Internal Control Program

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Purpose

This policy outlines the requirements for state agencies to implement, assess, and maintain good internal controls over state operations, financial reporting, and compliance.

Policy

A. Agencies must establish and maintain sound internal controls based on the five components of internal control.
B. Agencies must establish and maintain proper segregation of duties.
C. Agencies must participate in the Internal Control Program as described in this policy.

Background

As a result of the passing of the Sarbanes Oxley Act of 2002, governments experienced pressure to establish enhanced internal control frameworks similar to those used by U.S. public company boards, management, and public accounting firms. In addition, auditing standards were revised to emphasize the responsibility of management for internal control.

The Director of the Division of Finance is authorized and required by state statute to do the following:

- "provide for the accounting control of funds" UC 63A-3-103(1)(b);
- "prescribe other fiscal functions required by law or under the constitutional authority of the governor to transact all executive business for the state." UC 63A-3-103(1)(h);
- "exercise accounting control over all state departments and agencies." UC 63A-3-203(1)(a);
- "maintain a financial control system according to generally accepted accounting principles." UC 63A-3-204(1)(a).

To ensure compliance with auditing standards and the state statutes listed above, the State Division of Finance established an Internal Control Program to help ensure that agencies develop and maintain a good system of internal control.

The State Division of Finance participated with the National Association of State Comptrollers (NASC) in developing internal control questionnaires (ICQs) that may be used by all states to aid in the implementation and development of an effective internal control system and program. The Division of Finance then modified some of the ICQs to better fit the needs of Utah state agencies. The ICQs are the basis for the Internal Control Program.

Benefits of the Internal Control Program

The benefits of the program include the following:

- Reducing:
  a. The risk of fraud and errors in financial statements and reports,
  b. The risk of loss, misuse, or waste of taxpayer dollars or other assets,
  c. The risk of noncompliance with state and federal laws and state policies and procedures,
  d. Embarrassment and repercussions that can come from related events.
- A process to assist each agency in fulfilling their internal control responsibilities.
- A designated contact within the State Division of Finance who has a background in internal control.

- A designated agency contact that has a background in internal controls that can coordinate and work with the State Division of Finance.
- A process to assist the State's central management in assessing the condition of internal control systems in agencies.

Responsibilities of State Agency Management

Management of each state agency is responsible for establishing, monitoring, and maintaining internal control. The effectiveness of internal control depends on how well the five components of internal control, discussed below, are implemented at each agency. The State's internal control program is designed to help both state and agency management determine whether an effective internal control system has been designed and deployed at the agency level.

What is Internal Control?

According to COSO[1], internal control is broadly defined as a process, effected by an entity's board of directors, management and other personnel, designed to provide reasonable assurance regarding the achievement of objectives in the following categories:

- Effectiveness and efficiency of operations.
- Reliability of financial reporting.
- Compliance with applicable laws and regulations.

Components of Internal Control[2]

Internal control consists of five interrelated components, derived from the way management runs operations, and are integrated with the management process. The components represent what is needed to achieve the objectives listed above. When looking at any one category – the effectiveness and efficiency of operations, for instance – all five components must be present and functioning effectively to conclude that internal control over operations is effective.

The following is a brief overview of the five internal control components (see also the State Division of Finance Internal Control Guide).

1. **Control Environment**
   The control environment sets the tone of an organization, influencing the control consciousness of its people. It is the foundation for all other components of internal control, providing discipline and structure. It includes factors such as the integrity, ethical values and competence of the entity's people; management's philosophy and operating style; the way management assigns authority and responsibility, and organizes and develops its people; and the attention and direction provided by management.

2. **Risk Assessment**
   Every entity faces a variety of risks from external and internal sources that must be assessed. Risk assessment is the identification and analysis of relevant risks to achievement of management objectives, forming a basis for determining how the risks should be managed. Examples of these risks include new employees, new information systems and technology, and new organization structures.

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[1] COSO is a voluntary private sector organization dedicated to improving the quality of financial reporting through business ethics, effective internal controls, and corporate governance. COSO is jointly sponsored by the American Accounting Association, the American Institute of Certified Public Accountants, Financial Executives International, the Institute of Internal Auditors, and the Institute of Management Accountants.

[2] Source: COSO

3. **Control Activities**
   Control activities are the policies and procedures that help ensure management directives are carried out, helping to ensure that necessary actions are taken to address risks to achievement of the entity's objectives. Control activities include procedures such as approvals, verifications, reconciliations, security of assets, and segregation of duties. (More information on segregation of duties is included below in this policy.)

4. **Information and Communication**
   Pertinent information must be identified, captured in information and accounting systems, and communicated in a form and timeframe that enable people to carry out their responsibilities. Effective communication also must occur in a broader sense, flowing down, across, and up the organization. All personnel must receive a clear message from top management that control responsibilities must be taken seriously.

5. **Monitoring**
   Internal control systems need to be monitored - a process that assesses the quality of the system's performance over time – and is accomplished through ongoing monitoring activities, separate evaluations, or a combination of the two.

Segregation of Duties
Segregation of duties is one of the most important features of effective internal control and is one of the Control Activities discussed in the Components of Internal Control section above. The fundamental premise of segregated duties is that an individual or small group of individuals should not be in a position to initiate, approve, undertake, and review the same action. These are called incompatible duties when performed by the same individual. Examples of incompatible duties include situations where the same individual (or small group of people) is responsible for:

- Managing both the operation of and record keeping for the same activity
- Managing custodial activities and record keeping for the same assets
- Authorizing transactions and managing the custody or disposal of the related assets or records.

Procedures

Responsibility	Action
Finance	Provide Internal Control Questionnaires (ICQs) to be used by state agencies to assess their internal controls. Determine which ICQs are required and which are optional. Set deadlines for completion and submission of the ICQs and corrective action plans to the Division of Finance and the agency internal auditor (as applicable). Follow up with agencies to ensure ICQs are completed, problems noted are addressed in corrective action plans, and agency management has signed-off on the ICQs. Perform internal control field audits to ensure agencies: • Understand the ICQ questions • Have accurately reported internal control weaknesses, compensating controls, and proposed corrective action plans • Have implemented proposed corrective action plans Provide assistance to agencies on internal control issues and questions.

Agency ACT	The ACT (Agency Coordinating Team) lead member for each agency will be the main contact for the State Division of Finance for the Internal Control Program, unless an agency designates an alternative contact person. If an alternate is designated, they will need to attend the monthly ACT meetings to ensure that they receive information on the program.
Agency Chief Financial Officer (CFO)	The agency's chief financial officer (finance director or comptroller) shall determine how many of the required ICQs shall be completed. For example, the Cash Receipts ICQ should be completed for each separate receipting system and/or location in the agency. The agency's chief financial officer shall determine which of the optional ICQs will be completed. For example: Davis-Bacon, Federal Grant Administration, Investments.
Agency	Thoroughly complete the ICQs, following the instructions on each ICQ. Ensure that each "No" response is fully explained on the ICQ including identifying any compensating controls and any needed corrective action plans.
Agency CFO	The agency's top financial officer will review and approve each of the completed ICQs including any related corrective action plans.
Agency Head/ Executive Director	The agency head/executive director will sign each ICQ as an indication that they are aware of the completed ICQ and of any problems or corrective action needed.
Agency ACT	Submit the completed ICQs (including corrective action plans) signed by both the agency top financial officer and agency head, to the State Division of Finance by the required deadlines and provide copies to the agency internal auditor (if applicable).