Coates' Canons Blog: Statutory Internal Controls

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Article: https://canons.sog.unc.edu/statutory-internal-controls/

This entry was posted on December 20, 2017 and is filed under Cash Management & Investments, County Finance, Expenditure Control & Preaudit, Finance & Tax, Financial Management & Oversight, Municipal Finance, Public Authority Finance

Recent high-profile examples of alleged misappropriation and embezzlement of public funds, and other fraudulent activity, by local government officials across the state should prompt all local governments to examine their internal control systems. Internal controls are processes designed to safeguard the assets of the unit. Although the exact nature of internal controls will vary significantly from government to government, due to differences in size, resources, and organizational structure, all local government entities need to take steps to ensure the proper safeguard of public funds. And that duty should take precedence over the efficiency and expediency of business processes. Internal controls introduce redundancies and, to the frustration of local government officials, may cause administrative delays of even routine transactions. They serve an invaluable function, though, to ensure that monies are managed and spent appropriately, according to clear budget directives by the governing board. That is a necessary trade-off in the public sector.

Internal controls fall roughly into two categories—preventative (policies and procedures that do not allow certain events to occur) and detective (backup procedures to ensure that primary internal controls operate as intended). A local government needs to incorporate both into its financial operations. Perhaps the most common internal control is segregation of duties—so that no employee or official handles an entire transaction from start to finish. Other controls include providing oversight of financial activity by supervisors and board members, periodically rotating staff duties, doing a thorough and accurate audit of all receipts and claims, requiring that adequate records be maintained and presented for intermittent inspection by an internal audit committee, responding to deficiencies identified through the yearly external audit, educating employees and officials about detecting red flags of potential fraudulent activity, and even mandating that employees use all of their vacation time each year.

Employees and officials at all levels of local government must implement, monitor, and periodically re-evaluate the sufficiency of controls relating to the collection, management, obligation, and disbursement of public funds. Not sure where to start? The **Local Government Budget and Fiscal Control Act** is a good place. It sets the minimum internal controls required by law. Basic legal compliance could go a long way toward preventing fiscal malfeasance, but many local governments are not currently in full compliance. Below is a summary of the minimum statutory requirements.

What is the Local Government Budget and Fiscal Control Act?

The Local Government Budget and Fiscal Control Act (LGBFCA), found in **G.S. 159, Art. 3**, prescribes a “uniform system of budget adoption and administration and fiscal control,” laws detailing the proper procedures for budgeting, managing, and disbursing, and accounting for public funds. **G.S. 159-7(c)**.

Who is Subject to the LGBFCA?

Almost all local government entities are subject to the LGBFCA. That includes counties, municipalities (cities, towns, villages), and all special purpose local governments except public hospitals (as defined by **G.S. 159-39**), public housing authorities (as defined by **G.S. 159-42**), joint municipal power agencies, and joint municipal assistance agencies (as defined by **G.S. 159-41**). These four entities are subject to some, but not all of the provisions of the Act. Additionally, local school administrative units are not subject to the LGBFCA but are subject to a parallel set of provisions in the School Budget and Fiscal Control Act (**G.S. 115C, Art. 31**). And local ABC Boards are subject to some of the same provisions, as provided in **G.S. 18B-702**.

The following table details the most common special purpose governments that are subject to the LGBFCA. The Act collectively refers to these entities either as “units of local government” or “public authorities.”

Sanitary districts	County water and sewer districts	Metropolitan sewerage districts
Water and sewer authorities	Airport authorities and districts	Public, regional, and regional public transportation authorities
Housing authorities	Redevelopment commissions	Soil and water conservation districts
Parking authorities	Tourism development authorities	Regional natural gas districts
Single- and multi-county public health authorities	Councils of government	Regional planning commissions
Regional economic development commissions	Regional planning and economic development commissions	Area mental health, developmental disabilities, and substance abuse authorities
District health boards	Regional libraries	Mosquito control districts

What are the specific internal control provisions of the LGBFCA?

The following briefly summarizes the most significant statutory internal control mandates in the LGBFCA. Although not always easy to accomplish in practice, full compliance with these provisions should set the minimum internal control standards for all local government entities. And the first step is understanding when the provisions are triggered and what they require.

Finance Officers, Deputy Finance Officers. The first statutory internal control requires that a local government entity designate an employee or official of the unit as its finance officer. The LGBFCA assigns to this position various financial management duties, including (1) establishing and managing the unit’s account a system; (2) controlling expenditures and disbursing moneys; (3) preparing and presenting financial reports; (4) managing the receipt and deposit of moneys; (5) managing the unit’s debt service obligations; and (6) supervising investments. **G.S. 159-25; G.S. 115C-436 (school units).** (The unit may refer to this position by another name, but a single employee or official must be assigned all the statutory duties of the finance officer.) Although the finance officer need not be a certified public accountant or hold any specific degrees or certifications, it is imperative that the individual in this position be well versed in the legal and financial rules, regulations, and best practices governing public finance. The individual who serves in this role also must be bondable. It is up to the manager or board (depending on the appointing authority) to select a qualified individual and to provide that individual with the necessary training and support to carry out these duties.

In addition to the finance officer, a unit may designate one or more other employees or officials as deputy finance officers. The designation allows the individual(s) to perform the preaudit and/or disbursement processes discussed below. *See* **G.S. 159-28; G.S. 115C-441 (school units)**. The governing board must make this designation, even in units where the finance officer is hired and supervised by the manager.

Bonding Requirement.The finance officer must “give a true accounting and faithful performance bond with sufficient sureties” in an amount to be set by the governing board, not less than $50,000. **G.S. 159-29; G.S. 115C-442 (school units)**. A finance officer is bound to perform the duties of his office faithfully, and to use reasonable skill and diligence, and to act primarily for the benefit of the public. A true accounting and faithful performance bond typically insures for loss sustained by the failure of an employee to properly account for all moneys and property received by virtue of his or her position or the failure to otherwise faithfully perform his or her other duties. The bond inures to the benefit of the unit, and it typically covers acts or omissions due to the finance officer’s negligence, carelessness, or incompetence. The bond does not protect the bonded finance officer. In fact, if a bonding company makes good any loss to the protected unit, it succeeds to the unit’s right to recover the loss directly from the defaulting employee. The unit’s governing board pays the premium for the bond.

All other employees and officials of the unit must be covered by a faithful performance bond. A local unit typically procures a blanket bond, as opposed to individual bonds, to cover these individuals. (Note that there is a separate, individual bond requirement for the unit's tax collector.) There is no statutorily prescribed amount for the bond; it is to be set by the governing board. The unit may pay the premium on the bond each year, though it is not required to do so. The bond must be filed with the clerk to the board.

Preaudit Process Requirement.The preaudit statute, **G.S. 159-28; G.S. 115C-441 (school units)**, requires that the unit's finance officer (or a deputy finance officer appointed by the governing board), perform certain steps before any employee or official enters into a contract to order goods or procure services that will be paid for with public funds. The process is triggered when (1) a unit enters into a contract for goods or services that are accounted for in the annual budget ordinance or a project/grant ordinance; (2) that will require the unit to pay money; and (3) if the expenditures are included in the annual budget ordinance, the unit expects to pay at least a portion of the money in the current fiscal year. Once triggered, the statute requires that the finance officer or a deputy finance officer perform four steps: (1) ensure that there is a budget appropriation authorizing the expenditure; (2) ensure that sufficient monies remain in the appropriation to pay any amounts that are expected to come due this fiscal year; (3) encumber the amount of the contract that is expected to come due this fiscal year against the appropriation; and (4) affix a signed certificate to the purchase order or other agreement evidencing the contract. All of these steps must be performed **before** the order is placed or the contract is otherwise executed. The certificate states that "This instrument has been preaudited in accordance with the Local Government Budget and Fiscal Control Act."

The preaudit process applies regardless of the amount of the contract. It also applies regardless of who is ordering the goods or entering into the contract, be it the manager, a department head, or an elected official. This statute performs two functions. It ensures that public funds are spent in accordance with the governing board's budget directives. And it alerts vendors, contractors, and other outside parties that the proposed expenditure of public funds is authorized. Failure to follow the statute, makes the transaction void. It also can result in criminal penalties and civil restitution against any employees or officials who authorized the transaction without following the proper procedures. As detailed **here**, there are a few exceptions to the final step in the process (preaudit certificate). Note, however, that even these transactions are still subject to the first two steps in the process.

Disbursement Process Requirement.A second provision in **G.S. 159-28; G.S. 115C-441 (school units)**, prescribes the process that must be followed before public funds are disbursed by the unit. This process is often conflated with the preaudit process, but it is a separate requirement. In fact, most transactions will be subject to both processes—the preaudit process when the contract is entered into and the disbursement process when the amounts under the contract come due. The process is triggered when the unit receives a bill or invoice for goods that were delivered or services that were performed. The process requires the finance officer or a deputy finance officer (designated by the board) to four things: (1) determine the amount to be payable; (2) make sure that there is a budget appropriation authorizing the expenditure; (3) make sure that there are still sufficient monies remaining in the appropriation to cover the amount due; and (4) include on any payment made by check or draft a signed disbursement certificate, that states that "[t]his disbursement has been approved as required by the Local Government Budget and Fiscal Control Act."

As with the preaudit, the disbursement process ensures that public funds are spent for lawful purposes and according to budget directives. And, as with the preaudit, there are some statutory exceptions to the disbursement certificate part of the process. (Click **here** for more information on the disbursement process.)

Dual Signatures.In addition to the disbursement requirement*,* the LGBFCA mandates that all disbursements by check or draft be signed by the finance officer/deputy finance officer **and** countersigned by another employee or official of the unit, who is designated by the board. **G.S. 159-25(b).** If the board does not designate someone else, the chairman of the board or chief executive officer of the local government or public authority must provide the second signature. The statute does allow a governing board to waive the dual signature requirement, but only if it determines that it has sufficient other internal controls to accomplish the same purpose. A board should not waive this requirement lightly.

Daily Deposit. Another LGBFCA statute, **G.S. 159-32; G.S. 115C-445 (school units)**, specifies that all monies (checks, cash, money orders, etc.) collected or received by an officer or employee of the local government or public authority be deposited daily with the finance officer, in one or more official depositories, or with a properly licensed and recognized cash collection service. (A unit's official depository(ies) is a bank, savings and loan association, or trust company in North

Carolina that the unit's governing board has selected to hold the unit's cash.) This requirement recognizes that many different employees or officials within a single unit of government may collect and receive monies, and provides for a uniform process for accounting for those monies. (The board may waive the daily deposit for amounts up to $500, but even then, a deposit must be made at least once a month.)

The statute directs the finance officer to set up the processes and procedures to be followed by other government employees and officials who collect or receive monies. It further empowers the finance officer to audit the accounts of any officer or employee collecting or receiving monies at any time, and requires such a review at least once annually. The finance officer is ultimately charged with management of the unit's accounts. But it is up to the manager and governing board to support the finance officer's internal control efforts by demanding full compliance by all employees and officials. Without this support, a finance officer may not be able to adequately perform his/her duties.

Annual Audit.Each local government and public authority subject to the LGBFCA is required to have an annual external financial audit. (The only exception is for soil and water conservation districts who may choose to instead perform an internal audit. *See* **G.S. 139-7**). According to **G.S. 159-34; G.S. 115C-447 (school units)**, the audit must be performed by a certified public accountant or an accountant certified as otherwise qualified by the state's Local Government Commission (LGC). The auditor is selected by and reports directly to the unit's governing board. The audit contract must be approved by the LGC, though. And the LGC must sign-off on the final audit before payment by the unit.

The auditor's job is to render an opinion on the accuracy and reliability of the unit's Basic Financial Statements (which are typically prepared by the unit's finance staff and/or an outside professional). That does not mean that an auditor will catch every legal compliance problem. An auditor's opinion is only as good as the information provided to it and, even then, may not focus on all aspects of the government's operations. In other words, a unit should not rely on its auditor, alone, to identify unlawful activity.

The auditor normally suggests improvements to the government entity's internal control procedures in a management letter that accompanies the audit report. A board is well-advised to work with the auditor to address these issues and develop better accounting and other financial processes to minimize the risk of financial negligence or malfeasance.

Local Government Commission.Local government entities in North Carolina are subject to general financial oversight by the state's Local Government Commission (LGC). The LGC is a nine-member state body in the Department of State Treasurer. The commission approves most local government borrowing transactions and issues bonds on behalf of local units. It also monitors the fiscal health of local units in the state. The General Assembly has empowered the commission to "issue rules and regulations having the force of law governing procedures for the receipt, deposit, investment, transfer, and disbursement of money and other assets [by local units]. . . . " **G.S. 159-25(c); G.S. 115C-436(b) (school units).** The commission also may "inquire into and investigate the internal control procedures" and issue warnings to local units of any internal control deficiencies or violations of the LGBFCA. *Id.*

To aid the commission in its oversight role, commission staff members review the yearly financial audits of each local government and public authority in the state. Staff members often work with local officials to remedy any financial issues or potential financial issues. The commission issues management letters to the governing boards of local units identifying any problems and often demanding that the unit take remedial actions within a specified period of time. If the LGC issues a management letter to a local unit, the LGC also may mandate that the unit's finance officer, and/or one or more of its deputy finance officers, participate in training sponsored by the LGC.

State law allows the commission to take more drastic action if a unit willfully or negligently fails to take corrective action or otherwise comply with the LGBFCA's provisions in response to the commission's notices or warnings. Specifically, **G.S. 159-181(c)** allows the commission to "impound the books and records [of the unit] and assume full control of all its financial affairs. . . . " The commission becomes "vested with all the powers of the governing board as to the levy of taxes, expenditure of money, adoption of budgets, and all other financial powers conferred upon the governing board by law." *Id.*

Recently, the General Assembly has clarified and arguably expanded the commission’s authority to take action when a unit’s water or sewer system runs into financial trouble. The commission may assume full control of a unit’s water or sewer system and assume all powers of the governing board as to the operation of the public enterprise if the system, for three consecutive fiscal years, experiences negative working capital, has a quick ratio of less than 1.0, or experiences a net loss of revenue.

Governing Board Oversight.Finally, it is important to note that the governing board plays a critical role in overseeing compliance with all financial laws and internal policies. In addition to the roles specifically assigned to it by the LGBFCA, such as adopting the budget, selecting the official depository(ies), setting the amount of, and paying for, performance bonds, and hiring the independent auditor/receiving the audit report, the board is charged generally with the proper stewardship of the public funds. It must set expectations for all employees and officials of the unit to follow both statutory and other internal rules related to the collection, management, and disbursement of public funds. In some cases, the board may need to be more involved in developing internal control policies and practices, and in compelling compliance by all employees or officials by instituting meaningful consequences for non-conformance.

Links

- www.ncleg.net/EnactedLegislation/Statutes/PDF/ByArticle/Chapter_159/Article_3.pdf