# STATE OF GEORGIA
# ACCOUNTING PROCEDURES MANUAL

## SECTION: FIVE – INTERNAL CONTROLS
## TOPIC: OVERVIEW

Citizens demand and deserve cost effective government programs. They also expect to receive value for their tax dollars. Most major shortcomings that have been discovered in government programs, from lack of program accomplishment or results, to wasteful or fraudulent activity, can be traced to a breakdown in some component of the system of internal control. The purpose of this section of the Accounting Procedures and Instructions Manual is to guide employees of all State organizations in carrying out their responsibilities. This section, and the guidance contained herein, is not intended to take the place of management's judgment or to dictate how management chooses to carry out its responsibilities. It is presented to advise all employees in State organizations of the standards against which the performance of their programs and organizations will be assessed.

Internal control has been the focus of much attention over the past several years. This interest in internal control in government has increased in recent years as governments have become more complex and as taxpayers have demanded more accountability. Citizens are demanding more than just an accountability of how funds were spent. Government managers are now under the gun to demonstrate the value of the program and whether its objectives were met. One significant development concerning internal control occurred when The National Commission on Fraudulent Financial Reporting, known as the Treadway Commission, was created in 1985 to identify the causal factors of fraudulent financial reporting and to make recommendations to reduce its incidence. Recommendations made by the Treadway Commission led to a review of internal control literature by a task force called the Committee of Sponsoring Organizations of the Treadway Commission (COSO). This task force issued a report in September 1992 called *Internal Control - Integrated Framework*. The report, referred to as the COSO report, was used as a guide in developing the information relating to internal controls included in this manual.

In 1988, the AICPA's Auditing Standards Board issued a revised auditing standard on internal control, Statement on Auditing Standards No. 55, *Consideration of the Internal Control Structure in a Financial Statement Audit*. This Statement on Auditing Standards was amended in December 1995 with the issuance of SAS No. 78 "*Consideration of Internal Control in a Financial Statement Audit: An Amendment to Statement on Auditing Standards No. 55*", to reflect the definition and description of internal control contained in the COSO *Internal Control - Integrated Framework.*

**Each State organization is responsible for adopting an internal control framework that is suitable for the type of services they provide.** The establishment and maintenance of effective internal controls within a strong and effective internal control environment are fundamental components in the safe and sound management of all State organizations. An important aspect of every State organization's responsibility is to provide legislative bodies, citizen/tax payers, bond rating agencies, other governmental agencies, regulators and other interested parties, with reasonable assurance that the State organization's activities are controlled and the its risks are prudently and soundly managed.

**Each State organization has a responsibility to assess their internal control system and use this information to design, implement, and monitor internal controls that are suitable for their organization.** To accomplish this, they should be aware of current standards, become familiar with the COSO report, and follow the recommendations outlined in that report.

If State organizations build the components of an internal control system into its planning efforts as well as its daily activities, its members are more likely to avoid unnecessary costs, make quick responses as needs arise, and adapt to decreasing resources and changing political and economic climates.

## DEFINITION OF INTERNAL CONTROL

*Activities undertaken by management to increase the likelihood of achieving management objectives in the areas of efficiency and effectiveness of operations, reliability of financial reporting, compliance with laws and regulations, and safeguarding of assets.*

Internal control is a process that keeps an organization on course in achieving its objectives. A system of such controls should provide reasonable assurance that entity objectives are being met. These objectives fall into for separate but related categories:

l. effective and efficient operations;
2. reliability of financial reporting;
3. compliance with applicable laws and regulations; and
4. safeguarding of assets.

Several key points should be made about this definition. First, people at every level of a State organization affect internal control. Internal control is, to some degree, everyone's responsibility. **Within each State organization, department heads are primarily responsible, and will be held accountable for internal control in their respective departments.** Second, effective internal control helps each State organization achieve its operations, financial reporting, and compliance objectives. Internal control keeps each State organization on course toward its objectives and the achievement of its mission, and minimizes surprises along the way. Internal control promotes effectiveness and efficiency of operations, reduces the risk of asset loss, helps to ensure the reliability of financial reporting, and compliance with laws and regulations. Third, internal control can provide only reasonable (not absolute) assurance regarding the achievement of an organization's objectives. The likelihood of achievement is affected by limitations inherent in all internal control systems. These include the realities that human judgment decision-making may be faulty, that persons responsible for establishing internal controls need to consider their relative costs and benefits, and that breakdowns that can occur because of human failures such as simple error or mistake. Moreover, controls can be circumvented by collusion of two or more people, or by management override of the internal control system.

**Top management at each State organization must assume the leadership role in managing internal controls for their areas of responsibility.** The head of each organization and top management set the tone that affects integrity and ethics and other factors of a positive control environment. State organizations that have strong boards also affect internal control. A strong active board, particularly when coupled with effective upward communications channels and capable financial, legal, and internal audit functions, can often identify and correct situations in which controls are overridden, or when attempts are made to stifle communication from rank and file employees. Internal auditors play an important role in evaluating and monitoring the effectiveness of internal controls, however, internal auditors are not responsible for establishing or maintaining the internal controls of a State organization.

There are a number of groups outside a State organization that can play a role in the process. The Board of Regents, Legislative Budget Office, and the Office of Planning and Budget are often involved in developing institution-wide controls and procedures. External auditors can provide an independent and objective view, and contribute directly through the financial statement audit and indirectly by providing information useful to management.

The COSO model is recognized throughout the world as a significant standard for discussing internal control. This model is based upon three premises:

* the people in an organization, who face the realities of trying to work efficiently and effectively to achieve the goals and objectives set out for them, are in the best position to provide insights into the strengths and weaknesses of their processes;

* someone (or some group of individuals), internal to the organization, should be given the power and responsibility to identify control problems and develop solutions for improving and strengthening

controls; and

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