

# Section 7 – Internal Control Framework

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# Internal Control Framework

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## 7.1 Internal Control and Risk Management

An effective system of internal controls provides a level of assurance that financial information is reliable and the local government is meeting compliance with applicable regulations and internal procedures.

Achieving regulatory compliance should be viewed as the fundamental goal of an effective internal control system with further enhancement being ongoing as part of an overall organisational risk management process.

Developing the appropriate internal controls to minimise the risks, fraud or error to an acceptable level is achieved through a sound understanding of both the legislative framework and risk management practices.

## □ 7.1.1 Legislative Framework

### Responsibility for Internal Control

The Chief Executive Officer (CEO) is required to prepare and present the annual financial report in accordance with the *Local Government Act 1995* and the *Local Government (Financial Management) Regulation 1996*. The report must also comply with the Australian Accounting Standards (including the Australian Accounting Interpretations) and be free from material misstatement. Part of the process of ensuring the financial report is reliable and free of a material misstatement is the development of an effective system of internal control.

The overall responsibility for developing these control systems rests with the CEO and is set out in the *Local Government (Financial Management) Regulations 1996* as outlined below:

#### Regulation 5

- (1) Efficient systems and procedures are to be established by the CEO of a local government
  - (a) for the proper collection of all money owing to the local government;
  - (b) for the safe custody and security of all money collected or held by the local government;
  - (c) for the proper maintenance and security of the financial records of the local government (whether maintained in written form or by electronic or other means or process);
  - (d) to ensure proper accounting for municipal or trust —
    - (i) revenue received or receivable;
    - (ii) expenses paid or payable; and
    - (iii) assets and liabilities;
  - (e) to ensure proper authorisation for the incurring of liabilities and the making of payments;
  - (f) for the maintenance of payroll, stock control and costing records; and
  - (g) to assist in the preparation of budgets, budget reviews, accounts and reports required by the Act or these regulations.
- (2) The CEO is to —
  - (a) ensure that the resources of the local government are effectively and efficiently managed;
  - (b) assist the council to undertake reviews of fees and charges regularly (and not less than once in every financial year); and

The establishment of internal controls surrounding investments is specifically dealt with under the *Local Government (Financial Management) Regulations 1996* as follows:

Regulation 19

- (1) A local government is to establish and document internal control procedures to be followed by employees to ensure control over investments.
- (2) The control procedures are to enable the identification of —
  - (a) the nature and location of all investments; and
  - (b) the transactions related to each investment.

### Responsibility for Review

Establishing of a system of internal control in to comply with the Regulations would sit within a broader risk management process which includes the examination and review of these systems to identify the appropriate control relevant to the risk. The Regulations place an obligation on the CEO to undertake a review and develop a formal report every 4 financial years as follows:

Regulation 5(2)

The CEO is to —

- (c) undertake reviews of the appropriateness and effectiveness of the financial management systems and procedures of the local government regularly (and not less than once in every 4 financial years) and report to the local government the results of those reviews.

The Regulations also restrict who may undertake the internal audit function to ensure there is adequate independence in the process as follows:

Regulation 6

A local government is to ensure that an employee to whom is delegated responsibility for the day to day accounting or financial management operations of a local government is not also delegated the responsibility for —

- (a) conducting an internal audit; or
  - (b) reviewing the discharge of duties by that employee,
- or for managing, directing or supervising a person who carries out a function referred to in paragraph (a) or (b).

Establishing a formal internal audit function is not a legislative requirement but can play an important role within an effective internal control framework.

## **Audits and Internal Controls**

An important part of providing assurance to the council on the fair presentation of the Annual Financial Report is the performance of an independent external audit. External Auditors are required to be appointed by each local government from time to time on the recommendation of the audit committee. The audit requirements are addressed under Part 7 of the LGA and the *Local Government (Audit) Regulations 1996*. The main requirements are summarised below:

- each local government is to establish an audit committee consisting of three or more persons;
- members of the committee are to be appointed by an absolute majority decision of council;
- the CEO is not to be a member of the committee and may not nominate a person to be a member;
- an employee is not to be a member;
- the only powers and duties that can be delegated to a committee are only the powers and duties of the local government under Part 7 of the Act. The committee cannot on-delegate the powers and duties delegated to it;
- a decision of the committee is to be made by simple majority.

The relationship between internal and external audit and the role of the internal auditor within the WA Local Government context is further described in the Local Government Operational Guidelines – Number 13 titled “The relationship Between Internal and External Audit.

The role and functions of the audit committee is further defined in the Local Government Operational Guidelines – Number 09 titled “Audit Committees in Local Government their appointment, function and responsibilities”

## **Bank Accounts**

One of the more fundamental controls in any financial system is the utilisation of bank accounts to track cash transactions. Bank accounts provide an independent record of transactions and restrict access to the financial resources of the local government.

Regulation 8 and 10 of the *Local Government (Financial Management) Regulations 1996* require the establishment and use of various bank accounts as follows:

Regulation 8

- (1) A local government is to maintain a separate account with a bank or other financial institution for each of the following purposes —
  - (a) money required to be held in the municipal fund (other than money for which an account is to be established under paragraph (c), (d) or (e));
  - (b) money required to be held in the trust fund; and
  - (c) money required to be held in reserve accounts.
- (2) Money related to a purpose set forth in sub-regulation (1) is to be banked in the account maintained for that purpose.
- (3) Money from different accounts may be placed in a common investment authorised by the Act.

Regulation 10

Money received by a local government is to be paid into an account referred to in regulation 8.

### Controls for Payment of Accounts

There is also a requirement under Regulation 11 and 12 for a local government to establish basic internal controls over the payment of accounts as follows:

Regulation 11 states:

- (1) A local government is to develop procedures for the authorisation of, and the payment of, accounts to ensure that there is effective security for, and properly authorised use of —
  - (a) cheques, credit cards, computer encryption devices and passwords, purchasing cards and any other devices or methods by which goods, services, money or other benefits may be obtained; and
  - (b) petty cash systems.
- (2) A local government is to develop procedures for the approval of accounts to ensure that before payment of an account a determination is made that the relevant debt was incurred by a person who was properly authorised to do so.
- (3) Payments made by a local government —
  - (a) subject to sub-regulation (4), are not to be made in cash; and
  - (b) are to be made in a manner which allows identification of —
    - (i) the method of payment;
    - (ii) the authority for the payment; and

(iii) the identity of the person who authorised the payment.

(4) Nothing in sub-regulation (3)(a) prevents a local government from making payments in cash from a petty cash system.

Regulation 12 states:

- (1) A payment may only be made from the municipal fund or the trust fund –
  - (a) if the local government has delegated to the CEO the exercise of its power to make payments from those funds — by the CEO; or
  - (b) otherwise, if the payment is authorised in advance by a resolution of the council.
- (2) The council must not authorise a payment from those funds until a list prepared under regulation 13(2) containing details of the accounts to be paid has been presented to the council.

## Controls for Purchasing

Purchasing controls are established through the adoption of the annual budget under Section 6.2 of the Local Government Act 1995.

Section 6.2 states:

- (1) During the period from 1 June in a financial year to 31 August in the next financial year, or such extended time as the Minister allows, each local government is to prepare and adopt\*, in the form and manner prescribed, a budget for its municipal fund for the financial year ending on the 30 June next following that 31 August.  
*\* Absolute majority required.*
- (2) In the preparation of the annual budget the local government is to have regard to the contents of the plan for the future of the district made in accordance with section 5.56 and to prepare a detailed estimate for the current year of —
  - (a) the expenditure by the local government;
  - (b) the revenue and income, independent of general rates, of the local government; and
  - (c) the amount required to make up the deficiency, if any, shown by comparing the estimated expenditure with the estimated revenue and income.
- (3) For the purposes of subsections (2)(a) and (b) all expenditure, revenue and income of the local government is to be taken into account unless otherwise prescribed.
- (4) The annual budget is to incorporate —
  - (a) particulars of the estimated expenditure proposed to be incurred by the local government;
  - (b) detailed information relating to the rates and service charges which will apply to land within the district including —
    - (i) the amount it is estimated will be yielded by the general rate; and
    - (ii) the rate of interest (if any) to be charged by the local government on unpaid rates and service charges;
  - (c) the fees and charges proposed to be imposed by the local government;



- (d) the particulars of borrowings and other financial accommodation proposed to be entered into by the local government;
  - (e) details of the amounts to be set aside in, or used from, reserve accounts and of the purpose for which they are to be set aside or used;
  - (f) particulars of proposed land transactions and trading undertakings (as those terms are defined in and for the purpose of section 3.59) of the local government; and
  - (g) such other matters as are prescribed.
- (5) Regulations may provide for —
- (a) the form of the annual budget;
  - (b) the contents of the annual budget; and
  - (c) the information to be contained in or to accompany the annual budget.

Chapter 4 of the manual provides an explanation of the budget process and associated requirements.

Having adopted the annual budget Section 6.8 of the Local Government Act 1995 requires all expenditure to be included in the budget unless special circumstances prevail as follows:

Section 6.8 states:

- (1) A local government is not to incur expenditure from its municipal fund for an additional purpose except where the expenditure —
- (a) is incurred in a financial year before the adoption of the annual budget by the local government;
  - (b) is authorised in advance by resolution\*; or
  - (c) is authorised in advance by the mayor or president in an emergency.
- \* Absolute majority required.*
- (1a) In subsection (1) —
- additional purpose means a purpose for which no expenditure estimate is included in the local government's annual budget.
- (2) Where expenditure has been incurred by a local government —
- (a) pursuant to subsection (1)(a), it is to be included in the annual budget for that financial year; and
  - (b) pursuant to subsection (1)(c), it is to be reported to the next ordinary meeting of the council.

Purchases of goods and services made as part of the annual budget are subject to operational procurement controls under Regulation 11A of the *Local Government (Functions and General) Regulations 1996* as follows:

Regulation 11A states:

- (1) A local government is to prepare or adopt, and is to implement, a purchasing policy in relation to contracts for other persons to supply goods or services where the consideration under the contract is, or is expected to be, \$100 000 or less or worth \$100 000 or less.
- (2) A purchasing policy is to make provision for and in respect of the policy to be followed by the local government for, and in respect of, entering into contracts referred to in sub Regulation (1).
- (3) A purchasing policy must make provision in respect of —
  - (a) the form of quotations acceptable; and
  - (b) the recording and retention of written information, or documents, in respect of —
    - (i) all quotations received; and
    - (ii) all purchases made.
- (4) Different requirements may be imposed under a purchasing policy in respect of different classes, or types, of any of the following —
  - (a) goods and services;
  - (b) suppliers;
  - (c) contracts;
  - (d) any other thing that the local government considers appropriate.

The general provisions for calling and accepting tenders under the legislation are contained within Section 3.57 of the Local Government Act 1995 with the procedures and requirements of the tender process detailed within Part 4 of the Local Government (Functions and General) Regulations 1996.

The Western Australian Local Government Association (WALGA) "Purchasing and Tendering Guide" provides a useful best practice reference. For further information, email WALGA [purchasing@walga.asn.au](mailto:purchasing@walga.asn.au).

## Monitoring Controls

Procurement controls and the controls resulting from the annual budget process are subject to monitoring by the requirement to prepare regular financial reports for review by the Council. This requirement is contained in Regulation 34 and Section 6.4 of the Local Government Act 1995 as follows:

Regulation 34 states:

- (1) A local government is to prepare each month a statement of financial activity reporting on the revenue and expenditure, as set out in the annual budget under regulation 22(1)(d), for that month in the following detail —
  - (a) annual budget estimates, taking into account any expenditure incurred for an additional purpose under section 6.8(1)(b) or (c);
  - (b) budget estimates to the end of the month to which the statement relates;
  - (c) actual amounts of expenditure, revenue and income to the end of the month to which the statement relates;
  - (d) material variances between the comparable amounts referred to in paragraphs (b) and (c); and
  - (e) the net current assets at the end of the month to which the statement relates.
- (2) Each statement of financial activity is to be accompanied by documents containing —
  - (a) an explanation of the composition of the net current assets of the month to which the statement relates, less committed assets and restricted assets;
  - (b) an explanation of each of the material variances referred to in sub-regulation (1)(d); and
  - (c) such other supporting information as is considered relevant by the local government.
- (3) The information in a statement of financial activity may be shown —
  - (a) according to nature and type classification; or
  - (b) by program; or
  - (c) by business unit.
- (4) A statement of financial activity, and the accompanying documents referred to in sub-regulation (2), are to be —
  - (a) presented at an ordinary meeting of the council within 2 months after the end of the month to which the statement relates; and
  - (b) recorded in the minutes of the meeting at which it is presented.

Section 6.4 states:

- (1) A local government is to prepare an annual financial report for the preceding financial year and such other financial reports as are prescribed.
- (2) The financial report is to —
  - (a) be prepared and presented in the manner and form prescribed; and
  - (b) contain the prescribed information.
- (3) By 30 September following each financial year or such extended time as the Minister allows, a local government is to submit to its auditor —
  - (a) the accounts of the local government, balanced up to the last day of the preceding financial year; and
  - (b) the annual financial report of the local government for the preceding financial year.

Detailed monitoring of all payments of accounts is required by Regulation 13 as follows:

Regulation 13 states:

- (1) If the local government has delegated to the CEO the exercise of its power to make payments from the municipal fund or the trust fund, a list of accounts paid by the CEO is to be prepared each month showing for each account paid since the last such list was prepared —
  - (a) the payee's name;
  - (b) the amount of the payment;
  - (c) the date of the payment; and
  - (d) sufficient information to identify the transaction.
- (2) A list of accounts for approval to be paid is to be prepared each month showing —
  - (a) for each account which requires council authorisation in that month —
    - (i) the payee's name;
    - (ii) the amount of the payment; and
    - (iii) sufficient information to identify the transaction;and
  - (b) the date of the meeting of the council to which the list is to be presented.
- (3) A list prepared under sub-regulation (1) or (2) is to be —
  - (a) presented to the council at the next ordinary meeting of the council after the list is prepared; and
  - (b) recorded in the minutes of that meeting.

## □ 7.1.2 Accountability and Transparency

The custodial role played by a local government in managing public assets brings with it a high expectation of public accountability and transparency.

Ensuring this high level of accountability and transparency requires the maintenance of a compliance culture and promotion of a sound internal control environment developed within a risk management framework. A key element of risk management and internal control is the communication of risks to both internal and external stakeholders.

Accountability and transparency within an organisation is heavily influenced by the 'tone at the top'. The actions of the CEO in requiring compliance with the legislative framework and internal policies and procedures are crucial to maintaining accountability and transparency.

There are three main types of accountability in the local government environment namely:

1. Public accountability - the mechanisms for assuring stakeholders of the local government behave responsibly.
2. Legal and corporate accountability - covering the obligations of the local government to comply with various legal frameworks.
3. Community accountability - ensuring the council and executive perform functions in line with the wishes and expectations of the local community.

### **Public accountability and transparency**

Local governments provide services to the broad population through the provision of local services and infrastructure. In recognition of local governments role in the provision of these services and infrastructure they receive public funds from Federal and State government. Receipt of these funds establishes the following expectations:

1. A requirement for transparency to the wider community.
2. A requirement for disclosure of key financial and other information in a timely manner.
3. Accountability for financial viability and governance during the budget and reporting cycles.
4. An external audit and sound internal control framework where statutory compliance, performance and financial accountability are independently evaluated and reported on. In the relevant circumstances this may be further enhanced by a formal internal audit process.

As publically funded organisations local governments should also meet appropriate standards of public accountability and transparency including the following actions:

1. Policy Development - Open and transparent policy development which promotes well-informed decisions based on expert advice and key stakeholder involvement.
2. Decision making - Applying documented policies objectively with integrity, fairness and neutrality.
3. Responsiveness - Appropriate responsiveness to the needs of the public whilst obtaining informed input from those most affected.
4. Financial Reporting – Appropriate checks and balances should be built into the financial accountability framework including:
  - Alignment of budget to long term financial goals;
  - Timely reporting of performance against budget;
  - Review of monthly and annual financial reports by the council;
  - External audit of annual financial reporting; and
  - Publication of financial reports.

### **Legal and corporate accountability and transparency**

*The Local Government Act 1995* and associated regulations create the core accountability framework within which a local government operates. The legal 'duty of care' which exists for elected members and officers further adds to the legal and corporate accountability framework.

The financial transparency requirements under the Act are detailed within the financial reporting sections of this manual. Part 5 Division 6 of the *Local Government Act 1995* contains the transparency requirements for elected members and officers in relation to their disclosure of financial interests with Part 5 Division 7 providing the legal transparency requirements for access to information.

### **Community accountability and transparency**

The mechanism by which a local government may make itself more accountable to the local community includes:

1. The representative composition of the elected members from the local community.
2. Setting consultation principles to guide the process and encourage community input.

3. A consultative planning process when setting strategic direction and determining operational priorities and budgets, such as that detailed - "Integrated Planning and Reporting Framework and Guidelines".
4. Development of budgets in parallel with operating plans through a consultative process.

The development of an annual budget through a corporate business planning process developed as part of integrated planning and reporting forms a standard for community transparency.

## 7.2 Risk Management

### □ 7.2.1 Principles of Risk Management

The coordination of activities to direct and control an organisation with regard to risk is known as risk management. When local governments set objectives under their budget or any other plan they are exposed to risks or 'uncertainties' which need to be managed in order to meet the objectives set out in their budget or plan.

The International Risk Management Standard *AS/NZS ISO 31000 Risk Management- Principles and guidelines* defines

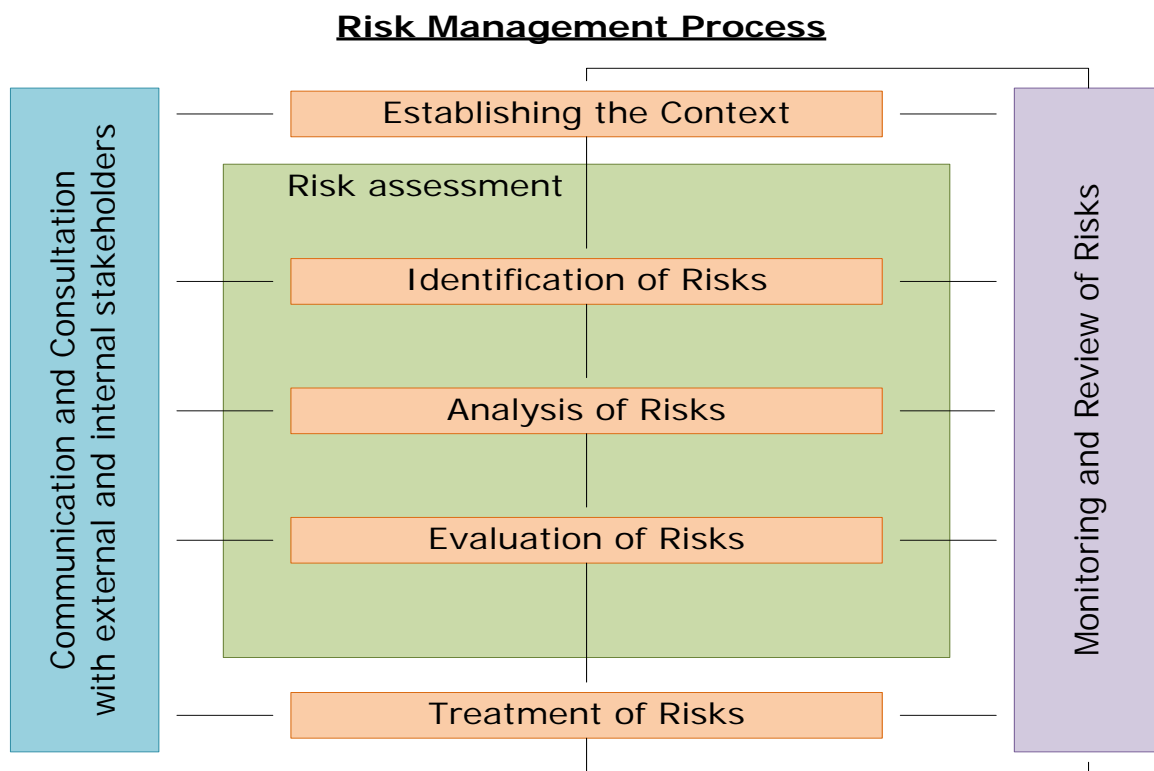
#### **Risk as the "Effect of uncertainty on objectives"**

Effect is defined as a deviation from the expected either positive and/or negative.

It is worth noting within this definition, risk is not only the existence of "hazards" but relates to the uncertainty in achieving an objective.

The risk management standard sets out key principles which need to be complied with for risk to be effectively managed. Under the associated framework information about risk is identified in a risk management process and adequately reported and used as a basis for decision making at all relevant organisational levels.

The risk management process is shown in the diagram below.



*AS/NZS ISO 31000 Risk Management – Principles and Guidelines*

Every local government should consider developing a tailored risk management process and make it an integral part of management.

The following risk areas arise from the accountability and transparency requirements placed on local government and should be addressed through a risk management process

- Waste - the misuse of resources
- Financial prudence - being careful with money
- Probity - the high standard of ethical behaviours expected of the staff, management and governing bodies of public sector entities
- Propriety - appropriateness to the purpose or circumstances
- Compliance - adherence to applicable laws, regulations and policy requirements.



## □ 7.2.2 Communication and Consultation

Communication and consultation with internal and external stakeholders throughout the risk management process is an essential element of risk management as it helps stakeholders understand the basis on which decisions are made, and the reasoning behind particular actions.

Transparent clear communications throughout the process will help meet the obligation on local governments for accountability and transparency.

Plans developed under the Integrated Planning and Reporting Framework requires communication of the risk assessment within the plans and informing strategies. Communication of risks to internal and external stakeholders should occur at the commencement of the planning process.

Consulting with all stakeholders using a planned consultation process helps identify and address risks through improved understanding. This consultation should occur throughout the risk management process as reflected in the diagram at section 7.2.1.

## □ 7.2.3 Establishing the Context

The defining of the external and internal parameters to be taken into account when managing risks requires a clear identification of the objectives of the activity. Where a risk assessment is performed as part of the formulation of a plan the context is defined by the plan itself.

Many risks which exist during the term of the Long Term Financial Plan (normally 10 + years) as opposed to those for an Annual budget are the same however the different timeframes of the two plans result in the risks being taken within two different contexts. The contexts of the risks may result in the assessment of the same risk differently in the two plans.

### Example:

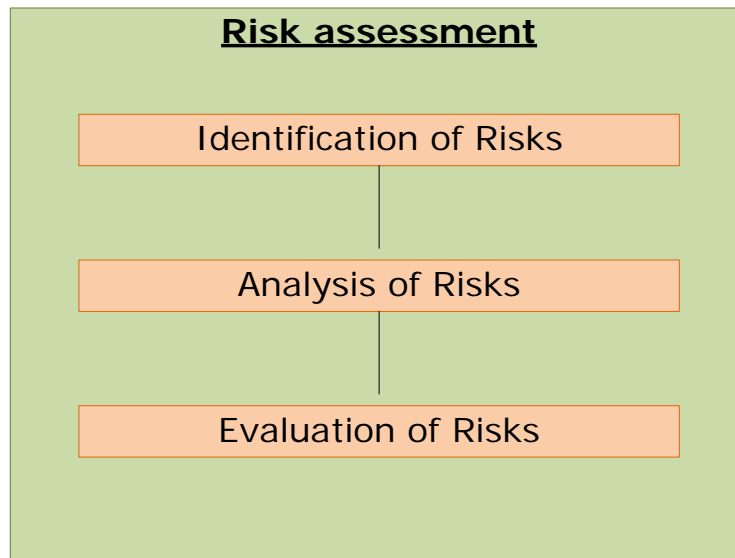
Interest rate movements will have limited impact in the context of an annual budget with the main impact being on Reserves.

In the context of the Long Term Financial plan the same movement over the long term will have far greater significance as it impacts the ability to utilise the Reserves.

It is important to clearly define the context of any risk assessment.

#### □ 7.2.4 Risk Assessment

Risk assessment is defined as the overall process of risk identification, risk analysis and risk evaluation as represented in the diagram below.



A risk assessment should be undertaken for each context in order to treat the risks adequately.

All decision makers assess risks as they make decisions, in many cases the risk assessment process is not formalised or documented resulting in decisions which may be difficult for other parties to understand.

Documentation of the risk assessment process adds context to the decision making process.

#### □ 7.2.5 Identifying Risks

Creating a list of all risks which might create, enhance or accelerate the achievement of an objective is as important as listing those which prevent, degrade or delay its success.

An understanding of risks associated with pursuing a given strategy should be obtained in the same way as an understanding of those associated with not pursuing an alternative strategy. The existence of relevant and up-to-date information is important as is the involvement of experienced qualified staff that are able to readily identify all the risks.

## □ 7.2.6 Analysis of Risks

All risks will have differing impacts on the ability of the local government to meet its objectives and have various likelihoods of occurring. It is the combination of the consequences and likelihood which determines the severity of the risk under evaluation.

The analysis of risk may be done with varying degrees of detail and may be qualitative, quantitative or a combination of both. A common approach is to use a table and rate the consequence and likelihood on a scale of 1 to 10 as illustrated in the table below:

Event	Consequence	Likelihood
Double input of a supplier invoice.	5	3
Unauthorised modification of bank account details	7	3
Double input of a supplier invoice and modification of associated bank account details	9	3



As demonstrated above where the likelihood of a breach of controls is relatively low (due to a sound control environment) the consequences of two risks occurring together may be far greater than each risk occurring individually.

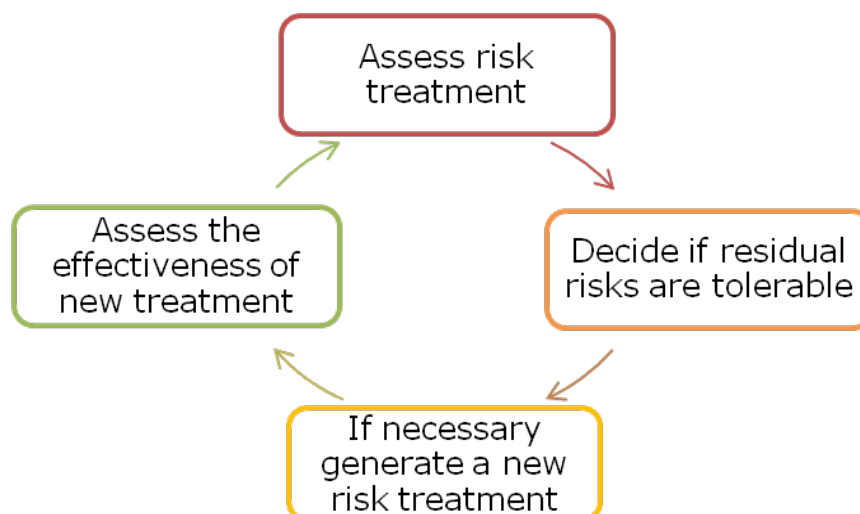
When utilising this method of risk evaluation it is important to recognise that risk is influenced by many interrelated matters including the relevant legal and regulatory environment. Risk analysis can identify and classify the various risks however the final decision to treat, mitigate or absorb the risk must be made within this broader context.

### □ 7.2.8 Risk Treatment

Having assessed the risks a local government has a number of options which may be implemented in isolation or combination. These options are to:

- Not undertake or stop the activity giving rise to the risk.
- Increase the risk to pursue an opportunity
- Remove the source of the risk
- Change the likelihood of the risk
- Change the consequences of the risk
- Share the risk with another party or parties (such as insurers)
- Retain the risk by informed decision

As the treatment of a risk by its very nature modifies the risk, risk treatment becomes a cyclical process as represented in the diagram below:



The aim of any risk treatment is to ensure risks are within tolerable levels.

The only risk treatment available to CEO's when fulfilling their financial management responsibilities is to implement internal controls over all the financial functions of the local government thereby changing the likelihood of the risk.

#### □ **7.2.9 Monitoring and Review**

An essential element of the risk management process is the monitoring and review of risks throughout the process. Monitoring and review may be periodic and routine or it may be ad hoc depending on the context. In the case of internal controls a combination of both ad hoc and routine monitoring is recommended.

The aim of monitoring and review of the risks is to:

- Ensure controls are effective and efficient in their design and operation
- Improve risk assessment
- Analyse and learn from events which have occurred
- Detect changes in the risk context or risk assessment which require revision of the risk treatment
- Identify emerging risks.

## □ 7.2.10 Major Financial Risk Areas

The following table presents a number of typical financial risks areas for local governments and provides a useful basis for performing a risk assessment of the financial management. The nature of financial risks is such that the list cannot be relied on as being exhaustive and does not substitute undertaking a formal risk assessment process by the local government.

Financial Areas	Risk Areas
<b>Strategic Financial Planning and Reporting</b>	Annual budget Annual statutory reporting Monthly statutory reporting Long term financial plans Asset management plans Workforce plans Corporate business plans
<b>Revenues</b>	Receipting Rates including interim and back rates Operating grants Financial contributions Non-financial contributions Fees and charges Service charges Investment/interest income Other revenue
<b>Expenditure</b>	Purchasing and procurement Employee costs Credit cards Elected members expenses Employee reimbursements Other expenses
<b>Assets</b>	Cash floats and petty cash bank accounts and banking Investments Rates receivables Trade receivables Property plant and equipment Infrastructure assets Prepayments Loans to clubs/community groups Inventory Depreciation Project costing

Financial Areas	Risk Areas
<b>Liabilities</b>	Goods receiving Trade payables Other payables Borrowings Employee liabilities Accrued expenses Taxation
<b>General Ledger</b>	Routine journals Cost reallocations Error corrections Period end processing Chart of accounts Sub ledger
<b>External Services</b>	Contracting
<b>Information Technology</b>	General IT risks Application IT risks



## 7.3 Internal Control Environment

### □ 7.3.1 Principles of Internal Control

Internal control environments may be viewed as five interrelated elements which impact on the Financial Reporting objectives of the local government. These five elements are represented in the following diagram.



#### **Control Environment**

Refers to the attitude, awareness and actions of council and staff towards internal controls and good governance.

The control environment has the broadest impact of any of the elements and is the most pervasive.

#### **Risk Assessment**

The purpose of an internal control is to mitigate business risks including error and fraud. As all controls carry a cost of implementation, no control should exist which does not mitigate risk therefore the identification of risks is of paramount importance when establishing, implementing or reviewing controls.

## Information Systems

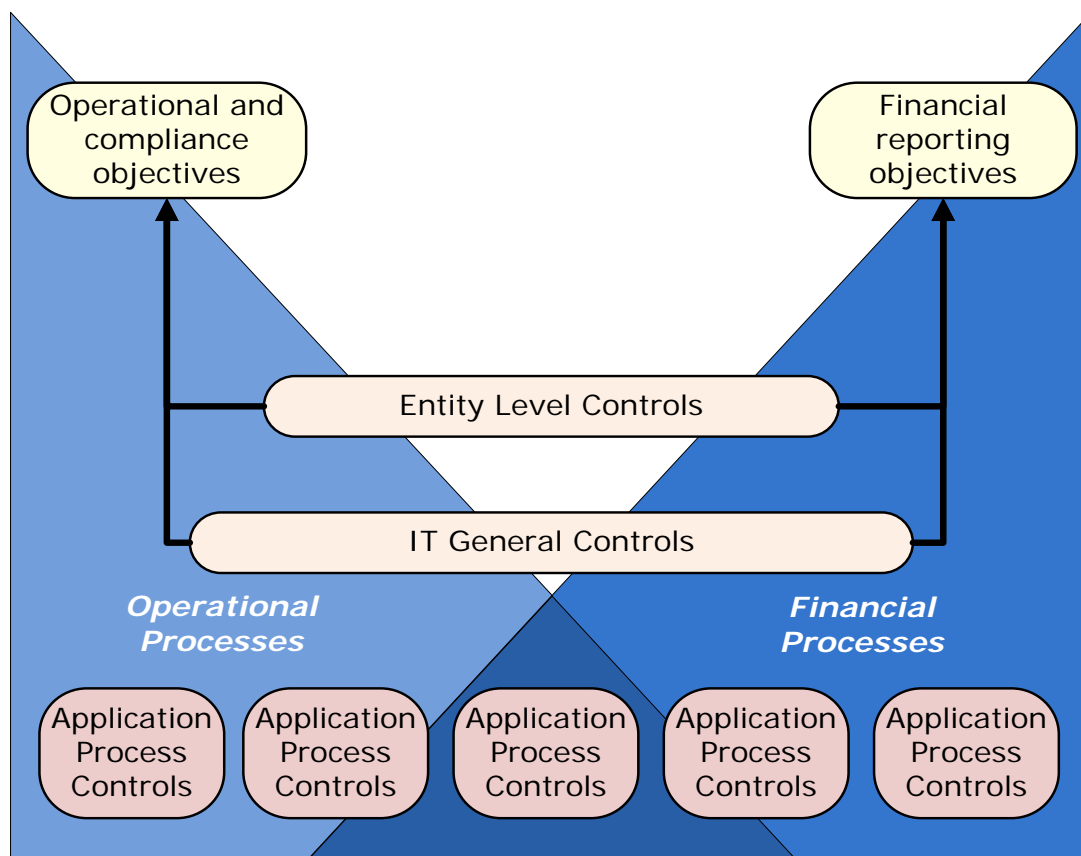
Information systems usually combine manual operations and computerised activity. These systems should provide the appropriate records for maintaining accountability and allow the CEO to fulfil part of their obligations under the *Local Government Act 1995* and *Local Government (Financial Management) Regulations 1996*.

## Control Activities

The day to day operational policies and procedures which help to ensure management directives are carried out are referred to as control activities. These controls include performance review activities, physical controls over assets as well as general and application controls over the IT system.

Control activities exist for operational and financial processes with some control activities covering both processes as represented in the diagram below.

### Operational processes and internal controls



*Adapted from 'Guide to Using International Standards on Auditing in the Audits of Small and Medium Sized Entities' Volume 2 – Practical Guidance*

Control activities for financial processes impact on the ability of the organisation to meet its financial reporting objectives.

Documentation of procedures and segregation of duties form the two primary elements of control activities over financial processes. This is due to their function as entity level controls and their impact on a large number of application process controls.

### **Monitoring of Controls**

The ongoing assessment of the design and operating effectiveness of controls along with the corrective actions helps the council and the CEO ensure appropriate controls exist and are being implemented.

#### **□ 7.3.2 Segregation of Duties**

A fundamental application of internal control is the segregation of duties which relies on the premise that the risk of two or more officers making the same error or colluding to defraud the local government is less than an individual act.

The design and implementation of internal controls will vary widely between local governments due to variations in the size and the complexity of operations.

It is recognised small local governments with less staff and limited resources have a reduced capacity to segregate duties. In the absence of full segregation the increased involvement of the CEO and other knowledgeable senior staff in checking transactions and controls takes on a greater significance in reducing the risk that material error will go undetected and uncorrected. The primary internal control weakness in these situations is the comparative ease with which senior officers may override the internal controls.

Management override may be mitigated by the establishment of well documented procedures and policies with systems to ensure these policies and procedures are followed and regularly reviewed.

### Example:

A policy or procedure containing a requirement for the officer authorising a purchase order, not to be permitted to also authorise the payment of the purchase would help minimise the risk of fraud or error.

The existence of the written policy would empower the accounts payable officer to request authorisation for payment from a person (with the appropriate delegated authority), who was not involved in generating the purchase order. In the absence of a written policy or procedure this control may not be consistently applied particularly if the role is subject to high levels of staff turnover.

In larger and more complex local governments, well documented procedures and policies should exist requiring a high level of segregation of duties. This will limit the opportunities for material misstatement, whether due to fraud or error.

Regardless of how well designed and implemented an internal control is, major limitations to their effectiveness will remain. These limitations include:

- The human judgements required in any control system and the simple human failures which may occur within any system (such as errors or mistakes).
- Circumvention of internal control by the collusion of two or more people.
- Inappropriate override of internal control.

The inherent weaknesses in internal controls when combined with a reduced segregation of duties (such as in small local governments) results in a need for increased staff training, more direct staff supervision and greater monitoring.

Timely monitoring of performance against budget by management and the council is also an effective means of compensating for a lack of segregation of duties and the inherent weaknesses in internal controls.

### □ 7.3.3 Documented Procedures

Some people view internal controls as a bureaucratic hurdle to be overcome. This may be the case for poorly designed internal controls. However, well designed and documented controls can achieve the following:

- Ensure compliance with policies, plans, procedures, laws and regulations
- Ensure the efficient, economical and effective use of resources
- Enable the accomplishment of established objectives and goals for operations or programs.

Clarity and continuity in the operation of any internal control is achieved by documenting the controls appropriately. Appropriate control documentation has the effect of clarifying the control activity and creating the appropriate control environment by improving the awareness and actions of staff.

Control documentation may take many forms. However, appropriate control documentation contains five elements to evidence how transactions are:

- Initiated
- Authorised
- Recorded
- Processed
- Reported

The responsible employee for each of the five elements of the procedure should be documented along with the frequency with which each element is to be performed (daily, weekly, monthly, annually or non-routine).

Documented procedures detailing the course of action, should a breach of internal controls occur, should exist to ensure breaches are recorded and appropriate corrective action is taken to avoid reoccurrence.

New or amended control documentation should follow a clearly defined process to ensure all relevant staff are aware of the new or amended control and have been appropriately trained in its application.

Retention of documents resulting from the operation of a control is essential to not only provide evidence of its existence and operation but also to provide a trail in the event of a breakdown of the control. Documentation retention is required even when the control operates in an IT environment. This will often take the form of transaction logs or audit

trails which should be verified to ensure the logs are recording sufficient appropriate detail of the operation of the control.

#### □ 7.3.4 Experience and Qualification of Staff

Control activities require an element of judgement based on the experience and qualification of the staff implementing and monitoring the control. The greater the risk treated by the control or the lower the level of documentation of the control, the higher level of experience and knowledge required.

Small local governments with little or no documented control procedures are heavily reliant on the competency of a relatively small number of staff in order to reduce risk through their ability to detect and correct material errors. Recruitment of inexperienced or unqualified staff into these environments may result in material errors remaining undetected and uncorrected resulting in a significant negative impact on the operations of the local government.

Large local governments with advanced risk management processes in place are far less exposed to the impact of inexperienced or unqualified staff as the risk they pose is addressed through the risk management process. The high level of documentation of control activities and extensive monitoring and review which exists in these organisations results in a reduced need for judgement.

Regardless of the size of the local government staff involved in the review and monitoring of controls require a higher level of experience and knowledge than those responsible for undertaking the control procedure. The higher level of judgement required will by its very nature require a far greater understanding of the wider context within which the control procedure is being applied.

Some smaller local governments find it difficult to engage experienced knowledgeable employees and need to resource training of any inexperienced employees to a level where they will be able to prevent, detect and appropriately report errors when they occur. Reliance on IT systems to provide a satisfactory level of control where experienced staff are not available is not a solution due to the risks associated with IT environments.

### □ 7.3.5 IT Controls

As with other controls there are two types of controls which exist within the IT environment:

- **General IT Controls**

These are controls over the wider IT environment of the local government; they include such items as virus protection, backups, system password and access controls.

- **Application IT Controls**

These are controls within the specific IT applications and include such items as application password and access controls, data field validations, processing restrictions and reporting restrictions.

The extensive use of IT to record, validate, collate and report financial transactions makes the IT control environment an excellent area to implement a number of financial process or application controls. However application controls may be significantly undermined by a lack of appropriate general controls.

Granting IT administrators administration rights to all applications, a lack of appropriate backups or the ability of someone to “hack” into the IT system are all examples of general IT control risks which will undermine the effectiveness of the best application controls.

Understanding and assessing the risks within an IT environment requires extensive IT knowledge and experience and may require the use of external parties in the case of small entities. As with other financial controls the review and assessment of these systems should be done by someone independent of the day to day management of the IT environment.

### □ 7.3.6 Monitoring Activities

Monitoring provides a level of assurance of the effectiveness of key financial controls. It is acknowledged it is impossible to monitor the effectiveness and operation of all controls at all times even in the largest local governments. However, monitoring should be performed on a routine and timely basis for all prime risk areas. In the case of low risk areas the intervals between monitoring may be extended based on an assessment of the risks. Higher risk areas such as cash need to be monitored frequently and in some cases daily.

Monitoring should be performed by someone independent of the preparation or processing of the relevant information. Signing and dating of reviews by the reviewer is an essential part of the process as it provides evidence of the review and helps ensure the task is performed.

In line with a risk based approach whenever system weakness are identified, management should take remedial action on a timely basis to minimise the risks.

The table below presents a number of key monitoring activities within a local government. This list is not exhaustive but rather a minimum level of monitoring activity which should be conducted.

Risk Area	Recommended Monitoring Activities
1. <b>Annual Budget</b>	a) Monthly actuals are compared to budget and significant variances fully investigated and explained.
2. <b>Financial reporting</b>	a) Through the presentation of the Monthly Statement of Financial Activity (SFA) to council actual results are compared to budget each month; management reviews, investigates and explains significant variances.
3. <b>Grants</b>	a) Management regularly reviews all grant income and monitors compliance with both the terms of grants and council's grant policy (including claiming funds on a timely basis). b) Through the SFA grant revenue is compared to budget; management reviews, investigates and explains significant variances.
4. <b>Receipting</b>	a) Income is compared to budget regularly in the SFA; management reviews, investigates and explains significant variances. b) Statements of accounts receivable are sent to customers enabling review.



Risk Area	Recommended Monitoring Activities
<p><b>5. Rates</b></p>	<ul style="list-style-type: none"> <li>a) Management reviews rates ageing profile on a monthly basis and investigates any outstanding items.</li> <li>b) Actual rate revenue is compared to budget; management reviews, investigates and explains significant variances.</li> <li>c) Annual valuation update is balanced prior to the generation of rates; this is reconciled to the rate record and reviewed.</li> <li>d) Interim valuation updates are balanced prior to the generation of the interim rates; this is reconciled to the rate record and reviewed.</li> </ul>
<p><b>6. Receivables</b></p>	<ul style="list-style-type: none"> <li>a) Receivables and revenue are compared to budget monthly; management reviews, investigates and explains significant variances.</li> <li>b) Management reviews provision for doubtful debts on a regular basis.</li> <li>c) Management reviews debtors ageing profile on a monthly basis and investigates any outstanding items.</li> <li>d) Trade receivables age reconciliation to the general ledger is reviewed at least monthly.</li> </ul>
<p><b>7. Bank accounts and banking</b></p>	<ul style="list-style-type: none"> <li>a) Management reviews journal transactions to the bank account.</li> <li>b) Management reviews bank reconciliations monthly to confirm large outstanding items are adequately explained and subsequently resolved.</li> </ul>
<p><b>8. Investments</b></p>	<ul style="list-style-type: none"> <li>a) Review the council investment performance regularly.</li> <li>b) Actual investment income compared to budget on a regular basis; management reviews, investigates and explains significant variances.</li> <li>c) Investments register maintained in accordance with regulations and investment policy.</li> <li>d) Reconciliation of investment register to general ledger routinely prepared and reviewed.</li> </ul>

Risk Area	Recommended Monitoring Activities
<b>9. Payroll</b>	<ul style="list-style-type: none"> <li>a) Management reviews employee costs against budget on a monthly basis and investigates any outstanding items.</li> <li>b) Each departmental manager performs a regular review of reports detailing all employees listed on payroll master file; all unusual items are investigated.</li> <li>c) Salary and hourly payroll reports (including compensation and withholding information) are reviewed and approved by management before payments are approved.</li> <li>d) The payroll deduction table data is periodically reviewed by management for accuracy and ongoing pertinence.</li> <li>e) Management reviews a selection of salary sacrifice calculations for accuracy and compliance with statutory requirements; identified errors are promptly corrected.</li> <li>f) Each pay run is reviewed prior to authorisation for payment for consistency with prior pay runs and for abnormal items such as overtime.</li> </ul>
<b>10. Purchasing, procurement and payments</b>	<ul style="list-style-type: none"> <li>a) Actual expenditure is compared to budget monthly; management reviews, investigates and explains significant variances.</li> <li>b) A list of all payments is prepared and presented monthly to the council; management reviews, investigates and explains any unusual or large payments.</li> <li>c) Management reviews supporting documentation before approving payments.</li> </ul>
<b>11. Trade payables</b>	<ul style="list-style-type: none"> <li>a) Management reviews trade payables ageing profile on a monthly basis and investigates any outstanding items.</li> <li>b) Trade payables age reconciliation to the general ledger is reviewed at least monthly.</li> </ul>
<b>12. Fixed Assets</b>	<ul style="list-style-type: none"> <li>a) Management compare actual fixed asset balance to budget; management reviews, investigates and explains significant variances.</li> <li>b) Activity recorded in fixed asset register is reviewed by management, including comparison to the capital budget.</li> <li>c) Management regularly reviews valuation of fixed assets (i.e. methodology and useful lives of assets) to ensure that assets' valuation is appropriate and in accordance with Australian Accounting Standards.</li> <li>d) Management reviews depreciation rates and methodology (at least annually) to ensure that rates and remaining useful lives are reasonable.</li> <li>e) Fixed asset register to the general ledger reconciliation is prepared and reviewed routinely.</li> </ul>
<b>13. Borrowings</b>	<ul style="list-style-type: none"> <li>a) Borrowings actual and interest charges are compared to budget monthly; management reviews, investigates and explains significant variances.</li> </ul>

Risk Area	Recommended Monitoring Activities
<b>14. Journals</b>	a) All journals are independently reviewed (including check to ensure correct account allocation) and contain sufficient support information.
<b>15. General IT Risks</b>	a) Regular IT audits performed focusing on data accuracy, retention, recovery and security. Results of these IT Audits reviewed by management and action plan promptly implemented.

### □ 7.3.7 Key Control Activities

The limited resources and number of staff in small rural local governments results in a reduced capacity to segregate tasks. However, regardless of the size of the local government it is important for certain key control activities to be undertaken due to the inherent high risks associated with various transactions.

The following key activities should be undertaken in addition to the key monitoring activities, any legislative requirements and any additional activities identified by the risk management process.

Risk Area	Key Control Activities
<b>1. Financial Report Preparation</b>	<ul style="list-style-type: none"> <li>a) Employees responsible for financial report preparation are competent and adequately trained.</li> <li>b) All journal entries require supporting documentation. Any non-routine entries require documented approval prior to being posted.</li> <li>c) Accounting software used contains application controls that prevent or detect an error from occurring.</li> </ul>
<b>2. Payroll</b>	<ul style="list-style-type: none"> <li>a) Payroll staffs are competent for their assigned tasks, adequately trained and supervised.</li> <li>b) Persons processing payroll are independent of other payroll functions, such as hiring/firing of staff, timekeeping and EFT payment.</li> <li>c) Approval in writing is obtained before adding new employees to payroll.</li> <li>d) Signed and dated approval of each employee's pay rate is documented on employee file.</li> <li>e) Timesheets and totals of hours worked are approved before being processed for payment</li> <li>f) Procedures exist to ensure terminated employees are immediately removed from payroll.</li> <li>g) Payroll register is reconciled to the general ledger and reviewed by a senior officer independent of payroll.</li> <li>h) Costs by sub program, are compared to budget.</li> </ul>

Risk Area	Key Control Activities
<b>3. Revenue</b>	<ul style="list-style-type: none"> <li>a) Rates/debtors officers are competent for their assigned tasks, adequately trained and supervised.</li> <li>b) Monthly statements are issued to trade debtors.</li> <li>c) Rates are raised in line with the approved budgeted rate in the dollar.</li> <li>d) The rate record is updated and reconciled monthly to the Valuer Generals Office (VGO) records.</li> <li>e) Documented procedures are in place to ensure the VGO is informed of any building works approved.</li> <li>f) The rates ledger is reconciled to the General Ledger.</li> <li>g) The approved schedule of Fees and Charges is used for invoice preparation. Exceptions require documentation and approval.</li> <li>h) Automatic or manual checks are performed on serial continuity of invoice documents.</li> <li>i) Credit note approvals are independent of accounts receivable.</li> </ul>
<b>4. Receivables/ Receipting</b>	<ul style="list-style-type: none"> <li>a) Staff handling cash receipts and managing receivables are competent for their assigned tasks, adequately trained and supervised.</li> <li>b) Bank reconciliation is prepared monthly (with statements from bank) and management approval documented.</li> <li>c) Customers are informed (signs, etc.) that they should obtain receipts.</li> <li>d) Pre-numbered cash receipts are issued for every cash sale. Serial continuity is reviewed periodically and checked against cash deposits data.</li> <li>e) Staff required to take their leave entitlements annually.</li> <li>f) When opening mail, cheques are stamped "for deposit only" with the local government bank account number. Cheques received are listed, totalled and reviewed before deposit.</li> <li>g) All receipts cash/cheques are deposited on a regular and timely basis.</li> <li>h) Reconciliation of daily deposit total to receivable posting and cash sales is prepared and reviewed.</li> <li>i) A reconciliation of aged receivables to control accounts is prepared monthly and management approval documented.</li> <li>j) Procedures exist to ensure receipts are recorded in the correct period.</li> <li>k) Significant overdue customer accounts are investigated by management and actions taken documented.</li> </ul>
<b>5. Purchases, payables, Payments</b>	<ul style="list-style-type: none"> <li>a) Personnel responsible for the purchasing, shipping, receiving and payable functions are competent, adequately trained and supervised.</li> <li>b) Management reviews outstanding cheques on period-end bank reconciliation.</li> <li>c) Pre-numbered cheques are used EFT's are allocated a sequential number for each creditor payment and details for</li> </ul>

## Risk Area

## Key Control Activities

- every number is documented. Spoiled cheques are clearly marked "VOID" and cancelled.
- d) The purchasing policy clearly defines who can issue purchase requisitions/orders and to what dollar limit.
  - e) Access to purchasing, receiving, accounts payable, and inventory records is restricted to authorised personnel.
  - f) Spending limits are set by budget or individual levels of authority. These limits are monitored by the system or manually.
  - g) A list of preferred suppliers is maintained and used where possible.
  - h) Controls exist to ensure corporate buying cards/credit cards are only issued to authorised staff and personal purchases are not allowed.
  - i) Pre-numbered purchase orders and receiving reports are used and exceptions are approved and documented.
  - j) Period-end procedures exist to detect and account for unprocessed goods/service receipts.
  - k) Personnel receiving goods do not perform any accounting functions.
  - l) An aged accounts payable listing is reconciled to general ledger each month and exceptions investigated by management.
  - m) Aged report of open orders is reviewed each month and old/unusual items are investigated.
  - n) Unit prices on invoices received are checked against price lists, quotes or approved purchase orders. Invoices are checked for correct calculations, discounts, taxes and freight before payment.
  - o) System has checks to prevent duplicate payments on same order.
  - p) A list of accounts for payments is prepared in line with the legislation and authorised by council or a person with delegated authority before cheques are signed or EFT is authorised.
  - q) Signing officers examine supporting documentation to payments and document approval
  - r) All cheques must be made out to authorised vendors and cannot be made out to "cash".
  - s) A reconciliation of the accounts payable sub ledger to the general journal is prepared monthly and approved by management.
  - t) Suppliers' statements are reconciled to accounts payable monthly and reviewed by management.
  - u) Procedures exist to ensure payments are recorded in the correct period.
  - v) Procedures exist to ensure all bank accounts and signatories are authorised by council.

Risk Area	Key Control Activities
	<ul style="list-style-type: none"><li>w) The accounting policy for when goods should be capitalised is documented and clearly understood by accounting personnel.</li><li>x) Management regularly compares actual purchases (costs and expenses) to budgeted purchases and investigates and documents variances.</li><li>y) Management follows up creditor queries on at timely basis.</li><li>z) Management addresses the reasons for debit balance creditor accounts on a timely basis.</li></ul>

### □ 7.3.8 Application of Controls to Different Sized Local Governments

Whilst there is no one standard set of internal controls for different size local governments, there are some variations which may be expected. These are illustrated in the table below.

Control environment	Small	Medium	Large
<b>Risk Management approach</b>	Limited risk management approach to all high level plans.	Risk management approach to all high and medium level plans.	Enhanced risk management with a risk management approach to all decision making
<b>Entity Level Controls</b>	Entity level controls required by regulation as a minimum. Further entity level controls identified by risk assessment.	Entity level controls required by regulation as a minimum. Further entity level controls identified by risk assessment.	Entity level controls required by regulation as a minimum. Further entity level controls identified by risk assessment.
<b>IT General Controls</b>	IT General Controls administered by external service providers subject to routine monitoring	IT General Controls administered by internal or external service providers routinely monitoring controls.	IT General Controls administered by internal IT staff routinely monitoring controls.
<b>IT Application Controls</b>	IT application controls administered by external service providers subject to routine monitoring	IT application controls administered by internal or external service providers routinely monitored	IT application controls administered by internal or external service providers routinely monitored
<b>Documented Procedures</b>	Documented procedures for all high risk operational activities and processes.	Well documented procedures for all high and medium risk operational activities and processes.	Well documented procedures for all operational activities and processes. Timely exception reporting in place
<b>Segregation of Duties</b>	Low level of segregation of duties. High level of review of overall results by council.	Segregation of high risk duties with timely documented reviews by officers independent of operations.	High level of segregation of duties with timely reviews by independent officers.
<b>Experience and Qualification of staff</b>	Experienced and qualified staff required for all key roles.	Experienced staff in key roles undertaking reviews with lower qualified staff in operational roles.	Experienced staff in senior roles with full range of experience and qualification of staff below.