Internal Controls:
What They Are And Why We Need Them

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is *NOT* an Internal Control

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Internal Control

Internal control - defined

- A **process** – effected by those charged with governance, management, and other personnel
- Designed to provide **reasonable assurance** about the achievement of an entity's objectives

Plans, methods, policies, and procedures

Mission, strategic plan, goals, and objectives

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Internal Control Framework

Why do we care about a “framework”?

- Framework for “effective” internal control
  - Present - design
  - Functioning – actually doing it; continuous
- Framework developed by the Committee of Sponsoring Organizations (COSO), which issued *Internal Control – Integrated Framework* (1992, updated in 2013)
- Uniform Guidance (2 CFR 200.303)



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2 CFR 200.303 Internal controls

Non-Federal entity **must**:

(a) Establish and maintain a **system of internal control** that provides for **reasonable assurance** that the entity is managing the award in compliance with Federal statutes, regulations and the terms and conditions of the award

- Internal controls **should** comply with the Committee of Sponsoring Organizations of the Treadway Commission (COSO) or Green Book

(b) Comply with Federal statutes, regulations, and terms and conditions of the award

45 CFR 75.303

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2 CFR 200.303 Internal controls

Non-Federal entity **must**: (cont.)

(c) Evaluate and monitor compliance

(d) Take prompt action for noncompliance

(e) Take reasonable measures to safeguard PPII



45 CFR 75.303

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Internal Control Framework – 3 Objectives

Operations

- Concerns effectiveness and efficiency of the entity's operations
  - Operational and financial performance goals
  - Safeguarding of assets against loss
- Entities expected to
  - Use funds in an effective and efficient manner
  - Safeguard funds from unauthorized use, disposition, or loss
- Operational goals for types of services provided
  - Who can provide the services?
  - Who are the intended recipients of those services?

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Internal Control Framework – 3 Objectives

Reporting

- Concerns internal and external reporting
  - Financial and nonfinancial reporting
  - Encompass reliability, timeliness, and transparency
- Relates to basic financial statements
  - Also to the submission of financial, performance, and special reports to governmental funding sources
- Transparency
  - Concerning the costs and benefits of government programs
  - Has increased in importance in recent years

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Internal Control Framework – 3 Objectives

Compliance

- Concerns adherence to the provisions of laws and regulations
  - Also terms and conditions of the awards, including contracts and grant agreements



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Internal Control Framework – 3 Objectives

Overlapping Objectives

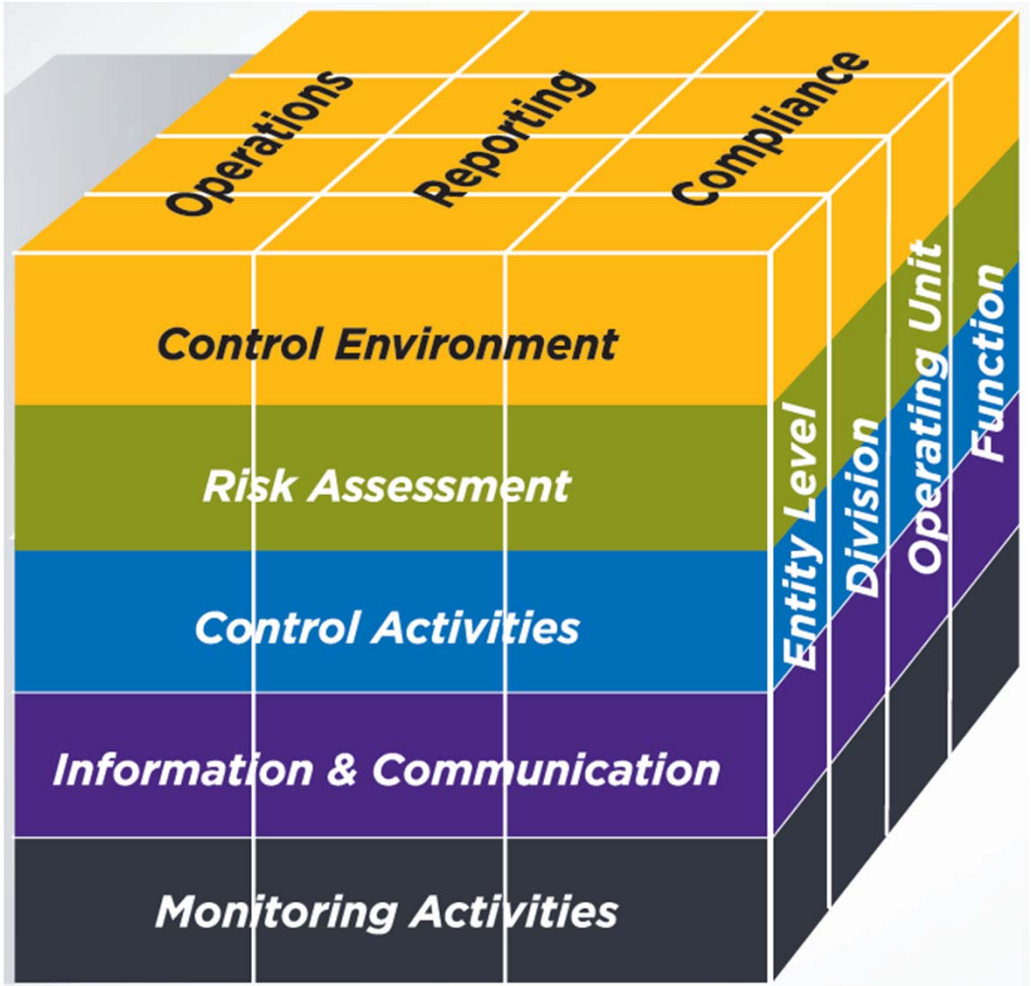
- A particular objective can fall under more than one category
- Address different needs
- May be the direct responsibility of different individuals within departments or programs
- Smaller Orgs
  - May be performed by the same person or group of persons
  - Regardless of Org's size, the objectives indicate what can be expected from internal control



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Internal Control Framework - Cube

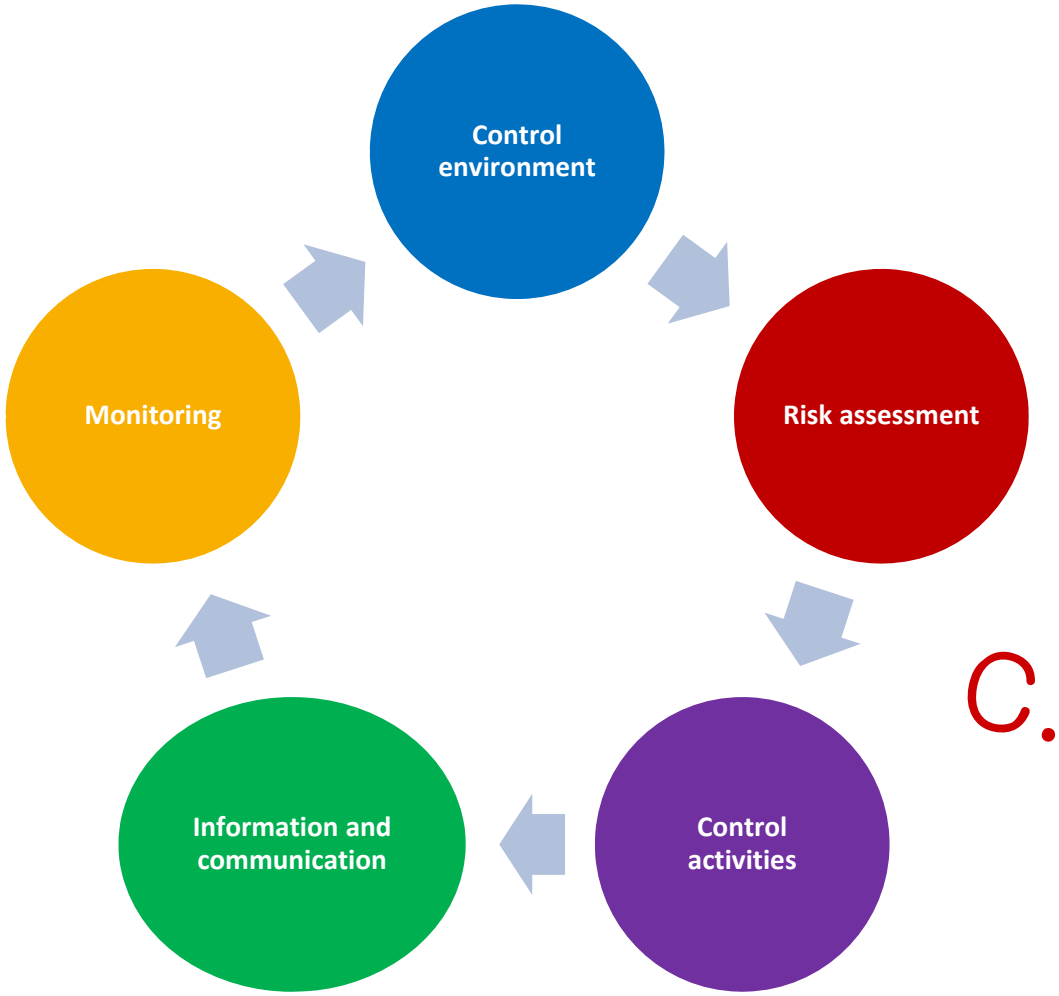
Integrated



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Internal Control Framework – 5 Components



C.R.I.M.E.

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Internal Control Framework – 5 Components

Control environment

- Foundation of internal control (I/C)
- Set of standards, processes, and structure
- Provides basis for carrying out I/C across organization
- Impacts overall system of internal control
- 5 principles



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Control Environment

Factors	Tools & Methods to Achieve
• Character, integrity & ethical values • Consciousness of the organization • "Tone at the top" • Competence of people and management • Accountability, attention, and direction • Oversight • Structure, authority and responsibility	• Mission statement • Ethics statement, code of conduct • Standing board committees with charters • Tenure and depth of senior management • Training to support assigned duties • Formal job descriptions • Segregate incompatible activities

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Internal Control Framework – 5 Components

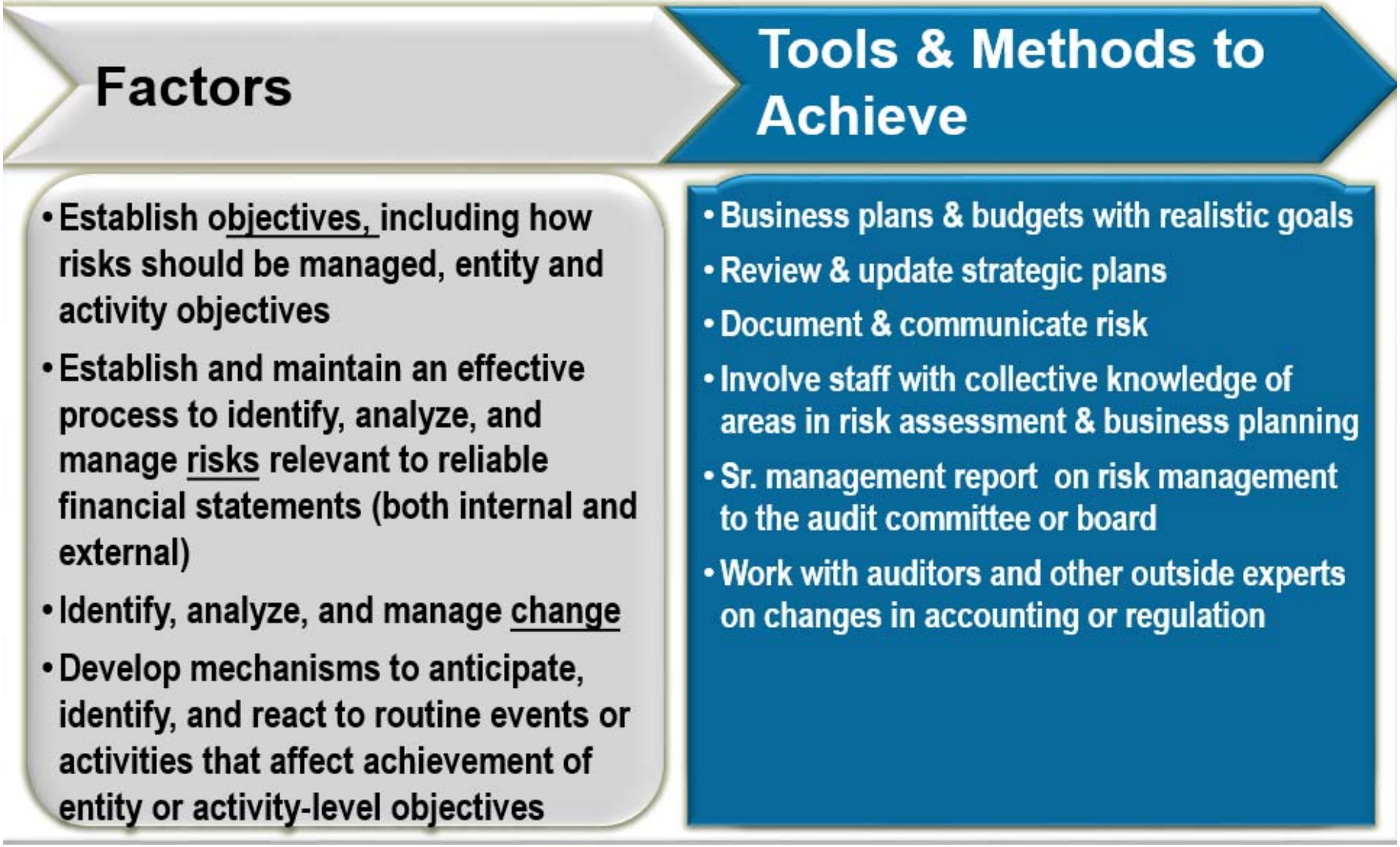
Risk Assessment

- Everyone has risk
- Greater attention to risk since original framework issued
- Defined – possibility that an event will occur and adversely affect the achievement of objectives
- Considered relative to risk tolerance
- Provides basis for determining how risks will be managed
- 4 principles



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Risk Assessment



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Risk Assessment

Identify & Analyze Risk



- Risk Identification
- Risk Analysis
- Risk Tolerance
- Risk Response

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Risk Assessment

Consider Fraud and Other Risks



- Fraudulent reporting
- Loss of assets
- Corruption
- Other misconduct
  - Waste and abuse
  - Management override

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Risk Assessment

Think like a fraudster



Fraud Triangle

- Opportunity
- Attitude/ Rationalization
- Incentive/ Pressure

Triangle has some shortcomings

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Risk Assessment

Fraud Triangle

Opportunity	Attitude/ Rationalization	Incentive/ Pressure
• Previously – weak I/C • Recently – tone at top	• Justify crime • Unobservable	• Non-sharable • Unobservable

Oversimplified; 2 characteristics cannot be observed; doesn't consider collusion

Fraud Scale
- Considers personal integrity

Fraud Diamond
- Considers person's capability

Other models

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Internal Control Framework – 5 Components

Control activities

- Actions resulting from policies and procedures, not the policies and procedures themselves
- Helps ensure management's directives to mitigate risk to the achievement of objectives is carried out
- Activities take place at all levels of the organization
- 3 principles



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Control Activities

Factors

- Policies and procedures to carry out management directives
- Controls address risks
- Controls throughout the organization at all levels and in all functions
- Action taken on exceptions
- Design and effectiveness of controls
- Controls over technology

Tools & Methods to Achieve

- Monitoring
- Policy
- Segregation of duties
- Verification
- System access
- System automation
- Board oversight
- Review & reconciliation
- Authorization

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Control Activities

Control Activities

- Processing Transactions
  - Complete
  - Accurate
  - Valid
- Control Activity Types
  - Preventative
  - Detective
  - Corrective

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Control Activities

Segregation of Duties

- Separate incompatible duties
- Custody, Authority, Recording or Reconciliation
- Utilize IT

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Internal Control Framework – 5 Components

Information and Communication

- Demand for information has increased
  - More of it
  - Greater accuracy and speed
- 3 principles



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Information and Communication

Factors

- Information identified, captured, and communicated
- Communicate internally and externally
- Report operational, financial, and compliance information
- Communicate seriousness of control responsibilities
- Enable upwards communication

Tools & Methods to Achieve

- Accounting updates and company handbook
- Employee orientation on ethics and values
- Record retention period that follows all applicable laws
- Determine the information needed or desired
- Period-end reporting deadlines
- Whistleblower hotline

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Internal Control Framework – 5 Components

Monitoring

- Assess whether each component of I/C is present and functioning
- Assess quality over time and promptly resolve findings
- Overall system of I/C
- Assess whether the components are present and functioning
- Ongoing and separate, periodic evaluations; activity
- 2 principles



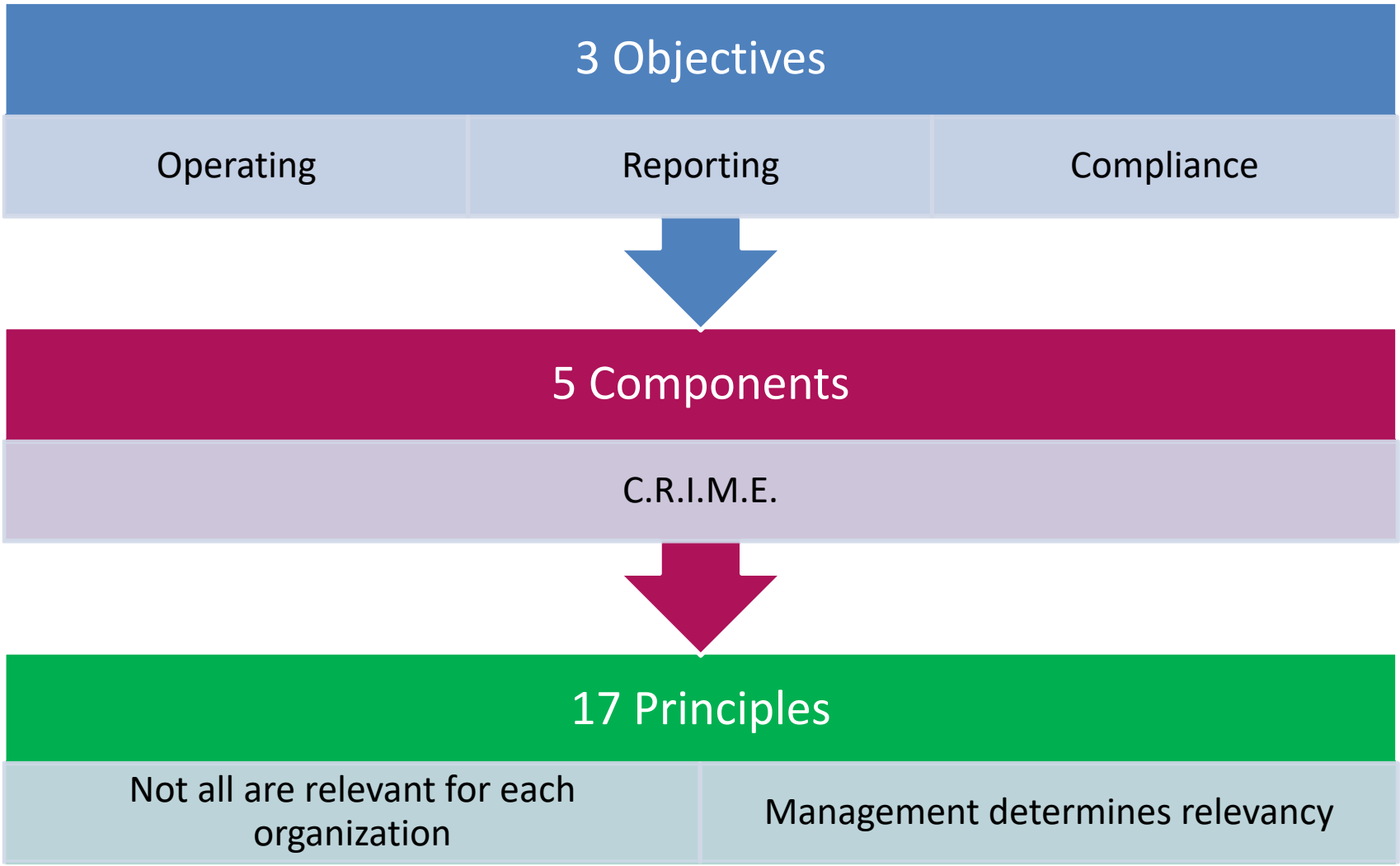
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Monitoring

Factors	Tools & Methods to Achieve
• Conduct ongoing evaluations • Ensure internal control deficiencies are reported • Detect and resolve control deficiencies	• Internal audit • Investigate complaints • Understand employee perceptions • Employees acknowledge compliance with the code of conduct • Require signatures to verify performance of significant controls • Checklists, questionnaires, or programs

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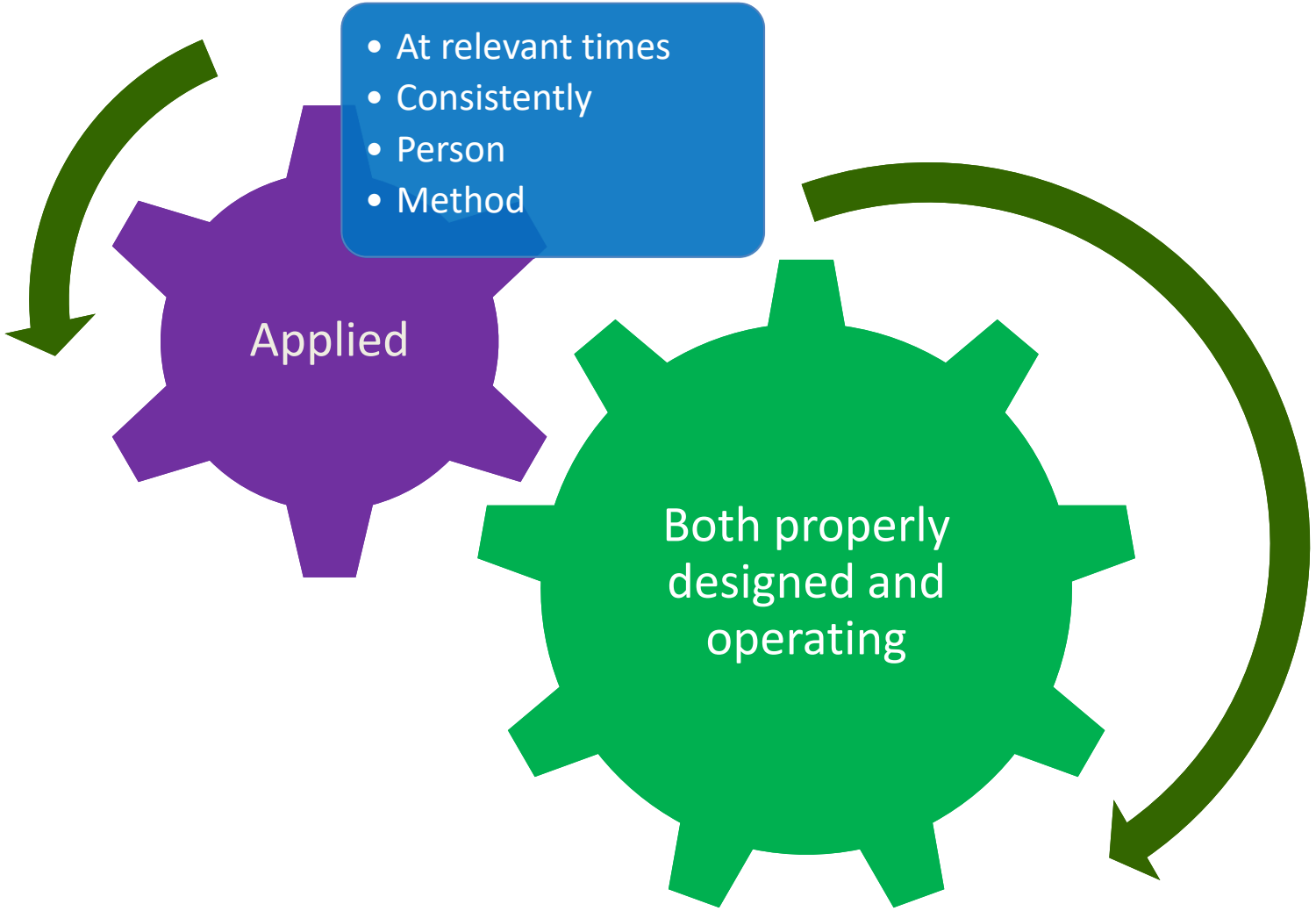
Framework Summary



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What is an effective control?



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Deficiencies in Internal Control – What are they?

- A deficiency in ***design*** exists when:
  - A control necessary to meet the control objective is missing; or
  - An existing control is not properly designed so that, even if it operates as designed, the control objective is not always met.

A deficiency in ***operation*** exists when:

- A properly designed control does not operate as designed; or
- When the person performing the control does not possess the necessary authority or qualifications to perform the control effectively.



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What is an Internal Control Deficiency?

Control Deficiency	Significant Deficiency	Material Weakness
Exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect misstatements on a timely basis.	Deficiency, or combination of deficiencies, in internal control that is less severe than a material weakness, yet important enough to merit attention by those charged with governance.	Deficiency, or combination of deficiencies, in internal control such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented or detected and corrected on a timely basis.

A reasonable possibility exists when the likelihood of the event is either **reasonably possible** or **probable**.

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Financial Policies & Procedures Manual

Identify what needs to be in your Financial Procedures Manual as a result of the Framework and the Uniform Guidance

Policies = “rule”, what, and/or why something is done

Procedures = description of how the “rule” will be followed

- Specific controls are not given in the Framework
  - Management must "obtain persuasive evidence…that components and relevant principles are present and functioning“

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Financial Policies and Procedures

Documentation



- Provide clarity
- Consistency
- Communicate
- Training
- Evidence of conduct of internal controls

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Regulation questions
Audit
Process
Human Resource
Technology
Leadership

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