Edward Karass
State Controller

Rebecca M. Wyke, Commissioner
Administrative & Financial Services

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SUBJECT: Statewide Internal Control

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TO: **All Departments and Agencies**

FROM: **Edward A. Karass, State Controller**

In the interest of promoting responsible, efficient and cost effective governance, the Office of the State Controller (OSC) has developed the following guidelines for departments and agencies concerning proper internal controls and financial management integrity. The Bureau of Accounts and Control has published the Internal Control Guide for Managers on its Website. The Guide provides Departments and Agencies with the standards and requirements necessary to implement the requirements of Title 5, §1541, sub-§10-A which was enacted in PL 2003, Chapter 451. The law requires that State agencies and departments be in compliance by June 2004.

The purpose of the Guide is to help managers evaluate the internal control systems and identify possible deficiencies within their areas of responsibility by requiring an annual self-evaluation and risk assessment process. Such an effort will lead to the implementation of more effective controls before problems arise. **OSC is committed to providing assistance to agency personnel in the completion of this important task.**

The final product of this process, an internal control self-assessment, will be completed annually by June 30 and kept on file at the agency. You are required to notify the OSC when the internal control plan has been completed, and annually thereafter as to required updates and changes to the plan. Notification must be received by June 30th of each fiscal year. The plan must be made available for inspection by the State Auditor, State Controller, and Commissioner of Administrative and Financial Services.

The internal control self-evaluation file should contain the back up materials for the self assessment (including worksheets, questionnaires and/or flowcharts describing the agency's financial operations), reports from auditors or consultants and the agency's response to those reports.

In addition to establishing the annual agency self assessment of internal controls, this Bulletin along with the Guide:

- Establishes responsibility for maintaining effective internal controls.

- Provides tools for Agencies to evaluate their own internal control structure.
- Defines what constitutes effective internal controls for the State of Maine.
- Institutes a mechanism for improving internal control deficiencies.

The management personnel of each State Agency are responsible for establishing and maintaining an effective internal control structure**. To fulfill this responsibility, estimates and judgments by management are required to assess the expected benefits and related costs for internal control policies and procedures.** The objectives of an internal control structure are to provide management with **reasonable assurance** that assets are safeguarded against loss from unauthorized use or disposition, that financial transactions are executed in accordance with management's authorization and recorded properly to permit the preparation of financial statements in accordance with generally accepted accounting principles (GAAP), and all state and federal laws as well as state and federal regulations are complied with by the agency. In addition, the management of each agency is responsible for adhering to the prescribed accounting policies and procedures as promulgated by the Office of the State Controller.

The United States General Accounting Office describes the significance of establishing and maintaining the internal control structure as an important management responsibility. Effective internal controls are essential to achieving the proper conduct of government business with full accountability for the resources made available. Internal controls also facilitate the achievement of management objectives by serving as checks and balances against undesired actions.

A well-designed internal control structure will reduce the risk of improper activity. The responsibility of designing and implementing internal controls is a continuous process. As conditions change, control procedures may become outdated and inadequate. Agency management must anticipate that certain procedures will become obsolete and modify internal control systems in response to these changes.

An annual self-evaluation and risk assessment shall be performed by each agency as a component of the documentation of controls. Documentation of internal controls usually takes the form of internal control questionnaires, written narratives, or flow charts. The traditional method of describing an internal control structure is to complete a standardized internal control questionnaire. The OSC's website provides some examples. Most internal control questionnaires are designed so that a "no" answer to a question indicates a weakness in internal control. If completion of the questionnaire is regarded as an end in itself, there may be a tendency to fill in the "yes" and "no" answers in a mechanical manner, without any real understanding or study of the transaction cycle. The intent is to have the evaluation team obtain a working knowledge of the existing internal control structure.

During each fiscal year, each agency may be subject to audit by the State Auditor or other audit agency with follow-up by the OSC's Internal Control Division. The audit report, compliance review, post audit report, or other evidence of an external review shall be filed in the internal control self-evaluation file. These materials should be reviewed, along with agency remedial actions taken, in preparing the self-evaluation questionnaire.

Beginning is Fiscal Year 2005, annually, prior to June 30th, each agency shall complete a checklist of internal control evaluation questions furnished by the OSC's Internal Control Division. The review of these questions shall be documented by a report noting weaknesses and recommending solutions. Whenever remedial action is required, the agency will prepare and implement an action plan to correct the deficiency.

While the agency head is in a position to have a risk assessment performed, the authority to effect necessary changes may lie outside of the control of the agency head (e.g., budget, personnel, legislative changes, etc.). **As part of an ongoing effort to promote efficient and cost effective State government, the OSC will assist State agencies in obtaining good internal controls via other means if necessary.**

One of the only certainties in life is change; an annual self-assessment allows each agency to discover what has changed and how that change has affected the agency's mission and internal control system. It is possible that the growth of agency functions has overwhelmed the staffing available to accomplish the agency's mission and maintain effective controls. It is also possible that a change of the agency's mission has diminished the responsibilities of staff to the point where reassignments or staff reductions are warranted without impairing internal controls.

The existence of current flowcharts of agency functions and narratives describing the transaction cycles give management an opportunity to better understand the operations of their area of responsibility, however simple or complex.

Whatever the findings from an annual self-evaluation, it is a beneficial process to be aware of potential internal control problem areas before such problems become overwhelming and unexpected or potentially embarrassing situations occur.

The best way to start the process is to gather existing information pertinent to the agency's financial operations. Examples of such documents include narrative descriptions, worksheets or flowcharts depicting the agency's financial systems, any reviews of agency financial operations by internal auditors, reports by the State Auditors or other independent auditors, and agency responses to these reports.

Once this material has been collected, the agency should be ready to begin its internal control self assessment.

Step One: Perform an Initial Review of the Accounting Systems in Place

The first step for evaluating internal control is to understand the accounting/transaction process and identify the systems currently in use at your agency. This initial review provides the basic foundation for identifying specific risks. Agency personnel should identify the major financial systems in place, the accounts these systems affect, and how these two elements interrelate.

Examples of typical processing cycles might include the following:

- Purchase ordering, receiving and processing.
- Payables and payment processing.
- Cash receipts and receivables accounting.
- Fixed asset accounting.
- Payroll and personnel.
- Other critical business systems.

For most State agencies, this step should require a minimal amount of time. The majority of agency heads and their business managers are familiar with the basics of their agency operations.

Step Two: Prepare Descriptions of These Systems

The second step would be to prepare descriptions of these processing cycles. A general description of a particular agency cycle should include the following:

- A brief description of the flow of major transactions that are processed by the system, from their inception to their recording in the accounts.
- Staff roles in initiating transactions and controlling the movements of State assets.
- The identification of "key controls" (i.e., the safeguard functions that staff perform to minimize risk of theft or loss).

The agency might use a narrative, a flowchart or questionnaire to describe the operation of the internal control system and to identify staff who perform relevant tasks.

Step Three: Analyze the Control Environment

The third step would be to analyze the control environment by employing questionnaires, work flows, and self assessment tools.

Step Four: Identify the System's Control Procedures

The fourth step would be to identify the control procedures in each system, and the operational importance of the transaction cycle, including its relative importance to the business of the agency. The basic control types include the following:

A. Separation of Duties

The separation of duties ensures that the four basic functions of recording, review of the transaction, reconciliation, and custody are adequately separated to reduce risk.

B. Reconciliation and Comparison of Assets with Records

These controls, such a bank reconciliation, involve independent checks over the output of the agency accounting system. If the total separation of duties is not achievable, then compensating controls must be identified and implemented by management.

C. Reviews

These include both *analytic reviews* and *transactional reviews*. The purpose of each type of analysis is to evaluate summary information.

The most common form of *analytical review* in government is the comparison of actual figures to budgeted amounts, with an investigation of variances. This can be effective when:

- Knowledgeable individuals participate in the budget and review process.
- There is an appropriate level of detail available to the reviewer.
- There is a proper awareness of the seasonal variances that exist throughout the expenditure cycle.

In addition, when there are differences discovered that represent a misstatement, there should be an established procedure for correcting the error.

Transactional reviews are performed with the use of exception reports. These reports list transactions that vary from the norm. Using this method, staff can assess the validity and accuracy of accounting output by comparing detail with expected results.

D. Physical Controls

This includes physical controls over access to assets and incurring liabilities.

E. Monitoring

Monitoring can include proper approval of transactions, comparing outputs to supporting documents and observing control procedures, including audit tests.

If assistance is needed, agency heads and business managers can obtain consultation from the Office of the State Controller's Internal Control Division.

Step Five: Document Key Internal Control Procedures

The fifth step would be to determine and document the key internal controls that the agency relies upon to guard its assets. To do so, an agency first needs to determine the risks and types of errors that might occur. When these potential areas are identified, agencies can match the internal controls that are in place to guard against these errors. This exercise is often done on a summary worksheet.

Each agency should have a series of self-evaluation files that contain the results of the most recent financial audit, the most recent single audit, any reports completed by the Office of Program Evaluation and Accountability, compliance reviews or other post audits, State agency responses to the recommendations in each of those audit reports, and compliance with recommended actions to be taken to correct deficiencies. In addition, the following documents should be kept on file: the annual self-evaluation of the internal controls including the completed checklists, questionnaires, or other evaluation tools, the risk assessment, and an action plan to reduce risks.

Effective internal controls are the foundation of efficient and cost effective State Government. Primary responsibility for the implementation and risk assessment is with each State agency head. The monitoring function is shared among the Auditors, Office of the State Controller, and the Commissioner of Administrative and Financial Services. To assist all parties in the monitoring function and to fulfill their primary responsibility, each State agency shall perform an annual self-evaluation prior to **June 30**, which shall be kept on file.

The Office of the State Controller is committed to assisting State agencies in their efforts to institute and maintain effective internal controls.

14 State House Station
Burton M. Cross Building, 4th Floor
Augusta, ME 04333-0014

Phone: (207)626-8420
Fax: (207)626-8422

www.maine.gov