

Applying COSO Internal Control Framework to Governments

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Key Resources on Internal Control and Fraud

- Evaluating Internal Controls, A Local Government Manager's Guide-GFOA
- www.coso.org
 - Executive summaries available for free on three main works
 - Internal Controls-An Integrated Framework- 1992
 - Enterprise Risk Management- 2004
 - Guidance on Monitoring Internal Control Systems- 2009
 - Actual publications available for purchase through AICPA

Key Resources on Internal Control and Fraud

- www.aicpa.org
 - Statement of Auditing Standards 99-Consideration of Fraud in a Financial Statement Audit
 - Appendix on Fraud Risk Factors
 - Appendix on Management Anti-Fraud Programs and Controls
- www.acfe.com
 - Association of Certified Fraud Examiners
 - Report to the Nation on Occupational Fraud
 - Fraud Prevention Check-Up

Introduction and background

- Management has key role in internal controls
- *Internal Control Integrated Framework (COSO Report)*
 - Issued by the Committee of Sponsoring Organizations of the Treadway Commission in 1992

Introduction and background (continued)

- Who are the “Organizations?”
 - American Accounting Association
 - American Institute of Certified Public Accountants
 - Financial Executives International
 - Institute of Management Accountants
 - The Institute of Internal Auditors

Introduction and background (continued)

- COSO Report
 - Discusses management objectives
 - Provides conceptual framework for internal controls
 - Discusses responsibility for internal controls

Management's Objectives

- Background
 - All organizations have a purpose
 - Management's role is to achieve that purpose
 - Constraints and expectations
 - Explicit
 - Implicit

Management's Objectives

- Four objectives
 - Effectiveness
 - Efficiency
 - Compliance
 - Financial Reporting

Management's Objectives

- Effectiveness
 - Is the entity achieving its objectives?
 - Compare focus on day-to-day activities
- Efficiency
 - Scarcity of resources
 - Natural tie to effectiveness

Management's Objectives

- Compliance
 - Management's authority limited
 - Policy, law, regulation
- Financial reporting
 - Managers as financial decision makers
 - Demonstrating accountability

Definition of Internal Controls

- The tools used by *management* to achieve *management's* objectives

Framework Overview

- Five essential elements
 - 1) Provides a favorable control environment
 - 2) Continually assesses risk
 - 3) Establishes and maintains effective control-related policies and procedures

Framework Overview

- Five essential elements (continued)
 - 4) Effectively communicates information
 - 5) Monitors the effectiveness of control policies and procedures as well as the resolution of potential problems identified by controls

Element 1 - Control Environment

- Spoken and unspoken expectations (i.e., “corporate culture”)
- Internal controls do not function in a vacuum
- Key to the effectiveness of the other framework elements

Element 1 - Control Environment (continued)

- Elements of a favorable control environment
 - Management is knowledgeable about controls
 - Management is committed to establishing and maintaining controls
 - Management communicates support to staff at all levels

Element 2 - Risk Assessment

- External risks
- Internal risks
- Management need to *anticipate* risks
- Ongoing process
 - Identification
 - Assessment

Element 3 - Control-Related Policies and Procedures

- Designed to compensate for identified risks
- Specific policies and procedures
 - Prevent undesired actions and events
 - Alert management

Element 4 - Communication

- Pervasive (part of all of the other elements)
- Basic requirements
 - Right information
 - Right individuals
 - Right Time
 - Right Format
- Within and between levels and activities
- With those outside the entity

Element 5 - Monitoring

- Ongoing
- Targets
 - Effectiveness of controls
 - Effectiveness of response to potential problems indicated by controls

Limitations of Internal Controls

- Cost/benefit considerations
- Potential for “management override”
- Risk of collusion
- Risks posed by redundant controls

Responsibility for Internal Controls

- Management *primarily* responsible
- Governing body *ultimately* responsible
- Auditors can *assist* management in meeting its control responsibilities

Responsibility for Internal Controls (continued)

- Specific responsibilities
 - Design
 - Implementation
 - Monitoring
 - Reporting

Auditors

- Internal auditors as “super control”
- Independent auditors
 - Support opinion on the financial statements
 - No assurance regarding “immaterial” weaknesses
 - *Not* a substitute for ongoing monitoring by management

Summary

- **Five framework elements**
 - Control environment
 - Risk assessment
 - Policies and procedures
 - Communication
 - Monitoring
- **Limitations**

- **Management *primarily* responsible**
- **Board *ultimately* responsible**
- **Role of internal auditor**
- **Role of independent auditor**

Management Objectives

- Effectiveness
- Efficiency
- Compliance
- Financial Reporting

Effectiveness

- Need to identify entity's objectives
 - Provide goals for management
 - Criteria for assessing management
- Focus on results
 - Output
 - Outcome
 - Combination measures

Efficiency

- Natural link with effectiveness
- Efficiency = Obtaining desired results with least expenditure of resources
- Measures of efficiency
 - Effort/output
 - Effort/outcome
 - Hybrid

Efficiency (continued)

- Economy
 - Reduction of cost side of equation
 - Only means of efficiency if level of effectiveness predetermined

Compliance

- Both *ensure* and *demonstrate*
- Specific examples of compliance
 - Annual appropriated budget
 - Grantor requirements
 - State oversight requirements
 - IRS requirements
 - Bond covenants
 - Local laws and regulations

Compliance (continued)

- Techniques to ensure budgetary compliance
 - Preaudit of available funds
 - Encumbrance accounting
 - Allotments

Financial Reporting

- Internal financial reporting
- External financial reporting
 - Special-purpose external financial reports
 - General-purpose external financial reports

Summary

- Objectives
 - Effectiveness
 - Efficiency / economy
 - Compliance
 - Financial reporting
- Tools to achieve objectives = internal controls

Five Minute Assessment of Internal Controls

- Control Environment
 - Management Attitude
 - Employee Morale and Commitment
- Segregation of Duties (throughout city)
 - Separate incompatible duties:
 - Authorization/Review
 - Record Keeping
 - Custody

Five Minute Assessment of Internal Controls

- Timely and Meaningful Reconciliations
 - Bank Accounts
 - Subsidiary Ledgers to G/L
 - Suspense Accounts
- System Controls and Vulnerabilities
 - Access and audit trails
 - Sensitive Systems
 - Treasury
 - Credit Cards
- Training and Documentation
 - Inside and Outside Finance
 - Knowing why controls are there

Aftermath of first COSO report

- First report (1992) well received
 - Provides criteria now commonly used for internal control assessments
- Follow-up report designed to place earlier report in an even broader, conceptual framework
 - *Enterprise Risk Management – an Integrated Framework* (2004)

Nature of “enterprise risk management”

- A process designed
 - To identify potential events that may affect the entity
 - To keep risk within the entity’s risk appetite,
 - To provide reasonable assurance regarding the achievement of the entity objectives.
- Necessarily involves both individual units and the organization as a whole.

Objectives - enterprise risk management

- Differences from COSO 1992
 - Reporting objective broadened to encompass nonfinancial and internal reporting
 - “Strategic objectives” category added
 - “Higher level objective”
 - Other objectives must align with it

Framework elements - enterprise risk management

- “Risk assessment” element of COSO 1992 divided into four separate elements
 - Objective setting (risk to retain)
 - Event identification (risks/opportunities)
 - Risk assessment (inherent risk)
 - Risk response (avoid, reduce, share, accept)
 - Retained risk within risk appetite

Objectives – COSO 1992 v. COSO 2004

Exhibit I: Comparison of COSO Framework Objectives

COSO I	COSO II
Internal Control – Integrated Framework	Enterprise Risk Management – Integrated Framework
	■ <i>Strategic objectives (higher level objective)</i>
■ Effectiveness and efficiency of operations	■ Operations
■ Reliability of financial reporting	■ Reporting (both financial and nonfinancial)
■ Compliance with applicable laws and regulations	■ Compliance

Framework elements – COSO 1992 v. COSO 2004

Exhibit 2: Comparison of COSO Framework Components

COSO I	COSO II
Internal Control – Integrated Framework	Enterprise Risk Management – Integrated Framework
<ul style="list-style-type: none"> ■ Control environment ■ <i>Risk assessment</i> 	<ul style="list-style-type: none"> ■ Internal environment (include risk appetite) ■ <i>Objective setting</i> ■ <i>Event identification</i> ■ <i>Risk assessment</i> ■ <i>Risk response (avoid, reduce, share, accept)</i>
<ul style="list-style-type: none"> ■ Policies and procedures 	<ul style="list-style-type: none"> ■ Control activities
<ul style="list-style-type: none"> ■ Communication 	<ul style="list-style-type: none"> ■ Information and communication
<ul style="list-style-type: none"> ■ Monitoring 	<ul style="list-style-type: none"> ■ Monitoring