

## PART 6 - INTERNAL CONTROL

### INTRODUCTION

The A-102 Common Rule and OMB Circular A-110 (2 CFR part 215) require that non-Federal entities receiving Federal awards (i.e., auditee management) establish and maintain internal control designed to reasonably ensure compliance with Federal laws, regulations, and program compliance requirements. OMB Circular A-133 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 for major programs, 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, unless internal control is likely to be ineffective, perform testing of internal control as planned.

This Part 6 is intended to assist non-Federal entities and their auditors in complying with these requirements by describing, for each type of compliance requirement, the objectives of internal control, and certain characteristics of internal control that, when present and operating effectively, may ensure compliance with program requirements. However, the categorizations reflected in this Part 6 may not necessarily reflect how an entity considers and implements internal control. Also, this part is not a checklist of required internal control characteristics. Non-Federal entities could have adequate internal control even though some or all of the characteristics included in Part 6 are not present. Further, non-Federal entities could have other appropriate internal controls operating effectively that have not been included in this Part 6. Non-Federal entities and their auditors 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 for compliance with Federal program requirements.

The objectives of internal control pertaining to the compliance requirements for Federal programs (Internal Control Over Federal Programs), as found in §\_\_\_\_.105 of OMB Circular A-133, are as follows:

- (1) Transactions are properly recorded and accounted for to:
  - (i) Permit the preparation of reliable financial statements and Federal reports;
  - (ii) Maintain accountability over assets; and
  - (iii) Demonstrate compliance with laws, regulations, and other compliance requirements;
- (2) Transactions are executed in compliance with:
  - (i) Laws, regulations, and the provisions of contracts or grant agreements that could have a direct and material effect on a Federal program; and
  - (ii) Any other laws and regulations that are identified in the compliance supplements; and
- (3) Funds, property, and other assets are safeguarded against loss from unauthorized use or disposition.

The characteristics of internal control are presented in the context of the components of internal control discussed in *Internal Control-Integrated Framework* (COSO Report), published by the Committee of Sponsoring Organizations of the Treadway Commission. The COSO Report provides a framework for organizations to design, implement, and evaluate control that will facilitate compliance with the requirements of Federal laws, regulations, and program compliance requirements. COSO also has published *Guidance on Monitoring Internal Control Systems* (January 2009), which is available at [www.coso.org/GuidanceonMonitoring.htm](http://www.coso.org/GuidanceonMonitoring.htm). Statement on Auditing Standards No. 78 (SAS 78), *Consideration of Internal Control in a Financial Statement Audit*, issued by the Auditing Standards Board of the American Institute of Certified Public Accountants (AICPA) and a related AICPA audit guide, *Consideration of Internal Control in a Financial Statement Audit*, incorporate the components of internal control presented in the COSO Report.

This Part 6 describes characteristics of internal control relating to each of the five components of internal control that should reasonably assure compliance with the requirements of Federal laws, regulations, and program compliance requirements. A description of the components of internal control and examples of characteristics common to the 14 types of compliance requirements are listed below. Objectives of internal control and examples of characteristics specific to each of 13 of the 14 types of compliance requirements follow this introduction. (Because Special Tests and Provisions are unique for each program, we could not provide specific control objectives and characteristics for this type of compliance requirement.)

**Control Environment** sets the tone of an organization influencing the control consciousness of its people. It is the foundation for all other components of internal control, providing discipline and structure.

- Sense of conducting operations ethically, as evidenced by a code of conduct or other verbal or written directive.
- If there is a governing Board, the Board has established an Audit Committee 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.
- Management's positive responsiveness to prior questioned costs and control recommendation.
- Management's respect for and adherence to program compliance requirements.
- Key managers' responsibilities clearly defined.
- Key managers have adequate knowledge and experience to discharge their responsibilities.
- Staff knowledgeable about compliance requirements and being given responsibility to communicate all instances of noncompliance to management.
- Management's commitment to competence ensures that staff receive adequate training to perform their duties.
- Management's support of adequate information and reporting system.

**Risk Assessment** is the entity's identification and analysis of risks relevant to achievement of its objectives, forming a basis for determining how the risks should be managed.

- Program managers and staff understand and have identified key compliance objectives.
- Organizational structure provides identification of risks of noncompliance:
  - Key managers have been given responsibility to identify and communicate changes.
  - Employees who require close supervision (e.g. inexperienced) are identified.
  - Management has identified and assessed complex operations, programs, or projects.
  - Management is aware of results of monitoring, audits, and reviews and considers related risk of noncompliance.
- Process established to implement changes in program objectives and procedures.

**Control Activities** are the policies and procedures that help ensure that management's directives are carried out.

- Operating policies and procedures clearly written and communicated.
- Procedures in place to implement changes in laws, regulations, guidance, and funding agreements affecting Federal awards.
- Management prohibition against intervention or overriding established controls.
- Adequate segregation of duties provided between performance, review, and recordkeeping of a task.
- Computer and program controls should include:
  - 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 commensurate with their level of competence.
- Personnel with adequate knowledge and experience to discharge responsibilities.
- Equipment, inventories, cash, and other assets secured physically and periodically counted and compared to recorded amounts.
- 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.

**Information and Communication** are the identification, capture, and exchange of information in a form and time frame that enable people to carry out their responsibilities.

- Accounting system provides for separate identification of Federal and non-Federal transactions and allocation of transactions applicable to both.
- Adequate source documentation exists to support amounts and items reported.
- Recordkeeping system is established to ensure that accounting records and documentation retained for the time period required by applicable requirements; such as the A-102 Common Rule (§\_\_\_\_.42), OMB Circular A-110 (2 CFR 215.53), and the provisions of laws, regulations, contracts or grant agreements applicable to the program.
- Reports provided timely to managers for review and appropriate action.
- Accurate information is accessible to those who need it.
- Reconciliations and reviews ensure accuracy of reports.
- Established internal and external communication channels.
  - Staff meetings.
  - Bulletin boards.
  - Memos, circulation files, e-mail.
  - Surveys, suggestion box.
- Employees' duties and control responsibilities effectively communicated.
- Channels of communication for people to report suspected improprieties established.
- Actions taken as a result of communications received.
- Established channels of communication between the pass-through entity and subrecipients.

**Monitoring** is a process that assesses the quality of internal control performance over time.

- Ongoing monitoring built-in through independent reconciliations, staff meeting feedback, rotating staff, supervisory review, and management review of reports.
- Periodic site visits performed at decentralized locations (including subrecipients) and checks performed to determine whether procedures are being followed as intended.
- Follow up on irregularities and deficiencies to determine the cause.
- Internal quality control reviews performed.
- Management meets with program monitors, auditors, and reviewers to evaluate the condition of the program and controls.
- Internal audit routinely tests for compliance with Federal requirements.
- 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.

## **General Guidance - Internal Control Over Compliance For Major Programs With Expenditures of ARRA Awards**

**ARRA provides significant Federal funding to supplement existing Federal programs, as well as funding for new programs. Section 3 of ARRA, Principles and Purposes, requires Federal agencies to manage and expend the funds made available to achieve its purposes: “commencing expenditures and activities as quickly as possible consistent with prudent management.” Such ARRA requirements make the establishment and operation of effective internal control over compliance (internal control) critical. Therefore, this addendum emphasizes several points related to the internal control testwork related to each major program funded with ARRA awards.**

- 1. It is essential that auditee management establish and maintain internal control designed to reasonably ensure compliance with Federal laws, regulations, and program compliance requirements, including internal control designed to ensure compliance with ARRA requirements. The auditor then performs and documents testwork relating to internal control as required by OMB Circular A-133. Part 6 of the Compliance Supplement is intended to assist management and their auditors in complying with these requirements.**
  
- 2. The effects of ARRA on audits under OMB Circular A-133 will increase significantly during calendar year 2009 as awards and expenditures under ARRA programs increase. It is imperative that deficiencies in internal control (i.e., material weaknesses and significant deficiencies) be corrected by management as soon as possible to ensure proper accountability and transparency for expenditures of ARRA awards. Early communication by auditors to management, and those charged with governance, of identified control deficiencies related to ARRA funding that are, or likely to be, significant deficiencies or material weaknesses in internal control will allow management to expedite corrective action and mitigate the risk of improper expenditure of ARRA awards. Therefore, auditors are encouraged to promptly inform auditee management and those charged with governance during the audit engagement about control deficiencies related to ARRA funding that are, or likely to be, significant deficiencies or material weaknesses in internal control. The auditor should use professional judgment regarding the form of such interim communications. Factors to consider in determining whether to make communications orally and/or in writing include the relative significance of the identified control deficiencies and the urgency for corrective action. However, regardless of how interim communications are made, the auditor should also communicate ARRA-related significant deficiencies or material weakness via the normal reporting process at the end of the audit (i.e., in the reporting on internal control over compliance and the schedule of findings and questioned costs).**

- 3. At many entities, awards funded by ARRA funds will result in material increases in funding, which may result in a material increase in the level of resources needed by management to properly manage, monitor, and account for Federal awards and effectively operate internal control. As part of the consideration of internal control over compliance, auditors should consider “capacity” issues as follows:**
- **Part 6 of the Compliance Supplement describes characteristics of internal control relating to each of the five components of internal control identified in *Internal Control-Integrated Framework* (COSO Report) that should reasonably assure compliance with the requirements of Federal laws, regulations, and program compliance requirements. A description of the components of internal control and examples of characteristics common to the 14 types of compliance requirements are also included in Part 6. One of those components, “Risk Assessment,” relates to an entity’s risk assessment process including its identification, analysis, and management of risks relevant to its compliance. When gaining an understanding of the internal control over the “Activities Allowed or Unallowed/Allowable Costs and Cost Principles” and “Eligibility” types of compliance requirements for major programs with ARRA funding, the auditor should consider the entity’s internal control environment and internal control established to address the risks arising from ARRA funding (e.g., risks due to rapid growth of a program, new and/or increased activities under a program, changes in the regulatory environment, or new personnel).**
  - **When evaluating whether identified control deficiencies, individually or in combination, are significant deficiencies or material weaknesses, the auditor should consider the likelihood and magnitude of noncompliance. One of the factors that affects the magnitude is the volume of activity exposed to the deficiency in the current period or expected in the future.**