



20.15 Internal Control Basics

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July 1, 2008

Background

In the United States there is common guidance on the structure of internal control systems. This is due in part to guidance issued by the American Institute of Certified Public Accountants (AICPA) and the federal Office of Management and Budget (OMB). It is also due to a 1992 report on internal control, *Internal Control – Integrated Framework (Framework)*, issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). An addendum was published in 1994, and the *Framework* has remained unchanged since then.

The *Framework* is the national internal control standard, and Chapter 20 has been and continues to be based on *Framework* guidance. In 2006, COSO published additional guidance on how to apply the *Framework* and in 2007 and 2008, published *Guidance on Monitoring*. In addition to the aforementioned COSO updates, new standards were recently adopted by the AICPA and OMB that strengthen assessment and reporting requirements for internal controls. Chapter 20 incorporates concepts from the updated COSO guidance and the new AICPA and OMB standards.

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Internal control definition

Internal control is a process – effected by those charged with governance, management, and other personnel – designed to provide reasonable assurance about the achievement of the entity’s objectives. For purposes of Chapter 20, the state’s objectives per RCW 43.88.160 fall into separate but related categories:

- Safeguard its assets.
- Check the accuracy and reliability of its accounting data.
- Promote operational efficiency.
- Encourage adherence to policies for accounting and financial controls.

This definition of internal control reflects the following fundamental concepts:

- Internal control is a process. It is not one event, but a series of ongoing actions and activities that occur throughout each agency's operations and should be an integral part of each agency rather than an add-on system within an agency.
- People are what make internal control work. While the responsibility for good internal control ultimately rests with management, all agency personnel play important roles.
- No matter how well designed and operated, internal control can provide only reasonable (not absolute) assurance that all agency objectives will be met.

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Who is responsible for internal control?

Each agency, regardless of size, is required to adopt methods to periodically assess risk and to develop, implement, and review its system of internal controls. The methods should be tailored to the specific needs of the agency.

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The **agency head or authorized designee** is ultimately responsible for identifying risks and establishing, maintaining, and reviewing the agency's system of internal control. If the agency head delegates this responsibility, the designated person should have sufficient authority to carry out these responsibilities. Normally, this person is a senior agency manager who does not serve in the internal audit function.

20.15.30.b

The **internal control officer** (ICO) is responsible for coordinating the agency-wide effort of evaluating internal controls, reporting on reviews, and improving control activities, using the guidance in this chapter. This person provides assurance to the agency head that the required risk assessments and the necessary evaluative processes have been done. In some agencies the ICO may perform these duties on a full-time basis. In other agencies the ICO duties may be assigned to staff who also perform other duties as long as the other duties are not incompatible with the ICO duties. Refer to Subsections 20.15.40.b and 20.15.50.

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20.15.30.c **Agency management** at all levels is responsible for internal control under their span of control. Management should make it clear that **agency staff** have explicit or implicit control activity duties including: delivery of services to the public; producing information for the management control system; maintaining financial information; and inspecting or maintaining physical assets. In addition, agency management should provide channels outside normal reporting lines so agency staff can report problems in operations, noncompliance with codes of conduct, violations of policy, and illegal acts.

Management is also responsible to convey the importance of internal controls to all personnel both by what they say and what they do. If management is willing to override controls, then the message that controls are not important will be conveyed to employees.

20.15.30.d **Each agency employee** is responsible to be aware of and attentive to risk management and internal control issues, to consider limitations and key risk areas, to document decisions and to provide support information. To be most effective, employees need to understand the agency's mission, objectives, responsibilities, and their own role in managing risk. Each employee is also responsible to report to management noncompliance with codes of conduct, violations of policies, and illegal acts.

20.15.30.e The **internal auditor or other professionals** (internal or external to the agency) may provide technical assistance in developing appropriate procedures to conduct risk assessments and internal reviews of control activities.

20.15.30.f Depending on an agency's governance structure, an **audit committee** could help the agency review, monitor, and/or direct the agency's activities related to maintaining effective internal control. An agency audit committee could also improve financial practices and reporting and enhance both the internal and external audit functions.

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Internal control framework components

There are five interrelated components of an internal control framework: control environment, risk assessment, control activities, information and communication, and monitoring. These components make up the minimum level of internal control an agency needs to have in place and are the basis against which internal control is evaluated.

To implement the framework, management develops the detailed policies, procedures, and practices to fit their agency's operations, and ensures that they are built into and are an integral part of operations. If an agency considers the framework components in its planning efforts and builds them into its daily processes, the agency will be poised to achieve the maximum benefit for the lowest cost.

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Control environment

The control environment of an agency sets the tone of the organization and influences the effectiveness of internal controls within the agency. The control environment is an intangible factor. Yet, it is the foundation for all other components of internal control, providing discipline and structure and encompassing both technical competence and ethical commitment.

Management is very influential in determining the control environment and influencing the control consciousness of agency staff. Internal controls are likely to function well if management believes that those controls are important and communicates that view to employees at all levels. Conversely, internal controls are likely to be ineffective if management does not believe the controls are important or if management communicates a negative view of controls to employees.

Management influences the control environment through their integrity and ethical values, commitment to competence, philosophy and operating style, design of the organizational structure, assignment of authority and responsibilities, and human resource policies and practices.

Management also influences the control environment through communication of the agency's values and behavioral standards to employees. This can be done by setting a good example, showing a positive attitude toward accounting and internal control, displaying and following a formal code of conduct, communicating other agency policies and procedures, taking swift and appropriate disciplinary action in response to policy departure, and maintaining clear and updated job descriptions.

20.15.40.b

Risk assessment

Within the context of the state's operating environment, management sets goals and objectives at the unit and agency level that align with the agency's mission and state law. Objectives must exist before management can identify potential events affecting their achievement.

Risk assessment is the process of: identifying risks to achieving agency objectives; analyzing potential events, considering their likelihood of occurring and impact on achieving agency objectives; and deciding how to respond to the risks.

The first step is risk identification, which is the ongoing process of collecting, analyzing and adjusting information about what could happen in agency operations that would adversely affect the ability to achieve agency objectives.

To fully identify risks, both internal and external events that can affect the achievement of an agency's objectives need to be considered. Risk identification methods may include qualitative and quantitative ranking activities, forecasting, strategic planning, and consideration of findings from audits and other assessments.

Management should be aware of potential high-risk areas and should look for high risk where:

- There is a susceptibility to or history of waste, fraud, or errors.
- Changes have occurred in the organizational structure, systems, or personnel.
- Controls have not been reviewed for a substantial period of time.

The second step is analyzing the key risks for their possible effect, considering likelihood and impact. **Likelihood** is the possibility that a specific event will occur. **Impact** is the result or effect of an event.

The third step is deciding how to respond to each risk. The most common risk responses are avoiding, reducing, transferring (sharing), and accepting risk. A complete risk response should consider what actions to take and who is responsible. Refer to Section 20.20 for more information on risk assessment.

20.15.40.c **Control activities**

Control activities help ensure risk responses are effectively carried out and include policies and procedures, manual and automated tools, approvals, authorizations, verifications, reconciliations, security over assets, and segregation of duties. These activities occur across an agency, at all levels and in all functions, and are designed to help prevent or reduce the risk that agency objectives will not be achieved.

Managers set up control activities to provide *reasonable assurance* that the agency and business unit objectives are met. An example of a control activity is something as simple as listing tasks assigned to staff members and then periodically checking the list to verify that assignments are completed on time. Refer to Section 20.25 for further discussion of control activities.

20.15.40.d **Information and communication**

An agency's control structure must provide for the identification, capture and exchange of information both within the agency and with external parties. Information communicated should be timely and accurate.

Risk communication creates a dialog about the existence, nature, severity, or acceptability of risks. The identification of new risks or changes in risk is dependent on communication.

Communication can be formal through reports, training, written policy manuals, accounting and financial reporting manuals, websites, memoranda, etc. Information is also communicated informally through email, speech, and actions of management and other agency personnel.

Effective **internal communication** happens when information can travel in all directions within an agency – up, down, and across. Clear internal communication conveys the agency's code of ethics, internal control philosophy and approach, and delegation of authority. Communication effectively conveys the importance and relevance of internal control and the roles each person plays to support it, including the means of reporting exceptions to an appropriate higher level within the agency.

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Open **external communication** channels allow stakeholders, including citizens, clients, and suppliers, to understand the agency's service standards and provide valuable input on performance and service quality and effectiveness. This exchange enables an agency to address evolving needs, demands, and preferences. Management should appropriately convert such input into continuous improvements in operations, reporting, and compliance.

20.15.40.e

Monitoring

Things change and, by monitoring the risks and the effectiveness of control measures on a regular basis, an agency can react dynamically to changing conditions.

Monitoring evaluates the effectiveness of an agency's internal controls and is designed to ensure that internal controls continue to operate effectively. Monitoring is effective when it leads to the identification and correction of control weaknesses *before* they **materially** affect the achievement of the agency's objectives.

An agency's internal control is most effective when there is a proper monitoring control environment, results are prioritized and communicated, and weaknesses are corrected and followed up on as necessary.

There are two types of monitoring: ongoing and periodic. Ongoing monitoring occurs in the course of operations. It includes tasks such as supervisory reviews of reconciliations, reports, and processes. Periodic monitoring includes tasks such as periodic internal audit sampling and annual reviews of high-risk business processes. Internal control deficiencies uncovered by monitoring should be reported to higher levels of management.

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Annual requirements for agencies

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Annual assurance

A risk assessment and internal control review process provides management with reasonable assurance that controls are operating as expected. In addition, the process should be used to determine if internal control modifications are needed by considering events that have occurred, processes or procedures that have changed, new projects or programs that are being planned or implemented, and other changes within the agency that may have additional risks. If the review uncovers internal control weaknesses or if prior weaknesses still exist, they should be documented and addressed.

Periodically, an agency should conduct a comprehensive review of the internal control structure to determine if it is adequately addressing agency risks. This can be done agency-wide at one time or by sections of the agency over a period of time.

Agencies must maintain adequate written documentation of activities conducted in connection with risk assessments, review of internal control activities and follow-up actions. This documentation includes any checklists and methods used to complete these activities. Refer to Subsection 20.25.50 for required documentation. For sample checklists and procedures, refer to the OFM Administrative and Accounting Resources website at: <http://www.ofm.wa.gov/resources/default.asp>.

Agencies have the flexibility to assign appropriate staff to complete the risk assessments and review of internal control activities required by this policy. The internal control officer is the person appointed by the agency head who is assigned responsibility for coordinating and scheduling the agency-wide effort of evaluating and reporting on reviews and improving control activities. The internal control officer also provides assurance to the agency head that the agency has performed the required risk assessments and the necessary evaluative processes. This communication may be ongoing and informal, but **at least once per year**, this assurance must **be made in writing** to the agency head.

The internal control officer is responsible for ensuring that the required documentation is maintained and available for review by agency management, the State Auditor's Office (SAO), and OFM.

20.15.50.b **Annual reporting**

Annually, each agency head and chief financial officer is required to sign and submit a Financial Disclosure Certification and, if applicable, a Federal Assistance Certification, to OFM's Accounting Division. By signing the certification(s), they certify that:

- They are responsible for establishing and maintaining effective internal controls over financial reporting.
- Their agency's system of internal controls complies with the requirements of Chapter 20.
- If applicable, they have established and maintained effective internal control over compliance for federal programs.

A summary description of any material internal control weakness(es) and a brief corrective action plan must be attached to the certification. Refer to Subsections 90.40.95 and 95.20.90.