

Internal Control Manual



Training for State Agencies

Peter Franchot, Comptroller



Internal Controls

- Sarbanes-Oxley Act of 2002
- Increased federal scrutiny
- Recent discovery of governmental weaknesses



Management Accountability

- Expectation that managers are responsible for:
 - Quality and timeliness of program performance
 - Increasing productivity
 - Controlling costs
 - Mitigating adverse aspects of operations
 - Management of programs with integrity
 - Compliance with applicable laws



Internal Control

- The organization, policies and procedures which are tools to help program and financial managers achieve results and safeguard the integrity of their programs.



Objectives

- Effective and efficient operations
 - Must be effective to be efficient
- Reliable financial reporting
- Compliance with applicable laws and regulations



Internal Control

- Is a means of “managing” the risk
 - Of waste, fraud, and mismanagement
- It does not eliminate risk



Internal Control

- Not an isolated management tool
- Should be integrated with other efforts to improve effectiveness and accountability



Internal Control Structure

- Financial/Accounting Controls
 - Controls on authorizing, processing, recording, and reporting transactions



Internal Control Structure (cont.)

- Administrative Controls:

Broad controls on all activities of the organization:

- Organizational controls

- Program and Operational controls



Internal Control Framework



Managers

- Define the control environment
- Perform risk assessments
- Implement control activities
- Communicate objectives
- Continually monitor and test controls
- Redesign or improve controls



Control Environment

- Created by management:
 - Organizational structure, for example, clearly defined areas of authority and responsibility,
 - Culture, i.e., management's leadership in setting values of integrity and ethical behavior



Risk Assessment

- Identify internal and external risks that may prevent organization from meeting its objectives
- Identified risks should be analyzed for their potential effect or impact on the agency



Control Activities

- Examples include:
 - Segregation of duties
 - Physical control over assets
 - Appropriate documentation
- Information Technology systems:
 - Need general (mainframe, network)
 - and application (transactions, data) controls



Information and Communication

- Effective lines of communication within organization and outside of it
- Communicated to relevant personnel at all levels
- Information should be relevant, reliable and timely



Monitoring & Follow-up

- Should be routine
- Periodic assessments
- Deficiencies identified, evaluated and corrected



Internal Control Review

- An aid for management
 - To learn of areas of vulnerabilities
 - Addresses weaknesses
- Needs to be done by responsible individuals
- Questions can and should be tailored to suit the individualities of the agency



Internal Control Review

- 1. Organize the Evaluation
- 2. Segment the Department
- 3. Conduct Risk Assessments
- 4. Develop plans for follow-up
- 5. Conduct detailed reviews
- 6. Take corrective action
- 7. Prepare reports



Organize the Evaluation

- Assign responsibilities
 - Appoint an internal control coordinator
 - Assure that each department is involved and completes analyses
- Commit an adequate level of resources



Internal Control Coordinator

- Plans, directs and controls the evaluation process
- Tracks the status of the evaluation and corrective actions
- Develops information needed to manage the process
- Prepares the final report



Divide the Entity

- “Segment” along:
 - Organizational lines
 - Activity (functional) lines
- Assign responsible individuals
- Provide overall dates and guidelines



Factors to Consider

- Clear organizational lines, multiple locations, independent functions, materiality
- Or by activity - related events and processes which satisfy a function of the department



Purpose

- Identify manageable entities
- Assure that
 - Meaningful evaluations are made
 - Knowledgeable individuals perform assessments
- Include all functions and activities
- All important risks are identified



Conduct Risk Assessments:

- Analysis of the general control environment
- Analysis of the inherent risks
- An evaluation of safeguards
- Assessment of results
- Subsequent action plans



Volume II

- Evaluation:
 - Forms IC-1, IC-2, IC-3.1, IC-3.2

- Assessment of Evaluation Results:
 - Form IC-4



Forms

- Provide questions that highlight areas of risk
- Management will use its judgment to prioritize
- Comments column will help with final decisions
- Top priority – High inherent risk with poor control environment and safeguards



Risk Assessments / General Control Environment

- Entity managers determine if acceptable general controls exist
- Evaluates:
 - Factors such as management attitude; organizational structure; personnel; policies and procedures, organizational checks and balances



Form IC-1

- Factor:
 - A. Management Attitude;
 - A.2; Management has communicated.....
 - B. Organization Structure
 - B.1 Organization chart is current.....
- Assessment
 - N/A, Yes, No, Needs Development, Comments



Assessment

- If response is yes – then copies should be provided for review; if not – the answer should be “No” or “Needs development”



Negative Answers

- Forms developed in this manner to alert agencies to what is expected and what can cause risks
- Usually mean there is a “weakness”
- Need to be evaluated to determine whether additional action or follow-up is needed



Assessment

- In Comments column – fill in what should be done, how long it will take, location of documentation, mitigating circumstances, other relevant information



Risk Assessments / Inherent Risks Form IC-2

- Purpose of the entity
- Recent changes that increase risk
- Budget level, procurement
- Special concerns
- Prior reviews



Risk Assessments

- Identify areas where internal control systems need to be strong
- And should be regularly and closely evaluated and monitored



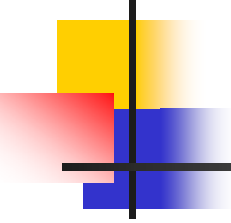
Evaluation of Safeguards

- Form IC.3.1
 - Addresses the Department's program operations and administrative functions
- Form IC.3.2
 - Addresses the Information Technology operations



Internal Accounting and Administrative Controls

- Detailed questionnaire on controls
- Developed specifically for use by state agencies
- Form may be modified to better suit an agency's uniqueness
- GAD will e-mail the spreadsheet



Internal Control over Financial Reporting

- Sarbanes-Oxley Act requires separate assessment and reporting
- Review Chapter VI before completion of Form IC-3.1
 - Assists in understanding of objectives for internal control over financial reporting when modifying and completing this Form



Objectives of Financial Reporting Controls

- All reported transactions, assets and liabilities
 - Actually occurred, exist
 - All that should be, are included
 - None are unauthorized
 - Valuation is proper



Objectives (cont.)

- All reported transactions, assets and liabilities -
 - Legal rights and legal obligations
 - Presentation and disclosure - reports
 - Compliance with laws and regulations
 - Safeguarded against fraud and abuse



Perform Analytical Reviews

- Determine reasonableness of financial data
 - By comparing it to other financial and non-financial data
 - By attempting to compare it to what is reasonably expected
 - Research reasons for questionable data



Evaluation of Safeguards Questionnaire

- A “no” answer indicates an area which must be addressed
- Should be considered for corrective action – unless there are compensating controls
- Evaluations should consider
 - Cost/benefit
 - Effectiveness



Comments Column

- Briefly describe compensating controls
- Reference supporting documentation
 - Detailed descriptions
 - Procedures manuals, etc.



Example

- Cash - general
 - Written instructions
 - Listings
 - Periodic review of activity
 - Segregation of duties



Cash (cont.)

- Procedural
 - List at time of opening
 - Restrictively endorse immediately
 - Pre-number receipts
 - Use and account for
 - Maintain inventory records of forms
 - Separate cash drawers



Note:

- Some questions pertain to statewide controls - issued under Manuals whether DGS, GAD or other control agencies – Review entities' procedures to assure compliance
- Or if your entity is not subject – make sure similar controls are established to meet objectives



Financial Reporting

- Separate Section (I.) in Questionnaire
- Keep in mind objectives when reviewing each section
 - Example: Are cash reports reviewed by management for reasonableness, unexpected differences – which are researched when found



Assessment of Evaluation Results

- Form IC-4
- Complete for each open item that has not been corrected by the end of the review



Detailed Reviews

- Required when the risk assessments show a vulnerability that cannot be corrected, or mitigated, without further study
- Evaluation results show an area of high risk and poor controls



Detailed Reviews

- Used whenever management feels an area or function should be carefully studied and evaluated
- Forms IC-5, 6, 7 and 8
- Management develops and tests its own control objectives and techniques



Appendix (Volume I)

- A – provides sample Internal Control Objectives and Techniques
- B – Procedures for flowcharts and working papers
- C - A listing of basic internal controls
 - Useful to know, especially when implementing/changing programs or procedures



Report on the Status of Internal Controls

- Letter to governing body – Executive Board, Secretary, etc.
- Prepared by Internal Control Coordinator
- Includes an assessment of the internal controls
- Lists material weaknesses and corrective action



Reminder: Causes of Fraud

- Pressures, internal and external
- Rationalization
- Opportunity
 - Is key to fraud
 - Poor internal controls promote fraud



Fraud Detection

- Remember - anyone can commit fraud
- Do not dismiss tips
- Use analytical reviews to identify potential problems
- Carefully examine unusual transactions
- Carefully examine documentation



GAD Web-site

[http://compnet.comp.state.md.us
/default.shtml](http://compnet.comp.state.md.us/default.shtml)

Click on General Accounting
Division", "State agencies",
"Forms and manuals"



Any questions?

- **General Information**

- **E-mail:** gad@comp.state.md.us

- **Fax:** 410-974-2309