Introduction

Internal control is one of the key elements of an effective financial management system and is an integral part of management's "control" of an organization. Broadly construed, internal controls consist of all those policies and procedures which management develops and maintains to provide reasonable assurance that the financial management and programmatic goals of the agency will be achieved.

An agency receiving federal and state funds must ensure that it has an effective internal control system. There are many reasons for this requirement. An effective internal control system is needed to:

- ensure that resources are used in a manner consistent with laws, regulations, and policies;
- minimize the likelihood of waste, fraud, or misuse of agency resources;
- obtain and maintain reliable financial and program data which is essential to sound internal management and to effectively meet external reporting requirements;
- meet contractual and legal requirements; and
- satisfy the public's expectations that agencies receiving public funds are making every effort to adhere to sound, fundamental business practices.

An agency's control system is critically linked to the other six essential financial management functions discussed in Chapter 2.1 (Basic Elements of an Effective Financial Management System) and can directly affect an agency's ability to effectively perform these functions. For example:

- accurate and reliable financial reporting is an objective of an internal control structure;
- adequate source documentation and accounting records are part of control procedures which
are, in turn, part of an agency's internal control structure; while

- **budget control** is one of management's control methods for monitoring and following up on performance, which in turn is part of the **control environment**, another element of an agency's internal control structure which will be discussed in more detail later in this chapter.

It should be noted that while having an internal control system is required for many reasons, any internal control system, no matter how well designed, is subject to certain inherent limitations. Since management must consider the cost of a control compared to the benefit likely to be achieved with that control, circumstances could arise where problems occur because a particular control was omitted on the grounds of cost-benefit considerations.

In addition, faulty judgement or errors can occur, although it is possible that well-functioning controls will help in detecting errors. Two or more people also might collude to circumvent controls. Therefore, an internal control system is not a guarantee of success, but it can provide reasonable, although not absolute, assurance that the agency's objectives can be achieved.

The number of general and specific factors to consider in developing and maintaining an effective control environment are far too numerous to be fully captured in this manual. Professional accounting, management, and audit associations have material that can give an agency some direction in determining whether it has a sound control environment. In addition, the agency's independent auditor can be a source of assistance, and the agency can contact the Wisconsin DHSS for further information and assistance.

The three key elements of an agency's internal control structure are discussed in more detail in this chapter. These three elements are the control environment, the accounting system, and control procedures.

### The Control Environment

The governing body (such as a county's finance and human services committees) and top managers of an agency receiving state and federal funds must establish a sound control environment. In general, a sound control environment exists when everyone's role and responsibility in an agency for ensuring the appropriate, effective, and efficient use of agency funds is:

- clearly stated in specific policies and procedures (including formal position descriptions);
- routinely monitored and evaluated against clear performance standards; and
- clarified and improved upon as necessary to achieve critical control objectives.

The following is a brief summary of seven key elements of an effective internal control environment:
1. Management's philosophy and operating style. The agency's management should have a philosophy and operating style which has a positive overall influence on agency operations. For example, the agency should act responsibly when deciding which business risks to accept, have a constructive attitude toward meeting financial reporting requirements, and emphasize the importance of meeting budget and program performance goals.

2. The agency's organizational structure. The agency's organizational structure needs to provide the overall framework for planning, directing, and controlling activities for achieving the agency's objectives. The organizational structure also needs to clearly delineate authority and responsibility within the agency and to establish appropriate lines of reporting.

3. Activities of the governing entity. The governing entity (e.g., a non-profit board or county human services committee) should actively provide guidance and oversight by engaging in activities such as: (a) carefully selecting and performing on-going evaluation of the agency's director; (b) receiving and evaluating key information such as financial statements, program performance information, and significant contracts; (c) fulfilling its fiduciary and accountability responsibilities; and (d) ensuring that all board or committee members are well trained.

4. Assigning authority and responsibility. The agency needs to assign authority and responsibility in a manner which ensures that everyone fully understands reporting relationships and key duties within the agency. In particular, the agency should: (a) use formal job descriptions which include specific references to duties, reporting relationships, and control related responsibilities; and (b) have the appropriate numbers of people with the requisite skill levels relative to the size of the entity and the nature and complexity of its operations.

5. Control methods for monitoring performance. The agency needs to develop control methods for monitoring and following up on performance. The agency needs to:

   - have planning, budgeting, and reporting systems that set forth management's goals and objectives;
   - use methods that identify the status of actual budget and program performance and compares actual to planned performance levels; and
   - continuously seek improvements in fiscal and program performance through routinely investigating variances from expectations and, when necessary, taking timely and appropriate action to correct problems.

6. Personnel policies and practices. The agency needs to develop and adhere to written personnel policies and procedures which comply with all laws and which result in: (a) recruiting, hiring, and promoting competent and trustworthy people; (b) clearly communicating performance expectations of all agency staff and evaluating staff according to these expectations; and (c) providing the training necessary to ensure that all staff have sufficient skills to fulfill assigned duties.
7. **Sensitivity to external influences.** The agency needs to be fully aware of external influences, such as reviews by granting agencies, and plan for and be responsive to these influences through accurate reporting on agency operations and establishment of specific internal control structure policies or procedures.

**The Accounting System**

The second key element of an agency's internal control system is the accounting system. The accounting system consists of the methods and records established to identify, assemble, analyze, classify, record, and report an entity's transactions and to maintain accountability for the related assets and liabilities.

An effective accounting system which contributes to fulfilling an agency's control responsibilities would give appropriate consideration to establishing methods and records that will:

- identify and record all valid transactions;
- describe on a timely basis the transactions in sufficient detail to permit the proper classification of transactions for financial reporting;
- measure the value of transactions in a manner that permits recording their proper monetary value in the financial statements;
- determine the time period in which transactions occurred to permit recording of transactions in the proper accounting period; and
- present properly the transactions and related disclosures in the financial statements.

Chapter 2.2, *(Accounting Records and Source Documentation)* provides more detailed information on the requirements an agency's accounting system needs to meet.

**Control Procedures**

Control procedures are those policies and procedures in addition to the control environment and accounting system that management has established to provide reasonable assurance that specific entity objectives will be achieved. Control procedures have various objectives and are applied at various organizational and data processing levels. They may also be integrated into specific components of the control environment and the accounting system.

In general, control procedures can be viewed as being part of one of the five broad categories of procedures noted below:

1. Proper authorization of transactions and activities.
2. Segregation of duties that reduce the opportunities to allow any person to be in a position to both perpetuate and conceal errors or irregularities in the normal course of his duties. Some key duties that need to be segregated include separating:
   - the physical custody of assets from accounting for these assets;
   - the authorization of transactions from the custody of related assets; and
   - operational responsibility from record-keeping responsibility.
3. Design and use of adequate documents and records help ensure the proper recording of transactions and events.
4. Adequate safeguards over access to, and use of, assets and records. The most important safeguard over assets and records is the use of physical precautions, such as the use of fireproof safes, safety deposit vaults, locked storerooms, etc. In addition, many types of computer information can be protected through appropriate use of passwords.
5. Independent checks on performance and proper valuation of recorded amounts. Examples of such checks include: (a) comparing assets to records; (b) reconciling accounts on a periodic basis; and (c) reviewing reports that summarize detail of account balances, such as an aged trial balance of accounts receivable.

**Compensating Controls for Small Agencies**

The underlying concepts of the control activities are also valid for small entities, although they may be less formal. Direct, hands-on involvement of management provides strong control over activities, lessening the need for more formal activities. Management's close involvement will often enable identification of significant variances from expectations and inaccuracies in financial or operating data. Direct knowledge of client/customer concerns and communication with granting agencies can alert management to operating or compliance problems.

Many small agencies have difficulty in obtaining an appropriate segregation of duties. Whenever possible, duties should be assigned in such a way as to achieve the necessary checks and balances. When this is not possible, direct oversight of incompatible functions by management can provide the necessary control. For example, the manager may be the only authorized check signer and sign checks only after carefully reviewing the supporting documentation, or the manager may review bank reconciliations or require that monthly bank statements are delivered directly to the manager unopened.