regular basis and investigates any outstanding items.		The Debtors Ageing profile is reviewed monthly and if greater than 120 days is forwarded to the Collection agency. This should be reviewed with the objective of reducing that time to 60 or 90 days.
By June 2009			
37	Activity recorded in fixed asset register is reviewed by management, including comparison to the capital budget.		Not current practice, but is planned for introduction.
56	<u>Monthly Report</u> Management clearly informed of their duties and responsibilities in relation to reporting.	Managers to have either electronic access to a monthly report or receive a hard copy.	Management reporting is to be upgraded. Managers should receive a monthly report to review their financial situation.