

INTERNAL CONTROL STANDARDS

INTRODUCTION

These standards define the minimum level of quality acceptable for internal control systems and set the criteria for evaluation of both individual controls and entire systems. They apply to all operations and administrative functions (both manual and automated) and are not intended to interfere with the development of legislation or policy in an agency.

Standards are provided for the following areas:

- General standards
- Specific standards
- Audit resolution standards.

General standards ensure an atmosphere of strong internal control throughout all agencies. They reflect the overall attitude of the state government leadership that strong internal controls are necessary in all agencies. Specific standards provide more direct process level guidance, while the audit resolution standard requires agencies to resolve audit findings and recommendations quickly and efficiently.

Following are further details regarding these standards:

GENERAL STANDARDS

1. REASONABLE ASSURANCE

Internal control systems are to provide reasonable assurance that management objectives are accomplished. A sound system recognizes that the cost of internal control should not exceed the benefits achieved, and reasonable assurance equates to a satisfactory level of confidence given the considerations of costs, benefits and risks. The required determinations call for judgment to be exercised by agency staff.

In exercising that judgment, agencies should:

- a) Identify:
 - Risks inherent in agency operations,
 - Criteria for determining low, medium, and high risks,
 - An acceptable level of risk under varying circumstances.
- b) Assess the quantity and quality of risks.

Costs refer to the financial measure of resources consumed in accomplishing a specified purpose; costs can also represent a lost opportunity, a decline in service or low employee morale. A benefit is measured by the degree that the risk of failing to achieve a stated objective is reduced. Examples include increasing the chance of detecting fraud, waste, abuse or error, preventing an improper activity, or increasing regulatory compliance.

2. SUPPORTIVE ATTITUDE

This standard requires that management and employees maintain and show a supportive attitude toward internal control at all times. Managers and employees are to be attentive to internal control matters. They need to take steps to promote the effectiveness of the control. Attitude affects the quality of performance and the quality of internal control.

A positive and supportive attitude is started and fostered by management. It is ensured when internal control is consistently a management priority. Positive attitudes are fostered by managers' commitment to achieving strong control. This commitment is met through good organizational structure, personnel practices, communication, protection and use of resources. Systematic accountability, monitoring and systems of reporting and general leadership are required. One important way to prove management's support for good internal control is emphasizing the value of internal auditing. The manager also proves commitment by showing responsiveness to information developed through internal audits.

The organization of an agency provides its management with the overall framework for planning, directing, and controlling its operations. Good internal control requires clear separation of duties.

General leadership is critical to maintaining a positive and supportive attitude toward internal control. Adequate supervision, training, and motivation of employees in the area of internal control are important.

3. COMPETENT PERSONNEL

Managers and employees are to have personal and professional integrity. They are to be qualified to perform their assigned duties, as well as to understand the importance of ensuring sound internal controls. Personal and professional integrity must be shown.

Many elements influence the integrity of managers and their staff. For example, personnel should periodically be reminded of their obligations under an operative code of conduct.

Hiring and staffing decisions should include proof of education and experience. Once on the job, the individual should be given formal and on-the-job training. Managers who have a good understanding of internal control are vital to effective control systems.

Counseling and performance appraisals are also important. Part of the appraisal should be based on determining that they support implementation and maintenance of internal control.

4. CONTROL OBJECTIVES

Internal control objectives are to be identified or developed for each agency activity. They are to be logical, applicable, and reasonably complete. This standard requires that objectives be tailored to an agency's operations.

All operations of an agency can be grouped into one or more groups called cycles. Cycles make up all specific activities (such as identifying, classifying, recording, and reporting information) required to process a transaction or event. Cycles should be compatible with an agency's organization and division of responsibilities.

Financial cycles cover the traditional control areas concerned with revenues and expenditures, assets, and financial information. The questionnaire addresses the following financial cycles:

The Financial Reporting Cycle encompasses the year-end accounting procedures and financial statement preparation. The cycle includes the recording of accruals and compilation of financial statement information.

The Budget Reporting Cycle includes the establishment, revision, reporting and administration of the budgets as directed by the entity and Office of State Budget and Management.

The Cash Receipts Cycle involves the preparation of receipts, deposits, and special reports for the funds received by an entity. The cycle could also include petty cash transactions. An entity may have more than one receipting area. If the processes are different indicate the variations on the internal control questionnaire.

The Accounts Receivable Cycle includes the recording, collection, billing and aging of accounts receivable. An entity may have several accounts receivable systems. A separate internal control questionnaire should be completed for each accounts receivable cycle.

The Purchasing/Accounts Payable Cycle records the purchase and payments for goods and services for all non-salary expense transactions. The cycle includes the recording of obligations, issuance of checks and the liquidation of encumbrances. There could be several different accounts payable systems within an entity. A separate internal control questionnaire should be completed for each separate accounts payable and purchasing system. For example, a college may have college purchasing/accounts payable and stores purchasing and payable.

The Human Resource Cycle pertains to the preparation and maintenance of payroll and personnel records required by state and federal governmental agencies for employees within the entity.

The Inventory Cycle involves the receiving and maintenance of various inventory items within an entity. The items may include supplies, uniforms, food or household items. The cycle would include the physical inventory of the items. A separate internal control questionnaire would be needed for each different inventory method.

The Capital Assets Cycle should adequately document, control and account for the expenditure of state and federal funds for capital items. The capital assets cycle provides

history of capital items from purchase or installation to disposal. The fixed asset system refers to automated and manual systems within the entity.

The Computer Security Cycle involves the existence of data logs, procedures for disaster control and recovery and authorization codes.

The Investment Cycle comprises the acquisition, disposal, record keeping and monitoring of market values of securities held by the entity.

The Debt Cycle involves the processing and recording of debt. The cycle includes the issuance, retirement and redemption of bonds.

The Tax/Payroll Compliance Cycle involves the preparation of information returns required by the Internal Revenue Service for employees and nonemployees of the governmental entity. The cycle includes the determination of employee status and proper reporting of employment related moving expense reimbursements.

The Major Financial Assistance Cycle for federal and state programs relates to the administration and financial management of contracts and grants awarded by federal and state programs. The internal control questionnaire for the major financial assistance cycle is divided into nine sections including eligibility, types of service, and matching or level of effort. A separate questionnaire is to be completed for each major grant or award. A major grant or award is defined to be programs receiving \$30 million or more from the federal government.

5. CONTROL TECHNIQUES

Internal control techniques are the means by which control objectives are achieved. Techniques include such things as policies, procedures, separation of duties, and physical arrangements. This standard requires that internal control techniques continually provide a high degree of assurance that the internal control objectives are being achieved.

To make sure the control objectives are being achieved; the techniques must be effective and efficient. To be effective, techniques should fulfill their intended purpose in actual application. They should provide the coverage and operation as intended. As for efficiency, techniques should be designed to derive maximum benefit with minimum effort. Techniques tested for effectiveness and efficiency should be those in actual operation and should be evaluated over time.

6. CONTINUOUS MONITORING

Agency heads are to set up and maintain a program of internal review that is designed to identify internal control weaknesses. Needed changes are to be implemented to correct any weaknesses.

SPECIFIC STANDARDS

1. DOCUMENTATION

Internal control systems, as well as all transactions and other significant events are to be clearly documented. Such documentation is to be readily available for examination. This standard requires written evidence of an agency's internal control objectives, techniques and accounting systems.

Documentation of internal control systems should include identification of the cycles and related objectives and techniques. It should appear in management directives, administrative policy, and accounting manuals. Documentation of transactions or other significant events should be complete and accurate. The transaction should be traced from its inception through its completion.

This standard requires that the documentation of internal control and transactions be purposeful and useful to managers. It should also fulfill the needs of the auditors or others involved in analyzing operations.

2. RECORDING OF TRANSACTIONS AND EVENTS

This standard requires that transactions and other significant events be promptly recorded and properly classified. Transactions must be promptly recorded if information is to maintain its value to management in decision-making and in controlling operations. This standard applies to:

- The entire process or life cycle of a transaction or event, including the initiation and authorization.
- Its final classification in summary records.

3. EXECUTION OF TRANSACTIONS AND EVENTS

Transactions and other significant events are to be authorized and executed only by persons acting within the scope of their authority. Such authorization deals with decisions to exchange, transfer, use, or commit resources for specified purposes and conditions. It is the principal means of assuring that only valid transactions and other events are entered.

Authorization should be clearly communicated to managers and employees. Documentation should include the specific conditions and terms under which authorizations are made. Conforming to the terms of this standard means employees are carrying out their assigned duties as set up by management.

4. SEPARATION OF DUTIES

It is necessary to reduce the risk of error, waste, or wrongful acts as well as the risk of such acts going undetected. This is achieved by making sure no one individual controls all key aspects of a transaction or event. Duties and responsibilities should be assigned to different individuals to be sure those effective checks and balances exist.

Key duties include the following: authorizing, approving, and recording transactions, issuing and receiving assets, making payments, and reviewing or auditing transactions. Collusion can reduce or destroy the effectiveness of this internal control standard.

5. SUPERVISION

Qualified and continuous supervision is to be provided to ensure that internal control objectives are achieved. This requires supervisors to review and approve the assigned work of their staffs. It also requires that staffs are provided with the necessary guidance and training to reduce errors, waste, and wrongful acts. Specific management directives must be achieved.

Assignment, review, and approval of a staff's work require that duties be clearly communicated to each staff member. Each staff member's work must be reviewed to the extent necessary. The work must be approved at critical points to be sure that work flows as intended.

Assignment, review, and approval of a staff member's work should result in the proper processing of transactions and events. This includes following approved procedures and requirements. Errors, misunderstandings, and improper practices must be detected and eliminated. Wrongful acts must be prevented from occurring or recurring.

6. ACCESS TO AND ACCOUNTABILITY FOR ASSETS

An individual is to be assigned custody, accountability, and maintenance for assets. Periodic comparison should be made of the assets with the records to determine whether the two agree.

The basic concept behind restricting access to assets is to reduce the risk of unauthorized use or loss, and to help achieve management goals. Restricting access to assets depends upon the vulnerability of the assets and the perceived risk of loss. These two factors should be assessed periodically. For example, access to and accountability for documents, such as checks, can be achieved by:

- Locking them in a safe,
- Assigning a sequential number,
- Assigning custodial responsibility.

Assigning and maintaining accountability for assets involves directing and communicating responsibility to specific individuals within an agency.

AUDIT RESOLUTION STANDARD

Managers are to promptly resolve any weaknesses in the internal control structure as determined by their self-assessment as well as immediately resolving any findings from the Office of the State Auditor. To do this, the following points must be considered:

- Findings and recommendations must be promptly evaluated.
- Determine the proper actions in response to audit findings and recommendations.
- Resolve all weaknesses in internal control brought to management's attention.

This standard requires managers to take prompt, responsive action on all findings and recommendations to correct identified deficiencies. Where audit findings identify opportunities for improvement rather than cite deficiencies, responsive actions are those that produce improvements.

The resolution process begins when the results of an audit are reported to management. It is completed only after action has been taken to complete one of the following steps:

- Identified deficiencies are corrected.
- Improvements are produced.
- Determined that after achieving a compliant status the cost of implementing the recommendations would outweigh the intended benefits.