

**THE CITY OF NEW YORK
OFFICE OF THE COMPTROLLER
INTERNAL CONTROL AND ACCOUNTABILITY DIRECTIVES**

DIRECTIVE 1 - PRINCIPLES OF INTERNAL CONTROL

INTRODUCTION AND SUMMARY

Internal Control must be an integral part of agency management in satisfying the agency's overall responsibility for successfully achieving its assigned mission and assuring full accountability for resources. In addition, effective internal control over the financial activities at the agency level is the foundation for ensuring the reliability of the City of New York's accounting systems and financial reporting.

Internal Control is defined by the United States Government Accountability Office (GAO) as a process affected by an entity's management and designed to provide reasonable assurance regarding the achievement of objectives for reliability of financial reporting, effectiveness and efficiency of operations, and compliance with applicable laws and regulations.

This Directive outlines the principles of a sound and effective financial control system that should be adopted by the City and its agency management and staff. It is consistent with the internal control framework adopted by The Committee of Sponsoring Organizations of the Treadway Commission in its "*Internal Control – Integrated Framework*".

The Directive also reaffirms and enhances the Office of the Comptroller's requirement for the filing of an annual *Agency Financial Integrity Statement*. The principles of effective internal control have been covered in the detailed checklist questions that are part of the *Agency Financial Integrity Statement*. The Office of the Comptroller considers the subject matter covered by the questions to be criteria that agency management should follow in maintaining a reliable and effective system of internal controls. The Audit Bureaus of the Office of the Comptroller may, therefore, choose to audit the information presented by agencies in their annual *Agency Financial Integrity Statements*. A copy of the latest *Agency Financial Integrity Statement* is attached to this Directive for your information and use. The Office of the Comptroller will update the annual *Agency Financial Integrity Statements* as required.

1.0 GENERAL INFORMATION

1.1 Organization

- 1.0 General Information
- 2.0 General Characterization
- 3.0 Fundamental Concepts
- 4.0 Standards of Control
- 5.0 Internal Control - Examples
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Attachment: Comptroller's Memorandum – *Agency Financial Integrity Statement*

1.2 Comptroller Authority

This Directive is issued pursuant to the Comptroller's authority to advise and make recommendations in regard to the operations, fiscal policies and financial transactions of the City where it is deemed advisable in the public interest, as established in Chapter 5, Section 93 of the New York City Charter. The Comptroller's authority to audit City agencies and matters relating to or affecting the finances of the City is also established in Chapter 5, Section 93 of the New York City Charter.

1.3 Effective Date

This Directive is effective immediately.

1.4 Assistance

Questions or comments concerning this Directive should be addressed to: The Office of the Comptroller, attention:, Directives/Policy Unit, Bureau of Accountancy, Municipal Building, One Centre Street, Room 200 South, New York, NY 10007, (212) 669-3675, e mail directives@comptroller.nyc.gov .

1.5 Internet Availability

An inventory of existing Comptroller's Internal Control and Accountability Directives, most with download and print capability, is available on the Comptroller's website at www.comptroller.nyc.gov.

2.0 GENERAL CHARACTERIZATION

Internal control is a fundamental component in the successful financial accountability of any public or private entity. Effective internal control provides a necessary and continuing surveillance over the various processes, plans and procedures that are the foundation for which management relies upon to successfully achieve the purpose, goals and objectives of the agency while maintaining appropriate financial accountability for the organization's activities. In addition, internal control serves as the first line of defense in safeguarding assets and help preventing or detecting errors and fraud.

Internal control should provide reasonable assurance that the objectives of the agency are being achieved in the following categories:

- Effectiveness and efficiency of operations including the appropriate use and safeguarding of all resources.
- Reliability of financial reporting including reports on budget execution, financial statements, and other reports for internal and external use.
- Compliance with all applicable laws and regulations.

A subset of these objectives is the safeguarding of all assets. Internal controls should be designed to provide reasonable assurance in respect to the prevention or prompt detection of unauthorized acquisition, use or disposition of an agency's assets.

3.0 FUNDAMENTAL CONCEPTS

The following fundamental concepts provide the underlying framework for designing and applying the standards of an effective internal control environment.

3.1 Continuous and Integral Component of Operations

Internal control is a series of actions or activities that exist as a continuing built-in component of an agency's operations. In order to be effective, internal control must be an integral part of the overall management business and control system, and should be similarly supported by a reporting structure including objectives, problem identification and accountability. Similar to other operational responsibilities, internal controls should be periodically reviewed and redirected as deemed necessary.

3.2 Requires Management and Staff Involvement

All personnel in an organization play important roles in making internal control effective. As such, management must realize that their responsibility for internal control extends beyond that of just creating the system's structure and mechanisms. It is equally important to ensure the existence of a healthy and participatory internal control environment throughout the agency. Management and staff must understand and accept internal control as a normal day-to-day business function.

3.3 Affords Only Reasonable Assurance

It is important for management to ensure that the design and implementation of agency internal controls is based on justifiable cost and benefit relationships. In doing so it should be recognized that well structured internal controls provide only reasonable, but not absolute assurance for the protection of an agency's operations. Factors such as employee mistakes, judgement errors, or collusion can occur and may not be detected despite the existence of appropriate internal controls. Management needs to balance the cost of establishing controls to prevent or detect inappropriate actions that could affect an agency's ability to satisfy objectives with the risk that such actions could occur and not be detected.

It is equally important that the agency's staff is informed of and understand the purpose of the internal control principles under which they are required to operate. Employees should question and/or appropriately challenge management direction when they believe they have been instructed to take an action in violation of existing internal control policy. As required by Executive Order 16, every City employee has an

affirmative obligation to report, directly and without undue delay, to the Commissioner of Investigation or an Inspector General any and all information concerning conduct which they know or should reasonably know to involve corrupt or other criminal activity or conflict of interest, (i) by another City officer or employee, which concerns his or her office or employment, or (ii) by persons dealing with the City, which concerns their dealings with the City.

Agency management, correspondingly, should not routinely bypass or override existing internal controls. In those rare instances where it is management's judgement that overriding policy or overriding an established control is fully justified, it must provide, for file purposes, complete justifying and signed documentation bearing the authorization of the next level of higher reporting authority. As an example, where an agency senior manager requests payment or reimbursement of a seemingly inappropriate expenditure, the justifying documentation would require the signature of the Agency Head prior to the voucher being processed for payment.

4.0 STANDARDS OF CONTROL

The following five control components outline the minimum level of quality acceptable in the development of an internal control system and provide the basis for which an agency's internal control may be evaluated.

4.1 Control Environment

A positive control environment is the foundation for all other standards of internal control. It should provide an obligatory discipline and structure while encouraging an understanding and acceptance of internal controls as a necessary element in the success of an agency operation. Several key factors contribute to a progressive control environment.

- Maintaining and demonstrating an atmosphere of teamwork, integrity and ethical values, among management and staff, is an important environmental factor towards the success of business financial control. Agency management must play an active and visible role providing the leadership in this area, especially in setting the tone of the organization's behavioral values. Management's philosophy and operating style bear a significant influence on organizational values.

- It is important that agency management and staff be provided with the required support necessary for them to accomplish their assigned duties, as well as understand the importance of developing and implementing sound internal control. Management must be alert to the various knowledge and skill levels required for the various staff assignments and should provide as needed on-the-job and internal/external training, as well as candid and constructive counseling and performance appraisals. Sound personnel policies and practices are also a critical factor in maintaining a motivated business financial control environment.
- Another factor affecting the control environment is the organizational structure. It is management's framework for planning, directing and controlling operations to achieve agency objectives. A good internal control environment requires that the agency's organizational structure clearly defines key areas of authority and responsibility and establishes appropriate lines of reporting. The appointment of competent and respected staff management is vital as well as is a properly assigned management span of control with clearly defined lines of authority and responsibility.

4.2 Risk Assessment

Internal control should provide for an assessment of the risks the agency faces from both external and internal sources. A precondition to risk assessment is the establishment of clear and consistent agency objectives.

Risk assessment is, basically, the identification, analysis and cost sizing of the relevant internal and external risks associated with achieving an agency's agreed upon objectives and includes the structuring of a plan to determine how these risks would be managed. As governmental, economic, regulatory and operating conditions continually change, agency management must be prepared to identify and deal with any special risks prompted by such changes.

Management should comprehensively identify risks and should consider all significant interactions between the agency and other parties as well as internal factors and activities. Risk identification methods may include qualitative and quantitative ranking activities, management conferences, forecasting and strategic planning, and consideration of findings from audits and other assessments. The specific risk analysis methodology used can vary by agency because of the difference in

agency missions and the difficulty in quantifying risk levels. Once risks have been identified, they should be analyzed for significance; likelihood for occurrence and management actions required (e.g., creation or enhancement of policies and procedures to minimize risk to achieving the agency's objectives).

4.3 Control Activities

Internal control activities help ensure that management's directives are carried out. They are, basically, the policies, procedures, techniques, and mechanisms used to enforce management's direction. They must be an integral part of an agency's planning, implementing, review and accountability for stewardship of its resources and are vital to its achieving the desired results.

Control activities should exist at all levels and functions of an agency. They include a wide range of diverse activities such as approvals, authorizations, verifications, record reconciliations, open item agings, transaction analyses, performance reviews, security evaluations, and the creation and maintenance of related records that provide evidence of the execution of these activities. Examples of individual control activities are provided in Section 5.0.

4.4 Information and Communications

In order for an agency to successfully manage and control its fiscal operations, it must have a reliable and timely communications system that flows both vertically and horizontally throughout the organization. It must be structured to provide the pertinent information relating to internal as well as external events that can affect the unit's overall performance.

Management requires both operational and financial data to determine whether they are meeting their agencies' strategic and annual performance plans as well as achieving their goals for the effective and efficient use of resources. For example, operational data is required for the development and understanding of financial reports. This covers a broad range of data on purchases, subsidies, and other business transactions to data on assets, inventories and receivables. Operating information is also needed to determine whether the agency is achieving its compliance requirements under pertinent laws and regulations.

Financial information is needed for both internal and external purposes. It is required to develop financial statements for periodic

external reporting and to make operating decisions, monitor performance, allocate resources and, most important, take necessary corrective measures, as necessary.

Pertinent operational and financial information must be identified, routinely captured, and distributed in a form and time frame that permits people to perform their duties efficiently. In addition to disciplined internal communication standards, management should ensure that there are adequate means of communicating with, and obtaining information from, external third parties that may have a significant impact on the agency achieving its goals.

In addition, effective information technology management is critical to achieving the useful, reliable, and continuous recording and communication of information. A comprehensive set of guidelines to assist agencies in the management and safeguarding of information technology assets is contained in Comptroller's Internal Control and Accountability Directive #18, *Guidelines for the Management, Protection and Control of Agency Information and Information Processing Systems*.

4.5 Monitoring

A sound internal control system must be supported by ongoing activity monitoring occurring at various organizational levels and in the course of normal operations. Such monitoring should be performed continually and be ingrained throughout an agency's operations. It should include appropriate measurements on regular management and supervisory activities, comparisons, reconciliations, and other actions taken by employees in performing their duties. Agency management must perform continual monitoring of activities and programs. Independent monitoring may be conducted by an agency's internal audit department, as well as by external auditors such as those of the New York City Office of the Comptroller, New York State Office of the Comptroller, and various federal agencies.

Monitoring of internal controls should also include policies and procedures for ensuring that the findings of audits and other internal and external reviews are promptly resolved.

In addition to ongoing internal control monitoring, separate evaluations should be utilized to focus directly on a control's effectiveness in a specific time frame. The scope and frequency of separate evaluations should depend primarily on the assessment of risks and the effectiveness of ongoing monitoring procedures. Separate assessments may take the

form of self-assessments as well as the review of control design and direct testing of internal controls (e.g., the *Agency Financial Integrity Statement*).

Deficiencies found during ongoing monitoring or through separate evaluations should be communicated to the individual responsible for the function and to, at least, the next level of higher management. Serious matters should be reported to senior management and/or the Agency Head, if deemed appropriate.

Recent audits performed by the Office of the Comptroller are replete with examples of serious internal control lapses that could have been alleviated or avoided by an agency's attention to these five basic components of acceptable internal control. Current and prior year audit reports are available for review on the Office of the Comptroller website at <http://comptroller.nyc.gov>.

5.0 INTERNAL CONTROL - EXAMPLES

The following are examples of some basic internal controls and are an illustration of the range and variety of controls that may be useful to agency management. They are not meant to be all-inclusive and may not include particular activities that an agency may require.

An agency's internal control system should be flexible and allow tailoring of its controls to fit its special needs. The specific controls used by a given agency may be different from those used by others due to a number of organizational factors including threats they may face and risks they may incur, differences in objectives, operational environment, and requirements for system reliability, availability and performance.

- **Top Level Agency Performance Reviews**

Senior management should consistently track major agency business achievement indicators and compare them to agency plans, goals and objectives. Management should develop contingency plans and make adjustments as appropriate. Situations identified by audits or operational experience that bear the potential for significant monetary loss or risk to achieving agency objectives should be noted and discussed at this level of agency review.

- **Management Review at Functional or Activity Level**

Management, throughout the organization, should be comparing actual functional or activity level performance data to planned or expected results, analyzing significant variances and introducing corrective action as appropriate. Key indicator tracking and self-assessment checklists are important tools in measuring the control posture of various functional activities. Tracking and aging mechanisms are crucial in those agencies that are responsible for collection of rents, taxes, fines, franchise fees and other types of revenue.

- **Workforce Management**

Effective management of an organization's workforce is essential to achieving desired results and an important part of internal control. Only when the proper personnel are on the job and are provided with the appropriate training, tools, structure, incentives, and responsibilities is financial operational success attainable. Management should ensure that skill needs are continuously assessed and that the organization is able to obtain a workforce that has the skills necessary to achieve organizational fiscal goals.

- **Control Over Computer Information Processing**

A variety of control activities are used in information processing to ensure that access to hardware, software and data is limited to only those individuals that management has decided should have such access. Management should exert particular control to limit the access of consultants and other individuals who may not be employees of the City of New York, to their areas of interest only and for the period of time that is required for them to complete their authorized assignments. Other management approved controls are used to ensure that software performs the functions that it is intended to, and that processed data is accurate and reliable.

Agencies should establish the appropriate controls when consultants and other individuals who are not employees of the City of New York, have access to Information Processing data, files and programs used in production in City-operated information systems, including the Financial Management System (FMS). Examples of such controls to be considered include performing background checks of the non-employees, use of confidentiality agreements, and appropriate supervision and monitoring by City employees. Approval by the Agency

Head, or designee, of such access should be documented. Programming changes which may have been made by consultants should be thoroughly tested and approved by management before being put into production. Third party vendors who may process data on behalf of City agencies should be monitored by City management to ensure that the data is accurate and appropriately processed.

- **Physical Control of Vulnerable Assets**

An agency must establish physical control to secure and safeguard vulnerable assets. Examples include security for and limited access to assets such as cash, securities, inventories, computers and other equipment, which might be vulnerable to risk of loss or unauthorized use. Periodic counting and comparison to control records for such assets is an important element of control of these assets.

- **Performance Measures and Indicators**

Activities need to be established to monitor fiscal performance measurements and indicators. These controls could be comparisons and assessments relating different sets of data to one another so that analysis of the relationships can be made and appropriate actions taken. Controls should also be aimed at validating the propriety and integrity of both organizational and individual performance measures and indicators. This is particularly important in measuring the performance of field personnel such as inspectors.

- **Segregation of Duties**

Key duties and responsibilities need to be divided or segregated among different staff members to reduce the risk of error or fraud. This should include separating the responsibilities for authorizing transactions, processing and recording them, reviewing the transactions, and handling any related assets. No one individual should control all key aspects of a transaction or event.

- **Proper Execution of Transactions and Events**

Transactions and other significant events should be authorized and executed only by persons acting within the scope of their authority. This is the principal means of assuring that only valid transactions to exchange,

transfer, use or commit resources are initiated or entered into. Approved authorizations levels should be documented, updated as necessary and clearly communicated to managers and employees.

Individuals who are not employees of the City of New York (e.g., community board members) should not be authorized to commit City resources or execute transactions on its behalf.

- **Accurate and Timely Recording**

Transactions should be promptly recorded to maintain their relevance and value to management in controlling operations and decision making. This applies to the entire process or life cycle of a transaction or event from the initiation and authorization through its final classification in the agency's records. Sound control activities help ensure that all transactions are timely and accurately recorded.

- **Access Restrictions to Records and Resources**

Access to agency resources and vital records should be subject to appropriate limitations and accountability for their custody and use should be clearly assigned and maintained. Periodic comparison of the resources with the recorded accountability should be made to reduce the risk of errors, fraud or misuse or unauthorized alteration.

- **Appropriate Documentation of Transactions and Internal Controls**

All transactions and significant events need to be clearly documented and the documentation readily available for use or examination. Internal controls should be documented in management administrative policies or operating manuals. All documentation should be properly managed and maintained in accordance with updated records retention schedules.

6.0 AGENCY FINANCIAL INTEGRITY STATEMENT

Prior to the release of this revised Directive #1 addressing the *Principles of Internal Control*, the Office of the Comptroller released, on an annual basis, a Comptroller's Memorandum entitled *Directive #1 - Financial Integrity Statement*.

As an integral part of this revised Directive #1, the Office of the Comptroller will continue to issue the annual Financial Integrity Statement and its accompanying internal control checklist (Directive #1 Checklist) by means of a Comptroller's Memorandum. (A copy of the latest version is attached for your information.)

The Agency Head (e.g., the Commissioner) is required to sign the Financial Integrity Statement, which represents a formal opinion regarding the adequacy of the agency's internal control structure. This opinion is supported by the Directive #1 Checklist that agency personnel are required to complete. As mentioned earlier, the Office of the Comptroller considers the Directive #1 Checklist questions to represent basic internal control criteria that agency management should follow in maintaining a reliable and effective control system.

The Audit Bureaus of the Office of the Comptroller may therefore choose to audit the annual agency Financial Integrity Statement responses (which would include the Directive #1 Checklist, any required attachments, and supporting documentation that would be available at agency sites) as part of the Comptroller's mandated audit responsibilities under Chapter 5 Section 93 of the New York City Charter.

Two copies of the Financial Integrity Statement with fully completed copies of the Directive #1 Checklist plus any additional documentation that the Directive #1 Checklist may require should be filed with the Office of the Comptroller and an additional copy sent to the Mayor's Office of Operations. Further instructions, annual reporting requirements and related due dates will be included in the annual updates to this Financial Integrity Comptroller's Memorandum. Updates to the Directive #1 Checklist will represent current criteria that agency management should follow in maintaining a reliable and effective system of internal control.