State of Arizona Accounting Manual

INTRODUCTION

There are a number of definitions of internal control promulgated by professional organizations and published in text books. These definitions generally feature similar characteristics:

1. Internal control is a process effected and affected by an organization's structure, work and authority flows, people, and information systems.

2. The internal control process is designed to help the organization accomplish specific goals and objectives.

3. Internal control plays an important role in preventing and detecting fraud, waste and abuse and protecting the organization's resources.

4. The objectives of internal control include the reliability of financial reporting, feedback on achieving organizational strategic goals, safeguarding of assets, increased efficiency, and compliance with laws, regulations, policies, and the terms of contracts and grants.

It can be said that an agency which establishes and maintains a good internal control structure ***CARES***:

Complies with applicable laws, policies and contractual obligations

Accomplishes its mission

Reports relevant and reliable financial data

Economically and efficiently uses its resources

Safeguards its assets

While management has overall responsibility for designing and implementing effective internal controls, everyone in an agency has a responsibility to conform to and support the agency's internal control structure.

Internal controls can provide reasonable, but not absolute, assurance that objectives of an agency—including the prevention or detection of fraud, waste and abuse—will be met. Reasonable assurance implies a high degree of assurance, constrained by the costs and benefits of establishing incremental control procedures.

As originally defined by the Committee of Sponsoring Organizations of the Treadway Commission (COSO), an initiative dedicated to the development of frameworks and guidance on risk management, internal control and fraud deterrence, an organization's internal control structure or framework consists of five components, which themselves each have several elements, as discussed below:

- Control Environment. The control environment refers to the overall attitude, awareness and actions of management regarding the system of internal controls and its importance to the agency.

  In part, the control environment is expressed through the integrity and ethical values demonstrated by and insisted upon by agency management—which is to say, the tone at the top. The organization's structure, policies and practices are all components of the control environment.

- Risk Assessment. Risk is anything that could negatively impact an agency's ability to meet its goals and objectives. Risks may be strategic, financial, regulatory, reputational or operational. Failure to comply with laws, regulations, policies and contractual requirements is another type of risk as is exposure to fraud, waste and abuse. Changes in personnel, procedures and systems increase risks of all sorts.

  Management has the responsibility to evaluate risks in the agency. To assess risk, one must identify potential hazards, evaluate the likelihood and extent of harm, develop cost-justified precautions, implement those precautions, and document the risk assessment process and its findings.

- Control activities. Control activities are the policies, procedures, processes, methods and mechanisms that management may employ to mitigate the likelihood and effects of risks identified during the risk assessment.

  Controls can be preventive, detective or corrective. Preventive activities are designed to deter the occurrence of an undesirable event. The development of preventive controls involves predicting, as is done in the risk assessment, potential problems before they occur. Many preventive control activities are built into information systems or the design of processes. Detective controls are designed to identify undesirable events that do occur so that management can take appropriate corrective actions. Corrective actions are those taken to reverse the undesirable outcomes of errors, anomalies or wrongdoings that have been detected and to correct the conditions that caused or permitted such irregularities to happen.

- Monitoring. Monitoring is the review of an organization's activities to assess the quality of performance and the effectiveness of internal controls.

  Monitoring is an activity that, while it is the responsibility of management, should be conducted by personnel at all levels of an organization. Some monitoring activities, such as audits, are periodic; other monitoring activities, such as daily supervision of employees and processes, are continuous. Some monitoring is conducted using resources internal to the organization; self-assessment is one form of such monitoring. Other monitoring employs outside entities, such as auditors or consultants.

- Information and Communication. This component of the framework supports all other control components by developing control related information and communicating that information to employees. Examples of such information and its communication are shown below:

Control Component	Information Example	Communication Example
Control Environment	Code of Ethics	Prominent Posting of the Code of Ethics
Risk Assessment	Risk Assessment Findings	Meeting with Employees to Discuss Findings
Control Activities	Data Entry Procedures Manual	Conducting Data Entry Classes for Employees
Monitoring	Internal Audit Report	Consulting Staff about Implementing Audit Recommendations

Certain types of information are needed throughout an organization to effectively and efficiently move toward the accomplishment of agency goals. Some information flows from management to the rest of the organization; some information flows to management from the rest of the organization. Communication is more than just information flow; communication requires clarity so that understanding can be established between those exchanging information. With respect to internal control, information should reinforce management objectives and communication should enable understanding of responsibilities. Certain kinds of information—such as those which are confidential or sensitive—and the access to that information, however, must be controlled.

To support its processes and operations, each agency must develop and maintain an appropriate system of internal controls. These controls must incorporate statewide policies, procedures and controls appropriately adapted to circumstances and applicable risks. The following general financial controls support the minimal internal control structure that must be implemented and followed by each agency.

POLICY & PROCEDURES

1. Each agency must, to the extent practicable, establish a system of checks and balances to ensure that no one person has control over all parts of a financial transaction. This is frequently referred to as the separation or segregation of duties. In general, the principal incompatible duties to be segregated are:

1.1. Custody of an asset or assets.

1.2. Authorization or approval of transactions related to the acquisition or disposal of such asset or assets.

1.3. Recording or reporting transactions related to such asset or assets.

1.4. Examples of the types of activities requiring segregation include:

1.4.1. Handling functions (e.g., accepting money, receiving inventory, etc.) should be separated from record keeping functions.

1.4.2. Purchasing duties should be segregated from payables duties.

1.4.3. Payroll functions should be separated from personnel functions.

1.4.4. Reconciliation responsibilities should be segregated from duties involving the entry, release or approval of the transactions to which the reconciliation applies.

1.4.5. Purchasing duties should be separated from receiving functions.

1.5. When, as may be the case in very small agencies, an appropriate level of duty separation is difficult to achieve, it is the agency's responsibility to implement compensating controls, such as outsourcing certain accounting functions to the CSB or staff sharing with other small agencies.

2. All transactions—payroll, disbursements, purchases, personnel, etc.—should be approved by a designated person.

3. Each agency must reconcile relevant activity as necessary; except as otherwise provided or in the case of certain boards and commissions that are only in session sporadically, "as necessary" means not later than the end of the month following the month in which the transactions occurred and no less frequently than once a month. Reconciliations are to be documented and retained in accordance with State record retention requirements. Among the reconciliations to be conducted are:

3.1. Reconciliation of bank balances to book balances.

3.2. Reconciliation of deposits received by the bank to cash that has been received by the agency.

3.3. Reconciliation, to the extent practicable, of services and/or goods provided to cash received for such services and/or goods.

3.4. If applicable, reconciliation between accounting records in a State system and those in a system other than a State system.

3.5. Reconciliation of all other internal accounting records to the State system and to other internal accounting records.

4. Anomalies, deficiencies, imbalances and errors detected through reconciliations or other methods must be investigated and resolved on a timely basis, which generally means within thirty (30) days or less of discovery. An explanation supporting the resolution is to be documented and retained.

5. Each agency head must develop an organization chart clearly defining lines of authority and responsibility.

6. All employees must be required to take annual vacations. Preferably, these vacations should be of uninterrupted periods of a week or more. To the extent possible, the work normally performed by the vacationing employee should be performed by other employees.

7. All principal accounting records and accounting employees at all locations of an agency must be under the direct or indirect supervision of the principal accounting officer.

8. All officers or employees in key positions must be unrelated to one another.

9. All official accounting reports must be prepared or checked by persons other than those responsible for operations for which the report is prepared.

10. Each agency head must develop a policy assigning approval authority for financial transactions.

11. Each agency head must follow controls to prevent expenditure of funds in excess of the appropriation in the case of appropriated funds.

12. Each agency head must develop controls to prevent expenditures of funds in excess of the cash balance in the case of both appropriated and non-appropriated funds.

13. If an agency receives Federal financial assistance, the agency head must develop a policy that requires the agency to prepare Federal grant financial reports in accordance with the requirements of both the Federal cognizant agency and the grant.

14. Each agency must retain all records in accordance with the records retention requirements of the State, the agency, the governing grant or contract, or the Federal Government, whichever is longest or most restrictive.