

ACCOUNTING PRINCIPLES AND STANDARDS HANDBOOK

CHAPTER 6. INTERNAL CONTROLSSection 1.0 General

This chapter describes the internal controls designed to protect resources against waste, loss, and misuse while ensuring that timely, reliable data are obtained, maintained, and fairly disclosed. Internal controls are safeguards built into a process or work flow to provide reasonable assurance to management that the system is working as intended and that resources are used in the most effective and efficient manner possible.

What constitutes an effective control system may vary with circumstances. Senior bureau management officials are responsible for adequate management controls in their bureaus. They should establish an environment that creates the appropriate control awareness, attitude, and discipline. Each management control system should be designed to fit the organization and its operating philosophy, focus on areas of inherent risk, and achieve a thoughtful balance between control costs and benefits. Management control systems should provide reasonable, but not absolute, assurance that the objectives of the system will be accomplished. This concept recognizes that the cost of management controls should not exceed the benefits to be derived from them, i.e., that the marginal costs of the planned controls do not exceed the marginal benefits to be derived.

Section 2.0 Authority

In addition to this chapter, the following laws, regulations, and guidelines are relevant to the bureau's system of internal control:

- a. [Federal Managers' Financial Integrity Act](#), 31 U.S.C. Sec. 3512;
- b. [Government Performance and Results Act of 1993](#) (31 U.S.C. Secs 1115-1119), (39 U.S.C. Secs 2801-2805);

- c. [GAO Standards for Internal Control in the Federal Government](#);
- d. GAO Policy and Procedures Manual for Guidance of Federal Agencies, Title 2, Accounting, Appendix II, and Title 7, Fiscal Procedures;
- e. [Office of Management and Budget \(OMB\) Circular A-123, "Management Accountability and Control"](#); and
- f. Department Administrative Order (DAO) 216-15, "Internal Management Control Systems."

Section 3.0 Responsibility

Bureau finance officers and program financial system managers are responsible for ensuring that adequate internal controls are established and maintained in all activities under their control. Accounting systems include all systems and subsystems that process and record transactions, track and control assets and other resources, make disbursements, receive payments, and/or produce financial reports.

Responsibility for preventing fraud and waste is not solely confined to financial or internal audit personnel. Each manager and supervisor, whether they be in accounting, administration, program, or budget, is responsible for management controls. A sound management control process is a dynamic, cost-saving management tool. Management control programs must anticipate and prevent (as well as detect and correct) errors, irregularities, and mismanagement.

The Accounting and Auditing Act of 1950 (P.L. 97-258, as amended by 31 U.S.C. Sec. 3512) requires the head of each agency to establish and maintain adequate systems of internal control. The Federal Managers' Financial Integrity Act (FMFIA) of 1982 amended the former Act to require ongoing evaluations and reports on the adequacy of the systems of internal control of each executive agency. At the bureau level, the management controls should provide reasonable assurance that:

- a. Obligations and costs are in compliance with applicable laws;

- b. Funds, property, and other assets are safeguarded against waste, loss, unauthorized use, or misappropriation;
- c. Revenues and expenditures applicable to agency operations are properly recorded and accounted for to permit the preparation of accounts and reliable financial and statistical reports, and to maintain accountability over the assets; and
- d. Programs are efficiently and effectively carried out in accordance with law and management policy.

Section 4.0 Oversight

The FMFIA requires each Department or agency head to express an opinion on the adequacy of the organization's system of management controls in an annual FMFIA report to the President and the Congress. To comply with this requirement, each agency should conduct continuous evaluations of its management control systems and such evaluations will form the basis of the annual report. OMB Circular A-123 states that the head of each agency is responsible for designing, installing, evaluating, improving, and reporting on the agency's management control systems. The agency head is specifically required to:

- a. Designate a senior official who will be responsible for coordinating the overall agency-wide efforts of evaluating, improving, and reporting on management control systems.
- b. Issue management control directives to establish specific responsibilities for seeing that agency management control systems are developed, maintained, evaluated, improved, and reported.
- c. Provide for coordination among principal participants, i.e., the designated management control official, heads of organization units including the Inspector General, and program and technical staff.

- d. Assign responsibility for management control to appropriate levels of management in each agency component.
- e. Perform (at least once every five (5) years or as program changes require) risk assessments providing a preliminary review of the susceptibility of a program or function to waste, loss, unauthorized use, or misappropriation of all agency components and assessable units.
- f. Provide for detailed examination of the system of internal controls to determine whether adequate control measures exist and are implemented to prevent or detect the occurrence of potential risks in a cost effective manner.
- g. Identify areas which have high inherent potential for waste, loss, abuse, unauthorized use, or misappropriation due to the nature of the activity itself, and give priority to designing and implementing timely corrective action for material weaknesses identified within those areas.
- h. Establish a formal follow-up system to record and track the implementation of corrective actions associated with the resolution of material deficiencies.

The Inspector General (or the senior audit official if there is no Inspector General) should provide technical assistance in the agency effort to evaluate and improve internal controls. The Inspector General is also responsible for the review of management control systems as part of its normal audit process.

The General Accounting Office also audits the agencies' efforts to comply with the FMFIA. OMB reviews the annual FMFIA reports of agencies and meets with appropriate agency personnel to ensure compliance with FMFIA and OMB Circulars A-123 and A-127. OMB works particularly close with those agencies reporting high risk areas.

Within the Department, the Director, Office of Budget, Planning, and Organization, is responsible for internal controls, audit follow-up, and liaison activities pursuant to DOO 20-7, as amended. The Director for Financial Management (Deputy CFO) is responsible for financial internal controls pursuant to DOO 20-27, as amended.

Section 5.0 General Standards

The following standards, as prescribed by GAO's Standards for Internal Control in the Federal Government, represent the minimum level of quality acceptance for internal control and provide the basis against which Departmental internal control is to be evaluated:

.01 Control Environment

Management and employees should establish and maintain an environment throughout the department that sets a positive and supportive attitude toward internal control and conscientious management.

The following are key factors affecting the control environment:

1. Integrity and ethical values maintained and demonstrated by management and staff.
2. Management's commitment to competence.
3. Management's philosophy and operating style.
4. Agency's organizational structure.
5. Delegation of authority and responsibility throughout the organization.
6. Human capital policies and practices.
7. External relationship, i.e., with Congress and central oversight agencies such as OMB, Treasury, etc.
8. Internal senior management councils and the Office of the Inspector General.

.02 Risk Assessment

Internal control should provide for an assessment of the risks the agency faces from external and internal sources. Risk assessment can be accomplished through:

- a. Establishment of clear, consistent agency objectives.
- b. Identification and analysis of risks associated with achieving such agency objectives.
- c. Forming a basis for determining how risks should be managed.

.03 Control Activities

Internal control activities help ensure that management's directives are carried out. The control activities should be effective and efficient in accomplishing the agency's control objectives. Control activities include policies, procedures, techniques, and mechanisms being put in place to ensure adherence to requirements established by these management directives.

Internal control activities also include special control activities for information systems. They apply to all information systems including mainframe, minicomputer, network, and end-user environments; and the processing of transactions within the application software.

.04 Information and Communications

Information should be recorded and communicated to management and others within the entity who need it, and in a form and within a time frame that enables them to carry out their internal control and other responsibilities.

Information pertinent to external as well as internal events must be relevant, reliable, and timely. Information must be communicated effectively with data flowing down, across and up the organization. Management should ensure that means of communication are adequate.

.05 Monitoring

Internal control monitoring should assess the quality of performance over time and ensure that the findings of audits and other reviews are promptly resolved. Monitoring should be performed continually and be ingrained in the agency operations.

Monitoring includes regular management and supervisory activities, comparisons, reconciliations, and other actions people take in performing their duties. It can take the form of self-assessment. It should include policies and procedures to ensure that audit findings are resolved in a timely manner and proper actions are taken to correct deficiencies, produce improvements, or demonstrate audit findings and recommendations do not warrant management actions.

Section 6.0 Accounting Control Activities

The following accounting control activities are prescribed for bureau accounting systems, subsidiary accounting systems, and program financial systems:

.01 Documentation

- a. All transactions, processing procedures, and systems of administrative controls, and other internal controls (e.g., objectives, techniques) are to be fully documented so that a clear audit trail is established.
- b. Controls should be established to assure that financial transaction documents are received and processed in a timely manner. Documents should be properly classified and filed for reference, and for certification of schedules for disposition in accordance with records management standards (see Chapter 15, Records Management, of this Handbook).

- c. Internal control requirements should be included in directives, policies, manuals, plans, flowcharts, and desk procedures.

.02 Recording Transactions and Events

- a. Transactions and other significant events are to be promptly and accurately recorded and classified.
- b. An approved system of general ledger and subsidiary accounts shall be maintained for assets, liabilities, net worth, revenues, costs, budgetary accounts, and statistical accounts.

.03 Execution of Transactions and Events

- a. Transactions and other significant events are to be authorized and executed only by persons acting within the scope of their authority.
- b. Authorization should be clearly communicated to managers and employees and should include the specific terms under which the authority exists.
- c. There should be a systematic, ongoing administrative review of disbursement transactions to ensure proper certification of vouchers and disbursement of Government funds.
- d. Statistical sampling may be employed in the administrative review process in accordance with Title 7, GAO Policy and Procedures Manual for Guidance of Federal Agencies.

.04 Reconciliation of Accounts

- a. Proper reconciliation of accounts shall consist of identification of differences between general ledger balances, subsidiary ledgers, and the detail. The reconciliation must include the timely processing (preferably in the following month) of the identified items constituting the difference between controlling accounts and the

detail. Accounting records must be promptly brought into agreement with the results of audits or physical inventories when they are taken. Differences should be investigated to determine the causes. Procedures need to be implemented to prevent recurrence and, if applicable, to effect recoveries.

- b. General ledger accounts must be reconciled to subsidiary ledgers and source documents as frequently as possible, but no less frequently than prescribed by the following schedule of reconciliations:

<u>General Ledger Account</u>	<u>Frequency</u>
Cash	Monthly
Imprest Funds	Monthly
Advances	Monthly
Accounts Receivable	Monthly
Loans Receivable	Monthly
Deposit Accounts	Monthly
Suspense Accounts	Monthly
Inventories	Annually
Fixed Assets	Annually
Other Assets	Annually
Undelivered Orders	Monthly
Accounts Payable	Monthly
Other Liabilities	Annually

The preparation of external financial statements or financial reports should be preceded by proper and completed reconciliations.

- c. Formal schedules and work papers for such reconciliations shall be of sufficient detail to ensure the accuracy of financial statements and reports. The working papers and records on which such verifications are based shall be retained within the bureau in a form that will facilitate audit.
- d. The reconciliation of general ledger accounts with subsidiary and support records helps to substantiate and maintain the accuracy of account

postings and balances. Different tools may be used to accomplish a meaningful reconciliation based on the finance officer's professional judgment and knowledge of the systems and controls involved. Whenever possible, computer-assisted procedures should be employed. When it is not feasible to pull every document, statistical sampling may be used. For example, the certification of obligations is a legally mandated reconciliation procedure. It is more stringent than other reconciliations, but statistical sampling is specifically authorized by GAO. All reconciliation procedures should be fully documented and explained.

- e. To ensure that the samples drawn are reliable, all samples must be drawn on a random basis. If a random sample is not used, no valid conclusion could be reached about the entire population. For example, drawing a sample of every tenth transaction is not a random sample; such a sample will only tell you with 100 percent certainty what your performance or results were on every tenth transaction. Samples taken must also be based on an adequate sample size to reach a 95 percent confidence level.

.05 Separation of Duties

Key duties and responsibilities in authorizing, processing, recording, and reviewing transactions, as well as the receipt, use, and disposition of resources, shall be separated among individuals. To reduce situations where errors or irregularities can go undetected, no one individual should control all phases of an activity or transaction.

.06 Supervision

Qualified and continuous supervision is to be provided to ensure that internal control objectives are achieved. Supervisors should control employee's activities to optimize

productivity and to achieve internal control objectives.

.07 Access to and Accountability for Resources

- a. Access to resources and records is to be limited to authorized individuals. Accountability for the custody and use of resources is to be assigned and maintained.
- b. Periodic comparison (at least annually) shall be made by taking a physical count of resources and comparing the result with the amounts recorded in the official records to determine whether the two agree.

.08 Litigation, Claims and Assessments

Management of the Federal reporting entity is responsible for adopting internal control policies and procedures to identify, evaluate and account for litigation, claims and assessments as a basis for the preparation of financial statements in accordance with the requirements of the Chief Financial Officers Act of 1990 and the Government Management Reform Act of 1994. These include litigation, claims and assessments handled by legal counsel outside of the Federal reporting entity's legal department¹.

Section 7.0 Audit Control Activities

- a. Promptly evaluate findings and recommendations reported by auditors and other reviewers.
- b. Determine proper actions and time-frames in response to audit/review findings and recommendations.

¹ Accounting and Auditing Policy Committee: @Audit Legal Representation Guidance@

- c. All actions that correct or otherwise resolve the matters brought to management's attention are to be completed within the established time-frame.

Section 8.0 Budget Control Activities

Operating budgets on a cost basis shall be made a part of the system of accounting and internal control. Reports to responsible officials, at least monthly, should be provided in sufficient detail to facilitate:

- a. Control of resources for the purposes intended;
- b. Comparison of actual performance to planned or budgeted performance and analysis of variances;
and
- c. Evaluation of personnel and organizational performances.

Section 9.0 Information Systems Control Activities

These activities include:

- a. General control over data center operations, system acquisitions and maintenance, access security and application system development and maintenance.
- b. Application control designed to help ensure completeness, accuracy, authorization, and validity of all transactions during application processing.

Details on this subject matter are provided in the AFederal Information System Control Audit Manual@ at the following address:

http://www.gao.gov/policy/12_19_6.pdf

Section 10.0 Review Control Activities

Internal controls associated with accounting functions will be subject to rigorous, systematic reviews and self-assessments in accordance with guidelines provided under DAO 216-15,

"Internal Management Control Systems," and DAO 203-3, "Reviews Required by the Federal Managers' Financial Integrity Act of 1982."

Section 11.0 The Basic Approach to Evaluating, Improving, and Reporting on Internal Controls

An evaluation of and reporting on internal control can be approached in several ways. The approach presented in this section provides an efficient and effective way, based on techniques used to evaluate and report on the internal controls associated with financial statements, but expanded to encompass the controls necessary for administrative and program activities with systems subject to these guidelines.

The recommended approach for evaluating, improving, and reporting on internal controls is comprised of seven (7) phases:

.01 Organizing the Process

This includes a determination as to the information and assurances to be provided to the bureau head to enable the annual Department statement to be made to the President and the Congress; the assignment of responsibilities for planning, directing, and controlling the evaluation process throughout the bureau; and the development of an information system that provides a tracking of the status of the evaluations and corrective actions, as well as other pertinent information necessary to manage the overall process and facilitate preparation of the annual report.

.02 Segmenting the Agency into Organizational Components and Identifying the Programs

For example, the Department of Commerce can be segmented into the National Oceanic and Atmospheric Administration (NOAA), the Bureau of the Census, etc. NOAA, in turn, could be segmented into the National Marine Fisheries Service; the National Weather Service, etc.; or into administrative functions such as ship loan systems, payment systems, quality control, etc.

.03 Assessing the Vulnerability

Assess the vulnerability to waste, loss, unauthorized use, or misappropriation of the funds, property, or other assets within each component and decide which are the most vulnerable. This is done by identifying the factors that create an inherent riskiness in the function, considering the operating environment in which the function is performed, and preliminarily evaluating whether safeguards exist to prevent waste, loss, unauthorized use, or misappropriation from occurring.

.04 Developing Plans and Schedules for the Performance
of Internal Control Reviews

Develop plans and schedules based on an evaluation of the results of the vulnerability assessments and other considerations (management priorities, resource constraints, etc.). Those components or functions deemed to be the most vulnerable should be reviewed first. Those deemed to be less vulnerable should be evaluated and improved as necessary to ensure a strong system of internal control.

.05 Reviewing the Internal Control System

A complete review of the internal control system for the selected components should be performed. The review should determine whether adequate control objectives have been established and that control techniques exist and are functioning as intended. Recommendations to correct weaknesses in either the design or functioning of the internal control system should be developed on the basis of the review.

.06 Determining, Scheduling, and taking the Necessary
Corrective Actions

The necessary corrective actions for improving internal controls on a timely basis should be

determined, scheduled, and carried out. Included in the determination should be the completion of an analysis to assure that the expected benefits to be obtained will outweigh the costs of any improvements made.

.07 Preparing the Annual Statement to the President and the Congress

As required by the Act, a bureau's status of internal controls shall be reported for inclusion in the year-end FMFIA report to the President and Congress. Recently, other laws have prompted renewed focus on internal control. The GPRA requires agencies to clarify their missions, set strategic and annual performance goals, and measure and report on performance toward those goals. These goals, performance measures, and results will be reflected in the Department's Accountability Report.

Section 11.0 Conclusiveness of Chapter

While this chapter includes all internal control standards prescribed by GAO, it is not to be considered a conclusive statement of internal controls. Other chapters of this Handbook describe additional internal controls relating to those subject areas.