GAO Topic of the Month – October 2023

Internal Controls

Background

This month's topic is Internal Controls. In 1992, COSO (Committee of Sponsoring Organizations of the Treadway Commission) developed a COSO Framework for evaluating internal controls. The COSO model defines internal control as a process effected by an entity's board of directors, management and other personnel designed to provide reasonable assurance of the achievement of objectives in the following categories:

- Operational Effectiveness and Efficiency
- Financial Reporting Reliability
- Applicable Laws and Regulations Compliance

In an effective internal control system , the five (5) components: control environment, control activities, information and communication, risk assessment, and monitoring, work together to support the achievement of an entity's mission, strategies and related business objectives.

A good example of risk assessment and monitoring is the Internal Control Self-Assessment Surveys that all agencies are required to complete each fiscal year. Additional resources regarding internal controls can be found in the SAAM Topic 05, *Internal Controls*, and the Internal Controls training available in TraCorp (course title INTCONTR_S) Additionally, a wide variety of research can be conducted on the subject, and there are many helpful resources available on the internet.

Practical Applications

Exhibit A below identifies the five (5) principles of internal controls and provides examples for each principle. The principles are authorization, documentation, reconciliation, safeguarding of assets, and the segregation of duties.

Segregation of Duties

Segregation of duties (SoD) is one of the most important controls an organization should have in place. This control is used in many procedures and processes.

Internal Controls

Adequate SoD reduces the likelihood that errors, intentional or unintentional, will remain undetected by providing for separate processing by different individuals at various stages of a transaction and for independent reviews of the work performed. There are four (4) primary benefits of SoD:

- The risk of deliberate fraud is mitigated as the collusion of two or more persons would be required in order to circumvent controls.
- The risk of legitimate errors is mitigated as the likelihood of detection is increased.
- The cost of corrective actions is mitigated as errors are generally detected relatively earlier in their lifecycle.
- The organization's reputation for integrity and quality is enhanced through a system of checks and balances.

One of the most common root causes of fraud is the lack of SoD controls, weak SoD controls, inappropriate compensating controls, or failure to update SoD controls when responsibilities change. Additionally, those who are part of the SoD must know why they are part of the control and what actions they need to take. Going through the motions is not an effective internal control.

Control Environment vs Behaviors

Internal controls are affected by the environment (the established controls) and behaviors (how the controls are followed). If controls are not in place, risk increases. If individuals bypass or do not follow controls, risk increases.

The control environment includes:

- Management's goals and objectives
- Management's intentions
- Management's risk tolerance
- Laws and regulations
- Organization history and culture
- The "Tone at the Top," "Middle," and "Bottom"
- Policies and procedures
- Limited access
- Transaction initiation
- Transaction support
- Transaction recording
- Transaction review and approval
- Transaction activity summary
- Meaningful quality/effectiveness analysis

Control behaviors are affected by an individual's:

- Knowledge and skills
- Interest (motivation, critical thinking, focus, alertness, mental clarity)
- Time
- Supervisor support
- Peer support

Internal Controls

Common Reasons Why Internal Controls Fail

- Poor design
- Poor implementation
- Poor maintenance
- Insufficient skills – situational incompetence
- Blind trust
- Willful blindness
- Inadequate information (physical and time distance or a third-party having key records, information not supplied, or the user doesn't understand the available information)
- Culture of not questioning the strange, odd, or curious
- Time pressure
- Process mindset
- Frustration
- Fatigue
- Acceptance of the situation
- Intentional override
- Wrongdoing/misconduct/theft/fraud
- Signing without knowing
- Trusting without verifying
- Not reviewing control reports
- Expectations without skills

When behaviors override the internal control environment, the internal controls are no longer effective. For example, when an individual is to review and approve a transaction or document, if the approver doesn't know what they are looking for and/or if they do not question, their approval will have little to no value. Additionally, if a physical security is in place such as a cipher lock on the door to a secured area such as a datacenter to control access, but the door is propped open, then the control is bypassed and is no longer effective. When evaluating your internal controls, you should look beyond the control environment or processes in place and also look at the control behaviors to make sure that the controls are actually effective.

Suggestions to improve internal controls include visible vocal leadership at every level, clear goals and objectives, meaningful risk brainstorming, effective design, effective implementation, real-world situation staff training, effective monitoring, independent objective compliance reviews, stress testing, and accountability.

What Doesn't Work When Reviewing Internal Controls?

- Inconsistent leadership example
- Mixed messages
- Unclear responsibility
- Lack of accountability

Internal Controls

- Cookbook approaches
- Form over substance
- Mechanical compliance
- Same old procedures
- Kicking the issue down the road

Conclusion

The COSO model defines internal control as "a process effected by an entity's board of directors, management and other personnel designed to provide reasonable assurance of the achievement of objectives." These objectives fall roughly into the following, distinct but overlapping categories: operations, reporting, and compliance. The COSO model can be applied to practical applications in day-to-day business operations. Segregation of duties in one of the most important aspects of internal controls because it mitigates the risk of fraud. Although an entity can establish a good set of internal controls there are many reasons and/or factors that can contribute to the breakdown of such controls.

Looking at the behaviors regarding your internal controls can also lead to improvements and a strengthening of your internal controls successes. Internal controls can be strengthened and improved by continual review and taking action to make it better. Internal controls are not stagnant. Factors, the environment, and the behaviors that impact internal controls are constantly changing.

Resources

State of Arizona Accounting Manual (SAAM) Topic 05 – *Internal Controls*
https://gao.az.gov/state-arizona-accounting-manual-saam

Section	Title
05	General Internal Controls
06	Internal Control Principles and Practices
07	Internal Controls Considerations for IT Environments
10	Internal Control by Process
15	Code of Conduct for Employees Involved in Financial Activities
20	Falsification of Public Records
21	Preparation and Correction of Paper Accounting Records
25	Monthly Financial Review and Verification
26	Internal Control Self-Assessment Surveys
30	Fraud, Theft, Waste and Abuse
35	Related Party Transactions
40	Limitation of Security Roles in Certain Systems
55	Transmission and Storage of Confidential and Sensitive Information

CBT – Internal Controls Training, Course Code INTCONTR_S available through TraCorp

AGA – Fraud Prevention Tool - https://www.agacgfm.org/Resources/intergov/FraudPrevention.aspx

Internal Controls

Note: Some information included was provided in a presentation by John J. Hall, CPA,
https://johnhallspeaker.com/.

Internal Controls

Exhibit A – Practical Applications

	Principles of Internal Control	Examples of Internal Controls
Authorization	Appropriate personnel should review and/or approve the transactions before execution	➢ Set the required level of authority within the organization (e.g. Director/Deputy Director/CFO, etc.) ➢ Define matters to be authorized ➢ Timely authorization
Documentation	Sufficient information is recorded or retained to support and illustrate transactions occurred	➢ Establish policies and procedures for key areas ➢ Use standard forms for key processes ➢ Maintain records of communications/meetings
Reconciliations	Account reconciliations are performed in a timely manner	➢ Monthly financial reviews ➢ Bank statements ➢ Inventories (fixed and retail)
Safeguarding of Assets	Physical items (e.g. cash, fixed assets, computers) are secured and are not accessible by unauthorized personnel	➢ Restrict unauthorized access to fixed assets and cash with security (e.g. store the cash in a locking safe, lock storerooms) ➢ Restrict, maintain, and review the list of authorized personnel with access to safes and storage of assets ➢ Track fixed assets, including IT assets ➢ Use of individual logins, passwords, and security to monitor and control access to buildings, equipment, computer systems, etc.
Segregation of Duties	No single individual should have taken over conflicting duties and responsibilities	➢ Separate duties where possible to maintain checks and balances ➢ Document assigned responsibilities ➢ Regular review of conflict in duties ➢ Ensure each individual is trained regarding their role and responsibilities