



WHITE PAPER

**CHANGES TO
THE INTERNAL
CONTROL
FRAMEWORK:
HOW DO THEY
AFFECT YOUR
GOVERNMENTAL
ORGANIZATION**

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October 2014

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CHANGES TO THE INTERNAL CONTROL FRAMEWORK: HOW DO THEY AFFECT YOUR GOVERNMENTAL ORGANIZATION

INTRODUCTION

Internal control is an integral component in the achievement of any organization's objectives. Areas such as operational effectiveness and efficiency, reliable financial reporting and compliance with laws, regulations and policies are directly affected by internal controls. Regardless of size and sector, the entities that understand and embrace this fact best position themselves for current and future success.

COMMITTEE OF SPONSORING ORGANIZATIONS OF THE TREADWAY COMMISSION (COSO)

Currently, the best in class standard for internal control implementation and execution is the *COSO Internal Control – Integrated Framework* report dated September 1992. This report presents a common definition of internal control and provides a framework against which internal control systems are assessed and can be improved.

In May 2014, COSO issued its first significant update to the *Internal Control – Integrated Framework* report. This update is expected to help organizations design and implement internal control in light of the many changes in operating environments, expand the application of internal control in addressing operations and reporting objectives, and simplify the requirements for determining what constitutes effective internal control. Specific changes addressed in the update include:

- ✓ EXPECTATIONS FOR GOVERNANCE OVERSIGHT
- ✓ GLOBALIZATION OF MARKETS AND OPERATIONS
- ✓ CHANGES AND GREATER COMPLEXITIES OF BUSINESS
- ✓ DEMANDS AND COMPLEXITIES IN LAWS, RULES REGULATIONS AND STANDARDS
- ✓ EXPECTATIONS FOR COMPETENCIES AND ACCOUNTABILITY
- ✓ USE OF, AND RELIANCE ON, EVOLVING TECHNOLOGIES
- ✓ EXPECTATIONS RELATING TO PREVENTING AND DETECTING FRAUD

The bottom line is that we are in a climate of increased volume and complexity of transactions coupled with stakeholder demand for enhanced transparency and accountability. Such a climate requires an internal control framework forged in fundamentals but agile enough to adapt in an ever changing, fast paced world. The expectation is that this updated COSO framework will respond to changing needs. COSO has stated that the 1992 framework will continue to be appropriate for use until December 15, 2014, at which point the new framework will be in effect.

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STANDARDS FOR INTERNAL CONTROL IN THE FEDERAL GOVERNMENT (GREEN BOOK)

While internal control is a universal and fundamental concept across all sectors, the application of the COSO framework for governmental entities can sometimes be problematic. As a result, the Government Accountability Office (GAO) was required to issue standards for internal control in the Federal government by the Federal Managers' Financial Integrity Act of 1982 (FMFIA). These standards are the GAO's best practices for governmental internal controls document known as the "Green Book".

The existing Green Book, issued in November 1999, utilizes the internal control concepts of COSO and applies them to a framework more conducive to governmental organizations. The GAO introduced a 2013 Green Book exposure draft in September 2013 which addresses the COSO updates from a governmental perspective. Final issuance of this new form is expected in late 2014.

Excerpt from the Green Book exposure draft:

This revision does not change the previous standards on a conceptual level. The revised standards retain the five components of internal control, but introduce 17 principles to assist management in achieving an effective internal control system. These principles were adopted from the Committee of Sponsoring Organizations of the Treadway Commission's revision of its Internal Control: Integrated Framework and adapted for the government environment. The revised standards also introduce attributes that support these principles and further define the requirements for an effective internal control system.

In applying the COSO framework to governmental organizations, certain differences arise between COSO and the Green Book. Examples of noted differences are:

AREA	COSO FRAMEWORK	GREEN BOOK
Points of Focus vs. Attribute	Utilizes Points of Focus to contribute to the effectiveness of the Principles	These Points of Focus are combined into attributes
Focus	Organization responsibility	Management responsibility
Terminology	Commercial	Governmental
Documentation	More judgmental	Specific minimum requirements
IT Consideration	IT general controls	IT general and application controls

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As the Green Book exposure draft has not yet been finalized, there are a number of comments still to be addressed. For example:

CONSIDERATION	COMMENT
Adaptations of COSO should be limited to governmental environment differences to avoid confusion	COSO language changes outside the scope of governmental terminology were noted in the Green Book and the need for the change is ambiguous
Necessity of level of detail	COSO requires components and principles to be present and function while Green Book appears to require such presence and function for all attributes of a principle as well
Application of the Green Book to smaller entities	With potential application of Green Book to such entities, a more practical framework in relation to size should be considered
Level of documentation	Additional guidance is requested to navigate minimum documentation requirements and management judgement considerations
Define the terms “must” and “should”	Explanatory language that clarifies the difference in responsibility imparted by each term would be helpful
Increased guidance on the focus of internal control over compliance	With the issuance of the Uniform Administrative Requirements, Cost Principles, and Audit Requirements for Federal Awards (Super Circular) enhanced illustrations with regard to how internal control over compliance falls into the Green Book framework would be beneficial

How the GAO decided to address these comments and others will contribute to the final Green Book form.

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POTENTIAL KEY GREEN BOOK CHANGES TO CONSIDER FOR YOUR ORGANIZATION

1. *Enhanced structure to the Green Book framework:*

The formalization of the 17 principles provides clarity to the foundation of the internal control framework and its components. In addition, the inclusion of the attributes provides the tangible qualities for each principle. This approach will allow for greater understanding and clarity in the development of an organization's internal control environment. For example:

COMPONENT	Control Environment
PRINCIPLE	The oversight body and management should demonstrate a commitment to integrity and ethical values
ATTRIBUTE	Establish standards of conduct

Entities that went the extra mile within the parameters of the original framework and have previously fleshed out a similar structure will not see significant change. However, those entities that took a more minimalistic approach based upon risk profile and cost/benefit analysis will need to take a deeper dive into the design and implementation of their internal controls.

2. *IT considerations:*

The new framework mentions specific considerations for entities with regard to information technology controls. No such specificity existed in the original framework. Once again, if your organization does not currently address IT implementation considerations, the new framework has made this a requirement.

3. *Controls regarding outsourced service providers:*

While there should have been controls in place previously with regard to control activities to outsourced service providers, the new framework requires an entity to consider controls in all five internal control components (control environment, risk assessment, control activities, information and communication, and monitoring activities). This includes controls related to ethical values and codes of conduct that apply to the service provider and their effect on your organization.

4. *Minimum documentation requirements:*

With the inclusion of formalized attributes for internal control principles, specific minimum documentation requirements must be met. While management judgment is still a key aspect to the framework, a minimum level of required documentation has been established.

5. *Explicit inclusion of not-for-profit organizations:*

The new Green Book indicates that the framework may also be applicable to not-for-profit organizations. It would be an organization's responsibility to determine its applicability. However, given the issuance of the Super Circular the use of the Green Book may be a requirement for organizations that receive federal funding.

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NEXT STEPS

The issuance of the new COSO framework and Green Book exposure draft will provide organizations with a best practice internal control environment. The more specific guidance is intended to be used to more effectively and efficiently address risk and uncertainty. For organizations refining their internal control environment, this is an opportunity to evaluate its current state and where it wants to go by utilizing a more formalized framework that eases use and application all the while maintaining an emphasis on the importance of management judgment in the process. Regardless of where your organization is today, each entity should consider the following next steps:

✓ REVISIT THE “OLD” COSO FRAMEWORK AND GREEN BOOK

to ensure an understanding of where you should be as an organization today.

✓ INTRODUCE YOURSELF TO THE “NEW” COSO FRAMEWORK AND GREEN BOOK

to understand the future requirements and to perform a deep dive into the changes and enhancements made and to be implemented

✓ IDENTIFY A KNOWLEDGE LEADER

Whether it's an individual, committee, team or vendor; assign a champion to be responsible and accountable for the transition to the new framework

✓ PERFORM AN INITIAL RISK/GAP ASSESSMENT AS PART OF THE IMPLEMENTATION PROCESS

Assess the risk of the transition and identify real and potential gaps (principle gaps, attribute gaps, testing gaps, evidence/documentation gaps, etc.)

✓ SEIZE THE OPPORTUNITY, DON'T JUST CHECK THE BOX

Look beyond meeting the minimum requirements imposed and take a fresh look at your internal control environment and the areas that have historically been a problem for your organization

A FEW WORDS ABOUT HORNE

Naturally, we would like you to consider us as a potential partner for your organization, but only if we are the right one for you. We offer a balanced combination of personal relationships and capabilities to support your organization. Our resources are available to assist you in meeting your goals and can provide the comprehensive assistance you need to reach them. We provide integrated accounting services, consulting, financial compliance and monitoring, and program management.