



Integrity Bulletin

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Implementing the Five Key Internal Controls

Purpose

Internal controls are processes put into place by management to help an organization operate efficiently and effectively to achieve its objectives. Managers often think of internal controls as the purview and responsibility of accountants and auditors. The fact is that management at all levels of an organization is responsible for ensuring that internal controls are set up, followed, and reviewed regularly. The purposes of internal controls are to:

- Protect assets;
- Ensure that records are accurate;
- Promote operational efficiency;
- Achieve organizational mission and goals; and
- Ensure compliance with policies, rules, regulations, and laws.

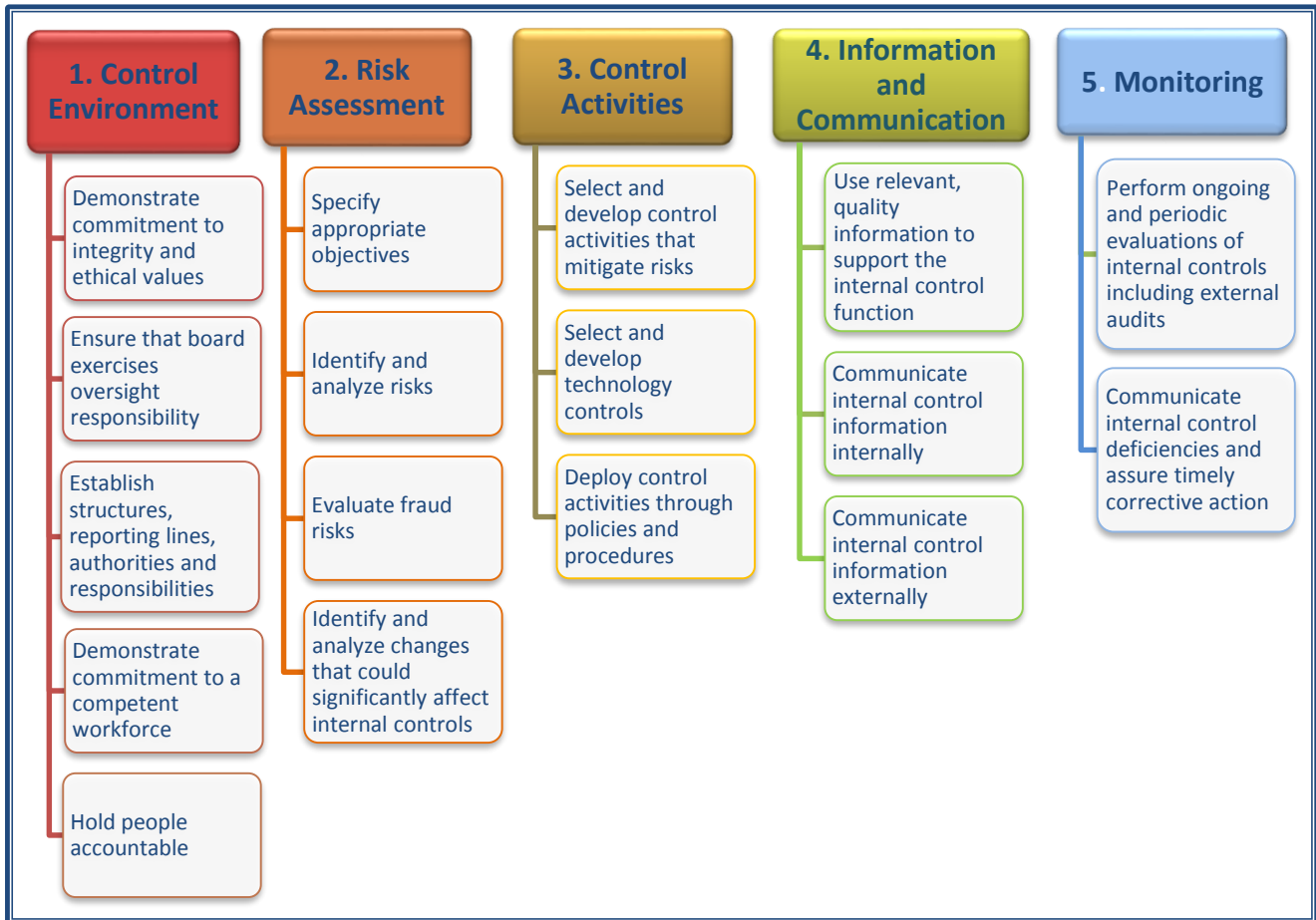
In administering various U.S. Department of Housing and Urban Development (HUD), Office of Community Planning and Development (CPD) programs, all grantee and subrecipient organizations deal with risks to achieving their organizational and programmatic goals. No rules, bad rules, or failure to follow rules disrupt the effectiveness of the internal controls and, ultimately, mission delivery. This bulletin explains the five internal control standards and ways to implement them effectively. It also provides case examples of deficiencies in internal controls and how those issues could have been avoided through use of internal controls.

Background

If your grant or subgrant is subject to the uniform administrative requirements of [2 Code of Federal Regulations \(CFR\) Part 200](#), then [2 CFR 200.303](#) requires that your organization follow one of the two approved internal control frameworks. The Government Accountability Office (GAO) Standards for Internal Control in the Federal Government (commonly called "[the Green Book](#)") is one of the frameworks, and the Committee of Sponsoring Organizations (COSO) has issued [the other](#). The former is used by the federal government, while publicly held companies use the latter.

Both GAO and COSO provide a framework for designing, implementing, and operating an effective internal control system. Using either will help achieve your objectives related to operations, reporting, and compliance. The frameworks have 5 components of internal control and 17 sub-principles.

Summary of Internal Control Standards



These standards are the foundation of good management and are described in more detail below.

Key 1. Establish a Control Environment

The control environment is the culture, values, and expectations that organizations put into place. Ways to establish and nourish the environment are:

- Set “tone at the top” by implementing and promoting ethical standards, integrity, and accountability policies;
- Set mission, goals and objectives (strategic planning) so the organization knows what it is to accomplish;
- Establish structure, organizational responsibilities, and reporting chains;
- Hire competent and trustworthy staff members and provide necessary training for them;
- Provide leadership and good governance by staying on top of operations and performance, and correcting problems when identified;
- Emphasize that compliance with laws and regulations is the expectation for the organization;
- Assure that goals and objectives are clear (especially when there are multiple grant awards) and not in competition with each other or compliance requirements; and
- Hold people accountable for their responsibilities.

Example of weak control environment

An audit of a grantee found deficiencies in six of seven contracts reviewed.

Problems included insufficient evidence that contracts were adequately competed, missing

contract forms and provisions, lack of justification supporting sole-source contracts, and board of commissioners' approvals signed after contract execution or missing. Further, auditors discovered that forms were added to the contract files after the request to review them and evidenced the use of correction fluid to conceal the date printed. The executive director acknowledged that the former purchasing director removed files from the organization. The executive director decided to create or reproduce the documentation before giving the files to the auditor. The audit recommended referral of the executive director to HUD's Departmental Enforcement Center for appropriate action regarding the questionable ethical conduct. The agency should have had policies concerning documentation, record archival, and removal of official records from the office.

Key 2. Conduct Risk Assessments

In the past, risk management focused exclusively on financial dangers. Enterprise Risk Management (ERM) looks at the entirety of an organization and everything that could affect it. Leadership should oversee a risk management process and ways to accomplish this are:

- Have each function identify the risks to operations and performance;
- Brainstorm with staff to determine possible external risks (See the appendix at the end of the bulletin that shows examples of types of risks);
- Learn about emerging risks through employee and customer surveys, etc.;
- Consider the potential for fraud when identifying, analyzing and responding to risks;
- Rate and rank the risks, and discuss controls or other actions needed to eliminate or reduce the risk;
- Develop corrective actions and assign someone to be in charge of implementing each.

Key 3. Implement Control Activities

Control activities are the policies and procedures put into place to run operations, accomplish goals, and prevent fraud. Basic internal control methods are:

- Establish responsibility;
 - Assign each task to only one person.
 - Establish organizational structure.
- Implement separation of duties;
 - Don't make one employee responsible for all parts of a process.
 - Use compensating controls, such as additional monitoring or secondary sign-offs, when separation is not possible.
- Restrict Access;
 - Don't provide access to systems, information, assets, etc. unless needed.
- Create policies and procedures;
 - Implement written instructions with directives to follow them.
 - Assure controls cover all areas of compliance.
 - Assure controls cover security of assets and technology.
- Establish record keeping;
 - Document all expenditures and the justifications for them.

Example of lack of control activities

A grantee city spent \$284,649 in program funds on projects that did not have required executed written agreements with its internal departments and subrecipients. Agreements or memorandums of understanding for these projects should have included the purpose statements and the national objectives they would meet. This condition occurred because

the city did not have internal controls to ensure that internal departments and subrecipients signed agreements before spending program funds. The lack of agreements kept the city from having the authority to monitor the work. The city should have had written policies and checklists to ensure that it had agreements or memorandums of understanding for these projects in place, and should have included the purpose statements and the national objectives the projects would meet. It also should have had controls over spending to ensure that program staff could not spend funds before signed agreements were properly in place.

Key 4. Implement Information and Communication Systems

Communications are essential for every organization. They rely on quality of information and effectiveness of dissemination. Use the following suggestions to guide your information and communication protocols:

- Establish relevant and reliable information systems to track operations, goal progress, and compliance;
- Broadly distribute information throughout the organization to ensure that critical information is delivered to the right staff in a timely way. Ask staff members what information they need but are not getting;
- Establish separate lines of communication, such as fraud and ethics hotlines, for confidential information. Inform employees of these separate reporting lines, how they operate, and how reports are handled;
- Establish both outgoing and incoming lines of communication with external entities. Stay aware of external events that could pose a risk.

Example of problematic information and communications

Seven years after a local government grantee got \$10 million in Federal money to build a cemetery and bus station, neither had been completed. Local authorities claimed they had no documentation about the projects, such as approved work drawings and as-built plans. The local government said it had no information about its own decisions because contractors had the only copies of the paperwork and were holding them for “ransom.” The contractors said they did not cooperate because the local government had not paid them for completed work. The local government should have had a system for capturing information regarding the status of projects, maintained reports available, and provided them to decision-makers, as needed. The local government grantee should have maintained all original records.

Key 5. Monitor Internal Controls

Establishing controls is not enough. Once they are in place, managers need to verify the effectiveness of the controls. Ways to accomplish this include:

- Establish a system of quality control over all processes such as supervisory reviews, approvals, and automated exception checks;
- Conduct routine reviews of actual performance compared to goals and budgets;
- Conduct separate management reviews of a function to determine whether it is working as intended, or controls need to be redesigned. Use the [GAO Internal Control Management and Evaluation Tool](#) to evaluate your internal controls;
- Arrange for external audits and be responsive to findings;
- Track all corrective actions, and ensure that they are implemented and working as intended;
- Use monitoring to tie corrective actions back to improvements in Control

- Environment and Control Activity standards;
- Watch for signs of control problems.

Even strong controls do not always work. As you implement controls be mindful that all of the controls systems are dependent upon people. The effectiveness of internal controls is directly proportional to staffs' willingness to adhere to them.

Example of inadequate monitoring of internal controls

An audit noted that a grantee had inadequate management oversight of its property and financial records. In addition, the grantee lacked adequate policies, procedures, and internal controls governing the use of vehicles, cellular phones, and credit cards. Staff regularly used these assets for personal activities. Paperwork was incomplete and supervisory review was nonexistent. Factors contributing to this noncompliance were the board of commissioners' failure to exercise its leadership and monitoring function. The board or other leadership should have had policies and procedures for the review and approval of expenses and use of assets. They should also have had a means to check that these controls were working through spot checks or other independent means such as audits. If management had monitored expenditure reports, it would have been alerted to the unauthorized spending.

Getting Help

Senior managers are responsible for internal controls, which are key to an organization's ability to achieve its goals. There are five basic standards that managers of CPD grantee organizations should use to ensure effective and efficient operations. Management's use and enforcement of the above methods is a major indicator of an organization's commitment to successful governance.

There are many internal control training and ERM programs available on-line. Many States also offer training or certification programs, as do many associations, including the [Institute of Internal Auditors](#), the [American Institute of Certified Public Accountants](#), the [Association of Government Accountants](#), and the [Committee of Sponsoring Organizations](#). There are also many private training companies that offer generic management and internal control training. You can also consult your local HUD office or independent auditor for ways to improve specific issues you may have with internal control issues.

If you have knowledge of possible fraud, you must promptly report it to your local HUD Office of Inspector General or online at HUD's hotline: <https://www.hudoig.gov/report-fraud%20>.

Examples of Risk Types and Risks

Governance	Financial	Business operations	Compliance and legal	Stakeholders	Physical environment	
Weak leadership (ignoring management problems)	Poor budget controls or poor accounting systems	Human capital problems (hiring, performance, training, diversity issues etc.)	Ignoring audit or monitoring findings	Congress funding and passing new laws	Poor safeguarding of physical assets (buildings, equipment, etc.) from loss, damage, and theft	
Lack of risk Identification			Not knowing rules	New State and local laws		
Missed or unclear project goals	Unsupported payments	Information technology issues (Equipment, systems, programs, etc.)	Lawsuits, health and Safety issues	New Federal regulations	Physical location risks: Natural Disasters, Super fund site, Flood prone site, etc. Economically depressed site	
Pressure on staff that undercuts integrity	Access to cash and accounting records		Allowing discriminatory practices			
Ineligible project activities	Purchase or travel card abuse	Poor recordkeeping	Faulty procurement processes	Political pressures		
Hiring for positions of trust without proper vetting.	Contractor billing Issues	Untimely or Inaccurate reports and communications	Federal law violations	Citizen complaints		Distances to Sites
		No quality control processes	Conflicts of interest			Difficulties Getting to sites
Weak organizational structure	Allowing conditions for embezzlement and other financial fraud	Contractor performance issues	Data security and privacy issues	Bad publicity posing reputational risks		Deteriorating or aging assets (buildings , equipment, and infrastructure)
Failure to monitor goals and finances		Lack of or outdated policies and procedures	Inadequate monitoring of sub-awardees			

While these categories and examples are not all inclusive, they show the breadth of areas senior leadership must consider and manage, to the extent possible.