VERMONT
DEPARTMENT OF FINANCE AND MANAGEMENT

Winter 2022 - Internal Control News

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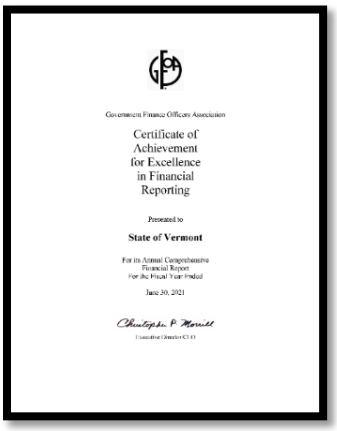
The purpose of this quarterly newsletter is to provide agencies and departments with articles on good business practices, fraud prevention, and internal control responsibilities. Through articles intended to promote educational and professional development opportunities for state employees, this newsletter seeks to raise awareness across state government on the importance of internal control. We hope that by providing you this array of information, we can keep you informed of internal control related activities, and help your staff and division implement and maintain effective internal controls.

https://finance.vermont.gov Volume 3, Issue 12

DFM Standard Internal Control - Helpful Web Hyperlinks:

Website Resources: https://finance.vermont.gov/policies-and-procedures/internal-controls
Standard Internal Control Manager's Guide: Purpose of Guide (vermont.gov)
Quick Hyperlink Reference Guide: Finance/files/documents/Pol_Proc/IC/Guidelines.pdf
State Auditor's Fraud, Waste, and Abuse Hotline: 1-877-290-1400 or Reporting Fraud, Waste or Abuse
DFM, IC Questions? Contact: fin.internalcontrol@vermont.gov

State of Vermont, Wins GFOA's Certificate


Government Finance Officers Association

Certificate of Achievement for Excellence in Financial Reporting

Presented to

State of Vermont

For its Annual Comprehensive Financial Report For the Fiscal Year Ended June 30, 2021

Christopher P. Morrill
Executive Director/CEO

Vermont's ***Annual Comprehensive Financial Report*** (ACFR) for the fiscal year ended June 30, 2021, qualifies for the ***Certificate of Achievement for Excellence in Financial Reporting***. This Achievement is the highest form of recognition in governmental accounting and financial reporting.

- ***Christopher P. Morrill, Executive Director / CEO.***

Congratulations to the DFM - Operational Team!

- ***John Becker, Director of Statewide Reporting***

2023 Delegation of Authority Forms

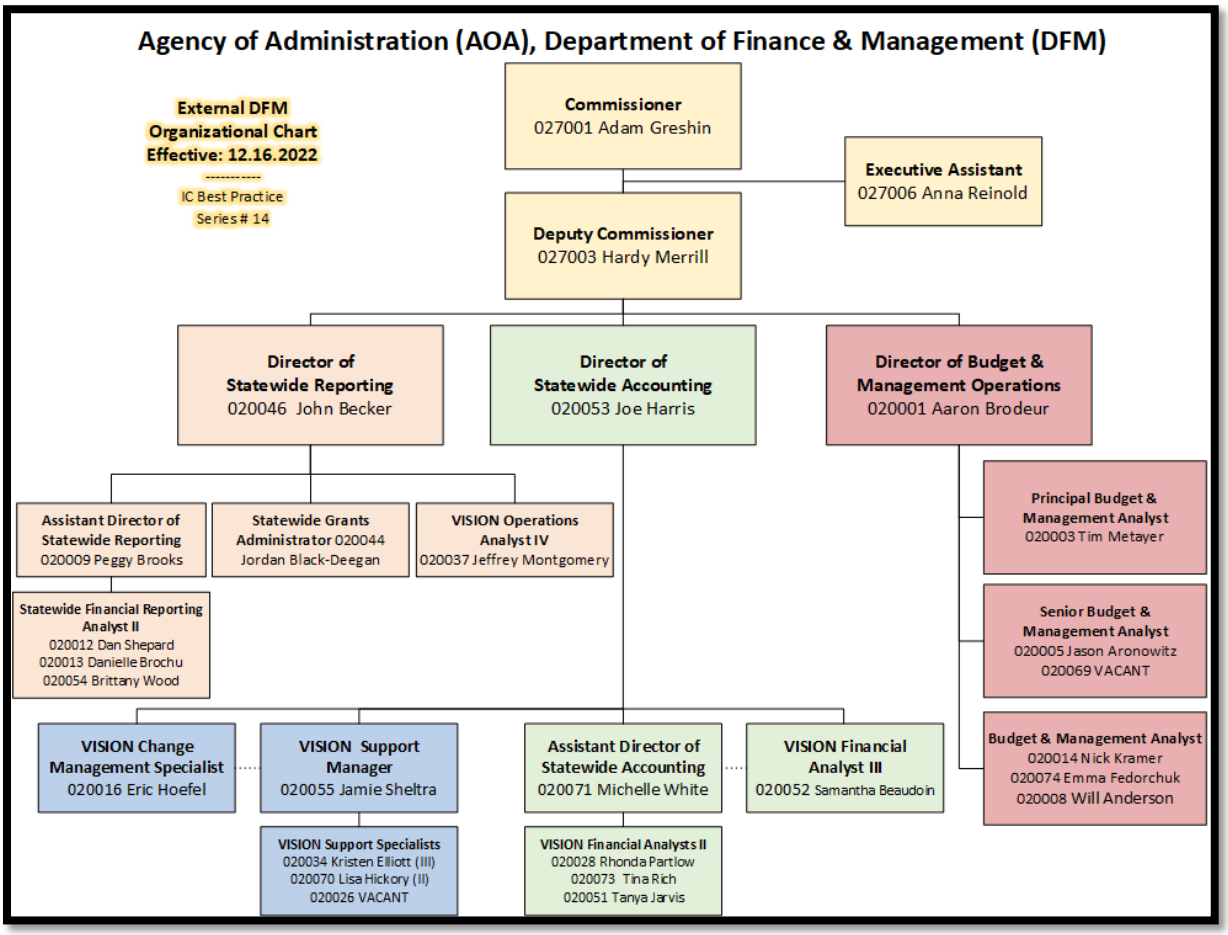
It's that time of year again, time to submit your 2023 Delegation of Authority form. This annual update is required from every department, even if there has been no change in the Appointing Authority or their designee(s). The 2023 Delegation of Authority form must be submitted by January 15, 2023. Completed forms can be sent to VISION Security. ***Please note that even though many employees are working from home, Addendum 3.3 requires that Delegation of Authority forms include actual signatures or an alternative method of signing such as DocuSign that include a facsimile of an actual signature.*** Bulletin 3.3, Delegation of Authority and Addendum 3.3 includes information on who may be designated as delegates. Please contact the VISION Support team with questions.

DFM Staff Happenings - Transfers:

- ***Kristen Elliott, VISION Support Specialist III.*** I am pleased to announce that Kristen Elliott has accepted the position of VISION Support Specialist III. Kristin comes to us from the Department of Disabilities, Aging and Independent Living. Her most recent position with DAIL was as the Contract and Grant Administrator. She brings years of experience providing team leadership, providing user trainings, being a department change agent and working on projects as well as having a solid foundation of VISION. Please join me in welcoming Kristen to the Department of Finance and Management.
    - ***Joe Harris, Director of Statewide Accounting, DFM***

- ***Aaron Brodeur, Director of Budget & Management Operations.*** Aaron began working for the State of Vermont in 2005 with the Department of Finance & Management and rose to Principal Budget and Management Analyst, then joined the Agency of Education as an Education Finance Manager, followed by the Department of Vermont Health Access as a Financial Director I. Aaron was most recently with the Agency of Transportation as a Financial Director IV. Aaron's work experience with the State of Vermont is a valuable resource, and we are happy to welcome him back to our department!
    - ***Hardy Merrill, Deputy Commissioner, DFM***

- ***Kimberly Baker, VISION Support Specialist II,*** it is very bittersweet for me to announce that Kim Baker will be leaving VISION Support and the Department of Finance and Management. She has taken a Financial Manager III position at DEC and her last day with us will be Friday, December 16th. Kim has been a great asset to the VISION Support Team, and she will be greatly missed. Please join me in wishing her well in her new position. Good luck and best wishes Kim!
    - ***Jamie Sheltra, VISION Support Manager, DFM***



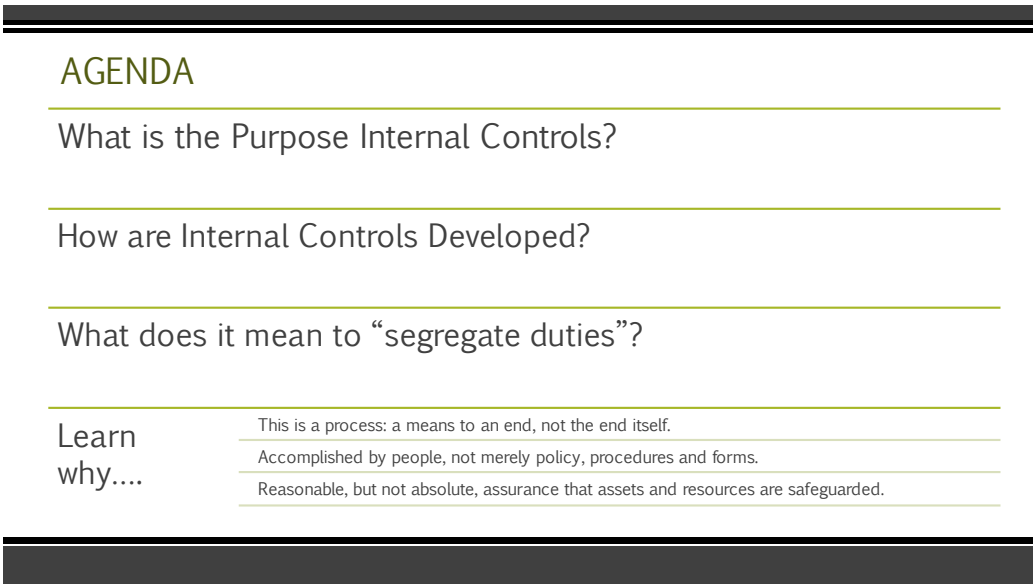
(A Special "Extended" IC Newsletter Edition)

Internal Controls and the Segregation of Duties

A Refresher Course for Existing or New State Agency Personnel

***Presented and sponsored by**: Katherine Heck, Government Finance Advisor NHMA (New Hampshire Municipal Association) 25 Triangle Park Dr. Concord, NH 03301 603.224.7447 and Melanson CPA's Merrimack, New Hampshire 800.282.2440 © Copyright*

Recently, one of our Senior DFM Team Leaders attended a ***New England States Government Finance Officers Association (NESGFOA)*** conference. One of the topics on the discussion agenda was ***Internal Controls and the Segregation of Duties***. We thought we would share with you highlighted segments of the presentation that potentially could impact your Agency. The full presentation can be downloaded at the end.



Internal Control Defined:

The Committee of Sponsoring Organizations of the Treadway Commission (COSO) is a joint initiative of the five private sector organizations listed on the left and is dedicated to providing thought leadership through the development of frameworks and guidance on enterprise risk management, internal control and fraud deterrence.

Internal control, as defined by COSO in its Internal Control–Integrated Framework is "a process, effected by an entity's board of directors, management, and other personnel, designed to provide reasonable assurance regarding the achievement of objectives relating to operations, reporting, and compliance."

Effective internal control is an integral part of an organization's governance system and ability to manage risk.

Source: http://www.coso.org/

What are Internal Controls?

Anything that helps safeguard assets.

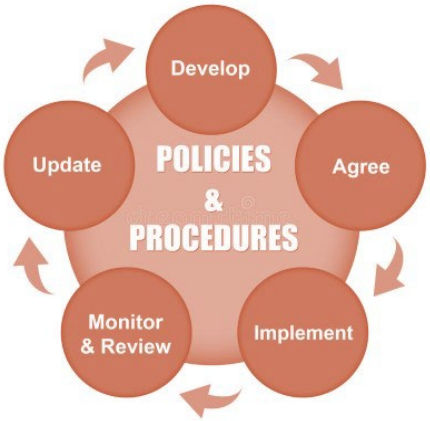
Anything that helps make more effective and efficient use of those assets.

What are Internal Controls?

Internal control is a process.

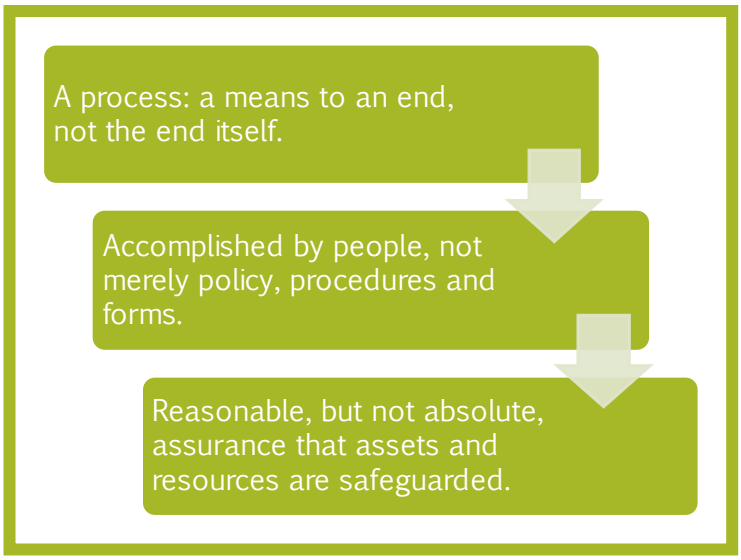
Dynamic– ongoing and active
Iterative

Each process is defined and implemented by a set of policies and procedures- a series of ongoing actions and activities that occur throughout the organization.



Internal Controls Are Meant To:

1. Protect assets from waste and abuse.
2. Promote operational effectiveness and efficiency.
3. Ensure accurate, reliable records.
4. Encourage adherence to policies, rules, regulations and laws.

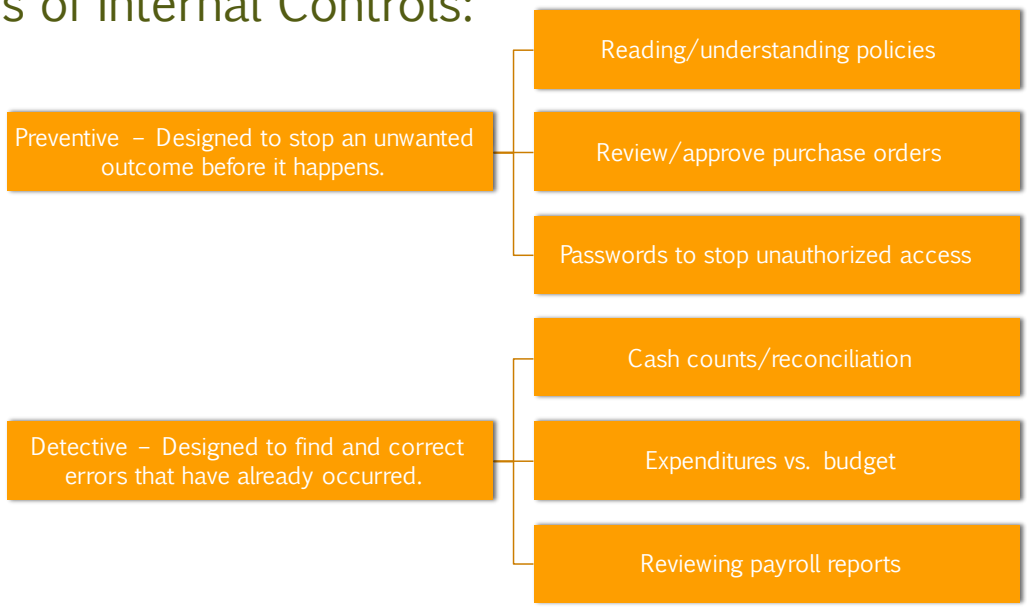


What Are Internal Controls?

Importance of Internal Controls

Ensure	Ensure objectives are accomplished.
Reduce	Reduce fraud opportunities.
Prevent	Prevent loss of funds or other resources.
Establish	Establish standards of performance.
Assure	Assure compliance with laws, regulations, policies and procedures.
Preserve	Preserve integrity.
Eliminate	Eliminate adverse publicity.
Assure	Assure public confidence.

Types of Internal Controls:



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Basic Objectives of Internal Control

Reporting Objectives

- Reporting objectives pertain to the preparation of reports for use by organizations and stakeholders and may relate to financial or non-financial reporting and to internal or external reporting.
- Internal reporting objectives are driven by internal requirements in response to a variety of potential needs such as the entity's strategic directions, operating plans, and performance metrics at various levels.
- External reporting objectives are driven primarily by regulations and/or standards established by regulators and standard-setting bodies.
- External Financial Reporting Objectives
  - accessing capital markets and may be critical to being awarded contracts or in dealing with suppliers and vendors
- External Non-Financial Reporting Objectives
  - reporting requirements as set forth by regulations and standards for management reporting on the effectiveness of internal control over financial reporting are part of external non-financial reporting objectives
- Internal Financial and Non-Financial Reporting Objectives
  - information deemed necessary to manage the organization

Source: http://www.coso.org/

The Control Environment

SET THE TONE AT THE TOP – INTERNAL CONTROLS ARE IMPORTANT!

INTEGRITY AND ETHICAL VALUES - MUST BE CLEARLY COMMUNICATED IN WRITING AND BY EXAMPLE.

COMMITMENT TO COMPETENCE – SOUND PERSONNEL POLICIES INCLUDING JOB DESCRIPTIONS, HIRING POLICIES, BACKGROUND CHECKS, JOB QUALIFICATIONS, PERFORMANCE EVALUATIONS.

AUTHORITY AND RESPONSIBILITY – CLEAR LINES OF AUTHORITY. IF EVERYONE IF RESPONSIBLE, THEN NO ONE IS RESPONSIBLE. PROVIDE ALL OF THE AUTHORITY NECESSARY AND ONLY THE AUTHORITY NECESSARY.

Control Activities

DIRECTIVE CONTROLS PROVIDE GUIDANCE TO EMPLOYEES TO HELP ACHIEVE THE DESIRED OBJECTIVES IN THE DEPARTMENT

PREVENTIVE CONTROLS ARE DESIGNED TO DETER THE OCCURRENCE OF AN UNDESIRABLE EVENT. THE DEVELOPMENT OF THESE CONTROLS INVOLVES PREDICTING POTENTIAL PROBLEMS BEFORE THEY OCCUR AND IMPLEMENTING PROCEDURES TO AVOID THEM.

DETECTIVE CONTROLS ARE DESIGNED TO IDENTIFY UNDESIRABLE EVENTS THAT DO OCCUR AND ALERT MANAGEMENT ABOUT WHAT HAS HAPPENED. THIS ENABLES MANAGEMENT TO TAKE CORRECTIVE ACTION PROMPTLY.

CORRECTIVE CONTROLS IDENTIFY FLAWS IN THE PROCESS AND DETERMINE ACTIONS TO BE TAKEN (EMPLOYEE TRAINING)

What is Risk?

When working toward its objectives, every organization faces a wide range of uncertain internal and external factors = Risks.

The effect of this uncertainty on the organization's objectives is called risk, which can be either positive, representing opportunity, or negative, representing a threat.

Risk should always be assessed in light of setting and achieving your organization's objectives. If there are no objectives, there is no risk.

This risk assessment process is both active and frequent.

Identify and Analyze Risks

- Identify risks at all levels of the entity
  - Ongoing and iterative process conducted to enhance ability to achieve objectives
  - What is the severity and likelihood of loss?
- Analyze internal and external factors
  - What is the frequency of risk assessment?
  - Takes into account operational priorities and cost
- Involve appropriate levels of Management
  - Responsibility and accountability for risk identification and analysis is the responsibility of management.
- Estimate the significance of each risk
  - What is the likelihood (probability)
  - Frequency
  - Duration of impact after the occurrence
- Determine how to respond to the risk
  - Once potential significant risks is assessed, management determines how to manage the risk

Risk Assessment – Consider Changes Effecting Risk:

- Changes in operations - economic, political.
- Changes in personnel.
- Changes in IT systems.
- Rapid growth.
- Change in structure, staff reductions.
- Change in programs, activities, services or vendors.

Risk Assessment – Consider Inherent Risk

Cash – the more easily an asset can be converted to personal use, the more likely it is to be stolen.

Complexity – the more that can go wrong, the more that is likely to go wrong.

Decentralization.

Unfamiliarity-An unresponsiveness to previously identified internal control weaknesses sends a negative message about management's attitude!

Red Flags

Employee Red Flags

- Employee lifestyle or behavioral change Significant personal debt and credit problems Refusal to take vacation or sick leave
- Lack of segregation of duties in vulnerable areas.

Management Red Flags

- Reluctance to provide information to auditors
- Management decisions are dominated by an individual or small group Weak internal control environment
- Excessive number of checking accounts or frequent changes in banking accounts Excessive number of year-end transactions
- High employee turnover rate
- Service contracts result in no products

- **Cash Receipts and Disbursements**
- **Records and Reports**
- **Purchasing**
- **Fixed Assets**

Questions To Ask Regarding Risk Assessment

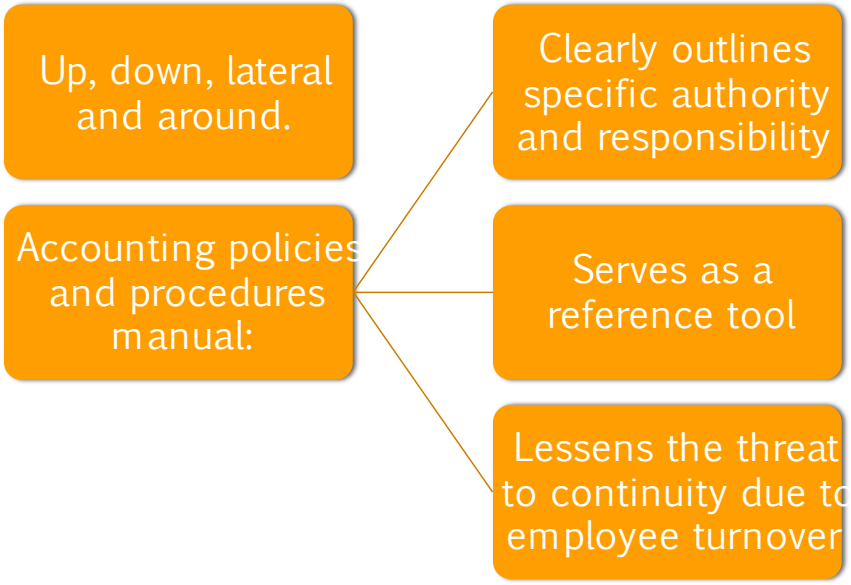
- Where is the potential risk?
- What is the likelihood of an unwanted occurrence and what would be the impact?
- What compensating controls can be implemented?
- Does the cost of the controls exceed their benefit?

Information and Communication

To be useful, information must be:

- ✓Appropriate
- ✓Accurate
- ✓Timely
- ✓Current
- ✓Accessible

Information and Communication



Monitoring

Periodic

- Separate evaluation of internal controls:
  - Independent Auditor – material weakness, reportable condition, non-compliance, significant deficiency
  - Insurance Carrier (Property/Liability) - internal control assessment

Ongoing

- Management and Leadership analysis.

Monitoring

- Investigate and resolve discrepancies.
- Maintain professional skepticism – explanations should be supported by some type of evidence.
- Promptly follow-up on all indications of potential errors and irregularities.

Who Is Responsible?

EVERYONE plays some role in effecting internal controls.

All personnel should be responsible to communicate:

- Problems in operations
- Deviations from established standards or expectations
- Violations of policy, law or regulations

- Governing Body – BOS, Council, School Board, Commissioners, Aldermen
- Manager, Superintendent
- Department Heads, Principals
- Supervisory Personnel
- Each Individual Employee
- Budget Committee

Accountability

Organization holds individuals accountable for their internal control responsibilities

- Enforces Accountability through structures, authorities and responsibilities
- Establishes Performance Measures, Incentives and Rewards
- Evaluates Performance Measures, Incentives and Rewards
  - Align incentives and rewards with fulfillment of internal control responsibilities
  - Clear objectives, defined implications, meaningful metrics
- Consider Excessive Pressures – evaluate the pressures associated with achieving objectives
  - Do not set unrealistic performance targets
- Evaluate performance of internal control responsibilities
  - Adherence to standards of conduct
  - Expected levels of competence

Accountability is interconnected with leadership and is the result of the tone established by the governing body and senior management.

Where to Start:
Internal Control Self-Assessment

A basic checklist from the checklist published by the Vermont State Auditors Office:

2022 VT checklist: https://diovermont.org/wp-content/uploads/2022/02/Internal-Control-Checklist-Fillable-.pdf

Answers on the right indicate a potential internal control weakness that may need attention.

Where to Start:
Where Are the Risks?

Cash, decentralization, no segregation of duties, change, potential for fraud.

Where does the money come from, where does it go?

Where to Start: Address the Identified Weakness

- Authorization controls
- Record controls
- Security controls
- Segregate duties
- Personnel policies
- Reconciliation
- Verification
- Analytic review

Government Finance Officers Association Statement on Fraud Prevention

Fear of detection and punishment is a product of effective internal controls. Weak internal controls both permit and invite irregularities by reducing or removing that fear.

The single most important step that can be taken to prevent fraud is for management to establish and maintain an effective internal control structure!

Implementing Control Activities

Periodic reconciliations – i.e. bank reconciliations, accounting record reconciliations (i.e. tax collector to treasurer), reasonableness review.

Periodic verification – i.e. physical inventory, payroll payout.

Analytical review – what's expected vs. what's reported, data entry controls, edit checks, exception reporting, financial vs. non-financial data.

Implementing Control Activities

- Policies (what should be done) and procedures (how it should be done) designed to ensure that the objectives (protect assets, effectiveness/efficiency, accurate records, and compliance) are achieved.

POLICY	PROCEDURE
The formal guidance needed to coordinate and execute activity throughout the district. When effectively deployed, policy statements help focus attention and resources on high priority issues - aligning and merging efforts to achieve the district's vision. Policy provides the operational framework within which the district functions.	*The operational processes required to implement district policy. Operating practices can be formal or informal, specific to a department or building or applicable across the entire district. If policy is "what" the district does operationally, then its procedures are "how" it intends to carry out those operating policy expressions.*
• Widespread application • Changes less frequently • Usually expressed in broad terms • States "what" and/or "why" • Answers operational issues	• Narrow application • Prone to change • Often stated in detail • States "how", "when", and/or "who" • Describes process

Policies reflect management or board statements of what should be done to effect internal control.

Such statements should be in writing	Explicitly stated in management communications	Implied through management actions and decisions.

Procedures consist of actions that implement a policy – actions should be described in writing, and this written documentation typically results in the formation of a policy.

These are actions that permeate an entity's activities and that are inherent in the way management operates the entity.

Most Common Internal Control Deficiencies

- Lack of written financial policies and procedures.
- Inadequate cash and receipts procedures.
- Inadequate reconciliations .
- Lack of personnel policies.
- Lack of personnel evaluations.

Limitations of Internal Controls

- Judgement – decisions made by people under pressure and time constraints, based upon information on hand.
- Breakdowns – lack of understanding, simply making mistakes.
- Management Override – high level management override prescribed policies and procedures.
- Collusion – 2 or more individuals circumventing controls.
- Cost vs. Benefit – risk and effect must be weighed against the cost of establishing controls.

Balancing Risks and Controls

Reasonable Assurances:

Excessive Risks – loss of assets, loss of funding, poor decisions, non-compliance, increased regulation, public scandal.

Cost-Benefit

Excessive Controls – increased bureaucracy, complexity, time, non-value-added activities, reduced productivity

Common Methods of Control Activities

Authorization-designed to provide reasonable assurance that all transactions are within the limits set by policy or that exceptions to policy have been granted by the appropriate officials.

Review and approval designed to provide reasonable assurance that transactions have been reviewed for accuracy and completeness by appropriate personnel.

Verification- Control activities in this category include a variety of computer and manual controls designed to provide reasonable assurance that all accounting information has been correctly captured.

Reconciliation-Provide reasonable assurance of the accuracy of financial records through the periodic comparison of source documents to data recorded in accounting information systems.

Physical security over assets Designed to provide reasonable assurance that assets are safeguarded and protected from loss or damage due to accident, natural disaster, negligence or intentional acts of fraud, theft or abuse.

Source: GFOA

Internal Control and Financial Reporting

- Institutionalize good financial management practices.
- Formal policies usually outlive their creators, and, thus, promote stability and continuity. They also prevent the need to re-invent responses to recurring issues.
- Clarify and crystallize strategic intent for financial management.
- Financial policies define a shared understanding of how the organization will develop its financial practices and manage its resources to provide the best value to the community.
- Define boundaries. Financial policies define limits on the actions staff may take.
- The policy framework provides the boundaries within which staff can innovate in order to realize the organization's strategic intent.
- Support good bond ratings and thereby reduce the cost of borrowing.
- Promote long-term and strategic thinking.
- The strategic intent articulated by many financial policies necessarily demands a long-term perspective from the organization.
- Manage risks to financial condition.
- A key component of governance accountability is not to incur excessive risk in the pursuit of public goals.
- Financial policies identify important risks to financial condition.
- Comply with established public management best practices.

- Establish formal written procedures
- Identifying risks
- Creating a separation of duties
- Safeguard physical and financial assets
- Efficiency of operations
- Reliability of financial reporting
- Compliance with legal requirements
- Minimize opportunities for fraud, employee error

Internal Control In the Treasury Function

Internal controls constitute specific policies and procedures (the controls) designed to achieve the objectives of:

Internal Controls for Investment Activity

Investment Authorization — Authorized decisionmakers

- Guidelines on permitted investments (investment policy) Flexible to respond to changes in the markets
- Restrictive to minimize the risk of fraud or loss

Investment Selection — Only permitted investments

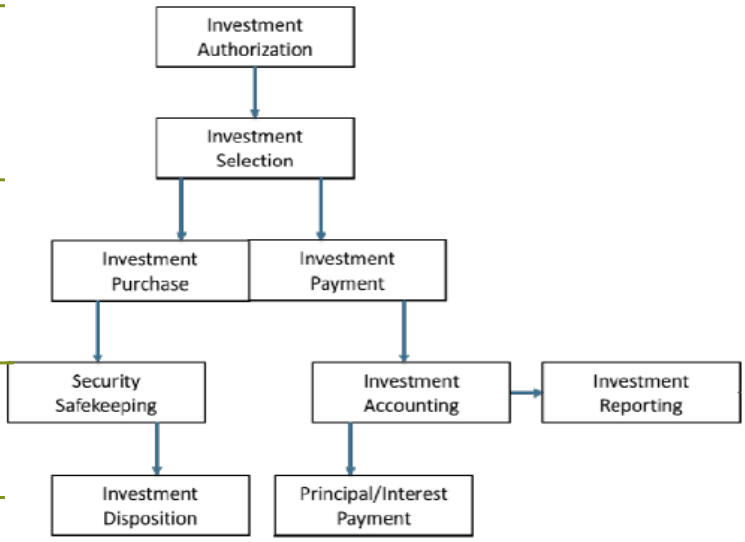
- Risk reward and market conditions
- Factors to consider: Yield, Maturity, Credit worthiness
  Permitted does not equal appropriate

Investment Purchase and Payment — Clearly, well documented transactions

- Trade ticket, custody statement, investment report

Security Safekeeping — Establishing and maintaining ownership

- Reconcile custody statements and other internal/external reports



Source: Investing Public Funds second edition

Common Methods of Control Activities

- Segregation of duties – Reduce the risk of error and fraud by requiring that more than one person is involved in completing a particular fiscal process.
- Education, training and coaching – Reduce the risk of error and inefficiency in operations by ensuring that personnel have the proper education and training to perform their duties effectively. Education and training programs should be periodically reviewed and updated to conform to any changes in the agency environment or fiscal processing procedures.
- Performance planning and evaluation – Establish key performance indicators for the agency that may be used to identify unexpected results or unusual trends in data which could indicate situations that require further investigation and/or corrective actions. Evaluations may be done at multiple levels within the agency, as appropriate: the agency as a whole; major initiatives; specific functions; or specific activities.
- Performance reviews may focus on compliance, financial or operational issues. For example, financial reviews should be made of actual performance versus budgets, forecasts and performance in prior periods.

Source: http://www.coso.org/

Segregation of Duties

Although control activity procedures are not intended to increase staffing levels, acceptable procedures are to be established and followed which may require changes in existing workloads and/or additional staff position(s).

A periodic thorough internal review of control activities may identify policies and procedures that are no longer required.

Small to medium size operations may not be able to institute internal control procedures on the same level as larger, more complex agencies.

In cases where staffing limitations may prohibit or restrict the appropriate segregation of duties, management must either have more active oversight of operations or utilize personnel from other units to the extent possible as compensating controls.

Segregation of Duties

	Receipt of Goods/Custody of Assets	Record Keeping/Document Prep	Authorization/ Approval	Reconciliation Prepared By	Reconciliation, Independent Approver
Receipt of Goods/Custody of Assets	Same Function	Incompatible unless a compensating control is built	Incompatible	Incompatible unless a compensating control is built	Incompatible
Record Keeping/Document Prep	Incompatible unless a compensating control is built	Same Function	Incompatible	Incompatible unless a compensating control is built	Incompatible
Authorization/ Approval	Incompatible	Incompatible	Same Function	Incompatible	Compatible
Reconciliation Prepared By	Incompatible unless a compensating control is built	Incompatible unless a compensating control is built	Incompatible	Same Function	Incompatible
Reconciliation, Independent Approver	Incompatible	Incompatible	Compatible	Incompatible	Same Function

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If one person performs two or more of the functions:

- Risk exists that presents the opportunity for something to go wrong
- A compensating control is needed to reduce the risk
- The compensating control might be an extra layer of review

When Segregation Is Not Possible

Examples of compensating controls may include:

A manager/dept head may perform a high level of review of detailed transaction reports

A manager may periodically sample transactions and request supporting documentation to ensure the transactions are complete, appropriate, and accurate.

Someone from an another area may perform an external review of a reconciliation.

- For instance, two departments within a municipality may share responsibility to review each others reconciliations.

Some local governments have a centralized collections and/or financial services department

Reconciliation & Balancing

What should you reconcile ?

Who should reconcile?

All accounts and transactions**credit card transactions, accounts payable, accounts receivable, payroll, fixed assets, Due to/Due From accounts, special revenue, and other areas against the general ledger, or balance sheet**

- Reconciliation should be performed by a person with no cash handling responsibilities
- The reconciliation must be dated and signed or initialed
- The reconciliation should be reviewed by an independent party

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Please Note: Full version of Presentation can be downloaded from here:

Internal Controls | Department of Finance and Management (vermont.gov)