Internal Control Guide & Resources

Section 2- The Five Components of Effective Internal Controls

Internal Control Environment

The control environment is the foundation for an internal control system. It includes the overall attitude and actions of management regarding the importance of controls in their organization. Internal controls are likely to function well if management believes that those controls are important and communicates that view to employees at all levels.

COSO's updated internal control framework identifies five principles associated with the 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 attract, develop, and retain competent individuals.

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

The implementation of these five principles is crucial to the implementation and operating effectiveness of the internal control environment.

For information regarding how to analyze your agency's internal control environment, refer to Section 3 of OIA's Internal Control Guide "How to Analyze Your Agency's Control Environment."

Risk Assessment

A risk is anything that endangers the achievement of an objective. The risk assessment process is used to identify, analyze, and manage the potential risks that could hinder or prevent an agency from achieving its objectives. Risk increases during a time of change, for example, turnover in personnel, rapid growth, or establishment of new services. Other potential high risk factors

include complex programs or activities, cash receipts, direct third party beneficiaries, and prior problems.

COSO's updated internal control framework identifies four principles associated with this internal control component:

> 6. Management should define objectives and 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 in the internal control system.

For information regarding how to conduct your own risk assessment, refer to Section 4 of OIA's

Internal Control Guide "How to Conduct a Risk Assessment."

Internal Control Activities

Internal control activities are nothing more than policies, procedures, and the organizational structure of an organization. Organizations establish policies and procedures so that identified risks do not prevent an organization from reaching its objectives. Clearly identified activities minimize risk and enhance effectiveness.

Internal control activities can be either preventive, for example, requiring supervisory sign off, or detective, for example reconciling reports. Excessive controls should be avoided, as they can be as harmful as excessive risk and result in increased bureaucracy and reduced productivity.

COSO's updated internal control framework identifies three principles associated with this internal control component:

> 10. Management should design control activities to achieve objectives and risk responses.

> 11. Management should design control activities for the entity's information system.

> 12. Management should implement control activities.

For further information and examples of Internal Control Activities, refer to Section 5 of OIA's Internal Control Guide "Internal Control Activities- Best Practices.

Information and Communication

Information must be reliable to be of use and it must be communicated to those who need it. For example, supervisors must communicate duties and responsibilities to the employees that report to them and employees must be able to alert management to potential problems. Information must be communicated both within the organization and externally to those outside, for example, vendors, recipients, and other applicable parties. Communication must also be ongoing both within and between various levels and activities of the agency.

COSO's updated internal control framework identifies three principles associated with the information and communication component:

       13. Management should use quality information.

       14. Management should internally communicate the necessary quality information.

       15. Management should externally communicate the necessary quality information.

For further information and examples of Internal Control Activities, refer to Section 6 of OIA's Internal Control Guide "Information and Communication."

Monitoring

After internal controls are put in place, their effectiveness needs to be periodically monitored to ensure that controls continue to be adequate and continue to function properly. Management must also monitor previously identified problems to ensure that they are corrected.

COSO's updated internal control framework identifies two principles associated with this internal control component:

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

       17. Management should ensure identified internal control deficiencies are remediated on a timely basis.

For further information and examples of Internal Control Activities, refer to Section 7 of OIA's

Internal Control Guide "How to Monitor Effectively."

The internal control system is a dynamic and integrated process in which each of the five components described above impact the effectiveness of the other components. A relationship exists not only between the components, but also the objectives and the agency's organizational structure. COSO's depiction of this relationship is provided below:
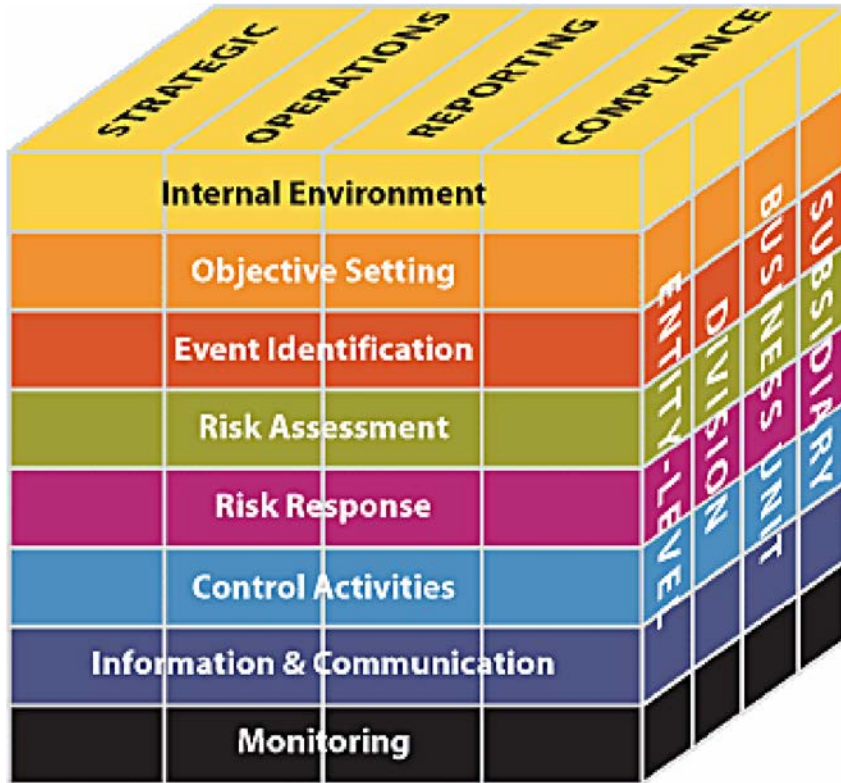
Source: Compliancy Software

Due to this integrated relationship, it is essential that management have a plan to implement each of the 17 principles associated with the five internal control components. The following sections of OIA's Internal Control Guide have been written and designed to assist management in evaluating and carrying out this objective.