The Importance of Internal Controls in Light of the Uniform Grant Guidance: How They Can Protect the Integrity of Federal Grants

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Why Do We Have Internal Controls?

"Stay with me now, people, because in step C, things get a bit delicate."
• The Federal Managers’ Financial Integrity Act of 1982
  • Requires the General Accountability Office (GAO) to issue standards for internal controls in the government.
  • Standards for Internal Control in the Federal Government, located here:
The Definition of Internal Controls

§ 200.61 Internal controls.

- *Internal controls* means a process, implemented by a non-Federal entity, designed to provide reasonable assurance regarding the achievement of objectives in the following categories:
  
a. Effectiveness and efficiency of operations;
  
b. Reliability of reporting for internal and external use; and
  
c. Compliance with applicable laws and regulations.
§ 200.62 Internal control over compliance requirements for Federal awards.

Means a process implemented by a non-Federal entity designed to provide reasonable assurance regarding the achievement of the following objectives for Federal awards:

A. Transactions are properly recorded and accounted for, in order to:

1. Permit the preparation of reliable financial statements and Federal reports;
2. Maintain accountability over assets; and
3. Demonstrate compliance with Federal statutes, regs, and the terms and conditions of the Federal award;
The Definition of Internal Controls (cont.)

b. Transactions are executed in compliance with:

1. Federal statutes, regulations, and the terms and conditions of the Federal award that could have a direct and material effect on a Federal program; and

2. Any other Federal statutes and regulations that are identified in the Compliance Supplement; and

c. Funds, property, and other assets are safeguarded against loss from unauthorized use or disposition
§ 200.303 Internal controls.

The non-Federal entity **must**:

A. Establish and maintain effective internal control over the Federal award that provides reasonable assurance that the non-Federal entity is managing the Federal award in compliance with Federal statutes, regulations, and the terms and conditions of the Federal award.
§ 200.303 Internal controls (cont.)

These internal controls should be in compliance with guidance in:

- “Standards for Internal Control in the Federal Government”, issued by the Comptroller General of the United States, or
- The “Internal Control Integrated Framework”, issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO).
§ 200.303 Internal controls (cont.)

b. Comply with Federal statutes, regs, and the terms and conditions of the Federal awards.

c. Evaluate and monitor the non-Federal entity's compliance with statutes, regs and the terms and conditions of Federal awards.

d. Take prompt action when instances of noncompliance are identified including in audit findings.

e. Take reasonable measures to safeguard protected personally identifiable info (PII) and other information.
§ 200.430 Compensation—personal services.

• (i) Standards for Documentation of Personnel Expenses (viii)(C):

The non-Federal entity's system of internal controls includes processes to review after-the-fact interim charges made to a Federal awards based on budget estimates. All necessary adjustment must be made such that the final amount charged to the Federal award is accurate, allowable, and properly
The 5 Components and 17 Principles of Internal Controls
The COSO “Cube”

Categories of Objectives

Levels of Organizational Structure

Levels of Organizational Structure
Internal Control is a process used by management to help an entity achieve its objectives.
Objectives

• **Operations Objectives** – pertain to effectiveness and efficiency of operations (i.e. financial performance goals and safeguarding assets).

• **Reporting Objectives** – pertain to internal and external financial and non-financial reporting. Includes reliability, timeliness, transparency, etc.

• **Compliance Objectives** – adherence or laws and regulations.

• Reflected in Internal controls definition at 200.61.
The Goals of Internal Controls

• **Safeguard assets**
  - Well designed internal controls protect assets from accidental loss or loss from fraud.

• **Ensure the reliability and integrity of financial information**
  - Internal controls ensure that management has accurate, timely and complete information, including accounting records, in order to plan, monitor and report business operations.

• **Ensure compliance**
  - Internal controls help to ensure the agency is in compliance with the many federal, State and local laws and regulations affecting the operations of our business.
The Goals of Internal Controls (cont.)

• **Promote efficient and effective operations**
  • Internal controls provide an environment in which supervisors and staff can maximize the efficiency and effectiveness of their operations.

• **Accomplishment of goals and objectives of the agency**
  • Internal controls provide a mechanism for management to monitor the achievement of operational goals and objectives.
The Goals of Internal Controls (cont.)

- Internal controls work best when they are applied to multiple divisions and deal with the interactions between the various business departments.

- No two systems of internal controls are identical, but many core philosophies regarding financial integrity and accounting practices have become standard management practices.
Components of Internal Controls

- Control Environment
  - 5 principles
- Risk Assessment
  - 4 principles
- Control Activities
  - 3 principles
- Information and Communication
  - 3 principles
- Monitoring
  - 2 principles

Source: GAO | GAO-14-704G
Principles of a Control Environment

1. A commitment to integrity and ethical values;
2. Independent oversight over the development and performance of internal controls;
3. Clearly defined organizational structure, clear reporting lines, appropriate authorities;
4. A commitment to attract, develop and retain competent individuals;
5. Maintain a level of competence that allows personnel to accomplish their assigned duties (and holding individuals accountable)

Maintaining a good relationship with oversight agencies (like ED and OIG for example!)
Control Environment Strategies

• Difference strategies to achieve these goals:

• A ‘Compliance Strategy’ tries to prevent violations of regulations and self-interested behavior by employees by imposing standards of conduct that are intended to compel acceptable behavior.

• An ‘Integrity Strategy’ seeks to create conditions that support right action by communicating the values and vision of the organization, aligning the standards of employees with those of the organization, and relying on the whole management team, not just lawyers and compliance officers.
Control Environment Examples

- Well-written policies and procedures manuals
  - Addressing employee responsibilities, limits to authority, performance standards, hiring practices, whistleblower policies, conflict of interests, etc.
- Organizational chart (clear lines of authority and responsibility)
- Clear job descriptions
- Adequate training programs and performance evaluations.
Risk Assessment

What is Risk?

A. A game of global domination;

B. The possibility that an event will occur and adversely affect the achievement of objectives;

C. The potential of losing something valuable; or

D. All of the above.
Risk Assessment Principles

1. Clear objectives to enable the identification and assessment of risks;
2. Identify risks to achievement of objectives across the entity and analyze risks as a basis for determining how the risks should be managed;
3. Consider the potential for fraud; and
4. Identify and assess changes that could significantly impact the system.
Risk Areas

1. **Strategic** – including political risk and risk from dependencies on other organizations

2. **Financial** – including risk of audit findings and other things that would undermine reporting integrity

3. **Compliance** – including fraud and non-compliance programmatic requirements.

4. **Operational** – including the risk that programs fail to meet their objectives and lack of technology
Risks are not stagnant; they increase and change as laws and operational environments change.

Examples:
- New personnel
- Experienced personnel
- Lack of personnel
- Reorganizations
- Cost Reduction Strategies

More Examples:
- Change in Laws and Regulations
- New Technology
- New Grants
- Competition
- Rapid growth
Example: "Current Risk Severity Map" graphically shows the level of risk prior to mitigation.
Risk Mapping (cont.)

![Risk Mapping Diagram]

- **Impact**
  - Extreme
  - Very High
  - Medium
  - Low
  - Negligible

- **Likelihood**
  - Rare
  - Unlikely
  - Moderate
  - Likely
  - Almost Certain
Control Activities Principles

1. Select and develop control activities that contribute to the mitigation of sick and achievement of objectives to acceptable levels;

2. Select and develop general control activities over technology to support the achievement of objectives; and

3. Deploy control activities through polices that establish what is expected and procedures that put policies into action.
Types of Control Activities

- **Preventive Controls:** Prevents the occurrence of a negative event in a proactive manner
  - Approval for purchase > $5,000
  - Passwords
  - Petty cash held in lockbox
  - Security and surveillance systems
  - Pre-numbered checks

- **Detective Controls:** Identify undesirable "occurrences" after the fact.
  - Supervisor review & approval
  - Report run showing user activity
  - Reconcile petty cash
  - Physical inventory count
  - Review missing/voided checks
Types of Control Activities (cont.)

• **Automated Controls**: Built into network infrastructure and software applications, e.g.,
  - Passwords
  - Data entry validation checks
  - Batch controls

• **Manual Controls**: Require action to be taken by employees, e.g.,
  - Obtain supervisor’s approval for overtime
  - Reconcile bank accounts
  - Match receiving to POs
Control Activity Examples

• Segregating Key Responsibilities
• Restricting Access to Systems and Records (Authorizations / Passwords)
• Implementing Clear Written Policies in Key Areas
• Maintaining Physical Control Over Valuable Assets (Security)
• Maintaining Appropriate Documentation (Approvals, Record Retention)
• Accurate and Timely Recording of Information
  • Check for accounting of transactions in numerical sequence
Types of Control Activities

A **compensating control** may be relied upon to mitigate the risk

- Can be preventive or detective, automatic or manual.

Example: A unit does not have the staff resources to establish an adequate segregation of duties. Potential compensating controls could include:

  - Automation of certain transaction data that cannot be altered by the staff
  - Manager review of detailed summary reports of the transactions initiated by the staff
  - Staff and/or manager monitors a sample of transactions back to supporting documentation
Information and Communications

Goal: Ensure personnel receive relevant, reliable and timely information that enables them to carry out their responsibilities.

or

To communicate the right information to the right people at the right time!
Information and Communication Principles

• Obtain or generate or use relevant, quality information to support the functioning of the entity;
• Internally communicate info, including objectives and responsibilities necessary to support the entity; and
• Communicate with external parties regarding matters affecting the functioning of the entity.

Develop procedures for identifying pertinent information and distributing it in a form and timeframe that permits people to perform their duties efficiently.

All personnel must receive a clear message from top down that responsibilities must be taken seriously.
How to Communicate

Communication is a two-way process

Success is attained when

ALL parties involved have the SAME understanding of what has been communicated
Monitoring Principles

Goal: Assess the quality of internal controls over time and ensure any findings are promptly resolved.

• Select, develop and perform ongoing and/or separate evaluations to ascertain whether the components of internal controls are present and functioning;

• Evaluate and communicate internal control deficiencies in a timely manner to parties responsible for taking corrective action.
Monitoring Examples

• Ongoing program and fiscal monitoring
• Regular oversight by supervisors
• Record reconciliation
• Formal program reviews/audits
• Annual single audits

Include policies and procedures for correcting any findings in a timely manner
How to Test and Review Your Internal Controls
Example: Problem with Unallowable Costs – Potential Solutions

Look at Resources/Guidance

• Create Checklists or Use of Funds Manual
  1. Is the cost consistent with federal cost principles?
  2. Is the cost allowable under the relevant federal program?
  3. Is the cost consistent with program specific fiscal rules?
  4. Is the cost consistent with the grant (and any special conditions placed on the grant)?

• Provide Training to Staff
Example: Problem with Unallowable Costs – Potential Solutions

Look at the Budget Process

• Strengthen the application/budget process
  • Link program elements to use of funds
  • Drop down menu with only allowable costs
  • Section to explain how other example costs are allowable
1. Identify significant transactions
2. Document an understanding of internal controls in place
   - Use checklists, flowcharts, narratives or questionnaires to determine the current internal controls
3. Select sample transactions and determine if the sample correctly flows through the internal controls system
4. Note any deviations
Internal Controls Test Example

1. Requisition Requested
2. Requisition approved by Program Director
3. Requisition Approved by Finance Office
4. Invoice Sent to Accounts Payable
5. Goods Delivered and Verified
6. Purchase Order Created
7. Check Sent to Vendor
8. Check Cleared; Money Withdrawn from Account
Internal Controls Test Example (cont.)

- Requisition Requested
- Requisition approved by Program Director
- Requisition Approved by Finance Office

- Invoice Sent to Accounts Payable
- Goods Delivered and Verified
- Purchase Order Created

- Check Sent to Vendor
- Check Cleared; Money Withdrawn from Account
• Document findings
• Discuss the results of the walkthrough with management and inform them of any deficiencies that need immediate attention.
Weak Internal Controls – What Now?

Avoidance
Do not proceed!

Mitigation
Improve controls to reduce likelihood/impact

Transfer
Shift responsibility to an external party

Acceptance
Accept the risk!

Creation
Seek risk activities strategically to maximize opportunities
Who Else Reviews Internal Controls? Auditors!

§ 200.514 Scope of audit.

• (c) Internal control. (1) The compliance supplement provides guidance on internal controls over Federal programs based upon the guidance in Standards for Internal Control in the Federal Government issued by the Comptroller General of the United States and the Internal Control—Integrated Framework, issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO).

§ 200.507 Program-specific audits.

• (b)(3) (ii) Obtain an understanding of internal controls and perform tests of internal controls over the Federal program consistent with the requirements of § 200.514 Scope of audit, paragraph (c) for a major program;
Reliability on Annual Single Audits

“We have no compliance issues, we have clean Single Audits”

• Single Audits are NOT necessarily reliable regarding compliance
  • Not all programs are covered
  • Depth of Review
  • Problems with Quality

• Hold Firms Accountable – What did they look at? What standard was used in their determinations? Question findings.
  • Must use Single Audits in monitoring and watch for repeat findings!
No. 1 Indication there is a Compliance Problem...

“Because we’ve always done it that way.”
Internal Control Weaknesses

• Problems
  • Magical Letters
  • Unsigned Forms
  • Automatic Signatures
  • Stolen Property
  • Employees in the News
If you already have great internal controls in place...

• Periodically assess risks and the level of internal control required to protect assets and records related to those risks.
  • Document the process for review, including when it will take place.
• Management is responsible for making sure that all staff are familiar with policies and changes in those policies.
QUESTIONS?

• To ask a question, please press *1 on your touchtone phone.

• If you are using a speaker phone, please lift the receiver and then press *1.

• If you would like to withdraw your question, press *1.
The Ultimate Internal Control
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