INTRODUCTION

This section of SAAM is but one of several dealing with the overarching topic of Internal Controls. Each section within this topic complements the others procedurally or philosophically and, hence, benefits from the reading of the others, just as the others benefit from the reading of this. As with much of SAAM, this section is largely prescriptive and includes only enough theory and background information to justify the advocacy of certain practices.

Much of what is contained herein is adapted for the State of Arizona Government from *Standards for Internal Control in the Federal Government*, a publication of the U.S. Government Accountability Office, to which the reader is referred for a more extensive discussion of this topic. This publication, informally known as the *Green Book*, can be found online at http://www.gao.gov/assets/670/665712.pdf.

Internal control is often thought of negatively, namely, as a series of prohibitions that prevents certain activities and introduces complexities and roadblocks. In actuality, internal controls are designed to help an agency achieve its goals. Internal controls provide reasonable assurance that an agency's objectives will be met. These objectives and the risks related to these objectives fall roughly into the following, distinct but overlapping, categories:

- Operations – the effectiveness and efficiency of operations.
- Reporting – the reliability of reporting.
- Compliance – compliance with applicable laws, rules, policies, etc.

Internal control provides many benefits to an agency. It provides agency management with confidence regarding the achievement of objectives, provides feedback on how effectively an agency is operating, and helps reduce risks affecting the achievement of an agency's objectives.

POLICY & PROCEDURES

1. An internal control system—also known as and referred to herein as an internal control structure—is a continuous built-in component of operations, accomplished by people, that provides reasonable, but not absolute, assurance that an agency's objectives will be achieved. Factors outside the control or influence of management can affect the agency's ability to achieve all of its objectives.

1.1. Internal control comprises plans, methods, policies, procedures and activities.

1.2. Internal control is a system of dynamic, iterative, and integrated processes; individual elements impact the design, implementation and operating effectiveness of other elements.

2. Internal control is a process effected by agency management and agency management retains responsibility for the internal control structure of its agency.

2.1. Agency management conducts activities in accordance with the applicable laws, statutes, regulations, rules and policies.

2.2. Agency management may, nonetheless, make use of external sources—such as the General Accounting Office—to assist in evaluating and recommending ways to strengthen an agency's internal control structure.

3. As discussed in SAAM 0505, there are five (5) components of internal control: control environment; risk assessment; control activities; information and communication; and, monitoring. The principles and practices applicable with each of these components are discussed below.

3.1. Control Environment. Control environment is the foundation of an internal control system. It provides the discipline and structure, which affect the overall quality of internal control. Management establishes and maintains an environment throughout the agency that sets a positive attitude toward internal control.

3.1.1. Agency management should demonstrate a commitment to integrity and ethical values.

3.1.2. An oversight organization should oversee an agency's internal control system.

3.1.3. Agency management should establish an organization structure, assign responsibility, and delegate authority to achieve an agency's objectives.

3.1.4. Agency management should evaluate performance and hold individuals accountable for their internal control responsibilities.

3.2. Risk Assessment. Risk assessment is the determination of quantitative or qualitative estimate of risk related to a concrete situation and a recognized threat. Quantitative risk assessment requires calculations of two components of risk, the magnitude of the potential loss, and the probability that the loss will occur.

3.2.1. Agency management should define objectives clearly to enable the identification of risks and define risk tolerances.

3.2.2. Agency management should identify, analyze, and respond to risks related to achieving the defined objectives.

3.2.3. Agency management should consider the potential for fraud when identifying, analyzing, and responding to risks.

3.2.4. Agency management should identify, analyze, and respond to significant changes that could impact the internal control system.

3.3. <u>Control Activities</u>. Control activities are the actions agency management establishes through policies and procedures to achieve objectives and respond to risks in the internal control system.

3.3.1. Agency management should design control activities to achieve objectives and respond to risks in a timely fashion.

3.3.2. Agency management should implement control activities and document internal control responsibilities through policies.

3.3.3. Common categories of control activities include, but are not limited to:

3.3.3.1. Reviews of actual agency, division, unit and individual performance at the activity or functional level.

3.3.3.2. Controls over information processing, including controls over:

3.3.3.2.1. Completeness—transactions that occur are recorded.

3.3.3.2.2. Accuracy—transactions are recorded at the correct amount in the right account.

3.3.3.2.3. Validity—recorded transactions represent events that actually occurred and were executed according to prescribed procedures.

3.3.3.3. Physical and/or other appropriate controls over vulnerable assets.

3.3.3.4. Segregation of duties.

3.3.3.5. Accurate and timely recording of transactions.

3.3.3.6. Access restrictions to and accountability for resources and records.

3.3.3.7. Appropriate documentation of transactions.

3.4. <u>Information and Communication</u>. Agency management uses information to support the internal control system. Effective and timely information and communication are vital for an agency to achieve its objectives.

3.4.1. Agency management should communicate necessary and appropriate information to support the achievement of an agency's objectives.

3.4.1.1. With respect to internal communication:

3.4.1.1.1. Information flows down from management and across reporting lines to enable personnel to achieve objectives, address risks, and support the internal control system.

3.4.1.1.2. Information flows up though reporting lines about the agency's operational processes to help management achieve the agency's objectives.

3.4.1.1.3. Personnel may use separate reporting lines, as established by statute, to go around upward reporting lines when these lines are compromised.

3.4.1.2. With respect to external communication:

3.4.1.2.1. Agency management selects the appropriate information and methods to communicate externally. Among the factors management should consider in selecting the appropriate information and methods to communicate externally are:

3.4.1.2.1.1. The intended recipients of the communication.

3.4.1.2.1.2. The purpose and type of information being communicated.

3.4.1.2.1.3. The availability of the information to the audience when needed.

3.4.1.2.1.4. The cost of the resources needed to compile and communicate the information.

3.4.1.2.1.5. The requirements of laws and regulations that may affect communication.

3.4.1.2.1.6. The confidentiality or sensitivity of information.

3.4.1.2.1.7. Attorney-client privilege, if applicable.

3.4.1.2.1.8. The best interests of the State.

3.4.1.2.2. Agency management and those to whom agency management has delegated appropriate authority communicate with external parties—such as suppliers, contractors, service organizations, regulators, internal and external auditors, other governmental entities, and the general public—using established reporting lines.

3.4.1.2.3. Agency management communicates with external parties so that external parties can help the agency achieve its objectives and address related risks.

3.4.1.2.4. Agency management receives information from external parties that can help the agency achieve its objectives and address related risks. Such information includes significant matters relating to risks, changes, or issues that affect the agency's internal control system.

3.4.2. Agency management should design a process that uses the agency's objectives and related risks to identify the information requirements needed to achieve the objectives and address the risks.

3.4.3. The identification of requirements is an iterative and ongoing process appropriately reacting to changes that affect the agency and its objectives that occurs through an effective internal control system.

3.5. *Monitoring*. Monitoring of the internal control system is essential in helping internal controls to remain aligned with changing objectives, laws, resources, risks and environments.

3.5.1. Agency management should establish and operate activities to monitor the agency's internal control system and evaluate the results.

3.5.1.1. Agency management monitors the internal control system through ongoing monitoring and separate evaluations.

3.5.1.1.1. Agency management performs ongoing monitoring of the design and operating effectiveness of the internal control system as part of the normal course of operations. Such ongoing monitoring includes normal management activities, supervision, analytics, reviews, and frequent reconciliation of financial activities.

3.5.1.1.2. Agency management uses separate evaluations to monitor the design and operating effectiveness of the internal control system at a specific time or with respect to specific functions or processes. Such activities include control self-assessments, risk assessments, and audits.

3.5.2. Agency management should remediate identified internal control deficiencies on a timely basis.

3.5.2.1. Personnel report internal control issues through established reporting lines to the appropriate internal and external parties on a timely basis to enable the agency to promptly evaluate those issues.

3.5.2.2. Agency management evaluates and documents internal control issues and determines appropriate corrective actions for internal control deficiencies on a timely basis.

3.5.2.3. Agency management completes and documents corrective action to remediate internal control deficiencies on a timely basis.

4. Controls should be effectively designed, effectively implemented, and effectively operating together in an integrated manner.

4.1. Effectively designed controls are capable of achieving an objective and addressing related risks.

4.2. Effectively implemented controls exist and operate as designed. A control cannot be effectively implemented if it has not been effectively designed.

4.3. Controls that are effectively operating together are appropriate controls applied at the appropriate time and working together to support the achievement of agency goals.

4.4. There are costs associated with the establishment and maintenance of an internal control structure. Cost vs. benefit considerations support management's ability to effectively design, implement, and operate an internal control system that balances the allocation of resources in relation to the areas of greatest risk, complexity, or other factors relevant to achieving the agency's objectives. Cost alone is not an acceptable reason to avoid implementing internal controls.

5. An agency's control environment is the foundation of its internal control system. It provides the discipline and structure that affect the overall quality of internal control. The agency's control environment, including the attitude and example of management, can be a driver or barrier to internal control. Because of this, agency management should:

5.1. Establish and maintain an environment throughout the agency that sets a positive attitude toward internal control.

5.2. Demonstrate a commitment to integrity and ethical values.

5.3. Communicate its expectation that all those employed or engaged by the agency in any capacity comply with all applicable laws, regulations and policies.

5.4. Establish an organizational structure, assign responsibilities, and delegate authority to achieve the agency's objectives.

5.5. Hold individuals accountable for their internal control responsibilities.

5.6. Lead by an example that demonstrates the agency's values, philosophy, and operating style. Reflects integrity and ethical values.

6. Documentation is part of an effective internal control system.

6.1. Agency management develops and maintains documentation of the agency's internal control system.

6.2. The agency's internal control system and its related documentation should, as appropriate and applicable, incorporate, by reference or otherwise, statewide policies and procedures published by relevant authorities, such as the GAO, SPO, HRD, Risk Management, LAPR, etc.

6.3. Agency internal control systems should support and provide reasonable assurance of compliance with all relevant laws, policies, grant requirements and contract provisions.

7. Internal control responsibilities include both performance of internal control duties and compliance with internal control policies.

7.1. Agency management should hold employees accountable for their internal control responsibilities.

7.2. Agency management should hold service organizations accountable for their assigned internal control responsibilities.

7.3. Agency management should take corrective action as necessary to enforce accountability for agency internal control.

8. Agency management should assess risks that may thwart an agency's accomplishment of its goals.

8.1. Agency management should define objectives so that risks can be identified.

8.1.1. Objectives should be defined in specific and measurable terms to enable the design of internal controls for related risks.

8.1.2. Objectives should be communicated as necessary to help assure their performance.

8.2. Agency management should identify, analyze and respond to risks.

8.3. Agency management should consider the potential for fraud when identifying, analyzing and responding to risks.

8.4. Agency management should identify, analyze and respond to significant changes that could impact the internal control system.

8.5. Agency management should estimate the significance of the identified risks to assess their effect. Agency management estimates the significance of a risk by considering the magnitude of impact, likelihood of occurrence, and nature of the risk.

8.5.1. Magnitude of impact refers to the likely magnitude of deficiency that could result from the risk and is affected by factors such as the size, pace, and duration of the risk's impact.

8.5.2. Likelihood of occurrence refers to the level of possibility that a risk will occur.

8.5.3. The nature of the risk involves factors such as the degree of subjectivity involved with the risk and whether the risk arises from fraud or from complex or unusual transactions.

8.6. Risks may be analyzed on an individual basis or grouped into categories—financial, operational, compliance-related, etc.—with related risks and analyzed collectively.

8.7. In its consideration of risks arising from fraud, agency management should consider the types of fraud to which an agency may fall victim: fraudulent financial reporting, misappropriation of assets and corruption.

8.7.1. Fraudulent financial reporting consists of intentional misstatements or omissions of amounts or disclosures in financial statements to deceive financial statement users. This could include intentional alteration of accounting records, misrepresentation of transactions, and intentional misapplication of accounting principles.

8.7.1.1. Internal fraudulent financial reporting by the agency or one its units.

8.7.1.2. External fraudulent financial reporting by bidders, contractors, recipients, subrecipients, grantees, etc.

8.7.2. Misappropriation of assets involves the theft of an agency's assets. This could include theft of property, embezzlement of receipts, or fraudulent payments.

8.7.3. Corruption refers to bribery and other illegal acts.

8.8. In addition to fraud, agency management should consider other forms of misconduct such as waste and abuse.

8.8.1. Waste is the act of using or expending resources carelessly, extravagantly, or to no purpose.

8.8.2. Abuse involves behavior that is deficient or improper when compared with behavior that a prudent person would consider reasonable and necessary operational practice given the facts and circumstances. This includes the misuse of authority or position for personal gain or for the benefit of another.

8.8.3. Waste and abuse do not necessarily involve fraud or illegal acts. However, they may be an indication of potential fraud or illegal acts and may still negatively impact the achievement of defined objectives.

9. No two agencies will have an identical internal control system because of differences in factors such as mission, regulatory environment, strategic plan, agency size, risk tolerance, and information technology, and the judgment needed in responding to these differing factors.

9.1. Internal control principles apply to both large and small agencies. However, smaller agencies may have different implementation approaches than larger agencies.

9.2. Any internal control system, however, should provide reasonable assurance regarding the prevention or prompt detection and correction of unauthorized acquisition, use, or disposition of an agency's assets.

10. Agency management retains responsibility for the performance of processes assigned to service organizations.

11. Tools available to agencies to support their efforts to implement, maintain and strengthen their internal control structures include:

11.1. The AGA's Fraud Prevention Tool

https://www.agacgfm.org/Tools-Resources/intergov/Fraud-Prevention.aspx

11.2. The AGA's Risk Assessment Monitoring Tool

https://www.agacgfm.org/Tools-Resources/intergov/More-Tools/Risk-Assessment-Monitoring-Tool.aspx

12. To support the internal control principles and practices set forth above, agency management is responsible for ensuring that policies and procedures are codified, published, appropriately distributed and enforced for all operations that require or may benefit from them.

13. While agency management is responsible for its agency's internal controls and enforcement of those controls, this fact does not preclude other entities with appropriate jurisdiction and authority from prescribing, evaluating, investigating, imposing or enforcing existing or additional internal controls