

Spring Hill ISD
Administrative Procedures
Internal Controls

The TEA Financial Accountability System Resource Guide details recommendations for internal controls and that information is included in this section.

The business manager is responsible for developing internal controls as directed by the superintendent. Care is taken to be certain that the assets of district are protected and that the internal controls are sufficient to deter fraud and to protect the integrity of the financial statements while allowing staff members to obtain the supplies and materials needed to meet the educational goals of the district. Additional internal controls and related procedures apply to expenditures from state and federal grants. Information for expenditures from these sources is detailed in the state and federal grants section of the business office procedures.

Internal controls are evaluated and updated annually as well as when any area of concern is identified.

FOR MORE INFORMATION

Please contact Ms. Barbara Shurbet at 903-759-4404 or at bshurbet@shisd.net for questions or more information.

4.6.3 Obtaining an Understanding of Internal Control

The independent auditor should obtain an adequate understanding of the school district's internal control related to the five components of internal control:

- (1) control environment,
- (2) risk assessment,
- (3) control activities,
- (4) information and communication, and
- (5) monitoring.

These are discussed in more detail in the following 5 sections of the resource guide. This may be accomplished by:

- Reviewing controls, and determining whether they have been placed in operation
- Assessing the materiality of the various account balances and transaction classes
- Evaluating the risk factors that could affect the scope of testing

4.6.3.1 Control Environment

The control environment establishes the school district management's attitude toward internal control. It is the basis for all other components of the system of internal control.

AICPA Statement on Auditing Standards No. 109 states that the control environment “sets the tone of an organization, influencing the control consciousness of its people. It is the foundation for all other components of internal control, providing discipline and structure.”

The control environment is affected by various factors, including the following:

- Integrity and ethical values
- Commitment to competence
- Participation of those charged with governance
- Management’s philosophy and operating style
- Organizational structure
- Assignment of authority and responsibility
- Human resource policies and practices

The substance of controls is more important than their form because the controls may not be effectively implemented and maintained. An auditor should weigh the collective effect on the control environment of strengths and weaknesses of the organization’s internal control. It may be that a particular weakness may have a significant effect on the control environment.

4.6.3.2 Risk Assessment

Risk assessment defined in AU section 314, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*, is the “entity’s identification, analysis, and management of relevant risks to the preparation of financial statements that are presented fairly in conformity with generally accepted accounting principles.”

Risks can arise or change as a result of the following factors:

- Changes in operating environment

- New personnel
- New or revamped information systems
- Rapid growth
- New technology
- New grant activities, building projects and other activities
- Organizational restructuring
- Accounting pronouncements
- Federal regulations
- School finance statutes

Consideration of Fraud

According to AU section 316, school districts' auditors are expected to perform procedures to assess the risk of fraud. The management of a school district is responsible for implementing appropriate administrative systems and policies that will sufficiently diminish the risk of fraud. Independent auditors will examine fiscal transactions, records, documents, procedures, processes, policies and/or systems, in addition to making observations and obtaining written evidence of close supervision and management of individuals that have access to fiscal assets and financial accounting processes. It is to be noted that school districts that provide evidence of proactive steps to adequately diminish the risk of fraud will achieve a more favorable assessment by their independent auditors.

It is recommended that school districts that have an enrollment of 5,000 and larger perform a periodic self-assessment of the risk for fraud. If a school district does not have an

internal audit department, the self-assessment may be obtained through a contract with a public accounting firm.

Additionally, certain procedures, policies and aspects of administrative systems will provide evidence of a proactive environment to diminish the risk of fraud, including:

- Separation of employees' roles and responsibilities relating to receipt of cash and access to accounting controls;
- Establishment of an audit committee of the board of trustees;
- Employee disclosure to the governing board and administration of a substantial interest in a business arrangement of the employee or immediate family prior to the award of contracts, or authorization of purchase orders and payment of invoices;
- Policies that require a monthly financial report to the board of trustees;
- Policies that address employee and board member relationships with vendors and suppliers;
- Policies that address acceptance of gifts, entertainment or favors;
- Policies that address kickbacks or secret commissions;
- Job descriptions that address access to accounting systems, and the organizational hierarchy of authorization, recording and approval of transactions;

- Processes to verify adherence to authorized access to accounting system components, and the organizational hierarchy of authorization, recording and approval of transactions;
- Policies that require dual signatures on checks;
- Implementation of a written code of ethics or conduct;
- Periodic training on a district's written code of ethics or conduct;
- Periodic training on fraud awareness to administrators assigned responsibility for supervising and managing individuals that have access to fiscal assets and accounting controls;
- Written policies communicating expectations for honest and ethical conduct;
- Reporting systems to promote prompt reporting of suspected fraud to appropriate levels of internal management;
- Policies that address prompt investigation of suspected fraud;
- Policies that address immediate dismissal of any employee that has committed fraud;
- Policies to require prompt analysis of factors that contributed to any instances of fraud, and reporting this information to the audit committee of the board and administration;
- Policies that require background and credit checks of applicants for positions that involve access to fiscal assets and accounting controls

- Systems to promote reporting fraud on a confidential basis;
- Policies addressing actual or apparent conflicts of interest, such as business agreements between employees or their immediate family and the school district;
- Written policies requiring true and accurate disclosure of information in reports and documents filed with the district, including expense, attendance, production, travel, financial, or similar reports and statements;
- Written policies prohibiting the preferential disclosure of information that would provide a competitive advantage to selected vendors or suppliers during the competitive procurement process and prior to award of a contract by administration or board, except for information required to be disclosed by law or appropriate responses to inquiries about specifications in requests for qualifications, proposals or bids;
- Policies requiring a full-faith effort by employees to comply with applicable governmental laws, rules and regulations;
- Policies requiring the prompt internal reporting of violations of the code of ethics or conduct to an appropriate person or persons;
- Accountability for adherence to written standards, policies and/or the code of ethics through an annual performance evaluations; and
- Periodic assessments by management of the risk of fraud through an internal audit function in mid- to large- enrollment school districts.

It is expected that independent auditors will not automatically reach an adverse conclusion about the risk for fraud if one or more of the above factors are not evidenced during the annual audit. However, independent auditors will expect a greater degree of sophistication in larger school districts in relation to the implementation of systems to diminish the risk

for fraud. The American Institute of Certified Public Accountants has provided extensive guidance to independent auditors about this auditing requirement.

4.6.3.3 Control Activities

Control activities are “the policies and procedures that help ensure that management directives are carried out.” Control activities can be divided into four categories:

- Authorization
- Safeguarding
- Asset accountability
- Segregation of duties

The application of control activities, such as segregation of duties, is affected to some degree by the size of the school district. In smaller school districts, control activities will be less formal than in larger school districts. Additionally, certain types of control activities may not be relevant in a smaller entity.

4.6.3.4 Information and Communication

The information system relevant to financial reporting objectives, “which includes the accounting system, consists of the procedures, whether automated or manual, and records established to initiate, authorize, record, process, and report district transactions (as well as events and conditions) and to maintain accountability for the related assets, liabilities, and equity.” The auditor should obtain an understanding of the information system to comprehend:

- the classes of significant transactions
- the procedures by which transactions are initiated authorized, recorded, processed, and reported

- the related accounting records involved in initiating, authorizing, recording, processing, and reporting
- how the information system captures events and conditions other than classes of transactions
- the financial reporting process used to prepare the district's financial statements, including estimates and note disclosures.

Those charged with governance should deliver a clear message to school district personnel that control responsibilities must be taken seriously. School district personnel must understand their own role in the internal control system, as well as how individual activities relate to the work of others. In addition, school district personnel must have a means of communicating significant information to upper levels of management. In addition to internal communication, effective communication with external parties such as parents, TEA and various agencies of the federal government when necessary should be made available.

4.6.3.5 Monitoring

Monitoring is “a process that assesses the quality of internal control performance over time.”

Ongoing activities include regular management and supervisory activities and other actions taken during the normal performance of an individual's daily responsibilities.

The nature and timing of *separate evaluations* depend on the effectiveness of ongoing activities and the risk that the internal controls are not performing as intended by school district management.

Deficiencies in the system of internal controls should be reported to management at the appropriate level.

One type of monitoring activity that management may perform is to examine certain ratios or financial indicators. These ratios and indicators are measures of performance reflecting key variables of the organization that normally lead to or indicate the current or future effectiveness of the school district.

The extent to which a manager is held accountable for the effectiveness of control procedures will probably determine the extent to which the manager monitors their performance. Management of a school district should assign responsibility and delegate authority with sufficient care to ensure that:

- Persons who perform control procedures are held accountable for their performance by those who monitor their activities
- Persons who monitor the performance of control procedures are held accountable by senior management, the board of trustees or the audit committee

If management routinely uses accounting information in making operating decisions, it is likely to establish effective controls and hold lower-level managers and employees accountable for their performance. In addition, if management routinely uses accounting information in measuring progress and operating results, it is likely to investigate significant variances between planned and actual results. This investigation may detect the causes of significant variances and affect the steps necessary to correct control procedures that failed to prevent misstatements.

4.6.3.6 Documentation of Understanding of the Internal Control

The auditor's understanding of the school district's internal control should be documented. The form of this documentation may consist of flowcharts and questionnaires or a memorandum depending on the size and complexity of the school district. As part of the documentation, the auditor should obtain an understanding of each of the five internal control components by performing procedures designed to determine if whether they have been placed in operation, as necessary for design of effective substantive tests.

The auditor should also document the discussion among the audit team regarding the possibility of misstatement due to error or fraud and the understanding of the school district's environment.

4.6.3.7 Identifying and Testing Internal Controls

The nature, timing and extent of procedures applied by the auditor to understand the five components of internal control will vary according to the size and complexity of the organization.

Refer to AU section 314, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement* for further detail and explanation on consideration of factors like size and complexity on internal control.

If the school district expends federal financial assistance, the independent auditor should consider the internal control categories for which testing is required in accordance with [OMB Circular A-133](#). These additional internal control categories include:

- Transactions are properly recorded and accounted for to:
 - Permit the preparation of reliable financial statements and Federal reports
 - Maintain accountability over assets
 - Demonstrate compliance with laws, regulations, and other compliance requirements
- Transactions are executed in compliance with:
 - Laws, regulations, and the provisions of contracts or grant agreements that could have a direct and material effect on a Federal program
 - Any other laws and regulations that are identified in the [Compliance Supplement](#)
- Funds, property, and other assets are safeguarded against loss from unauthorized use or disposition
- Specific requirements for major federal financial assistance programs
 - Activities allowed or unallowed.
 - Allowable costs/cost principles.
 - Cash management.
 - Davis-Bacon Act.
 - Eligibility.
 - Equipment and real property management.

- Matching, level of effort, earmarking.
- Period of availability of Federal funds.
- Procurement and suspension and debarment.
- Program income.
- Real property acquisition and relocation assistance.
- Reporting.
- Subrecipient monitoring.
- Special tests and provisions.

4.6.3.8 IT Internal Controls

Since so many of today's business processes are IT driven, a key area of internal control involves IT control. A general IT controls section should be included in the documentation of each process. Schools must have reliable replicable, and audit proof detail about control of, and access to, the infrastructure (physical and hardware components) and software that support the financial data.

The auditor should obtain an understanding of how IT affects control activities that are relevant to planning the audit. There are two broad groupings of IT internal controls:

- **Application Controls** – apply to business processes they support and designed within the application to prevent and detect unauthorized transactions. These controls help ensure that transactions occurred, are authorized, and are completely and accurately recorded and processed.
- **General Controls** – apply to all information systems, support secure and continuous operation. In order to construct IT general controls, specific controls should be set up for different functional areas:
 - **Systems Security** – Use a password policy to make sure user authentication; access rights should be controlled and documented
 - **Configuration Management** – Only authorized software is in use; confirm that standard server configuration is documented and implemented

- Data Management – Set up policies for handling, distribution and retention of data and financial reporting output; backup and recovery plan should be implemented
- Operations – Management should establish and maintain standard policies and procedures for IT operations

The auditor should obtain sufficient knowledge of the information system, including the related business processes relevant to financial reporting, to understand:

- The classes of transactions in the entity's operations that are significant to the financial statements;
- The procedures within the automated system by which those transactions are initiated, authorized, recorded, processed, and reported in the financial statements;
- How the information system captures events and conditions, other than classes of transactions, that are significant to the financial statements;
- The financial reporting process used to prepare the entity's financial statements, including significant accounting estimates and disclosures.

The auditor should obtain an understanding of how the incorrect processing of transactions is resolved.

The auditor should consider whether the entity has responded adequately to the risks arising from IT by establishing effective controls. From the auditor's perspective, controls over IT systems are effective when they maintain the integrity of information and the security of the data such systems process.

Refer to AU section 314, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement* for further detail on IT internal controls.