OREGON ACCOUNTING MANUAL		Number 10.10.00.PR
Oregon Department of Administrative Services State Controller's Division	**Procedure**	Effective Date July 1, 2001
Chapter	**Internal Control**	.1 OF .5
Part	**Management's Responsibilities**	
Section		Approval Signature on file at SCD

Authority **ORS 291.015**
ORS 291.038
ORS 293.590
ORS 293.595

Requirement to Maintain Adequate Internal Controls

.101 Each **agency head** is ultimately responsible for establishing, maintaining and improving the agency **internal controls**. The internal control of agencies must be adequate to provide reasonable, but not absolute, assurance that management's goals and objectives are being accomplished effectively and efficiently; assets are safeguarded; and transactions are accurate, properly recorded and executed in accordance with management's authorizations.

.102 All agencies are required to implement and maintain internal controls. Throughout the year, the **agency** will need to document periodic reviews, tests, and analysis of internal controls to assure proper operation. Agency management is responsible for the extent of efficiency and effectiveness of internal controls as well as any deficiencies therein.

.103 Each agency head may designate one senior agency manager as the internal control officer. This person's responsibility is for coordinating the overall agency-wide effort of annually (at a minimum) evaluating, improving and reporting on internal controls. The internal control officer provides assurance and documentation to the agency head that internal control review processes have been conducted. Each manager is responsible for review, evaluation and reporting for his/her particular part of internal control.

.104 Any material inadequacy or material weakness in an agency's internal control, including unresolved internal or external audit comments, should be identified. A plan and schedule for correcting any such inadequacy, including an estimated completion date, should be described in detail.

Components of Internal Control

.105 According to the Committee on Sponsoring Organizations of the Treadway Commission's (COSO) model, there are five components of internal control: control environment, risk assessment, control activities, information and communication, and monitoring. Effective internal controls promote accountability, facilitate achievement of agency goals and objectives, and ensure compliance with state and federal laws, rules, and regulations.

Control Environment

.106 The control environment encompasses the following factors:

a. *Integrity and ethical values.* Integrity and ethical behavior are the product of ethical and behavioral standards, how they are communicated, and how they are reinforced in practice. Managers and employees are to maintain and demonstrate support of internal controls at all times. This support includes management's obligation to remove or reduce incentives and temptations that might prompt personnel to engage in dishonest, illegal, or unethical acts. Also part of management responsibility is communication of values and behavioral standards to personnel through policy statements and codes of conduct and by behavioral example. Management's values should be corroborated by adequate supervision, training, and motivation of employees in the area of internal controls. To demonstrate support for good internal controls, management should emphasize the value of internal auditing and be responsive to information developed through internal and external audits.

b. *Commitment to competence.* Commitment to competence includes management's consideration of the competence levels for particular jobs and how those levels translate into requisite skills and knowledge. Managers are required to comply with established personnel policies and practices for hiring, training, evaluating, promoting, and compensating employees, and to provide employees the resources necessary to perform their duties. Hiring and staffing decisions should include pertinent verification of education and experience and, once on the job, the individual should be given the necessary formal and on-the-job training.

   Counseling and performance appraisals are also important. Performance appraisals should be based on an assessment of many factors, one of which should be the implementation and maintenance of effective internal controls. Promotions driven by periodic performance appraisals demonstrate commitment to the advancement of qualified personnel to higher levels of responsibility.

c. *Management's philosophy and operating style.* Management's philosophy and operating style encompass a broad range of characteristics. Such characteristics may include management's attitudes and actions toward financial reporting (conservative or aggressive selection from available alternative accounting principles, and conscientiousness and conservatism with which accounting estimates are developed). Management's attitude should positively reinforce and personnel should support adherence to **Generally Accepted Accounting Principles (GAAP)** in the implementation of information processing and accounting functions.

   Managers should remain cognizant of the purpose of internal control with respect to accounting and reporting. The purpose of internal control is to help assure the assertions made by management in the accounting records and reports are materially correct with respect to existence, completeness (including proper period), rights and obligations, valuation, and presentation.

   In a government environment, evaluation of the cost of controls must be considered in light of legal and public policy framework. The controls in place should produce the largest net benefit, both quantitative and qualitative. Managers should periodically review for the optimum level of controls and eliminate unnecessary controls.

d. *Organizational structure.* An organizational structure provides the framework within which activities for achieving objectives are planned, executed, controlled, and monitored. Management should establish well designed organizational structures that incorporate the form and nature of the organizational units, including the data processing organization and related functions. For good internal control, management must require clear lines of authority and responsibility, appropriate reporting relationships, and appropriate separation of authority. The appropriateness of an organizational structure will depend, in part, on the size and nature of a unit's activities.

e. *Assignment of authority and responsibility.* This factor includes how authority and responsibility for operating activities are assigned and how reporting relationships and authorization hierarchies are established. Management should establish policies relating to appropriate business practices, knowledge and experience of key personnel, and resources provided for carrying out duties. In addition, management should provide policies and direct communications so that all personnel understand the organization's objectives, know how their individual actions interrelate and contribute to those objectives, and recognize how and for what they will be held accountable.

   Proper segregation of responsibilities is a necessary condition to make control procedures effective. Management should ensure adequate separation of authorization for the execution of transactions, recording of transactions, custody of assets, and periodic reconciliation of existing assets to recorded amounts.

f. *Human resource policies and practices.* Human resource policies and practices relate to hiring, orientation, training, evaluating, counseling, promoting, compensating and remedial actions. To demonstrate commitment to competent and trustworthy people, management should establish and adhere to standards for hiring the most qualified individuals – with emphasis on educational background, prior work experience, past accomplishments, and evidence of integrity and ethical behavior. Management is also required to implement training policies that communicate prospective roles and responsiblities. Training should be designed to illustrate expected levels of performance and behavior.

Risk Assessment

.107 Risk assessment is the identification, measurement, and management of risks relevant to the achievement of the organization's objectives. Risks include external and internal events or circumstances that may occur and adversely affect operations. Once risks are identified, management should consider their significance, the likelihood of their occurrence, and how to manage them. Management may initiate plans, programs, or actions to address specific risks or it may decide to accept a risk because of cost or other considerations. Risks can arise or change due to circumstances such as the following:

- *Changes in operating environment.* Changes in the regulatory or operating environment can result in changes in the competitive pressures which may alter risks.

- *New personnel.* New personnel may have a different focus on or understanding of internal control.

- *New or revamped information systems.* Significant and rapid changes in information systems can change the risk relating to internal controls.

- *Rapid growth.* Significant and rapid expansion of operations can strain controls and increase the risk of a breakdown in controls.

- *New technology.* Incorporating new technologies into service delivery or information systems may change the risk associated with internal control.

- *New activities or lines of service.* Entering into business areas or transactions with which the organization has little experience may introduce new risks associated with internal control.

- *Organization restructure (centralizing, decentralizing).* Restructuring may be accompanied by staff reductions and changes in supervision and segregation that may change risks associated with internal control.

- *Accounting pronouncements.* Adoption of new accounting principles or changing accounting principles may affect risks in preparing financial statements.

.108 Risks are potential costs or undesirable results from weaknesses. When reviewing internal controls, focus on the objective, for example, that all user charges are billed and recorded. The controls which serve to meet that objective should be identified.

.109 When evaluating a system, the strength of individual controls should be compared. How well does a particular control prevent or detect and correct errors? What does it cost? Who performs the control? Does a particular control require other controls working with it to adequately prevent errors?

.110 There may be more than one weakness causing a risk. For example, cash may be misappropriated because licenses and permits are not controlled through prenumbering and receipts are not validated on a cash register. These weaknesses together create a much larger risk than either one taken alone.

Control Activities

.111 Management should develop control activities (policies and procedures) to ensure directives are carried out and that necessary steps to address risks are taken.

Control activities should pertain to the following:

- Timely and appropriate *performance reviews*: actual to budgeted and to prior periods, financial to nonfinancial, function or activity performance.

- *Information processing* general and application controls to ensure that transactions are valid, properly authorized, and completely and accurately recorded.

- *Physical controls* for safeguarding of assets, including:

    a. Physical segregation and security of assets, protective devices and bonded or independent custodians (e.g. banks, safe deposit boxes, lock boxes, independent warehouses).

    b. Authorized access to assets and records (such as through the use of computer access codes, prenumbered forms, and required signatures on documents for the removal or disposition of assets).

    c. Periodic counting and comparison of actual assets with amounts shown in accounting records (e.g. physical counts and inspections of assets, reconciliations and user review of computer-generated reports).

- *Segregation of duties* for authorization, recordkeeping, and custody of the related assets to reduce the opportunities for any individual to be in the position to both perpetrate and conceal errors or fraud in the normal course of duties.

- *Documentation*: Internal control systems, all transactions and other significant events are to be clearly documented, and the documentation is to be readily available for examination at each agency.

    a. Documentation of internal control systems is valuable to managers in controlling their operations and may also be useful to auditors or others involved in analyzing and reviewing operations.

    b. Written evidence of (1) the internal control objectives and techniques and accountability systems, and (2) all pertinent aspects of transactions and other significant events is essential. For each agency, two written documents are recommended: a narrative on the review of internal control and an analysis of risk factors.

c. Documentation of internal control systems should appear in management directives, administrative policy, and accounting procedure manuals. Documentation of transactions and other significant events should be complete and accurate and should allow tracing the transaction or event from before it occurs, while it is in process, through its completion.

d. Many documentation tools are available such as checklists, flow charts, narratives, and software packages. Supporting documentation for conclusions should be gathered and kept on file at least five years.

Information and Communication

.112 The information system, which includes the accounting system, should provide identification, capture, and exchange of information in a timely manner.

.113 Communication should provide an understanding of individual roles and responsibilities pertaining to internal control; it should be written (policy and procedure manuals, financial reporting manuals, and memoranda), or may be oral and by example (through the actions of management).

Accounting System

.114 The accounting system should consist of the methods and records established to record, process, summarize, and report entity transactions (as well as events and conditions) to maintain accountability for the related assets, liabilities, and equity. These methods and records are to:

- Identify and record all valid transactions.
- Describe transactions in a timely manner and in sufficient detail to allow proper classification.
- Measure and record the proper monetary value of transactions.
- Determine and ensure recording of transactions and events in the proper time period.
- Present transactions and events and related disclosures properly.
- Maintain a traceable audit trail.

.115 The Oregon Department of Administrative Services (DAS), State Controller's Division (SCD) will review all proposed acquisitions, development, or modifications of **accounting systems**. See **OAM 10 65 00**, Approval of Proposed Fiscal Systems.

Monitoring

.116 Establishing and maintaining internal controls is a responsibility of management. Monitoring is the process that assesses the quality of internal control performance over time, by assessing design and operation on a timely basis and taking necessary corrective actions. The monitoring process should include ongoing activities built into regular management and supervisory activities.

.117 Agencies, at their option, should consider implementing a review process and preparing a formal report periodically on the adequacy of the agency's internal control. The report should certify the adequacy of the internal control and identify weaknesses and planned corrective actions. Agency management is responsible for follow through and appropriate actions necessary to correct identified weaknesses and risks.