OSC GUIDANCE ON INTERNAL CONTROL

Introduction

As stewards of state resources, all agencies and institutions of higher education and their staff have been entrusted by taxpayers to ensure accountability for the proper use of public funds. An effective system for Internal control allow State entities a means to provide reasonable assurance that their assets are adequately protected and accounted for, programs are operated in an efficient and effective manner and in compliance with applicable laws and regulations, and financial statements are fairly and accurately presented regarding the State's financial activities and balances. Establishing and maintaining good internal control must be central to an entity's overall financial structure. According to the Association of Certified Fraud Examiners, "the United States Security and Exchange Commission (SEC) has acknowledged that having proper internal controls is essential in the prevention and detection of fraud."

In February 2016 the Office of State Controller issued a policy entitled "Internal Control System." The policy makes it mandatory that State agencies adopt and follow the U.S. Government Accountability Office's (USGAO) Standards for Internal Control in the Federal Government (commonly referred to as the Green Book). Further, the policy requires that principal departments of the Executive Branch comply with Section 24-17-102, Colorado State Department Financial Responsibility and Accountability Act. **[See Resources, "OSC Policy: Internal Control System"]**

To assist in gaining a better understanding of the concept of internal control and its purpose we have summarized the related authoritative guidance regarding establishing and maintaining a system for effective internal control below.

Authoritative Guidance

There are a number of authoritative sources which discuss and provide requirements and a framework for implementing and maintaining effective internal control. These sources include laws enacted by the Colorado General Assembly, guidance provided by the Colorado Office of the State Controller, and the USGAO Green Book.

Colorado Laws

The Colorado State Department Financial Responsibility and Accountability Act (Act) requires that each state agency establish accounting and administrative controls to ensure public funds are used efficiently, effectively, and for approved purposes. Specifically, the Act [Section 24-17- 102, C.R.S.] states that:

> *Each principle department of the executive department of the state government listed in section 24-1-110 shall institute and maintain systems of internal accounting and administrative control within said department, which shall be applicable to all agencies within said department and which shall provide for: (a) A plan of organization that specifies such segregation of duties as may be necessary to assure the proper safeguarding of state assets; (b) Restrictions permitting*

> *access to state assets only by authorized persons in the performance of their assigned duties; (c) Adequate authorization and record-keeping procedures to provide effective accounting control over state assets, liabilities, revenues, and expenditures; (d) Personnel of quality and integrity commensurate with their assigned responsibilities; (e) An effective process of internal review and adjustment for changes in conditions.*

In addition, the Act [Section 24-17-103, C.R.S.] requires that state agencies file a written statement that attests to its compliance with the statutory requirements listed above. Specifically, statute requires that:

> *Not later than December 31 of each year . . . the head of each principle department shall file, with the controller, the state auditor, and the governor, a written statement that the department's systems of internal accounting and control either do or do not fully comply with the requirements of section 24- 17-102. In the event that the statement filed indicates that the systems employed by the department are not in compliance with section 24-17-102, the statement shall further detail specific weaknesses known to exist, together with plans and schedules for correcting any such weaknesses.*

The Office of the State Controller (OSC) also has statutory responsibilities for managing the state's financial affairs. Specifically, statute [Section 24-30-201(f), C.R.S.] requires the OSC "to coordinate all the procedures for financial administration and financial control so as to integrate them into an adequate and unified system, including the devising, prescribing, and installing of accounting forms, records, and procedures for all state agencies."

To meet its statutory obligations, the OSC provides fiscal oversight of agencies' in a number of ways including providing guidance through policies and procedures (for example, State Controller Policy: Internal Control System and the Fiscal Procedures Manual); best practices (such as model contracts); training; and advisory services (help provided by the Office's Financial Analysis and Reporting Team, which includes the Statewide Internal Audit Unit).

USGAO Green Book

As discussed above, the State Controller issued a policy that requires State agencies follow the Green Book **[See Resources, "Standards of Internal Control in the Federal Government (USGAO Green Book)"]**. Its purpose was to bring the State of Colorado into compliance with OMB's Uniform Guidance, Section 200.303, "Internal Controls." The Uniform Guidance, Section 200.303 indicates:

> *The non-Federal entity must:*
>
> *(a) Establish and maintain effective internal control over the Federal award that provides reasonable assurance that the non-Federal entity is managing the Federal award in compliance with Federal statutes, regulations, and the terms and conditions of the Federal award. These internal controls should be in compliance with guidance in "Standards for Internal Control in the Federal Government" issued by the Comptroller General of the United States and the "Internal Control Integrated Framework," issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO).*

The Green Book is an important and essential resource for State agencies and institutions of higher education in providing criteria for establishing an acceptable framework for internal control on the state and local government levels under the Office of Management and Budget's (OMB) Uniform Guidance for Federal Awards. To accomplish this the Green Book leverages the concepts developed by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). The COSO concepts are presented in its "Internal Control – Integrated Framework" publication. COSO is a voluntary private-sector organization that disseminates guidance and best practices related to helping entities (both public and private) run effective, efficient, and ethical business operations. In 1992, COSO developed a framework for designing and implementing internal control systems. COSO updated this guidance in 2013. The Green Book (September 2014) has adopted the latest COSO internal control concepts and principles for the government environment.

The purpose of the Green Book is to provide government managers with guidance on designing, implementing, operating, and maintaining an effective internal control system. It establishes an internal control framework that is based on the five components of internal control. These components include the control environment, risk assessment, control activities, information and communication, and monitoring. Each of the components have guiding principles for establishing and maintaining effective internal control.

Background on Internal Control

Each State entity was established to support the State of Colorado's mission in providing services and/or products to Colorado citizens. Taxpayer dollars are used to fund the majority of these services and products. As a result the State has both a statutory and ethical responsibility for ensuring that public monies are used efficiently, effectively, and for the purposes intended. Internal controls are vital for ensuring accountability over the use of public funds. Appropriate controls must be implemented and maintained to help mitigate the risk of errors, omissions, misstatements, waste, fraud, and abuse. Internal controls are generally developed by State entity management (e.g., Executive Directors, Deputy Directors, controllers, and program managers), implemented by staff, and evaluated and monitored by both management and staff. As a result, staff at all levels of State entities are responsible for implementing and maintaining effective internal control.

Controls are typically designed to include each phase of a process to ensure that entities safeguard State assets and achieve their desired objectives. For example, if an entity is responsible for issuing hunting licenses, they must establish appropriate controls, such as printing pre-numbered licenses to ensure it can account for all licenses sold and un-issued licenses still on-hand. According to the Green Book, internal control is defined as *". . . a process, effected by an entity's oversight body, management, and other personnel that provides reasonable assurance that the objectives of an entity 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 for internal and external use*
• ***Compliance -*** *Compliance with applicable laws and regulations."*

For internal controls to be viable and useful to a State entity and its staff they need to be relevant, sustainable, and implemented in timely manner. Additionally, controls need to be evaluated and monitored to ensure they are operating as intended; effective in helping protect the entity from fraud, waste and abuse; and updated when programs, processes, or organizational changes occur.

It is critical that staff fully understand the importance of their job responsibilities in relation to an entity's system for internal control. For example, if staff responsible for performing internal control procedures do not understand the purpose of a specific control function, such as verifying that all goods and/or services an agency ordered were actually received, and documenting the receipt, they may conclude the related procedures are unnecessary. As a result the control in place may be circumvented by modifying procedures or omitting the procedures entirely. Conversely, if staff understand the importance of specific controls to the process and associated overall control structure they are more likely to follow all procedures related to the control function.

When designing internal controls, agencies need to ensure the cost to implement a control does not outweigh the benefits. For example to illustrate this concept, a new building is being constructed for the State and an internal control procedure requires that staff conduct daily onsite inspections to verify that all building materials used, including the least expensive materials such as nails, screws, caulking compound, etc., are all accounted for. In this case the cost to do this would likely be excessive when compared with the benefits derived. A more effective and cost beneficial control may involve performing onsite inspections to monitor progress and identify issues that could potentially cause construction delays and significantly impact project costs. Further, to help ensure that the cost to implement a control does not outweigh its benefits entities should perform risk assessments to identify those areas that represent the greatest risk to the State. Guidance on performing risk assessment, one of the five components of the COSO internal control framework, can be found in the USGAO Green Book **[See Resources, "Standards of Internal Control in the Federal Government (USGAO Green Book)"]**.

As mentioned above, the effectiveness of an internal control system requires that the controls that are a part of the system are relevant, implemented in a timely manner, understood by staff, kept current, and consistently maintained. To help accomplish this, State entities need to perform ongoing evaluation and monitoring of controls to ensure that the internal control system is working as intended. This should include reviewing and identifying any changes in operations. For example, an entity changes a key function it manages from a paper to an electronic process. When these types of changes occur entities must take appropriate and timely actions to establish new controls or modify existing ones to ensure that overall control objectives are maintained. Ongoing monitoring is essential to ensure controls are working as intended and there are no gaps that could potentially have a negative impact on achieving an entity's objectives. Guidance on monitoring, one of the five components of the internal control framework, can be found in the USGAO Green Book.