

UNIFORM INTERNAL CONTROL STANDARDS FOR INDIANA POLITICAL SUBDIVISIONS



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Part One:

Minimum Level of Internal Control Standards

FIVE COMPONENTS OF INTERNAL CONTROL

A system of internal control may be implemented in many different ways. Because political subdivisions vary in purpose, size and complexity, no single method of internal control is universally applicable. However, the five internal control components and seventeen principles should be present and functioning, operating in an integrated manner. Some components may have principles implemented entity-wide, which impact the internal control system for all objectives, while other components may be specific to a given objective.

The terms oversight body and management are used throughout these guidelines. Please refer to the Introduction Section for the definitions appropriate to your political subdivision.

Component One: Control Environment

The control environment is the basic commonality for all and comprises the integrity and ethical values of the political subdivision established by the oversight body and management. The standards, processes, and structures which form the control environment pervasively impact the overall system of internal control. The oversight body and management convey leadership expectations, and overall tone which are reinforced by all officials and management throughout the various offices and departments. The control environment also contains the overall accountability structure for all employees through performance and reward measures. Within this structure, leadership demonstrates commitment to the political subdivision by having a process for attracting, developing, and retaining competent individuals. This component is static in that its underpinnings do not generally change with a given objective.

Five of the seventeen principles of internal control pertain to the control environment:

Principle 1. The oversight body and management demonstrate a commitment to integrity and ethical values.

The oversight body and management demonstrate these values through directives, attitudes and behavior. Established standards of conduct are expected to be observed by all throughout the political subdivision and are used when evaluating adherence to the values of the political subdivision.

Principle 2. The oversight body oversees the entity's internal control system.

There is an oversight structure in place. The oversight body oversees management's design, implementation, and operation of the political subdivision's internal control system.

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Principle 3. Management establishes an organizational structure, assigns responsibility, and delegates authority to achieve the political subdivision's objectives.

Organizational structure is designed, responsibilities are assigned and authority delegation is identified to enable the political subdivision to plan, execute, control and assess achievement of objectives. The organizational structure is designed so that it is clear where responsibilities are, especially for those areas where statute has not assigned particular responsibilities. When needed, management will go back to the legislative body to enact the policies that will clearly define these areas, specifically when the organizational structure extends beyond office or department boundaries to affect the political subdivision as a whole. Management develops and maintains documentation of the internal control system.

Principle 4. Management demonstrates a commitment to attract, develop and retain competent individuals.

Policies pertaining to the recruitment, training, mentoring, and retention of personnel consider the objectives of the political subdivision, including succession and contingency plans for key roles.

Principle 5. Management evaluates performance and holds individuals accountable for their internal control responsibilities.

Individuals are held accountable for their internal control responsibilities through a recognized, understood structure which includes corrective action procedures. Additionally, management evaluates for excessive pressures on personnel and adjusts these pressures accordingly.

**Component Two:
Risk Assessment**

Risk is the possibility that an event will occur and adversely affect the achievement of objectives. Risk assessment is the process used to identify and assess internal and external risks to the achievement of objectives, and then establish risk tolerances. Each identified risk is evaluated in terms of its impact and likelihood of occurrence. Overall, risk assessment is the basis for determining how risk will be managed.

Four of the seventeen principles of internal control apply to risk assessment:

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Principle 6. Management defines objectives clearly to enable the identification of risks and defines risk tolerances.

Objectives defined in clear terms will include information such as: who is to achieve the objective, how the objective will be achieved, and when the objective will be achieved.

Principle 7. Management identifies, analyzes, and responds to risk related to achieving the defined objectives.

Management identifies risks to the achievement of the political subdivision's objectives across the unit as a whole and within each office or department. Analysis of risk through determination of objective measures and variance tolerances is the basis for determining how the risks should be managed. The response to risk is selected: acceptance, avoidance, reduction, or sharing.

Principle 8. Management considers the potential for fraud when identifying, analyzing, and responding to risks.

The types of fraud which could impact the achievement of objectives include fraudulent financial reporting, misappropriation of assets, and corruption. As a part of this analysis, fraud risk factors are identified: pressure, opportunity, and rationalization. The response to fraud risk exercises the same process used for all analyzed risks.

Principle 9. Management identifies, analyzes, and responds to significant changes that could impact the internal control system.

Internal control is a process, and part of that process is the responsibility for management to be continually aware of changes, both external and internal, that could affect the achievement of the political subdivision's objectives. Those changes should be analyzed for both their immediate effect and for any future impact. Management would then determine any modifications needed in the internal control process to adapt to these changes.

**Component Three:
Control Activities**

Control activities are the actions and tools established through policies and procedures that help to detect, prevent, or reduce the identified risks that interfere with the achievement of objectives. Detection activities are designed to identify unfavorable events in a timely manner whereas prevention activities are designed to deter the occurrence of an unfavorable event. Examples of these activities include reconciliations, authorizations, approval processes, performance reviews, and verification processes.

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An integral part of the control activity component is segregation of duties. The fundamental premise of segregation of duties is that an individual or small group of individuals should not be in a position to initiate, approve, undertake, and review the same action. Separating the ability to record, authorize, and approve the transactions along with the handling of the related asset reduces the risk of error or fraudulent actions. It also reduces the risk of management override.

In very small governmental units, such segregation may not be practical. In this case, compensating activities should be implemented which may include additional levels of review for key operational processes, random and/or periodic review of selected transactions. These additional levels of review may take the form of managerial review of reports of detailed transactions, periodic review of performance of reconciliations, and periodic counts of assets and comparison to records. Certain situations may require management to go outside of the office or department for help in implementing controls and these reviews might be performed by governing boards or other elected officials.

There is an expectation of segregation of duties. If compensating controls are necessary, documentation should exist to identify both the areas where segregation of duties are not feasible or practical and the compensating controls implemented to mitigate the risk. Clear documentation should be maintained for continuity as well as ease of communication to outside parties.

Three of the seventeen principles of internal control apply to control activities:

Principle 10. Management designs control activities to achieve objectives and respond to risks.

Control activities are designed to fulfill defined responsibilities and address identified risks. An evaluation of the purpose of the control activity is performed as well as an evaluation of the effect a deficiency would have on objectives. Control activities may be either automated or manual. The Green Book identifies a list of control activity categories that are meant only to illustrate the range and variety of control activities; the list is by no means all inclusive, but is reproduced here for reference purposes:

- Top-level reviews of actual performance.
- Reviews by management at the functional or activity level.
- Management of human capital.

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- Controls over information processing.
- Physical control over vulnerable assets.
- Establishment and review of performance measures and indicators.
- Segregation of duties.
- Proper execution of transactions.
- Accurate and timely recording of transactions.
- Access restrictions to and accountability for resources and records.
- Appropriate documentation of transactions and internal control.

Principle 11. Management designs the political subdivision's information system and related control activities to achieve objectives and respond to risks.

Control activities are designed to support the completeness, accuracy, and validity of information processing by technology including the design of security management. Management evaluates changes to systems and updates control activities in response. For example,

- Disaster Recovery ensures that critical accounting information will be processed in the event of interruption of computer processing capacity.
- Back-Up Processing provides for accounting information to be backed up on a periodic basis sufficient to allow restoration of the information in a timely manner.
- Physical Security protects the computer system and the associated telecommunications equipment from environmental damage and unauthorized access.
- Logical Security requires access to accounting information and processes be controlled by operating system software and by the computerized accounting application through user identification codes and passwords.
- Change Controls are internal controls over changes made to the accounting system's computer programs.

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- Audit Trails allow for sufficient documentation to trace all transactions from the original source of entry into the system, through all system process, and to the results produced by the system.
- Input Controls provide input edits and controls to assure that information entered into the system is accurate, that all appropriate information is entered into the system.
- Segregation of Duties can be achieved within information technology systems by appropriate assignment of security profiles that define the data the users can access and the functions they can perform.
- Output Controls are features that assure all accounting information is reported accurately and completely.
- Interface Controls allow for Information generated in one computer application system to be transferred to another computer application system accurately and completely.
- Internal Processing provides written verification procedures and actual verification results that document accurate calculating, summarizing, categorizing, and updating of accounting information on a periodic basis.

Principle 12. Management implements control activities through policies.

Management works with each office or department in determining the policies necessary to address the objectives and related risks for the operational process. Further defined policies through day-to-day procedures may be warranted. These policies are periodically reviewed for continued relevance and effectiveness.

Component Four: Information and Communication

Relevant information from both internal and external sources is necessary to support the functioning of the other components of internal control. Communication is the continual process of providing, sharing, and obtaining necessary information. Internal communication enables personnel to receive a clear message that control responsibilities are taken seriously by the organization. External communication enables relevant outside information to be internalized and internal information to be clearly communicated to external parties.

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Three of the seventeen principles of internal control pertain to the component of information and communication:

Principle 13. Management uses quality information to achieve the political subdivision's objectives.

Management defines the types of information needed and the acceptable sources of information. Then, management processes and evaluates the information for relevancy. Information should be appropriate, current, complete, accurate, accessible, and timely.

Principle 14. Management internally communicates the necessary quality information to achieve the political subdivision's objectives.

Information is communicated using established reporting lines. Appropriate communication methods consider the audience, nature of the information, availability, cost, and any legal or regulatory requirements.

Principle 15. Management externally communicates the necessary quality information to achieve the entity's objectives.

Management identifies external parties and communicates relevant information. Appropriate communication methods are developed and should include the same consideration as outlined for internal communication.

Component Five: Monitoring Activities

Evaluations are used to determine whether each of the five components of internal control is present and functioning. These evaluations may be conducted on an ongoing or periodic basis. The criteria used are developed by the oversight body, elected officials, management, governing boards, or recognized standard-setting bodies or regulators.

Two of the seventeen principles of internal control apply to monitoring activities:

Principle 16. Management establishes and operates monitoring activities to monitor the internal control system and evaluate the results.

A baseline of the current state of the internal control system is compared against the original design of the internal control system. The baseline consists of issues and deficiencies identified in the internal control system. The results of the monitoring process are evaluated and documented.

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Potential changes to the internal control system are identified. Control and monitoring activities may be the same, but it is the intent of the activity that distinguishes which component the activity is supporting. For example, a review of reconciliation with the intent to detect errors would be a control activity while a review of the same reconciliation with the intent to determine if internal control procedures are in place and functioning properly would be a monitoring activity.

Principle 17. Management remediates identified internal control deficiencies on a timely basis.

Management establishes a mechanism for personnel to report internal control issues identified while performing their responsibilities. These issues are documented and evaluated on a timely basis.

Management remediates identified issues. **Corrective actions include resolution of audit findings.**

