Internal Controls
FMC February 2016

Agenda

✓ **Introduction**

✓ **Anticipated Future**

✓ **SAO Framework**

✓ **What can you do now…….**

Who Am I?

- **Rachael Krizanek**
  - Internal Controls and Policy Manager
  - Been in GA a short time
  - Background is in performance/internal control auditing

Internal Controls – what is it?

- A process that provides reasonable assurance that the objectives of the organization will be achieved

- Not one event, but a series of actions that occur throughout an organization's operations.

- An integral part of the operational processes and not a separate system.

Internal Control Responsibility

Everyone has a responsibility for internal controls

- <u>Management</u> – directly responsible for the design, implementation, and operating effectiveness

- <u>Staff</u> – help management and are responsible for reporting issues

External auditors are ***not*** considered part of an organization's internal control system.

Anticipated Future

Upcoming

- **Redefine the statewide internal control framework**
  - Update standards and policies
  - Provide communications to organizations
  - Provide support to organizations
  - Monitor progress

- **Initial focus will be on financial reporting objective**
  - Still an obligation to comply with Federal Grant requirements

Internal Control Expectations

- **Agency management needs to ensure they understand and assess the risks and ensure they have appropriate and sufficient internal controls**

- **Still responsible even if function is provided by a third party** (ex: Teamworks infrastructure is outsourced but SAO is still responsible for internal controls relating to that outsourced work)

SAO Framework

Future in Georgia

State leadership recognizes the importance of internal controls and as a result SAO will be renewing our focus on this topic. The State will shift from the Committee of Sponsoring Organizations (COSO) framework to our interpretation of the "Green Book" which is published by the Federal Office of Management and Budget (OMB). The Green Book defines the criteria through components and principles and explains why they are integral to an organization's internal control system. **SAO's goal is to provide consistent criteria for designing, implementing, and operating an effective internal control system to mitigate relevant risk.**

SAO Framework

- SAO expects that most organizations already have controls in place, just not yet formally documented

- SAO will communicate general guidance in order to provide consistency on expectations and on what is to be documented

Website Updates

Old guidance has been removed from SAO's website

Framework Content

- Will be based on Green Book, including:
    - General oversight
    - May include some Georgia specific examples or suggested templates

- SAO's framework will provide general guidance, but it will not prescribe *specifically* how management should design, implement, and operate their internal control system.

Green Book Structure

Hierarchical structure of 5 Components and 17 Principles

Control Environment

1. The oversight body and management should demonstrate a commitment to integrity and ethical values.

2. The oversight body should oversee the entity's internal control system.

3. Management should establish an organizational structure, assign responsibility, and delegate authority to achieve the entity's objectives.

4. Management should demonstrate a commitment to recruit, develop, and retain competent individuals.

5. Management should evaluate performance and hold individuals accountable for their internal control responsibilities.

Risk Assessment

6. Management should define objectives clearly to enable the identification of risks and define risk tolerances.

7. Management should identify, analyze, and respond to risks related to achieving the defined objectives.

8. Management should consider the potential for fraud when identifying, analyzing, and responding to risks.

9. Management should identify, analyze, and respond to significant changes that could impact the internal control system.

Control Activities

10. Management should design control activities to achieve objectives and respond to risks.

11. Management should design the entity's information system and related control activities to achieve objectives and respond to risks.

12. Management should implement control activities through policies.

Information and Communication

13. Management should use quality information to achieve the entity's objectives.

14. Management should internally communicate the necessary quality information to achieve the entity's objectives.

15. Management should externally communicate the necessary quality information to achieve the entity's objectives.

Monitoring

16. Management should establish and operate monitoring activities to monitor the internal control system and evaluate the results.

17. Management should remediate identified internal control deficiencies on a timely basis.

Source: GAO. | GAO-14-704G

Where is it Already?

- **Framework/guidance will be phased in by each component over the next calendar year:**

  - Control Environment and Risk Assessment components before end of fiscal year

  - Remaining three components (Control Activities, Information and Communication and Monitoring) by December 2016

- Direct relationship between objectives (which are what an entity strives to achieve) and the components (which represent what is needed to achieve the objectives)

- The relationship is depicted in the form of a cube:

  - The three categories objectives are represented by the columns
  - The five components are represented by the rows
  - The entity's organization structure is represented by the third dimension

Sources: COSO and GAO. | GAO-14-704G
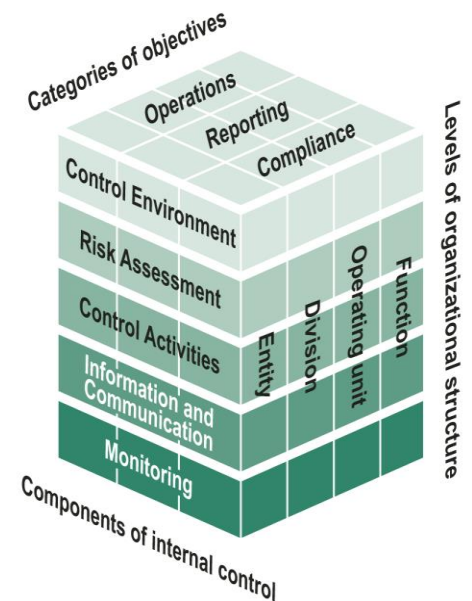
Objectives

Objectives are generally grouped into these categories:

- <u>Reporting</u> – reliability of internal and external reports (BCR & CAFR, including year end forms).

- <u>Operational</u> – effectiveness and efficiency of operations (accomplish mission at least possible cost).

- <u>Compliance</u> – compliance with applicable laws and regulations.

- Established in order to:
  - meet the organization's mission and
  - be in compliance with applicable laws and regulations.

- May be set as part of the strategic planning process, but must be set before designing the organization's internal control system.

- Sub-objectives can be set for operating units within the organizational structure.

Internal Control Design

- Use a risk-based approach to identify the key risks, that would prevent an organization from achieving their objectives
  - Drives allocation of more resources to the areas of highest risk.

- *No* two organizations should have an identical internal control system because of differences in factors such as mission, regulatory environment, size, and management's judgment.

Internal Control System

- The components must be properly designed, implemented, and then operate together, for an internal control system to be effective.

- The 17 principles support the associated components and represent additional requirements for an effective internal controls system.

- Attributes provide further explanation of the requirements

- Once system is in place, how is it working?

- Determine if the controls were :
    - applied at relevant times
    - in a consistent manner
    - by whom they were applied

A deficiency exists when a control does not operate as designed, or when the person performing the control does not possess the appropriate **authority or competence**.

Documentation Requirements

- Documentation is a necessary part of an effective internal control system, but consider cost/benefit.

- The level and nature of documentation will vary based on the size of the organization and the complexity of the internal control system.

- Therefore, management uses judgment in determining the extent of documentation that is needed, however the Green Book does establish some *minimum documentation requirements*.

Documentation Example

- **If a principle is not relevant, the organization supports that determination with documentation that includes:**
  - the rationale of how, in the absence of that principle, the associated component could be designed, implemented, and operated effectively.

What can you do now?

Let's Talk Specifics

Ultimate goal is to document your established internal control system

- Based on guidance from the five components, principles and relevant attributes

  - Start with Control Environment
  - Then move on to Risk Assessment

Starting Points - Consider

Consider the first component – Control Environment:

- Foundation for an internal control system.

- Provides the discipline and structure, which impact the overall quality of internal control.

- Need to maintain an environment that sets a *positive attitude toward internal control.*

Overall, it establishes and documents the tone that personnel should "do the right thing"

Document your control environment:

In narrative form (including all <u>five principles</u> using <u>relevant attributes</u> from the Green Book as guidance)

Control Environment

Component	Principles	Attributes
Control Environment	1. Management and the oversight body should demonstrate a commitment to integrity and ethical values.	1.1 Tone at the top 1.2 Standards of Conduct 1.3 Adherence to Standards of Conduct
	2. The oversight body should oversee the internal control system.	2.1 Oversight Structure 2.2 Oversight for the Internal Control System 2.3 Input for Correction of Deficiencies
	3. Management should establish a structure, assign responsibility, and delegate authority.	3.1 Organizational Structure 3.2 Assignment of Responsibility and Delegation of Authority 3.3 Documentation of the Internal Control System
	4. Management should demonstrate a commitment to recruit, develop, and retain competent individuals.	4.1 Expectations of Competence 4.2 Recruitment, Development and Retention of Individuals 4.3 Succession and Contingency Plans and Preparation
	5. Management should evaluate performance and hold individuals accountable for their internal control responsibilities.	5.1 Enforcement of Accountability 5.2 Consideration of Excessive Pressures

Things to Consider

Documenting your control environment:

- Items to Consider/Include:
  - Code of Ethics (is it easily available for review, are there yearly recertifications for all employees, and is it discussed and provided at new hire orientation)
  - Governor's Executive Order relating to Code of Ethics
  - OCGA sections (code of ethics and conflicts of interest)
  - Employment practices (hiring competent personnel, retaining personnel, evaluating performance, and holding personnel accountable for their responsibilities)
  - Etc.

Next Steps - Consider

Consider the next component – Risk Assessment

- Management performs a risk assessment and develops appropriate risk responses which specify how risks will be handled.

- The nature and extent of management's risk assessment activities should be proportionate to the size of the organization and complexity of its operations.

Overall, it considers what could cause objectives not to be met and documents applicable responses

Next Steps - Consider

- Consider financial reporting objectives, the internal and external reports should:

    ▪ Comply with accounting standards (items recorded at the proper basis)

    ▪ Be complete

    ▪ Contain accurate amounts

    ▪ Be available on a timely basis

The risk assessment process identifies risks that could impact the above from occurring and determines an appropriate risk response

Next Steps Document

Document your risk assessment process relative to financial reporting (for all funds)

- Revenue collections
- BCR process
- CAFR process/Year end forms

Should include all <u>four principles</u> using <u>relevant attributes</u> from the Green Book as guidance

Risk Assessment

Component	Principles	Attributes
Risk Assessment	6. Management should define objectives clearly in order to identify risks and define risk tolerances.	6.1 Definitions of Objectives 6.2 Definitions of Risk Tolerances
	7. Management should identify, analyze, and respond to risks related to achieving the defined objectives.	7.1 Identification of Risks 7.2 Analysis of Risks 7.3 Response to Risks
	8. Management should consider the potential for fraud when identifying, analyzing, and responding to risks.	8.1 Types of Fraud 8.2 Fraud Risk Factors 8.3 Response to Fraud Risks
	9. Management should identify, analyze, and respond to significant changes that could impact the internal control system.	9.1 Identification of Change 9.2 Analysis of and Response to Change

Things to Consider

Documenting your risk assessment process relative to financial reporting (for all funds)

- Consider risks, including fraud, that impact the reporting objectives:
    - Example Revenue Collections
        - I don't know what's owed
        - I don't collect it all
        - I don't record all collected
        - I don't transmit to Treasury timely or at the full amount collected
        - Etc

- Consider risk responses, as appropriate (taking no action may be acceptable, if you are willing to accept the risk occurring)

Documenting your risk assessment process relative to financial reporting (for all funds)

- Consider risks, including fraud, that impact the reporting objectives:
    - Example BCR
        - I don't record all expenditures
        - I don't record to right chartfield (budget reference, program, funding source)
        - Etc

- Consider risk responses, as appropriate (taking no action may be acceptable, if you are willing to accept the risk occurring)

Documenting your risk assessment process relative to financial reporting (for all funds)

- Consider risks, including fraud, that impact the reporting objectives:
  - Example CAFR
    - Forms are incomplete or inaccurate (such as capital assets and leases)
    - New pension and OPEB requirements
    - Are year end forms completed accurately (proper amounts, correct basis, all information provided, etc)
    - Etc

- Consider risk responses, as appropriate (taking no action may be acceptable, if you are willing to accept the risk occurring)

Future

- More to come on……
    - Control Activities
    - Information and Communication
    - Monitoring

Control Activities

- Established through policies and procedures to achieve objectives and respond to risks in the internal control system

- Includes Information Systems

Control Activities

Component	Principles	Attributes
Control Activities	10. Management should design control activities to achieve objectives and respond to risks.	10.1 Response to Objectives and Risks
		10.2 Design of Appropriate Types of Control Activities
		10.3 Design of Control Activities at Various Levels
		10.4 Segregation of Duties
	11. Management should design the information system and related control activities to achieve objectives and respond to risks.	11.1 Design of the Information System
		11.2 Design of the Appropriate Types of Control Activities
		11.3 Design of Information Technology Infrastructure
		11.4 Design of Security Management
		11.5 Design of Information Technology Acquisition, Development, and Maintenance
	12. Management should implement control activities through policies.	12.1 Documentation of Responsibilities through Policies
		12.2 Periodic Review of Control Activities

Information & Communication

- Use of quality information to support the internal control system

- Effective information and communication are vital for an organization to achieve its objectives

- Management needs access to relevant and reliable communication related to internal as well as external events.

Information & Communication

Component	Principles	Attributes
Information and Communication	13. Management should use quality information to achieve the organization's objectives.	13.1 Identification of Information Requirements
		13.2 Relevant Data from Reliable Sources
		13.3 Data Processed into Quality Information
	14. Management should internally communicate the necessary quality information to achieve the organization's objectives.	14.1 Communication throughout the Organization
		14.2 Appropriate Methods of Communication
	15. Management should externally communicate the necessary quality information to achieve the organization's objectives.	15.1 Communication with External Parties
		15.2 Appropriate Methods of Communication

Monitoring

- Internal controls is a dynamic process and needs to be adapted continually to the risks and changes an organization faces

- Helps internal controls remain aligned with changing objectives, environment, laws, resources, and risks

- Assesses the quality of performances over time and promptly resolves the findings of audits and other reviews

Monitoring

Component	Principles	Attributes
Monitoring	16. Management should establish and operate monitoring activities of the internal control system and evaluate the results.	16.1 Establishment of a Baseline
		16.2 Internal Control System Monitoring
		16.3 Evaluation of Results
	17. Management should correct identified internal control deficiencies on a timely basis.	17.1 Reporting of Issues
		17.2 Evaluation of Issues
		17.3 Corrective Actions

✓ **The Green Book is available on GAO**'**s website at:**

www.gao.gov/greenbook

SAO's website:

http://sao.georgia.gov/internal-controls

Information will be added when available

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