

STATE BOARD OF INTERNAL CONTROL

INTERNAL CONTROL OVERVIEW

Outline

1. Defining Internal Control
2. Internal Control Guidance – Two Frameworks
3. Components and Principles of Internal Control
4. Example
5. How the State of South Dakota is doing?
Keith's opinion
6. What is the role the State Board of Internal Control

Disclaimer

Keith Senger is not an Internal Control expert

- I have not received any special training
- I do not have all the answers
- I have never set up an Internal Control system
- I am not smarter than anyone else in this room
- **We are all in the same situation – we will learn together**

DON'T SHOOT THE MESSENGER

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Defining Internal Control

Why do we need Internal Control?

- Helps an organization meet its OBJECTIVES
- Helps management stay focused on achievement of goals
- Enables an organization to effectively and efficiently achieve goals and OBJECTIVES
- Increased time and effort on the front end will create savings on the backend
 - Increase efficiencies
 - Minimize inefficiencies
- Good Government

(Per COSO Integrated Control – Integrated Framework and The Green Book)

Defining Internal Control

Internal Control (I/C) is:

- A dynamic and integrated process created and used by management
- A responsibility of management
- Designed to provide *reasonable* assurance regarding the achievement of the entity's OBJECTIVES
- Built into the entity as part of the organizational structure to help the entity achieve its OBJECTIVES on an ongoing basis

It is an entity's CULTURE

(Per COSO Integrated Control – Integrated Framework and The Green Book)

Defining Internal Control

An entity's OBJECTIVES (and related risks) can be broadly classified into one or more of the following three distinct but overlapping categories:

- ***Operational Objectives*** – effectiveness and efficiency of operations – operational and financial goals
- ***Reporting Objectives*** – reliability, timeliness, and transparency of internal/external financial/non-financial accounting and reporting
- ***Compliance Objectives*** – adherence to applicable laws and regulations (state, federal, and other)

(Per COSO Integrated Control – Integrated Framework and The Green Book)

Defining Internal Control

Internal Control is:

- ▶ The plans, methods, policies, and procedures used to fulfill the mission, strategic plan, goals, and objectives of the entity.
- ▶ The first line of defense in achieving the entity's objectives.
- ▶ Management's tool to achieve desired results through effective stewardship of public resources.

(Per COSO Integrated Control – Integrated Framework and The Green Book)

Defining Internal Control

Internal Control is:

- ▶ Continuously built into the components of operations
- ▶ Effected by people
- ▶ A series of actions (NOT ONE EVENT) that occur throughout the entity's operations
- ▶ An integral part of operational processes used to guide operations

(Per COSO Integrated Control – Integrated Framework and The Green Book)

Defining Internal Control

Fundamental Concepts of Internal Control :

- Geared to the achievement of objectives
- Consists of ongoing tasks – a means to an end, not an end in itself
- Effected by people – not merely about policies and procedures manuals, system and forms but about people and the actions they take at every level of an organization to affect internal control
- Able to provide reasonable assurance – not absolute assurance
- Adaptable to the entity structure – flexible in application to departments, offices, processes, etc.

(Per COSO Integrated Control – Integrated Framework and The Green Book)

Defining Internal Control

- Internal Control is NOT just an accounting thing
- It covers every aspect of State Government
 - Budgeting
 - Building roads and bridges
 - Correctional facility operation
 - Education
 - EVERYTHING and Accounting

Defining Internal Control

- Internal Control is everything an entity does to help achieve its objectives
 - Prevent bad things from happening
 - Foster good things to happen
- It should include **EVERY INDIVIDUAL** associated with State Government.

VERY BROAD

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Internal Control Guidance

▶ COSO's Internal Control – Integrated Framework

- Committee of Sponsored Organizations of the Treadway Commission
- 1992 – Original Internal Control framework
- Updated May 2013
- Predominantly the private sector

▶ Standard for Internal Control in the Federal Government (Green Book)

- US Code required the Comptroller General to issue I/C standards
- US Government Accountability Office – by the Comptroller General
- Published September 2014
- The “Green Book”

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3 OBJECTIVES

(COSO and the Green Book)

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(Per COSO Integrated Control – Integrated Framework and The Green Book)

5 Components of Internal Control

(COSO and the Green Book)

1. Control Environment
2. Risk Assessment
3. Control Activities
4. Information and Communication
5. Monitoring

INTEGRATED AND INTERDEPENDENT

5 Components of Internal Control

(COSO and the Green Book)

1. Control Environment

- The culture and attitudes that exists in the entity toward meeting the entity's objectives
- Integrity and ethical values of the organization
- Attitudes of all employees within the entity
- Sets the standards, processes, and structures for internal control system
- Foundation for internal control system
- Provides discipline and structure
- Management's reinforcement
- **Tone At The Top**
- **Tone At The Bottom**

5 Components of Internal Control

(COSO and the Green Book)

2. Risk Assessment (internal and external)

- Risk is defined as the possibility that an event will occur and adversely affect the achievement of objectives
- Risk assessment is a dynamic and iterative process for identifying and controlling those risks to an acceptable tolerance
- **Risk Assessment is the PROCESS of determining:**
 - What can go wrong
 - What can we do to prevent it or minimize the impact
 - Iterative – repeating – ongoing – never ending

5 Components of Internal Control

(COSO and the Green Book)

2. Risk Assessment

- How do we accomplish?
 - Management, team leaders and employees
 - Brain storming meetings
 - Identify and document what risks the entity faces on every level
 - Document what the entity is going to do to minimize that risk to acceptable levels

5 Components of Internal Control

(COSO and the Green Book)

3. Control Activities

- Actions established through policies and procedures to help ensure the achievement of the entity's objectives and to mitigate risk
- Performed at all levels of the entity, within different stages of processes, and within the technology environment
- Control activities can be:
 - Preventive or Detective controls
 - Manual or Automated activities
- Segregation of duties, reconciliations, review of work
- Documentation, **DOCUMENTATION, DOCUMENTATION**

5 Components of Internal Control

(COSO and the Green Book)

4. Information and Communication

- Necessary for entity to carry out internal control responsibilities and achievement of objectives
- Continual and iterative process of providing, sharing, and obtaining necessary information and disseminating it throughout the organization (up, down, and across)
- Quality information exchanged between management and personnel and is used to support the internal control system
- Clearly communicate mission, objectives, integrity, expectations, etc.
- Communicate the results of controls, errors, etc.

5 Components of Internal Control

(COSO and the Green Book)

5. Monitoring

- Ongoing evaluations, separate evaluations, or a combination of both that management establishes and operates to assess the quality of performance of the internal control system
- Ascertain whether each of the 5 components are present, and functioning as anticipated
- I view the Monitoring component as an additional Control Activity to ensure the other 4 components are present and functioning as anticipated

5 Components of Internal Control

(COSO and the Green Book)

5. Monitoring

Fictitious example of a KEY control procedure:
State Park fees are reconciled and deposited by someone other than the person at the park station cash register (segregation of duties).

Monitoring: What is being done to verify this is happening? Is anyone looking at who is reconciling before depositing? Is anyone looking to see if a reconciliation is done?

5 Components of Internal Control

(COSO and the Green Book)

1. Control Environment
 2. Risk Assessment
 3. Control Activities
 4. Information and Communication
 5. Monitoring
- All five Components are **INTEGRATED AND INTERDEPENDENT**
 - All five Components are necessary to have effective Internal Control

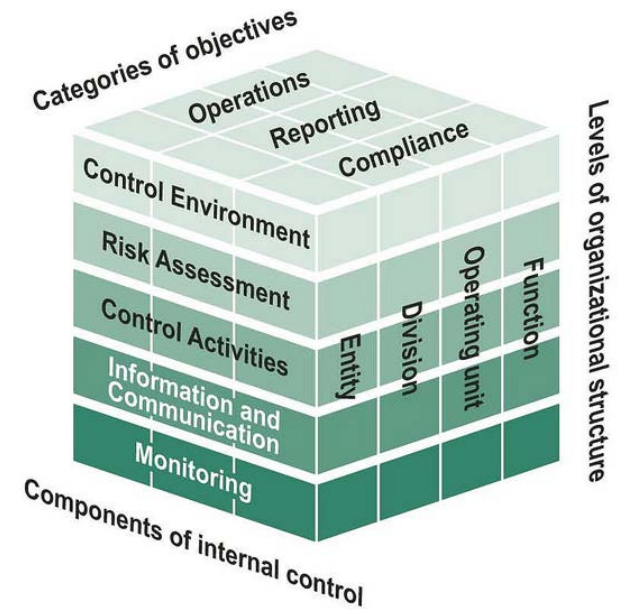
Relationship of Objectives and Components

A direct relationship exists between *objectives*, which are what an entity strives to achieve, *components*, which represent what is required to achieve the objectives, and the *organizational structure* of the entity. This relationship can be depicted in the form of a cube.

- ▶ The three categories of objectives – *Operations*, *Reporting* and *Compliance* – are represented by the columns
- ▶ The five components are represented by the rows
- ▶ An entity's organizational structure is represented by the third dimension



COSO Cube



Green Book Cube

17 Principles (COSO)

Control Environment

1. Demonstrates commitment to integrity and ethical values
2. Exercises oversight responsibility
3. Establishes structure, authority and responsibility
4. Demonstrates commitment to competence
5. Enforces accountability

Risk Assessment

6. Specifies relevant objectives
7. Identifies and analyzes risk
8. Assesses fraud risk
9. Identifies and analyzes significant change

Control Activities

10. Selects and develops control activities
11. Selects and develops general controls over technology
12. Deploys through policies and procedures

Information & Communication

13. Uses relevant information
14. Communicates internally
15. Communicates externally

Monitoring Activities

16. Conducts ongoing and/or separate evaluations
17. Evaluates and communicates deficiencies

17 Principles (Green Book)

Control Environment

1. Demonstrate Commitment to Integrity and Ethical Values
2. Exercise Oversight Responsibility
3. Establish Structure, Responsibility, and Authority
4. Demonstrate Commitment to Competence
5. Enforce Accountability

Risk Assessment

6. Define Objectives and Risk Tolerances
7. Identify, Analyze, and Respond to Risk
8. Assess Fraud Risk
9. Analyze and Respond to Change

Control Activities

10. Design Control Activities
11. Design Activities for the Information System
12. Implement Control Activities

Information & Communication

13. Use Quality Information
14. Communicate Internally
15. Communicate Externally

Monitoring

16. Perform Monitoring Activities
17. Remediate Deficiencies

COSO Internal Control — Integrated Framework Principles



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Control Environment

- 1 The organization demonstrates a commitment to integrity and ethical values.
- 2 The board of directors demonstrates independence from management and exercises oversight of the development and performance of internal control.
- 3 Management establishes, with board oversight, structures, reporting lines, and appropriate authorities and responsibilities in the pursuit of objectives.
- 4 The organization demonstrates a commitment to attract, develop, and retain competent individuals in alignment with objectives.
- 5 The organization holds individuals accountable for their internal control responsibilities in the pursuit of objectives.

Risk Assessment

- 6 The organization specifies objectives with sufficient clarity to enable the identification and assessment of risks relating to objectives.
- 7 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.
- 8 The organization considers the potential for fraud in assessing risks to the achievement of objectives.
- 9 The organization identifies and assesses changes that could significantly affect the system of internal control.

Control Activities

- 10 The organization selects and develops control activities that contribute to the mitigation of risks to the achievement of objectives to acceptable levels.
- 11 The organization selects and develops general control activities over technology to support the achievement of objectives.
- 12 The organization deploys control activities through policies that establish what is expected and procedures that put policies into action.

Information & Communication

- 13 The organization obtains or generates and uses relevant, quality information to support the functioning of internal control.
- 14 The organization internally communicates information, including objectives and responsibilities for internal control, necessary to support the functioning of internal control.
- 15 The organization communicates with external parties regarding matters affecting the functioning of internal control.

Monitoring Activities

- 16 The organization selects, develops, and performs ongoing and/or separate evaluations to ascertain whether the components of internal control are present and functioning.
- 17 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.

For more information about COSO, visit coso.org.

COSO vs. Green Book

Component	COSO	Green Book
Control Environment	5 Principles 20 Points of Focus	5 Principles 13 Attributes
Risk Assessment	4 Principles 27 Points of Focus	4 Principles 10 Attributes
Control Activities	3 Principles 16 Points of Focus	3 Principles 11 Attributes
Information & Communication	3 Principles 14 Points of Focus	3 Principles 7 Attributes
Monitoring	2 Principles 10 Points of Focus	2 Principles 6 Attributes

Difficulties of Implementing Internal Control

▶ Time consuming

- Good internal control systems take **years** to develop, implement, and document
- Good internal control systems must be continuously evaluated and updated

▶ Costly

- Resources (staffing, systems, etc.)
- Cannot eliminate all risk
- Must accept some level of risk

▶ How much is enough?

- Should we spend \$1 to safeguard \$10?
- Should we spend \$10 to safeguard \$1?

▶ **BABY STEPS**

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Every Day Example

- ▶ Family = Business Entity or Government Agency
- ▶ Parents = Management
- ▶ Children = Employees
 1. Control Environment
 - Tone of the parents
 - Willingness to accept that tone by the children
 2. Risk Assessment
 - Objective – keeping kids safe
 - Risk – taken by stranger
 3. Control Activities
 - Stranger Danger – You are NOT my dad.
 4. Information and Communication
 5. Monitoring – Some parents actually tested children to make sure they followed though.

Everyday Example

- ▶ We are just formalizing this process for the State of South Dakota
- ▶ Internal Control is taking an every day process and
 - Implementing it
 - Integrating it into everyday work processes
 - Documenting it

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The State's Internal Control System

The State has a lot of Control Activities but weak Internal Controls

- The State has hundreds upon hundreds of Control Activities (policies and procedures) both detective or preventative; and automated or manual
- Weak Internal Control System
- Missing Components and Principles

State's I/Cs – Control Environment

- ▶ In order for an internal control to be effective and successful, it must start at the top and have buy-in all the way to the bottom
 - We have a weak Control Environment
 - Management wants it, encourages it, but does not give enough resources or ample attention
 - Many in state government are more focused on getting the job done, or the task completed and do not think about the importance or the necessity of strong Internal Controls
 - BURDEN

State's I/Cs – Risk Assessment

- ▶ Essentially nonexistent

State's I/Cs – Control Activities

- ▶ The State has hundreds upon hundreds of Control Activities
 - Manuals
 - Policies and procedures
 - Both detective or preventative
 - Automated or manual
 - Job descriptions
- ▶ Many are not properly documented
- ▶ Many are inefficient (spend \$10 to protect \$1)
- ▶ Many are ineffective (do not prevent risk)
- ▶ Need to implement more or different controls in high risk areas
- ▶ Need to eliminate some controls in low risk areas (cost efficiency)

State's I/Cs – Information and Communication

- ▶ Very weak to nonexistent

State's I/Cs – Monitoring Activities

- ▶ Very weak to nonexistent

What Can The State Do?

1. Improve the *Control Environment*
 - From top to bottom
 - From bottom to top
2. Implement State, Agency, Division, and Office *Risk Assessments*
3. Revamp, revise, and document *Control Activities*
4. Develop and Improve *Information and Communication*
5. Increase and Improve *Monitoring Activities*

What Will it Take?

Commitment and Persistence from:

- Legislature
- Governor
- Lieutenant Governor
- Cabinet Members
- Agency Secretaries
- Department Directors
- Program Managers
- Finance Officers
- ALL State Employees

What Will it Take?

- ▶ Support from the top
- ▶ Buy-in from the bottom
- ▶ Statewide Internal Control training
- ▶ Agency specific Internal Control Officers
- ▶ A LOT of work
- ▶ Required documentation of Internal Control
- ▶ Professional skepticism (trust, but verify)
- ▶ **TIME**

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State Board of Internal Control

Control Environment

- The Legislature, the Governor, and the Lieutenant Governor have started to set the tone at the top.
- This Board must do the same.
 - Demonstrate a commitment to integrity and ethical values
 - Demonstrate a commitment to attracting, developing, and retaining competent individuals in alignment with objectives (do not hire an accountant to design a bridge, and do not hire an engineer to do financial accounting and reporting)
 - Hold individuals accountable
 - Expect and require excellence of all individuals
- Start with developing a Statewide Code of Conduct and a Conflict of Interest policy
- Lead the way for all the agencies to improve the Control Environment.

State Board of Internal Control

Risk Assessment

- This Board must:
 - Identify high level Statewide objectives
 - Evaluate high level Statewide risks, analyze risks, and determine how they should be managed
 - Consider potential fraud

Control Activities

- This Board must:
 - Develop high level Statewide policies, procedures, and other control activities that mitigate risk to acceptable levels in order to achieve objectives

State Board of Internal Control

Information and Communication

- This Board must:
 - Facilitate, enable, and expect adequate information and communication
 - Practice adequate information and communication itself
 - Push information down
 - Receive information

Monitoring Activities

- This Board must:
 - Partake in monitoring activities
 - Ask questions
 - Take an active role in agency deficiencies

CLOSING

- ▶ We need to follow the lead of the Governor, the Lt. Governor, and the Legislature
 - Governor's Internal Control Initiative
 - SB162
- ▶ We have a lot to do
- ▶ We will all learn along the way
- ▶ We will take baby steps

QUESTIONS?