

Internal Controls Training

A GUIDE TO INTERNAL CONTROLS: WHAT THEY ARE AND WHY YOU NEED THEM



Introduction

- ❖ We hear about internal controls often, but what are they and why do our State departments need them?
- ❖ We will present an overview of basic internal control concepts and provide examples and best practices



Objectives

- ❖ Learn the definition of internal control
- ❖ Understand why internal controls are necessary
- ❖ Knowledge of management's role & responsibilities
- ❖ Learn about internal control frameworks and what is needed to implement them



What is Internal Control?

- ❖ The Committee of Sponsoring Organizations of the Treadway Commission (COSO) defines internal control as:

“a process, effected by an entity’s Board of Directors, management, and other personnel, designed to provide reasonable assurance regarding the achievement of objectives relating to operations, reporting, and compliance.”

- ❖ Internal controls consist of:

- ❖ Policies
- ❖ Procedures
- ❖ Processes
- ❖ Practices

- ❖ The COSO Internal Control Integrated Framework is the most widely used internal control framework around the world.



Why do we need Internal Control?

- ❖ To provide **accountability** and to encourage **sound management practices**
 - ❖ Management is responsible for managing the resources entrusted to them to carry out government programs
 - ❖ Major factor in fulfilling this responsibility is ensuring that adequate controls are in place and functioning properly
 - ❖ Public officials, legislators, and taxpayers are entitled to know whether government agencies are:
 - ❖ properly handling funds
 - ❖ complying with laws and regulations, and
 - ❖ achieving the purposes for which they were authorized and funded



Rhode Island Requirements

❖ Rhode Island General Law Title 35 Chapter 14 Financial Integrity and Accountability Act of 1986

❖ § 35-14-2 Policy

(b) The legislature declares that:

(1) The management of each state agency is responsible for establishing and maintaining an adequate internal control structure and policies and procedures for financial reporting;

(2) Each state agency shall perform an assessment and produce a report on the effectiveness of the internal control structure and procedures for financial reporting and, when detected, weaknesses must be promptly corrected; and

(3) All levels of management of the state agencies must be involved in assessing and strengthening the systems of internal control structures to minimize fraud, errors, abuse, and waste of government funds.



Rhode Island Single Audit Finding

- ❖ Single Audit Finding 2016-002 *Comprehensive Documentation of the State's Internal Control Structure Consistent with the Revised Internal Control Framework*
- ❖ Finding stated that the State can enhance its communication and implementation of a statewide approach to design, document, and monitor its internal control policies and procedures following the principles contained in the revised internal control framework. The State's system of internal controls is intended to safeguard public resources and support accurate financial reporting.
- ❖ Recommendation:
 - ❖ "Enhance communication and implementation of a statewide approach to design, document, and monitor its internal control policies and procedures following the principles contained in the COSO/Green Book. Reassess, document, and monitor control procedures following the guidelines of the internal control framework."



COSO Framework

❖ According to the COSO framework, there are 5 components of effective internal control:

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



COSO Framework (cont.)

❖ The 5 components are supported by 17 principles, which if effectively implemented serve to achieve the following 3 classes of objectives:

❖ **Operations**

- ❖ Pertain to the effectiveness and efficiency of operations
- ❖ Includes *safeguarding of assets*

❖ **Reporting**

- ❖ Objectives are related to financial and non-financial reporting
- ❖ Also related to internal or external reporting

❖ **Compliance**

- ❖ Objectives are related to complying with laws, rules, and regulations- particularly important in the government sector!
- ❖ Also related to complying with internal policies and procedures



COSO Internal Control Cube



Relationship to Government

- ❖ Framework can be applied to entities in business, not-for-profit, and government even though a lot of the terminology and examples lean towards large businesses (SOX 404 compliance for publicly traded companies-IC framework required and most use COSO model)
- ❖ In an effort to tailor this framework to the government environment, the federal Government Accountability Office (GAO) issued an update to its “Green Book”, *Standards for Internal Control in the Federal Government*.
 - ❖ The “Green Book” is required for federal agencies as a basis for establishing effective internal control systems; however, it can be useful to other governments when applying the principles contained within the COSO internal control framework.



Relationship to Government (cont.)

- ❖ OMB Federal Register Update, Section 200.303 *Internal Controls*:
 - ❖ The non-federal entity must maintain effective internal control over Federal awards and controls should be in compliance with both the Standards for Internal Control in the Federal Government and COSO Internal Control Framework.



Key Differences: COSO vs. Green Book

COSO Framework

- ❖ Accommodates global operations
- ❖ Focus on organization's responsibilities for internal control
- ❖ Requires that each of the 5 components and relevant principles are present and functioning
- ❖ Addresses deficiencies in general terms
- ❖ Documentation is a matter of judgment

Green Book

- ❖ Accommodates government operations
- ❖ Focus on management's responsibility for internal controls
- ❖ Requires that each of the 5 components and relevant principles are effectively designed, implemented, and operating
- ❖ Addresses deficiencies in design, operation, and implementation
- ❖ Specifies minimum documentation requirements



Green Book Documentation Requirements

- ❖ Green Book's minimum documentation requirements are as follows:
 - ❖ Management develops and maintains documentation of its internal control system. (3.09)
 - ❖ Management documents in policies the internal control responsibilities of the organization. (12.02)
 - ❖ Management evaluates and documents the results of ongoing monitoring and separate evaluations to identify internal control issues. (16.09)
 - ❖ Management evaluates and documents internal control issues and determines appropriate corrective actions for internal control deficiencies on a timely basis. (17.05)
 - ❖ Management completes and documents corrective actions to remediate internal control deficiencies on a timely basis. (17.06)

Control Environment

- ❖ Formally defined as:
a set of standards, processes, and structures that pervasively affect the system of internal control.
- ❖ The foundation on which everything rests.
- ❖ Key factors:
 - ❖ Management's attitude, or the "Tone at the Top"
 - ❖ Individual attributes, such as Integrity, Ethical Values, & Competence
- ❖ 5 related principles



Control Environment: Principle 1

COSO: “The organization demonstrates a commitment to integrity and ethical values”

Green Book: “The oversight body and management should demonstrate a commitment to integrity and ethical values.”

Attributes that contribute to the design, implementation, and operating effectiveness of this principle:

- ❖ Tone at the Top
- ❖ Standards of Conduct
- ❖ Adherence to Standards of Conduct



Control Environment: Principle 2

COSO: “The board of directors demonstrates independence from management and exercises oversight of the development and performance of internal control.”

Green Book: “The oversight body should oversee the entity’s internal control system.”

Attributes

- ❖ Oversight Structure
- ❖ Oversight for the Internal Control System
- ❖ Input for Remediation of Deficiencies



Control Environment: Principle 3

COSO: “Management establishes, with board oversight, structures, reporting lines, and appropriate authorities and responsibilities in the pursuit of objectives.”

Green Book: “Management should establish an organizational structure, assign responsibility, and delegate authority to achieve the entity’s objectives.”

Attributes

- ❖ Organizational Structure
- ❖ Assignment of Responsibility and Delegation of Authority
- ❖ Documentation of the Internal Control System



Control Environment: Principle 4

COSO: “The organization demonstrates a commitment to attract, develop, and retain competent individuals in alignment with objectives.”

Green Book: “Management should demonstrate a commitment to recruit, develop, and retain competent individuals.”

Attributes

- ❖ Expectations of Competence
- ❖ Recruitment, Development, and Retention of Individuals
 - ❖ Succession and Contingency Plans and Preparation



Control Environment: Principle 5

COSO: “The organization holds individuals accountable for their internal control responsibilities in the pursuit of objectives.”

Green Book: “Management should evaluate performance and hold individuals accountable for their internal control responsibilities.”

Attributes

- ❖ Enforcement of Accountability
- ❖ Consideration of Excessive Pressures



Your responsibilities

- ❖ In your leadership role, you should make every effort to:
 - ❖ Create a positive control environment
 - ❖ Create an open workplace where concerns and comments are welcomed and acted upon
 - ❖ Ensure all duties are performed in an ethical and professional manner
 - ❖ Endorse and actively support internal control system
 - ❖ Communicate and provide training to all employees
 - ❖ Ensure employees are aware of and adhere to Rhode Island Code of Ethics



Risk Assessment

- ❖ A risk is anything that endangers the achievement of an objective.
- ❖ Assessment process is used to identify, analyze, and manage potential risks
- ❖ Involves assessing potential risks in terms of likelihood and impact
- ❖ Purpose is to attain a ***reasonable*** level of assurance that objectives will be achieved
- ❖ 4 related principles



Risk Assessment: Principle 6

COSO: “The organization specifies objectives with sufficient clarity to enable the identification and assessment of risks related to objectives.”

Green Book: “Management should define objectives clearly to enable the identification of risks and define risk tolerances.”

Attributes

- ❖ Definitions of Objectives
- ❖ Definitions of Risk Tolerances



Risk Assessment: Principle 7

COSO: “The organization identifies risks to the achievement of its objectives across the entity and analyzes risks as a basis for determining how the risks should be managed.”

Green Book: “Management should identify, analyze, and respond to risks related to achieving the defined objectives.”

Attributes

- ❖ Identification of Risks
 - ❖ Analysis of Risks
 - ❖ Response to Risks



Risk Assessment: Principle 8

COSO: “The organization considers the potential for fraud in assessing risks to the achievement of objectives.”

Green Book: Management should consider the potential for fraud when identifying, analyzing, and responding to risks

Attributes

- ❖ Types of Fraud
- ❖ Fraud Risk Factors
- ❖ Response to Fraud Risks



Risk Assessment: Principle 9

COSO: “The organization identifies and assesses changes that could significantly impact the system of internal controls.”

Green Book: “Management should identify, analyze, and respond to significant changes that could impact the internal control system.”

Attributes

- ❖ Identification of Change
- ❖ Analysis and Response to Change



Control Activities

- ❖ Actions supported by policies and procedures that help ensure management directives to achieve objectives and respond to risks are carried out properly and timely.
- ❖ To be effective, control activities must be:
 - ❖ Appropriate
 - ❖ Functioning consistently and according to plan throughout the period
 - ❖ Cost effective, comprehensive, reasonable
 - ❖ Directly related to the control objective
 - ❖ Derived from a defined risk to the department
- ❖ Controls can be directive, preventive, or detective
- ❖ Avoid excessive controls!



Control Activities: Principle 10

COSO: “The organization selects and develops control activities that contribute to the mitigation of risks to the achievement of objectives to acceptable levels.”

Green Book: “Management should design control activities to achieve objectives and respond to risks.”

Attributes

- ❖ Response to Objectives and Risks
- ❖ Design of Appropriate Types of Control Activities
 - ❖ Design of Control Activities at Various Levels
 - ❖ Segregation of Duties



Control Activities: Principle 11

COSO: “The organization selects and develops general control activities over technology to support the achievement of objectives.”

Green Book: “Management should design the entity’s information system and related control activities to achieve objectives and respond to risks.”

Attributes

- ❖ Design of the Entity’s Information System
- ❖ Design of Appropriate Types of Control Activities
- ❖ Design of Information Technology Infrastructure
 - ❖ Design of Security Management
- ❖ Design of Information Technology Acquisition, Development, and Maintenance



Control Activities: Principle 12

COSO: “The organization deploys control activities through policies that establish what is expected and procedures that put policies into action.”

Green Book: “Management should implement control activities through policies.”

Attributes

- ❖ Documentation of Responsibilities through Policies
 - ❖ Periodic Review of Control Activities



Information and Communication

- ❖ Information must be current, accurate, appropriate in content, and made available on a timely basis at all staff levels to permit management to achieve its objectives.



Information and Communication: Principle 13

COSO: “The organization obtains or generates and uses relevant, quality information to support the functioning of internal control.”

Green Book: “Management should use quality information to achieve the entity’s objectives.”

Attributes

- ❖ Identification of Information Requirements
 - ❖ Relevant Data from Reliable Sources
 - ❖ Data Processed into Quality Information



Information and Communication: Principle 14

COSO: “The organization internally communicates information, including objectives and responsibilities for internal control, necessary to support the functioning of internal control.”

Green Book: “Management should internally communicate the necessary quality information to achieve the entity’s objectives.”

Attributes

- ❖ Communication throughout the Entity
- ❖ Appropriate Methods of Communication



Information and Communication: Principle 15

COSO: “The organization communicates with external parties regarding matters affecting the functioning of internal control.”

Green Book: “The organization should externally communicate the necessary quality information to achieve the entity’s objectives.”

Attributes

- ❖ Communication with External Parties
- ❖ Appropriate Methods of Communication



Monitoring

- ❖ Internal control is a dynamic process that has to be adapted continuously to the risks and changes that all organizations face
 - ❖ Monitoring is essential to help ensure that internal control remains aligned with changing objectives and risks
- ❖ Monitoring must be an on-going process!



Monitoring: Principle 16

COSO: “The organization selects, develops, and performs ongoing and/or separate evaluations to ascertain whether the components of internal control are present and functioning.”

Green Book: “Management should establish and operate monitoring activities to monitor the internal control system and evaluate the results.”

Attributes

- ❖ Establishment of a Baseline
- ❖ Internal Control System Monitoring
- ❖ Evaluation of Results



Monitoring: Principle 17

COSO: “The organization evaluates and communicates internal control deficiencies in a timely manner to those parties responsible for taking corrective action, including senior management and the board of directors, as appropriate.”

Green Book: “Management should remediate identified internal control deficiencies on a timely basis.”

Attributes

- ❖ Reporting of Issues
- ❖ Evaluation of Issues
- ❖ Corrective Actions



Keep in mind...

- ❖ All objectives, controls, and desired levels of performance must be communicated to all personnel to ensure accountability in an internal control system.
- ❖ It is *up to managers to set up controls and check that they are working*, BUT
- ❖ Unless every employee is aware of his/her responsibilities in the process, the control system will not be completely functional.



Resources

- ❖ COSO

- ❖ <https://www.coso.org/Pages/default.aspx>

- ❖ <https://www.coso.org/Documents/COSO-ICIF-11x17-Cube-Graphic.pdf>

- ❖ The Green Book

- ❖ <http://www.gao.gov/greenbook/overview>

- ❖ RI Office of Internal Audit- Internal Control Guide

- ❖ <http://www.omb.ri.gov/internal-audit/>

- ❖ RI Office of Accounts and Control- Best Practices

- ❖ <http://controller.admin.ri.gov/Best%20Practices/index.php>





Internal Controls Training: Office of Accounts and Control

FUNCTIONS OF ACCOUNTS AND CONTROL & BEST PRACTICES



Joint responsibility for Internal Controls

State Agency Management is responsible for the design and operation of internal control.

The **Office of Accounts and Control's** function is to promote the financial integrity and accountability of state government through sound administrative and *accounting controls* and procedures.

The **Office of Internal Audit (OIA)** provides the Governor and the Director of OMB with an independent appraisal and evaluation of the *effectiveness of financial and operational controls* through objective analyses, evaluations, and recommendations on operations, systems, and contracted services of state government.

Oversight bodies

Federal

Office of Management and Budget

Federal Granting agencies (Dept of Transportation, Health & Human Services, etc.)

U.S. Government Accountability Office (GAO) - Green Book

Office of the Inspector General (OIG)

State

Department of Administration, OMB: *Grants Management & Performance Management*

- Office of Internal Audit (RI OMB)

Office of Auditor General (Legislative Audit Agency)



Internal Control in General

- ❖ Internal control: all of the related methods and measures adopted within a business to enhance the accuracy and reliability of its accounting records by reducing the risk of errors (unintentional mistakes) and irregularities (intentional mistakes and misrepresentations) in the accounting process.



Improving Controls for Cash Receipts

- ❖ Agencies are responsible for developing processes and procedures for the receipt, recording and deposit of cash receipts coming into their control and custody
- ❖ Proper procedures are needed for several reasons:
 - ❖ Safeguard assets of the state
 - ❖ Minimize idle and nonproductive funds
 - ❖ Protect State employees from unfounded charges of mishandling funds

Note: Cash means currency, coins, checks, money orders and debit/credit card transactions.



Risks related to cash

- ❖ Cash has a high degree of inherent risk (vulnerable to being lost, stolen, or misappropriated)
- ❖ Transactions and deposits could be recorded in incorrect account or wrong fiscal period
- ❖ Subject to concealed errors or irregularities going undetected
- ❖ State may not use asset to fullest potential (i.e. loss of interest income if not managed)



General Best Practices for Cash Receipts

- ❖ Access to and location of cash receipts should be limited and restricted only to authorized employees.
- ❖ All cash receipts are to be deposited into a bank account designated and/or approved by the General Treasurer and State Controller.
- ❖ Conduct appropriate background/reference checks on prospective cash receipts handlers.



Principle of Safeguarding

- ❖ Timely deposit of all cash receipts: Deposit daily when cash receipts total more than \$500, but in no case less frequently than once a week.
- ❖ Restrictively endorse checks (“for deposit only”) immediately upon receipt.
- ❖ Cash receipts must be properly safeguarded at all times prior to deposit through the use of adequate physical security (e.g. safe locking cabinets, etc.)



Principle of Safeguarding

- ❖ Provide receipts to each payer, if practical, and maintain a copy of the receipt. Reconcile the total deposited in the bank to the total receipts each month (also applies to principle of Independent Internal Verification).
- ❖ Count cash in a non-public area not easily visible to others.



Best Practices for Agency Review

Review checks to be deposited and verify that:

- ❖ The check has been signed and dated.
- ❖ The pre-printed name (personal checks) agrees with the signature.
- ❖ The numbered amount agrees with the written amount.
- ❖ The check amount agrees with any accompanying documentation.
- ❖ The check is not stale-dated and has not been altered.



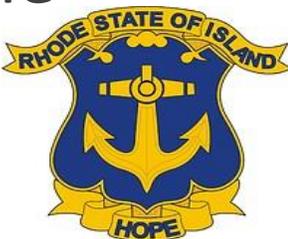
Principle of Segregation of Duties

- ❖ Centralize the receiving of cash for each department or agency within an office, if practical. The preference is to minimize the number of employees who actually handle the cash before it is deposited, while maintaining appropriate separation of duties.
- ❖ All cash receipts must be deposited intact in the bank, that is - no checks may be cashed or disbursements made from cash receipts.



Segregation Examples

- ❖ Separate cash handling duties among different employees:
- ❖ In larger agencies, different employees should be designated to (1) receive cash, (2) deposit cash, and (3) record transactions so that no single employee has control over the entire process.
- ❖ In smaller agencies, with a minimal number of employees, cash operations should be reviewed and approved by someone (preferably a supervisor or manager) other than the person receiving the funds.



Principle of Independent Internal Verification

- ❖ Departments should maintain written procedures for all cash receipting and deposit operations. Procedures should address, at a minimum, staff responsibilities (including backup personnel), key activities, timelines, and the safeguarding of receipts.
- ❖ Procedures should be reviewed on a regular basis for applicability and for monitoring self-compliance.



Principle of Independent Internal Verification

- ❖ Maintain and match a copy of the deposit slip with the bank deposit receipt for all bank deposits.
- ❖ Upon suspicion of fraud or theft, immediately notify the appropriate personnel (i.e. state agency management, Office of Internal Audit, State Controller).



RIFANS Best Practices

- ❖ Employees are set up in the State's accounting system which is known as RIFANS with user names and passwords appropriate for their duties, and their access is requested by their supervisor, and reviewed and approved by Office of Accounts and Control staff. Employees do not share passwords. Only authorized employees are allowed to process payments.
- ❖ Only authorized agency employees request drawdowns from the federal government.
- ❖ An authorized state agency employee initiates the cash receipt journal entry (CR entry) in RIFANS. If material, the RIFANS hierarchy requires it to be approved by the employee's supervisor.



RIFANS Best Practices (continued)

- ❖ The CR entry must then be approved by an authorized employee in the General Treasurer's office who verifies that it agrees to the amount deposited in the state's bank account. Bank reconciliations are prepared & reviewed monthly to ensure that general ledger balances in the accounting system (RIFANS) are reconciled to account balances in the bank.
- ❖ Bank deposit tickets are encoded with a four-digit location number assigned by Treasury to easily identify the agency depositing funds. This same location number is entered in the cash receipt entry in RIFANS to facilitate matching the deposits per the bank to journals in RIFANS.



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