

## PART 6 - INTERNAL CONTROL

Internal control is generally defined as a process effected by an entity's oversight body, management, and other personnel that provides reasonable assurance that the objectives of an entity will be achieved.

The A-102 Common Rule, OMB Circular A-110 and 2 CFR section 200.303 require that non-Federal entities receiving Federal awards (i.e., auditee management) establish and maintain internal control designed to reasonably ensure compliance with Federal statutes, regulations, and the terms and conditions of the Federal award. 2 CFR section 200.514 requires auditors to obtain an understanding of the non-Federal entity's internal control over Federal programs sufficient to plan the audit to support a low assessed level of control risk of noncompliance for major programs, and, unless internal control is likely to be ineffective, plan the testing of internal control over major programs to support a low assessed level of control risk for the assertions relevant to the compliance requirements for each major program and perform testing of internal control as planned.

The objectives of internal control over the compliance requirements for Federal awards as found in 2 CFR section 200.62, are as follows:

1. Transactions are properly recorded and accounted for in order to:
  - a. Permit the preparation of reliable financial statements and Federal reports;
  - b. Maintain accountability over assets; and
  - c. Demonstrate compliance with Federal statutes, regulations, and the terms and conditions of the Federal award;
2. Transactions are executed in compliance with:
  - a. 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
  - b. Any other Federal statutes and regulations that are identified in the Compliance Supplement; and
3. Funds, property, and other assets are safeguarded against loss from unauthorized use or disposition.

A system of internal control is expected to provide a non-Federal entity with reasonable assurance that these objectives relating to compliance with Federal statutes, regulations, and the terms and conditions of Federal awards will be achieved.

Internal control should be an integral part of the entire cycle of planning, budgeting, management, accounting, monitoring, and reporting. It should support the effectiveness and the integrity of every step of the process and provide continual feedback to management. Non-

Federal entities' program managers must carefully consider the appropriate balance between controls and risk in their grant award programs and operations. Too many controls can result in inefficient and ineffective operations; managers must ensure an appropriate balance between the strength of controls and the relative risk associated with particular grant award programs and operations. Additionally, the benefits of controls should outweigh the costs. Non-Federal entities should consider both qualitative and quantitative factors when analyzing costs against benefits.

2 CFR section 200.303 indicates that the internal controls required to be established by a non-Federal entity receiving Federal awards should be in compliance with guidance in "Standards for Internal Control in the Federal Government," issued by the Comptroller General of the United States (Green Book) or the "Internal Control Integrated Framework" (revised in 2013), issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). COFAR Frequently Asked Question (FAQ) 200.303-2 indicates that the word "should" is used in 2 CFR part 200 to indicate a best practice. In addition, COFAR FAQ 200.303-3 indicates that, while non-Federal entities must have effective internal control, there is no expectation or requirement that the non-Federal entity document or evaluate internal controls prescriptively in accordance with COSO, the Green Book, or this part of the Supplement, or that the non-Federal entity or auditor reconcile technical differences between them.

The Green Book and COSO are both organized by five components of internal control as shown in the exhibit below. COSO introduced the concept of 17 principles related to the five components of internal control, each of which has important attributes which explain the principles in greater detail. The Green Book adapts these principles for a government environment.

### Summary of Green Book and COSO Components and Principles of Internal Control

Components of Internal Control	Principles
A. Control Environment	<ol style="list-style-type: none"> <li>1. Demonstrate Commitment to Integrity and Ethical Values</li> <li>2. Exercise Oversight Responsibility</li> <li>3. Establish Structure, Responsibility and Authority</li> <li>4. Demonstrate Commitment to Competence</li> <li>5. Enforce Accountability</li> </ol>
B. Risk Assessment	<ol style="list-style-type: none"> <li>6. Define Objectives and Risk Tolerances</li> <li>7. Identify, Analyze, and Respond to Risks</li> <li>8. Assess Fraud Risk</li> <li>9. Identify, Analyze, and Respond to Change</li> </ol>
C. Control Activities	<ol style="list-style-type: none"> <li>10. Design Control Activities</li> <li>11. Design Activities for the Information System</li> <li>12. Implement Control Activities</li> </ol>
D. Information and Communication	<ol style="list-style-type: none"> <li>13. Use Quality Information</li> <li>14. Communicate Internally</li> <li>15. Communicate Externally</li> </ol>
E. Monitoring	<ol style="list-style-type: none"> <li>16. Perform Monitoring Activities</li> <li>17. Evaluate Issues and Remediate Deficiencies</li> </ol>

Because both COSO and the Green Book have the same components of internal control and similar principles, for simplicity, the remaining discussion in this part is based on the Green Book.

The following describes characteristics of internal control relating to each of the five components of internal control (as defined by the Green Book) that should reasonably ensure compliance with the requirements of Federal statutes, regulations, and the terms and conditions of Federal awards. (The bracketed information highlights a relationship to one of the Green Book principles.). This description is intended to assist non-Federal entities and their auditors in complying with their respective requirements. However, the characteristics may not necessarily reflect how an entity considers and implements internal control. Also, the following is not a checklist of required internal control characteristics. Non-Federal entities could have adequate internal control even though some or all of the following characteristics are not present. Further, non-Federal entities could have other appropriate internal controls operating effectively that have not been included. Non-Federal entities will need to exercise judgment in determining the most appropriate and cost-effective internal control in a given environment or circumstance, to provide reasonable assurance of compliance with Federal program requirements.

**A. Control Environment.** The foundation for an internal control system. It provides the discipline and structure to help an entity achieve its objectives.

- There is a sense of conducting operations ethically, as evidenced by a code of conduct or other verbal or written directive. [Principle 1]
- There is a governing Board or equivalent that is responsible for engaging the auditor, receiving all reports and communications from the auditor, and ensuring that audit findings and recommendations are adequately addressed, and they fulfill those responsibilities. [Principle 2]
- Key managers' responsibilities are clearly defined. [Principle 3].
- The Board has established an Audit Committee. [Principle 3]
- Key managers have adequate knowledge and experience to discharge their responsibilities. [Principle 4]
- Management's commitment to competence ensures that staff receive adequate training to perform their duties. [Principle 4]
- Staff are knowledgeable about compliance requirements and are given responsibility to communicate all instances of noncompliance to management. [Principle 4]
- Management demonstrates respect for and adherence to program compliance requirements. [Principle 5]
- Management initiates positive responsiveness to prior compliance and control findings. [Principle 4]
- Management makes evident its support of adequate information and reporting systems. [Principle 1]

**B. Risk Assessment.** Assesses the risks facing the entity as it seeks to achieve its objectives. This assessment provides the basis for developing appropriate risk responses.

- Program managers and staff understand and have identified key compliance objectives and risk tolerances. [Principle 6]
  - Management is aware of results of monitoring, audits, and reviews, and considers related risk of noncompliance. [Principle 7]
  - Management and employees identify, analyze, and adequately respond to risks related to achieving the defined objectives. [Principle 7]
- The organizational structure provides identification of risks of noncompliance [Principle 7]
  - Key managers have been given responsibility to identify and communicate changes.
  - Employees who require close supervision (e.g., they are inexperienced) are identified.
  - Management has identified and assessed complex operations, programs, or projects.
- Management considers the potential for fraud when identifying, analyzing, and responding to risk. This assessment includes at a minimum the following: [Principle 8]
  - types of fraud,
  - fraud risk factors, and
  - response to fraud risks.
- Processes are established to implement significant changes in program objectives and procedures. [Principle 9]

**C. Control Activities.** The actions management establishes through policies and procedures to achieve objectives and respond to risks in the internal control system, which includes the entity's information system.

- Adequate segregation of duties is provided between performance, review, and recordkeeping of a task. [Principle 10]
- Computer and program controls include [Principle 11]:
  - Data entry controls, e.g., edit checks.
  - Exception reporting.
  - Access controls.
  - Reviews of input and output data.
  - Computer general controls and security controls.
- Supervision of employees is commensurate with their level of competence. [Principle 10]
- Personnel possess adequate knowledge and experience to discharge their responsibilities. [Principle 10]
- Operating policies and procedures exist and are clearly written and communicated. [Principle 11]

- Procedures are in place to implement changes in statutes, regulations, and the terms and conditions affecting Federal awards. [Principle 11]
- Management prohibits intervention or overriding established controls. [Principle 11]
- Equipment, inventories, cash, and other assets secured physically and periodically counted and compared to recorded amounts. [Principle 10]
- If there is a governing Board, the Board conducts regular meetings where financial information is reviewed and the results of program activities and accomplishments are discussed. Written documentation is maintained of the matters addressed at such meetings. [Principle 11]

**D. Information and Communication.** The quality of information management and personnel communicate and use to support the internal control system.

- The accounting system provides for separate identification of Federal and non-Federal transactions and allocation of transactions applicable to both. [Principle 13]
- Adequate source documentation exists to support amounts and items reported. A recordkeeping system is established to ensure that accounting records and documentation are retained for the time period required in the statutes, regulations, and the terms and conditions applicable to the program. [Principle 13]
- Accurate information is accessible to those who need it. [Principle 13]
- Reports are provided timely to managers for review and appropriate action. [Principle 13]
- Reconciliations and reviews ensure accuracy of reports. [Principle 13]
- Established internal and external communication channels exist. [Principle 14]
  - Staff meetings.
  - Bulletin boards.
  - Memos, circulation files, e-mail.
  - Surveys, suggestion box.
- Employees' duties and control responsibilities are effectively communicated. [Principle 14]
- Channels of communication for people to report suspected improprieties have been established. [Principle 14]
- There are established channels of communication between the pass-through entity and subrecipients. [Principle 15]
- Actions are taken as a result of communications received. [Principle 13]

**E. Monitoring.** Activities management establishes and operates to assess the quality of performance over time and promptly resolve the findings of audits and other reviews.

- Ongoing monitoring is built-in through independent reconciliations, staff meeting feedback, rotating staff, supervisory review, and management review of reports. [Principle 16]
- Periodic site visits are performed at decentralized locations (including subrecipients' locations) and checks are performed to determine whether procedures are being followed as intended. [Principle 16]
- Management meets with program monitors, auditors, and reviewers to evaluate the condition of the program and controls. [Principle 16]
- Management follows up on irregularities and deficiencies to determine the cause. [Principle 17]
- Internal quality control reviews are performed.
- Internal audit routinely tests for compliance with Federal requirements. [Principle 17]
- If there is a governing Board, the Board reviews the results of all monitoring or audit reports and periodically assesses the adequacy of corrective action. [Principle 17]