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Internal Control

Policy Objectives:

The primary objective of this policy is to enhance Admin employees' understanding that internal controls are necessary to ensure:

- Reliable financial and operational information,
- Compliance with policies and procedures, plans, laws, rules and regulations,
- Assets are safeguarded,
- Operational efficiency, and
- Achievement of established objectives and goals for Admin's operations and programs.

This policy is also designed to:

- Broadly define internal control,
- Clarify each Admin employee's responsibility to make important contributions for effective internal control,
- Identify areas that are particularly vulnerable to weaknesses in internal control, and
- Provide guiding principles for effective internal control.

Background Information:

In 1985, the Treadway Commission, also known as the National Commission on Fraudulent Financial Reporting, was established by the joint sponsorship of the American Institute of Certified Public Accountants, the American Accounting Association, the Institute of Internal Auditors, the Institute of Management Accountants and the Financial Executives Institute. The Treadway Commission's major objective was to identify the causal factors of fraudulent financial reporting and to make recommendations to reduce its incidence. The Commission's report, issued in 1987, called for the sponsoring organizations to work together to develop a common reference point of internal control by integrating various control concepts and definitions.

From this recommendation, the Committee of Sponsoring Organizations (COSO) of the Treadway Commission undertook a project to provide practical, broadly accepted criteria for establishing internal control and evaluating its effectiveness. The COSO *Internal Control – Integrated Framework,* published in 1992, is the product of this study. The COSO *Internal Control – Integrated Framework* provides a broad definition of internal control, its objectives, fundamental concepts, and interrelated components. The framework is designed to meet management's needs since management is responsible for establishing, monitoring, evaluating, and reporting on the effectiveness of internal control.

The COSO *Internal Control – Integrated Framework* has gained recognition and acceptance nationally among businesses and other entities, including government. Other professional associations in nations, like Canada and the United Kingdom, have developed similar internal control models.

In 1995, the Department of Minnesota Management and Budget (MMB) developed a statewide policy on internal control. (Refer to a description of this policy in the authority section below.) The MMB policy is silent to internal control objectives like reliable financial reporting, compliance with laws, and operational efficiency. It also does not address other internal control components including the control environment, risk assessment, monitoring, and communication. This agency internal control policy compensates for this void and provides guidance to all staff on internal control.

Authority:

- **MAPS Operations Manual Policy and Procedures 0102-01** states management has a primary responsibility to safeguard public resources entrusted to their care and mandates internal control elements for accounting processes. These elements include proper authorizations, separation of duties, documentation for audit purposes, access controls, and independent checks. (http://www.mmb.state.mn.us/chapter-1/201-201)

Business Risks:

Internal control is essential to maintain fiscal and operational accountability in state government. Internal control helps to produce reliable data and meet our responsibilities to taxpayers. Effective internal control opens the door that leads to successful achievement of agency objectives. Ineffective (weak) or nonexistent internal controls create opportunities for the following conditions to occur.

- Fraud, waste, and errors may result when controls are weak. They can, in extreme cases, cause failure to reach objectives with potentially dire consequences: bankruptcy, collapse of major programs, and financial disaster.
- Organizations may become ineffective, inefficient, and unable to achieve their objectives.
- Non-compliance with laws and regulations may result in fines, penalties, prosecution, termination, and embarrassment.
- Financial information may be unreliable and result in poor business decisions.

Policies and Procedures:

1. Internal Control Defined

   A. Definition of Internal Controls – The COSO *Internal Control – Integrated Framework* defines internal control as processes, effected by management and other personnel, designed to provide reasonable assurance that the following objectives can be achieved:
      1. Effectiveness and efficiency of operations,
      2. Reliability of financial reporting, and
      3. Compliance with applicable laws and regulations.

   B. Internal control consists of five interrelated components:
      1. Control environment,
      2. Risk assessment,
      3. Control activities,
      4. Information and communication, and
      5. Monitoring.

2. Roles and Responsibilities of Admin Employees Relative to Internal Controls

   A. Responsibilities of all Admin employees
      1. All Admin employees are responsible to make important contributions for effective internal control. They may produce information, perform various activities to comply with pertinent laws, safeguard resources, or take other actions needed to effect control.
      2. All Admin employees are responsible for communicating problems in operations, deviations from established standards, and instances of noncompliance with laws.

   B. Additional responsibilities of Admin's Management Team and supervisors:

1. E-Team members should provide leadership and direction to Admin's Management Team and supervisors. Together they shape Admin's guiding values, disciplined business conduct, and major operating policies that form the foundation of the agency's internal control structure.
2. Division directors should provide guidance to management and supervisors responsible for major functional areas in setting objectives, assessing risks, and evaluating internal controls.
3. Managers and supervisors should design and implement internal controls. Once internal controls are implemented, managers and supervisors are responsible for maintaining and supporting the internal control system, as well as discouraging circumvention of internal controls.
   a. Supervisors should provide adequate supervision necessary to ensure that internal controls are operating as intended, and to ensure the reliability for accounting, operational, and compliance controls by pointing out errors, omissions, exceptions, and inconsistencies in procedures.
   b. Managers should periodically review procedures to ensure that general internal control concepts are being followed. Management is responsible for strengthening internal controls when weaknesses are detected.
4. Managers and supervisors are responsible for obtaining the necessary training on internal controls for themselves and their staff.

C. Responsibilities of other persons
1. Internal auditors should evaluate the effectiveness of internal controls, but they are not responsible for establishing or maintaining them.
2. Outside parties, such as external auditors, can also evaluate the effectiveness of internal controls and provide recommendations for improving internal controls.

3. <u>Areas Vulnerable to Weak Internal Controls</u> - Areas experiencing any of the following conditions are particularly vulnerable to having inadequate internal controls:

A. High volume of cash transactions,
B. Benefit payments (non-vendor payments),
C. Implementation of new programs,
D. Computer hardware and software conversions,
E. Complex program requirements,
F. Turnover of key personnel,
G. Divisions with financial stress such as cash flow problems, and
H. Rapid organizational changes.

4. <u>Internal Control Guiding Principles</u>

A. In establishing, monitoring, evaluating, and reporting on internal controls, agency personnel should refer to the COSO *Internal Control Integrated Framework* for guidance.
B. The following criteria offer insight into what effective internal controls should look like and should be used for establishing and evaluating the adequacy of an internal control structure in an Admin division.
1. Control Environment – A positive control environment is a work atmosphere that instills integrity, builds control consciousness among its employees, and fosters shared ethical values and teamwork in pursuit of agency objectives. Meeting the criteria below is essential to attain a positive control environment.
   a. Shared ethical values, including integrity, should be established, communicated, and practiced throughout the agency.
   b. People should have the necessary knowledge, skills, and tools to support the achievement of the organization's objectives.
   c. An audit committee should exist, with sufficient knowledge and experience, to scrutinize agency activities and the appropriateness of management's actions.
   d. Management's philosophy and operating styles should be consistent with agency beliefs and values.

e. Organization structure within each bureau should provide an appropriate framework within which division activities for achieving agency objectives are planned, executed, controlled, and monitored.
f. Authority, responsibility, and accountability should be clearly defined and consistent with the agency's objectives so that appropriate personnel make decisions and take necessary actions.
g. An atmosphere of mutual trust should be fostered to support the flow of information between individuals and their effective performance toward achieving objectives.

2. Risk Assessment – Effective risk assessment processes are necessary to identify and to deal appropriately with constantly changing economic, industrial, regulatory, and operating conditions. These conditions impact a division's ability to maintain its financial strength, a positive public image, and the overall quality of its products and services.
   a. Criteria for risk assessment are identified below.
      1. The agency's strategic plans and objectives should be established and communicated to all employees.
      2. Work plans to guide efforts in achieving Admin's objectives should be established and communicated.
      3. Significant internal and external risks that a division faces in achieving its objectives should be identified, analyzed, and managed at an acceptable, cost-effective level.
      4. Mechanisms should exist to anticipate, identify, and react to events, activities, or conditions that signal new risks and demand management's attention to reevaluate objectives or controls.
   b. The risk analysis process should include estimating the significance of identified risks, assessing the likelihood (or frequency) of the risks occurring, and determining needed actions to manage the risks at an acceptable level.
3. Control Activities – Control activities are designed to ensure management's objectives are carried out effectively. Criteria for control activities are listed below.
   a. Policies and procedures designed to support the achievement of a division's objectives and the management of its risks should be established, communicated, and practiced so that all staff understand what is expected of them and the scope of their freedom to act.
   b. Other control activities should be designed as an integral part of the organization, taking into consideration its objectives, the risks of their achievement, and the inter-relatedness of control elements. These controls include approvals, authorizations, verifications, reconciliations, reviews of operating performance, physical controls to secure assets, performance indicators like trend or variance analyses, and separation of incompatible duties.
4. Monitoring – Monitoring is a process that assesses the quality of a system's performance over time. It can be accomplished in ongoing management and supervisory activities, separate evaluations, or a combination of the two. The criteria identified below help to ensure internal controls are operating effectively.
   a. Ongoing monitoring procedures should be built into normal, recurring operating activities to provide important feedback on the effectiveness of control components.
   b. Separate evaluations, like self-assessments or internal audits, should focus on the effectiveness of a control system or ongoing monitoring procedures.
   c. Follow-up procedures should be established and performed to ensure appropriate change or action occurs in a timely manner, with complete resolution of any detected problems or exceptions.
   d. Mechanisms should exist for capturing monitoring results and reporting control deficiencies appropriately to individuals responsible for the function or activity involved, and those individuals in a position to take corrective action.
5. Communication and Information - Criteria for effective communications between Admin employees and with external parties is listed below.
   a. Communication processes should support the organization's values and the achievement of its objectives. Effective communication must flow down, up, and across the organization.
   b. Sufficient and relevant information should be identified and communicated timely in a usable format to enable employees to perform their assigned duties.

c. The decisions and actions of different parts of the agency should be coordinated, whenever practical.
d. Information needs and related information systems should be reassessed as objectives change or as reporting deficiencies are identified.

See Also:

COSO *Internal Control – Integrated Framework*
Refer to the *Glossary* for definitions of the key terms listed below:

E-Team	Management Team
Effective control	monitoring
Internal control	reasonable assurance