Table of Contents: Chapter 2 – Internal Control

Chapter 2 – Internal Control

State policymakers and program managers are continually seeking ways to improve accountability in achieving an Organization's mission. A key factor in achieving that goal is to implement an effective internal control system.

An effective internal control system helps an Organization adapt to changing environments, evolving demands, and new priorities. As programs change and Organizations strive to improve operation processes and implement new technology, everyone involved must continually evaluate the control system to ensure that it is effective and updated when necessary.

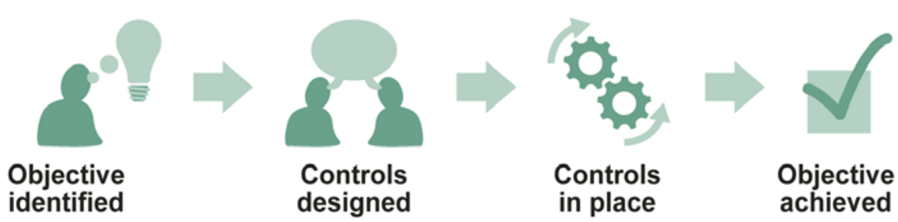
The State has adopted the Committee of Sponsoring Organizations (COSO) of the Treadway Commission Internal Control Integrated Framework (COSO Framework) for Organizations to use in the assessment of internal control as adapted by the Government Accountability Office (GAO) *Standards for Internal Control in the Federal Government* issued September 2014.

2.1 Establishing an Effective Internal Control System

Internal control is a process affected by an Organization's oversight body, management and other personnel that provide reasonable assurance the objectives of an Organization will be achieved. These objectives and related risks can be broadly classified into one or more of the following three categories:

- Operations – Effectiveness and efficiency of operations
- Reporting – Reliability of reporting of internal and external use
- Compliance - Compliance with applicable laws and regulations

These are distinct, but overlapping categories. A particular objective can fall under more than one category, can address different needs and may be the direct responsibility of different individuals.



Source: GAO. | GAO-14-704G

The Organization determines its mission (within the approved limits of Delaware Code Title 29), sets a strategic plan, establishes Organization objectives and formulates plans to achieve its objectives. Management, with oversight from the Organization's oversight body or Organization

Head, may set objectives as a whole or target activity within the Organization. Management uses internal control to help the Organization achieve those objectives.

Internal control comprises the plans, methods, policies, and procedures used to fulfill the mission, strategic plan, goals, and objectives of the Organization. Internal control serves as the first line of defense in safeguarding assets. Internal control assists managers with providing results through effective stewardship of public resources, promoting accuracy and reliability of the Organization's accounting data, and encouraging compliance with all the policies and procedures of the State.

An internal control system is a continuous built-in component of operations, effected by people, that provides reasonable assurance, not absolute assurance, that an Organization's objectives will be achieved.

Within the Plan/System, the five components of internal control must be present. They are described as follows:

- **Control Environment** - The foundation for an internal control system. It provides the discipline and structure to help an Organization achieve its objectives.
- **Risk Assessment** - Assesses the risks facing the Organization as it seeks to achieve its objectives. This assessment provides the basis for developing appropriate risk responses.
- **Control Activities** - The actions management establishes through policies and procedures to achieve objectives and respond to risks in the internal control system, which includes the Organization's information system.
- **Information and Communication** - The quality information management and personnel communicate and use to support the internal control system.
- **Monitoring** - Activities management establishes and operates to assess the quality of performance over time and promptly resolve the findings of audits and other reviews.

In addition to the five components in an internal control system, management must also assess the design, implementation, and operating effectiveness of those components with 17 principles (see chart below.) All components and principles are required for an effective internal control system.

Organizations need to implement relevant principles as shown in the following table:

COMPONENT	PRINCIPLE
Control Environment	Demonstrate commitment to integrity and ethical values
	Ensure that board exercises oversight responsibility
	Establish structures, reporting lines, authorities and responsibilities
	Demonstrate commitment to a competent workforce
	Hold people accountable
Risk Assessment	Specify appropriate objectives
	Identify and analyze risks
	Evaluate fraud risks
	Identify and analyze changes that could significantly affect internal controls
Control Activities	Select and develop control activities that mitigate risks
	Select and develop technology controls
	Deploy control activities through policies and procedures
Information and Communication	Use relevant, quality information to support the internal control function
	Communicate internal control information internally
	Communicate internal control information externally
Monitoring	Perform ongoing or periodic evaluations of internal controls (or a combination of the two)
	Remedy internal control deficiencies on a timely basis

Documentation is also a necessary part of an effective internal control system. The level and nature of documentation vary based on the size of the Organization and the complexity of the operational processes the Organization performs. Management uses judgment in determining the extent of documentation needed. Documentation is required to demonstrate the design, implementation, and operational effectiveness of an Organization's internal control system. Minimum documentation requirements are as follows:

- If management determines that a principle is not relevant, management supports that determination with documentation that includes the rationale of how, in the absence of that principle, the associated component could be designed, implemented, and operated effectively.
- Management develops and maintains documentation of its internal control system.
- Management documents in policies the internal control responsibilities of the Organization.
- Management evaluates and documents results of ongoing monitoring and separate evaluation to identify internal control issues.
- Management evaluates and documents internal control issues and determines appropriate corrective actions for internal control deficiencies on a timely basis.
- Management completes and documents corrective actions to remediate internal control deficiencies on a timely basis.

2.1.1 Sample Internal Control Plan Elements

- The control environment is the foundation for an internal control system. It provides the discipline and structure which affect the overall quality of internal control. It influences how objectives are defined and how control activities are structured. The oversight body and management establish and maintain an environment throughout the Organization that sets a positive attitude toward internal control.

- After establishing an effective control environment, management assesses the risks facing the Organization as it seeks to achieve its objectives. The assessment provides the basis for developing appropriate risk responses. Management assesses the risk the Organization faces from external and internal sources.

- Control activities occur throughout the Organization, at all levels and in all functions. Internal control systems vary from one Organization to another. The control objectives and features are dependent on the organizational complexity of an Organization and the management objectives for that Organization.

Some of the basic objectives of control procedures are as follows:

- Authorization
  - Transactions are properly authorized. A properly authorized document must have the correct number of approvals (hardcopy or electronic signature(s)) as required by the Organization's internal policy and this Manual.

- Review and approval
  - Proper supporting documentation for all financial documents is required. Supporting documentation is defined as invoices, logs, worksheets, memos, or additional documentation that provides support for both the purpose and amount of a transaction.

  - Recording and approving transactions timely in the accounting system to ensure transactions are recorded in the appropriate accounting period.

- Reconciliations
  - Monthly reconciliations of financial data in the accounting system are properly recorded on month-end reports.

- Physical security over assets
  - Assets are guarded and protected from loss or damage due to accident, natural disaster, negligence or intentional acts of fraud, theft or abuse.

- Segregation of duties
  - A comparison or check of recorded assets against existing assets is performed regularly by staff that is independent of the financial area responsible for recording the assets.
  - The division of responsibility for accounts receivable records and cash receipts.
  - The preparation of monthly bank reconciliations by an employee not responsible for disbursing cash or depositing cash.
  - Access to the State's finance and accounting system, First State Financials (FSF), is structured so that Organizations may segregate authorized duties. **Users are not permitted to share logon IDs or passwords under any circumstances. Sharing this information is a direct violation of the State's security policy (See Section 2.6 below).** Violation of security measures weakens the overall internal control structure of an Organization. **Security personnel will promptly disable a user's access if the sharing of IDs and/or passwords is discovered.**
  - State Organizations are required to have procedures in place to ensure that the individual who generates a payment is not the same individual who approves the same payment.
  - When segregation of duties is impossible or impractical, management should look for other methods of ensuring internal control, such as regular periodic supervisory reviews, rotation of duties, edits built into automated systems, unannounced verification of assets, etc.
- Reviews of operating performance
  - A structural plan of the Organization that provides the framework for the appropriate division of authority, responsibility, and duties among employees.
  - An accounting system designed to measure the results of operations and financial position.
- Education, training, and coaching
  - Personnel policies designed to employ, train, evaluate, and compensate employees.

Managers should continuously monitor and improve the effectiveness of internal control associated with their respective internal programs. This continuous monitoring and other periodic evaluations provide the basis for management's verification that existing controls are sufficient to safeguard the Organization's assets.

Management is responsible for maintaining and communicating written policies and procedures to ensure that an effective system of internal control exists within each Organization. Effective policies and procedures help ensure management directives are carried out and that necessary actions are taken to address risks to the achievement of the Organization's objectives.

2.1.2 Limitations of Internal Control

Internal control is not foolproof. Management's monitoring of and attitude towards the adherence to control procedures are critical to making controls work. The objective of internal control is to provide reasonable assurance that management's defined control objectives are being met.

The concept of reasonable assurance recognizes that the cost of the system of internal accounting control should not exceed the benefits expected to be derived, and also recognizes that the evaluation of the cost-benefit relationship requires estimates and judgments by management.

2.2 Approvals Internal Control

See Chapter 6 for controls related to the approval of business transacted on behalf of the State.

2.3 PCard Internal Control

See Chapter 12 for controls related to the State's Purchasing Card (PCard).

2.4 Payroll Internal Control

See Chapter 14 for controls in payroll processes monitored by the State's Payroll Compliance Group.

2.5 Reconciliation and Certification Requirements for First State Financials

State Organizations are required to comply with the following reconciliation and certification requirements:

- State Organizations' management must establish and maintain an internal control plan process. **The Division of Accounting will utilize the written policies to conduct annual internal control plan reviews.**

- State Organizations' management must establish a process in-house to determine outstanding transactions and resolve them internally. Contact the FSF Service Desk for assistance with transactions that cannot be resolved internally.

- Management is required to certify that they have reviewed FSF reports for balance verification as part of each Organization's regular monthly reconciliation process by signing and submitting the FSF Monthly Reconciliation Certification (Form DOA001). **The Certification is to be submitted to the Division of Accounting (DOA) in accordance with the FSF Monthly Close-Out Schedule disseminated by DOA at the start of the fiscal year.**

  The FSF Monthly Reconciliation Certification acknowledges that:

  - There were no deficiencies that arose which could adversely affect the Organization's ability to record, process, summarize, and report financial data;

  - No material weaknesses in the Organization's internal control were identified;

  - Transactions have been properly reviewed and authorized prior to and during processing to ensure the proper delivery, receipt, and payment for goods/services; and,

  - Appropriations reflect accurate charges and all discrepancies identified have been corrected.

  Any identified exceptions need to be acknowledged on the Monthly Reconciliation Exception Report (Form DOA002) and submitted with the monthly reconciliation form.

- Responsible officers are required to make annual representations to attest that they have complied with monthly certifications, conducted an annual review of their Organization's finance and accounting system Internal Control Plan, and analyzed the Organization's operations to ensure compliance with the plan.

2.6 Records Retention

2.6.1 General

Certain documents are retained and reviewed to determine the accuracy of the State's financial records, including the Budgetary Status Reports received from DOA. These documents are also used by the Department of Finance (DOF), the Office of Management and Budget (OMB), and the Office of the Auditor of Accounts (AOA) to determine the validity of financial data and the propriety of transactions. The methods and retention guidelines described in this Manual are the minimum requirements placed on Organizations that generate financial documents for central processing.

Each agency is required to maintain transactional receipts and supporting documents in the manner established by the Director of OMB. All invoices, bills, statements, letters, vouchers, and other documents pertaining to receipts and disbursements must be systematically preserved by each agency. **(29 Del. C. §6504)** Organizations may electronically attach (scan) supporting documentation to transactions in FSF, or Organizations may maintain and file hardcopy (paper) documents for this purpose.

The Secretary of Finance is responsible for keeping a distinct account, under appropriate headings, of all:

- Receipts and expenditures of State monies;
- State property; and
- Debts and obligations due to and from the State.

For this purpose, the Secretary of Finance is granted free and unfettered access to all the books, papers, documents, and records of State agencies receiving or expending any State money. **(29 Del. C. §6523)**

Records retention requirements are established by the Delaware Public Archives (DPA), an office of the Department of State. The most current State Agency General Records Retention Schedule is available at http://archives.delaware.gov. DPA has issued "Model Guidelines for Electronic Records" for use by all Organizations in State and local government in Delaware. The purpose of these guidelines is to assist Organizations to maintain records to meet the accepted standards for a variety of criteria, including ensuring that records are readily available, adequately protected, legally acceptable, auditable, and evidential.

DPA also establishes General Records Retention Schedules for electronic and paper-based records in an effort to ensure only necessary records are retained and the records are retained for the proper time periods. **Organizations are responsible for adhering to all DPA records retention requirements.** Organizations should consult with DPA and DOA to determine specific record retention requirements as part of each Organization's Internal Control Plan. DPA is also available to discuss Organizations' records storage requirements. For additional information about records retention schedules, Organizations should refer to http://archives.delaware.gov/govsvcs/retention/index.shtml.

Documents supporting financial transactions must be retained until the completion of a successful audit. A successful audit is one in which all general, special, and federal findings and recommendations have been completely resolved. Financial reports must be retained for five years and until the completion of a successful audit. Organizations may set higher standards or criteria for internal records retention and filing.

Organizations should contact their Federal agent for the record retention requirements of a Federal grant. At a minimum, Organizations must follow the State's record retention policy, but must also adhere to any additional requirements that may be imposed by the Federal agency as it relates to grants.

2.6.2 Electronic Filing

Electronically processed transaction records, such as purchase orders and invoices, are automatically stored in FSF for reporting, auditing, and document retention purposes. These electronic files must be maintained to show the budget on an individual appropriation basis. Organizations remain responsible for maintaining any necessary documents and records for all manually processed transactions (where the hard copy signature for a transaction serves as the approval record), as well as any hard copy documents used to support processing for both electronic and manual transactions.

Any supporting paper documents may be scanned into FSF electronically and attached to a specific transaction that reflects activity for a particular appropriation. These documents may not be commingled with any other appropriation. For further information on this record retention option, the Organization should contact DOA.

2.7 Security (General and Information Technology)

All State employees are required to abide by the State's policies for the safeguarding of proprietary and personal information, and the Department of Technology and Information's computer usage security policies. Employees are expected to safeguard and secure, and are prohibited from sharing, information, such as employee identification numbers, social security numbers, computer and software passwords, State credit card account and PIN numbers (e.g., fleet services card, Procurement Card), building access badges, and other identifiers and access instruments distributed as State issued security measures. Any questions regarding this policy should be directed to http://dti.delaware.gov/default.shtml**.**

2.7.1 First State Financials User Roles

A complete listing of FSF User Roles can be found at the following link: http://extranet.fsf.state.de.us/documents/training/job_role_handbook.pdf.

2.8 Audit and Compliance

State Organizations and programs are subject to periodic audits of their activities to ensure they are in compliance with State law, regulatory requirements, and the Organization's own internal control plan. These audits may be conducted by internal or external auditors.

Internal audits are management oriented. These audits gather information that is reported back to Department managers and Organization heads to assure these individuals are in a position to make informed decisions. These audits can also detect areas in need of further internal control; activities and practices that may require process changes to bring them into alignment with required policies; and identify opportunities for Organizations to improve the way services are delivered.

External audits are oversight oriented. These independent audits contribute to the transparency and reliability of public sector financial reports. External auditors report to other branches and levels of government and to the public to assure effective legislative and public oversight of government activities.

Internal Control processes must also be evaluated on a regular basis by internal or external parties to satisfy managers and elected officials that activity and system controls are adequately designed for their intended purposes, have been properly implemented, and continue to function. Regular audit and compliance checks enable the State to identify changes, modifications, and corrective measures needed for continued prudence in the management of public funds.

2.9 Policy Maintenance Requirements

The Budget and Accounting Policy Manual is maintained by OMB and DOF, through DOA.

2.10 Penalties

Failure to adhere to State policies and practices as outlined in the Delaware Budget and Accounting Policy Manual, or as disseminated from time to time by DOA, may result in restricted or limited access to FSF or any applicable State information technology systems, disciplinary action, dismissal, and/or legal action.