

## Office of the State Controller

### Self-Assessment of Internal Controls

#### Introduction

The Self-Assessment of Internal Controls, commonly referred to as the Internal Control Questionnaire (ICQ), is a tool to be utilized by North Carolina State government agencies to assist in confirming the presence of a sound system of internal controls. For purposes of this document, the term agency is used to refer to all component units, occupational licensing boards and commissions that are reported within the State of North Carolina's Comprehensive Annual Financial Report (CAFR).

A proper system of internal control provides *reasonable assurance* that the financial statements are fairly presented and that management's goals are being properly pursued. Such a system includes fully documented policies and procedures which accomplish, among other things, the following:

- A. Transactions that are executed according to management's general or specific authorization;
- B. Transactions that are recorded, as necessary, to:
  - 1. prepare financial statements that conform with generally accepted accounting principles, and
  - 2. account for assets;
- C. Access to assets is permitted only according to management's authorization.
- D. Asset records are compared with the existing assets at reasonable intervals and action is taken to reconcile any differences.

The ultimate responsibility for a strong system of internal control rests with management. On an annual basis, management must attest to the accuracy of financial statement information along with the soundness of internal controls. The ICQ should be used as a key tool in making these assertions.

The ICQ consists of the following sections and accounting cycles:

- Control Environment
- Financial Reporting Cycle
- Budget Reporting Cycle
- Cash Receipts Cycle
- Accounts Receivable Cycle
- Purchasing/Accounts Payable Cycle
- Human Resources Cycle
- Inventory Cycle
- Capital Assets Cycle
- Computer Security Cycle
- Investment Cycle
- Debt Cycle
- Tax/Payroll Compliance Cycle

Many aspects of internal control are currently documented in the Office of the State Controller (OSC) North Carolina Accounting System Information Guide (SIG). The SIG contains information on statewide policies and procedures and is updated on a regular basis.

The internal control questionnaire should be maintained for review and audit. For questions, contact the Risk Mitigation Services Section of OSC.

## The Statewide Internal Control Framework

*Note: This Framework contains information adapted from the Committee of Sponsoring Organizations of the Treadway Commission's (COSO) Internal Control – Integrated Framework, published in 1992.*

### Introduction

North Carolina State Government is a highly significant organization both fiscally and in number of employees and locations. The State's budget often surpasses the Gross Domestic Product of many small countries. Every citizen of North Carolina is touched by state government, with millions of individuals and families using State services daily. In order to successfully govern the State in such complex environments, operations must be effectively managed. Internal control enables management to effectively deliver services to the citizens of North Carolina and to help ensure the reliability of financial statements and compliance with laws and regulations.

Because of the crucial importance of internal controls and the complexity of state government, the Office of the State Controller has composed this Framework to establish a single definition of internal control applicable Statewide and also to detail the elements which form a sound system of internal control.

### Internal Control...A Definition

Internal Control has often meant radically different things to different people. Common understandings of internal control have centered on the routine actions surrounding certain transactions meant to ensure correctness and reduce risk of error and loss. While those actions are indeed examples of specific internal controls, a more comprehensive definition is required. Following is the State of North Carolina's definition of internal control:

Internal control is broadly defined as an integral process, affected by an entity's governing body, management and other personnel, designed to provide reasonable assurance regarding the achievement of objectives in the following categories:

1. Reliability of financial reporting.
2. Compliance with applicable laws and regulations.
3. Effectiveness and efficiency of operations.

This definition establishes that internal control:

- Affects every aspect of government - all people, processes and infrastructure.
- Is a basic organizational element and not an add-on feature.
- Is dependent upon people and will succeed or fail depending on people.
- Provides a level of comfort (reasonable assurance) regarding the likelihood of achieving organizational objectives.
- Assists an organization to achieve its mission.

## Elements of Internal Control

Internal control consists of the following five interrelated elements:

- Control Environment
- Risk Assessment
- Control Activities
- Information and Communication
- Monitoring

These elements connect all the business processes of an organization and must be in place and properly functioning for an effective system of internal control to flourish. The following paragraphs offer detail on how these elements function within a system of internal control.

### Control Environment

The control environment sets the tone of an organization, influencing the control consciousness of its people. It is the foundation for all other elements of internal control, providing discipline and structure. Control environment factors include:

- Integrity, ethical values and competence of the entity's people;
- Management's philosophy and operating style;
- Management's assignment of authority and responsibility; and
- Management's organization and development of its people and the attention and direction provided by the governing body.

As the foundation, if the control environment of an organization is compromised, all internal control elements will face severe problems.

### Risk Assessment

Every entity faces a variety of risks from external and internal sources that must be assessed. For a risk assessment to function properly, objectives must be set and the organization's risk tolerance known. Risk assessment is the identification and analysis of relevant risks to achievement of the objectives, forming a basis for determining how the risks should be mitigated. Because conditions change, risk assessment must be a perpetual activity.

### Control Activities

Control activities are those specific policies, procedures and tasks that help provide reasonable assurance that objectives will be met. They help ensure that necessary actions are taken to mitigate risks. Control activities occur throughout the organization, at all levels and in all functions. They include a range of activities as diverse as approvals, authorizations, verifications, reconciliations, reviews of operations, security of assets and segregation of duties.

## Information and Communication

Information pertinent to the operation of an organization must be identified, captured and communicated in an effective form. Effective communication must occur in a broader sense as well, flowing down, across and up the organization. Employees must have a clear understanding of management expectations and management must hear and understand employees' concerns. The State's citizens must have access to necessary information. With modern communication means available, a state government entity has little reason not to communicate information properly.

## Monitoring

Monitoring is a process that assesses and seeks to mitigate the risk that internal controls within the State will not provide reasonable assurance that operational, reporting and legal/regulatory objectives are met. Although external audits conducted by the Office of the State Auditor do provide a monitoring function related to controls, primary monitoring must be a function internal to state government. Such internal monitoring can occur within the following formal activities:

- Internal Audit Activities
- Self-Assessment of Internal Control Questionnaires

Also important to the monitoring element are the procedures that are performed by a State entity that allow its management to attest to the accuracy of financial reporting information regularly submitted to OSC. Monitoring must also occur on a less formal basis as a part of management's operation of government.

- Control Environment
- Risk Assessment
- Control Activities
- Information and Communication
- Monitoring

These components should be considered inextricably linked both with one another and with the definition of internal control. The objectives of a system of internal control cannot be achieved without the working of each element within the system. State government strives to achieve the internal control objectives of efficient and effective operations, sound financial reporting and compliance with laws and regulations. These five elements are the means of achieving reasonable assurance that those objectives will be met.

## Reasonable Assurance

As stated in the definition and repeated above, internal control aims for reasonable assurance. Even a highly effective system of internal controls cannot guarantee that an organization will meet all objectives. Any system designed to strive for such a goal would consume many resources and inhibit delivery of government services. A sound system of internal control finds the balance between assurance and operations and offers a reasonable assurance that objectives will be met.

## Responsibilities

Everyone in an organization has responsibility for internal control. Management must implement the system and set the “tone at the top” but all levels within an organization must take ownership of internal control. Responsibilities must be effectively communicated to all levels and support of the system of internal control must be considered a part of proper workplace performance. When necessary, understanding must be communicated through formal training methods.

*Note: In authoring the Framework many sources outside State Government have been consulted and as with all work related to internal control, this office owes much to the Committee of Sponsoring Organizations of the Treadway Commission (COSO). Their groundbreaking work is reflected in much of this document, as it is in nearly all discussions related to internal control.*