Governance

Federal Government's adoption of the COSO framework

(The Green Book)

The effect of COSO on the governance structure of an entity

Introduction

- An organization’s leadership creates the tone at the top – an ethical (or unethical) atmosphere in the workplace.
- Management’s tone has a trickle-down effect on employees.
- If top managers uphold ethics and integrity, so will employees.
- In short, employees will follow the examples of their bosses.

What has changed in the nonprofit world that places more emphasis on the Board of Directors?

Enhanced Expectations

- 1970's-1980's — Reasonable Assurance
- 1992 - — Treadway Commission
- 2001 - — Enron, WorldCom, Tyco
- 2002 - — Sarbanes-Oxley Act (for publicly held companies)
- 2005 - — Report to Congress & Nonprofit Sector on Governance, Transparency, and Accountability (by Panel of the U.S. Senate Finance Committee)

2005 Report to Congress-Nonprofits

- More IRS enforcement/oversight
- Improved Annual Information Returns (990s)
  - Board/Committee review
  - Officer signature required
- Required audits or reviews – part of 990
- Disclosure of performance data
- "Financial literacy" of Board/Committee
- Conflict of interest and misconduct by Board members

Impact on Nonprofits

- **2006 – Eleven new Statements on Auditing Standards (SAS) in one year**
  - SAS 106 - Board responsible for Internal Control
  - SAS 112 - Nonpublic companies must report deficiencies to Board
  - SAS 114 - Auditor's Communication with Those Charged with Governance
- **2008 – IRS redesigned and made Form 990 much more complex, developed 11 core parts and 16 supporting schedules**
  - Nonprofit officer must now sign off on many new questions regarding governance structure, compensation, program service accomplishments, major polices, and more.

Committee of Sponsoring Organization (COSO)

Who is COSO?

COSO, the Committee of Sponsoring Organizations of the Treadway Commission, is a private sector initiative established in 1985 by five financial professional associations.

AICPA-American Institute of Certified Public Accountants
TheIIA-The Institute of Internal Auditors
AAA-American Accounting Association
IMA-Institute of Management Accountants
FEI-Financial Executive Institute

Committee of Sponsoring Organization (COSO)

Definition of Internal Control

"Internal control is a process effected by an entity's **Board of Directors**, management and other personnel designed to provide reasonable assurance regarding the achievement of the entity's objectives relating to **Operations**, **Reporting** and **Compliance**."

Committee of Sponsoring Organization (COSO)

Primary Objectives of Internal Control

- Accurate Financial Information
- Compliance with Policies and Procedures
- Safeguarding Assets
- Efficient Use of Resources
- Accomplishment of Objectives and Goals

Committee of Sponsoring Organization (COSO)

Why are Internal Controls Important?

1. Transactions are properly recorded and accounted for, in order to:

- Permit the preparation of reliable financial statements and Federal and State reports;
- Maintain accountability over assets; and
- Demonstrate compliance with Federal and State statutes, regulations, and the terms and conditions of Federal and State awards;

2. Transactions are executed in compliance with:

- Federal and State statutes, regulations, and the terms and conditions of the Federal and State awards that could have a direct and material effect on Federal and State programs; and
- Any other Federal or State statutes and regulations that are identified in the respective Compliance Supplements; and
  a) Funds, property, and other assets are safeguarded against loss from unauthorized use or disposition.

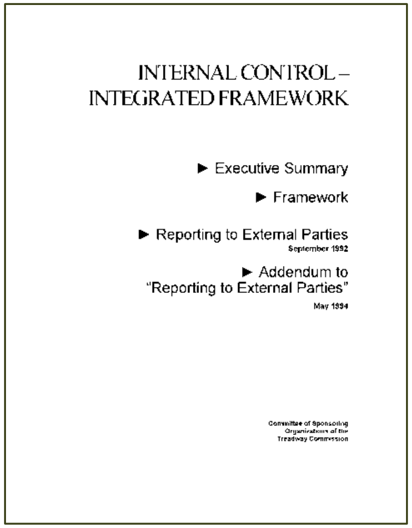
Committee of Sponsoring Organization (COSO)

Why are Internal Controls Important?

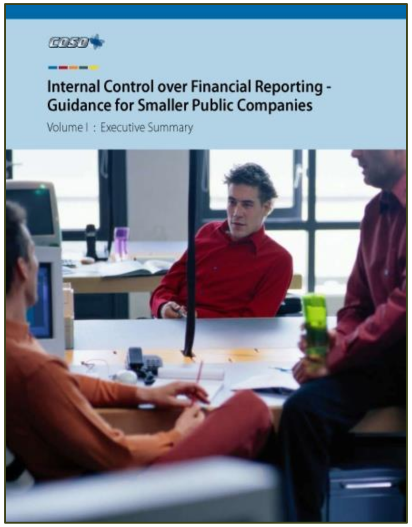
- **Effectiveness and Efficiency of Operations**
  addresses an entity's basic business objectives, including performance and profitability goals and safeguarding of resources and assets.
- **Reliability of Financial Reporting**
  preparation of reliable financial statements and publicly reported financial data.
- **Compliance with Laws and Regulations**
  compliance with those laws and regulations to which the entity is subject.

COMMITTEE OF SPONSORING
ORGANIZATIONS OF THE TREADWAY COMMISSION

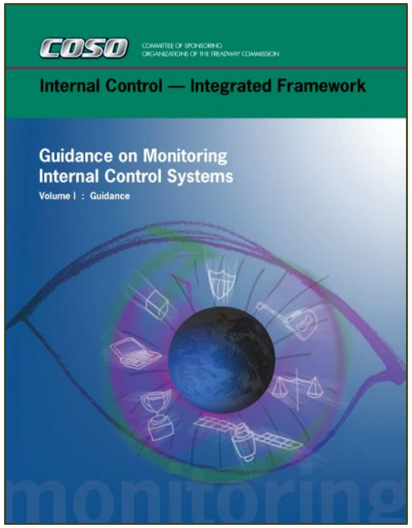
COSO Overview – Internal Control Publications



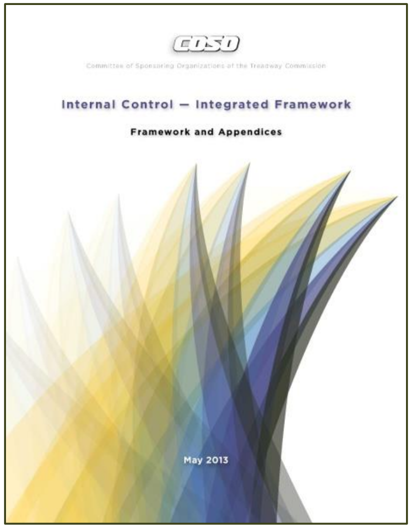
1992



2006



2009



2013

COMMITTEE OF SPONSORING
ORGANIZATIONS OF THE TREADWAY COMMISSION

Update considers changes in business and operating environments

Environments changes...	***…have driven Framework updates***
Expectations for governance oversight	
Globalization of markets and operations	
Changes and greater complexity in business	
Demands and complexities in laws, rules, regulations, and standards	
Expectations for competencies and accountabilities	
Use of, and reliance on, evolving technologies	
Expectations relating to preventing and detecting fraud	

COSO Cube (2013 Edition)

Federal Government's Green Book
Adoption of the COSO model

- Effective for fiscal year 2016 the Federal government has officially adopted the COSO framework-OMB-A123

- House and Senate Bills currently in draft form that will add a new subsection 3 to Florida Statute 218.33, requiring local governments to establish and maintain internal controls designed to:

  1. Prevent and detect fraud, waste and abuse
  2. Promote and encourage compliance with laws rules, contracts, grant agreements and best practices
  3. Support economic and efficient operations
  4. Ensure reliability of financial records and reports
  5. Safeguard assets

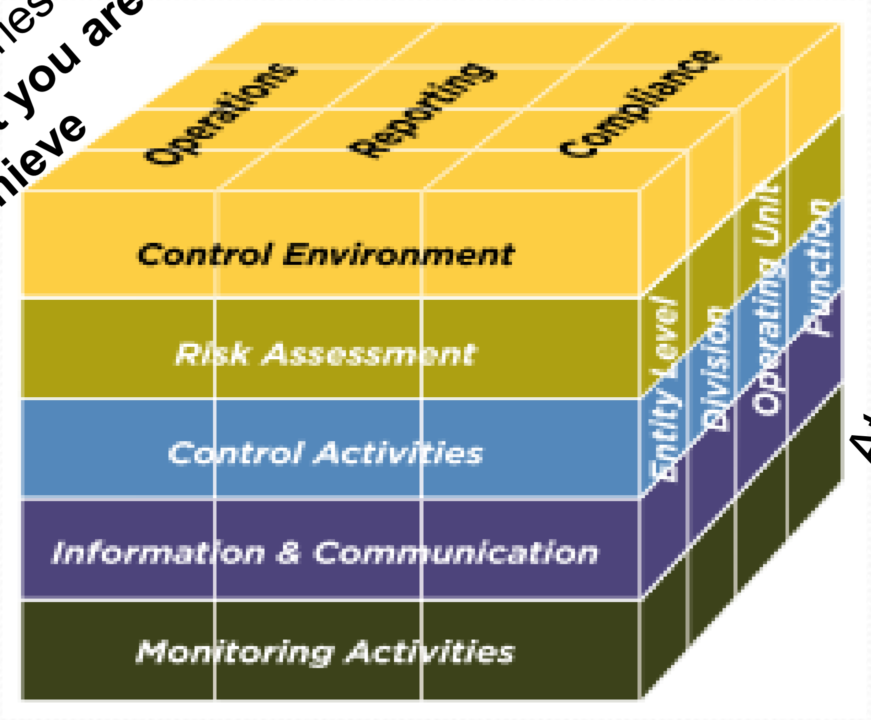
Federal Government's Green Book
Adoption of the COSO model

- The new Super Circular requirements for grants provides that internal controls over grant compliance **should** be in compliance with

1. Internal Control Integrated Framework", issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO)

COSO Cube

Along the **3** Categories of **objectives- What you are trying to achieve**



At **all** levels of the organization

5 integrated components of Internal Control with 17 principles-What is required to achieve the objectives

Update articulates principles of effective internal control

Control Environment	1. Demonstrates commitment to integrity and ethical values 2. Exercises oversight responsibility 3. Establishes structure, authority and responsibility 4. Demonstrates commitment to competence 5. Enforces accountability
Risk Assessment	6. Specifies suitable objectives 7. Identifies and analyzes risk 8. Assesses fraud risk 9. Identifies and analyzes significant change
Control Activities	10. Selects and develops control activities 11. Selects and develops general controls over technology 12. Deploys through policies and procedures
Information & Communication	13. Uses relevant information 14. Communicates internally 15. Communicates externally
Monitoring Activities	16. Conducts ongoing and/or separate evaluations 17. Evaluates and communicates deficiencies

COSO Cube

The 3 Categories of Objectives

Operations-Relate to the achievement of an entity's mission and vision-the fundamental reason for its existence. May relate to financial performance, program performance, management of GHMEI	• Effectiveness • Efficiency • Safeguarding assets-Protecting and preserving entity assets-Controls to detect and prevent unauthorized use, acquisition and disposal
Reporting-External Financial and Non-Financial Reporting objectives Internal Financial and Non-Financial Reporting Objectives	• Reliability • Timeliness • Transparency
Compliance-Minimum standards of conduct expected of an entity. Laws that the entity is required to comply with-Human Resources, Taxation etc.	• With regulatory environment

COSO Cube

INTERNAL CONTROLS are

Continuous	• Built into operations • Not one single event • Dynamic
Effected by people	• It is everybody's responsibility
Able to provide reasonable assurance	• Provides reasonable not absolute assurance
Adaptable	• To the entire entity or to a particular division, business process, etc.

Three Categories of Objectives

1. **Operations-**Effectiveness and efficiency operations

2. **Reporting-**Reliability of reporting for internal external and external use

3. **Compliance-**Compliance with applicable laws and regulations

Internal Controls

Why Internal Controls are Important

- Provides management with confidence that the entity is operating according to standards which are monitored-**someone is watching**.
- Indicates to staff that what they are doing is important and that QUALITY is important.
- Sends a signal that certain behaviors will not be tolerated.

Internal Controls Responsibility

The **internal control process**, *including the prevention and detection of fraud, waste, and abuse*, **is the responsibility of :**

Board of Directors

Management

Employees

Control Environment

Control environment is the foundation for an internal control system. It provides the discipline and structure to help an entity achieve its objectives.

Principles Relating to the Control Environment

1. Organization demonstrates a commitment to integrity and ethical values

2. The board of directors demonstrates independence from management and exercises oversight of the development and performance of internal control

3. Management establishes, with board oversight, structures, reporting lines, and appropriate authorities and responsibilities in pursuit of objectives

Control Environment

Principles Relating to the Control Environment *cont'd*

4. Organization demonstrates a commitment to attract, develop and retain competent individuals in alignment with objectives

5. Organization holds individuals accountable for their internal control responsibilities in the pursuit of objectives

Board Governance Across 5 Components

1. Control Environment

- **Setting the tone-at-the-top**
- **Evaluate management's adherence to standards of conduct as well as adherence by the entity overall**
- **Establish expectations and evaluate performance, integrity and ethical values prevalent in the organization**
- **Commitment to hiring and retaining competent staff**
- **Exercise fiduciary responsibilities**
- **Ask probing questions and challenge senior management**
- **Establish oversight structure and processes**
  - **Committees as appropriate**
  - **Members with requisite skills and expertise***-(ethical values, leadership, critical thinking and problem solving abilities)***

Board Governance Across 5 Components

2. Risk Assessment

- **Consider internal and external factors that pose significant risks to achieving objectives**
- **Challenge management's assessment of risks**
- **Evaluate how proactively the organization assesses risks relating to innovations and changes such as those triggered by new technology, economic and political shifts**

Board Governance Across 5 Components

3. Control Activities

- ***Make specific inquiries of management regarding the selection, development, and deployment of control activities in significant risk areas***
- ***Oversee senior management in its performance of control activities***

Board Governance Across 5 Components

4. Information and Communication

- **Communicate direction and tone at the top**
- **Obtain, review, and discuss information relating to the entity's achievement of objectives**
- **Scrutinize information provided and present alternative views**
- **Allow for and address upward communication of issues**
  - **Direct communication with the board by other personnel**
  - **Board should have direct access to employees without interference from management**
    - **Ethics or whistleblower hotline with direct reporting to board**
    - **Mechanism to encourage reporting of suspected violations of Code of Conduct or Code of Ethics**
    - **Board commissioned surveys, audits of functions or processes etc.**
    - **Interview staff in absence of management**

Board Governance Across 5 Components

5. Monitoring- Ensure 5 components are present and functioning

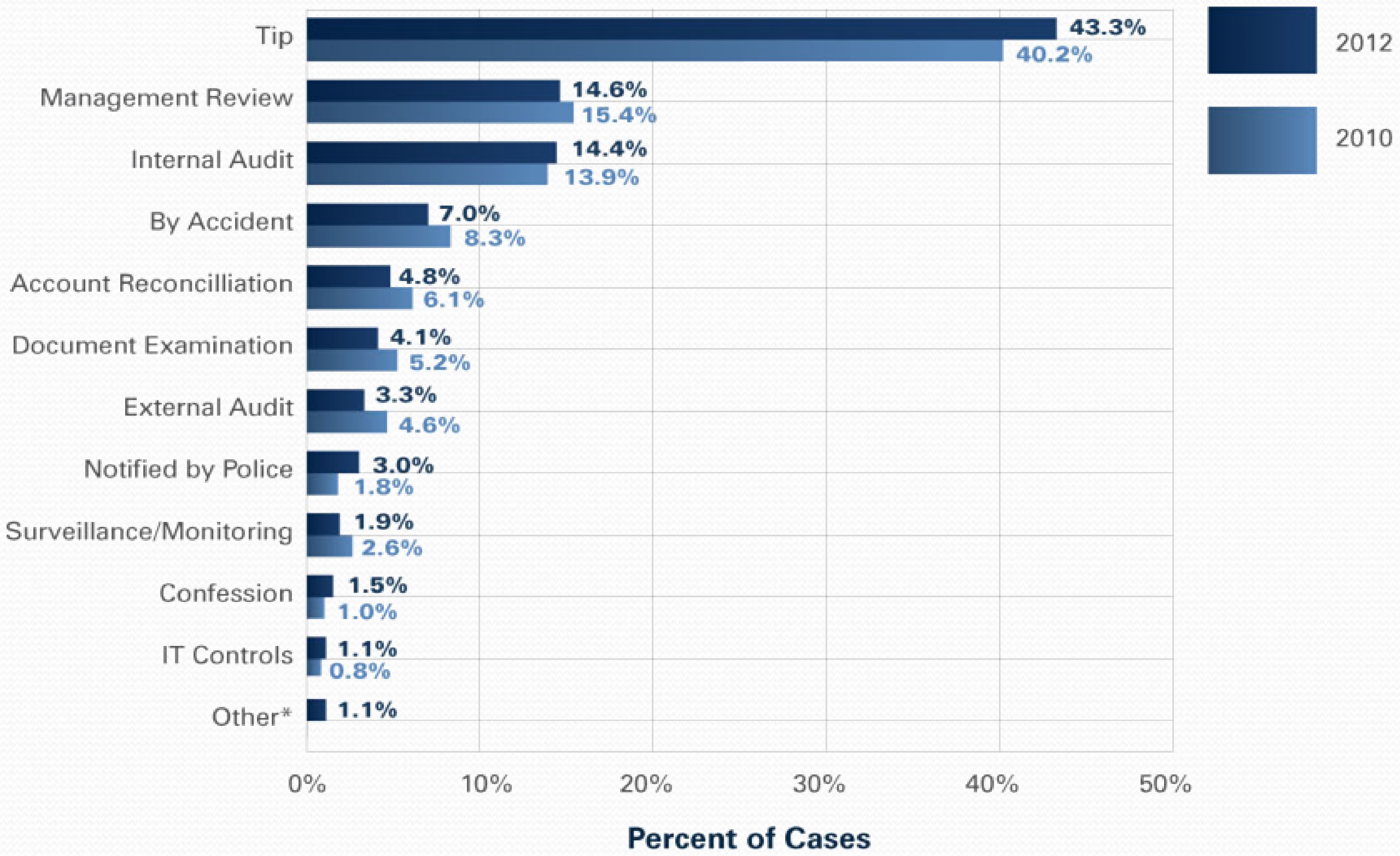
- **Assess and oversee the nature and scope of monitoring activities using ongoing and separate evaluations**
  - **Management overrides of controls**
  - **Management's evaluation and remediation of deficiencies**
- **Engage with management, internal and external auditors and others as appropriate to evaluate**
  - **Level of awareness of entity's strategies**
  - **Specified objectives**
  - **Risk**
  - **Control implications associated with evolving business, infrastructure, regulations and other factors**

Fraud Definition

- ***Fraud*** *is an intentional* *deception* *made for personal gain or to damage another individual*

- ***COSO framework*** requires that an entity's risk assessment considers the potential for fraud.

Fraud Detection Methods



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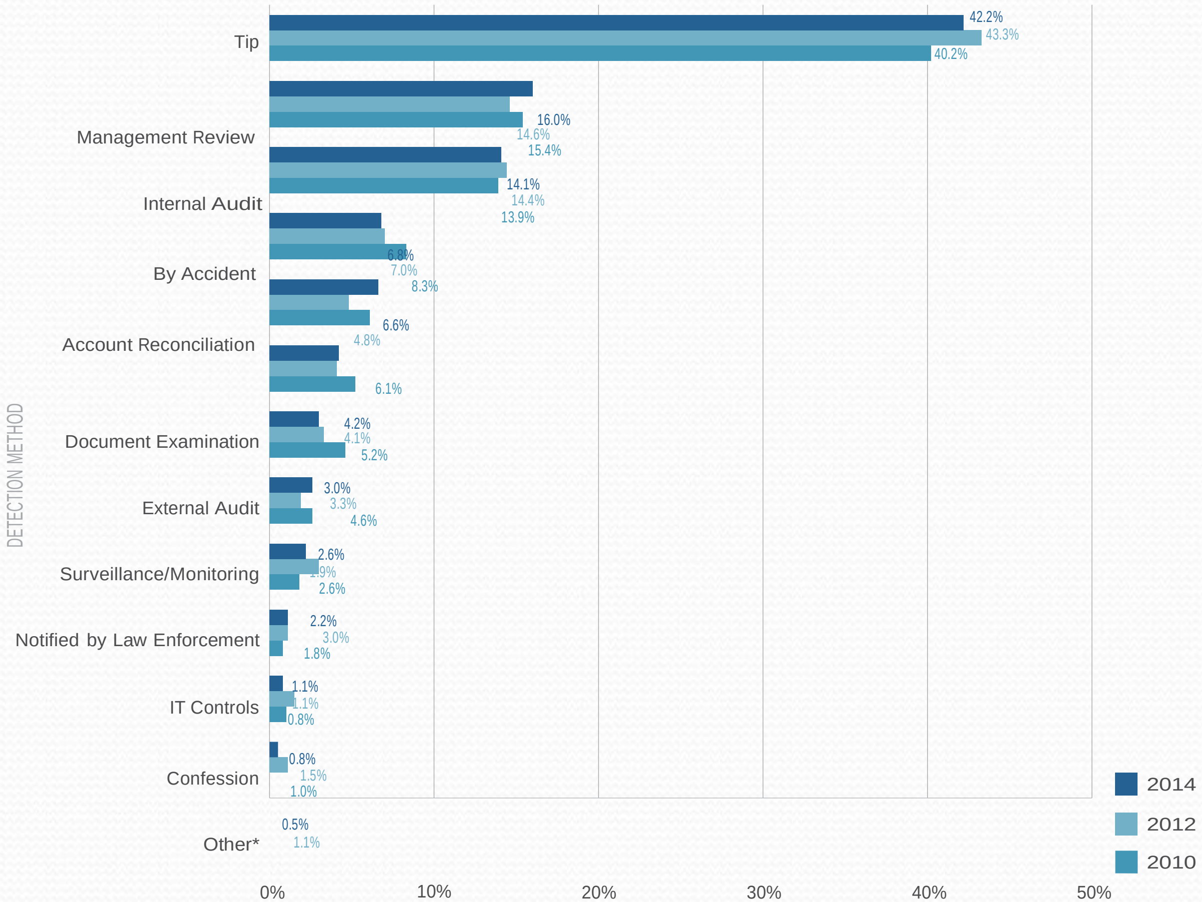
Fraud Detection Methods



*"Other" category was not included in the 2010 Report.

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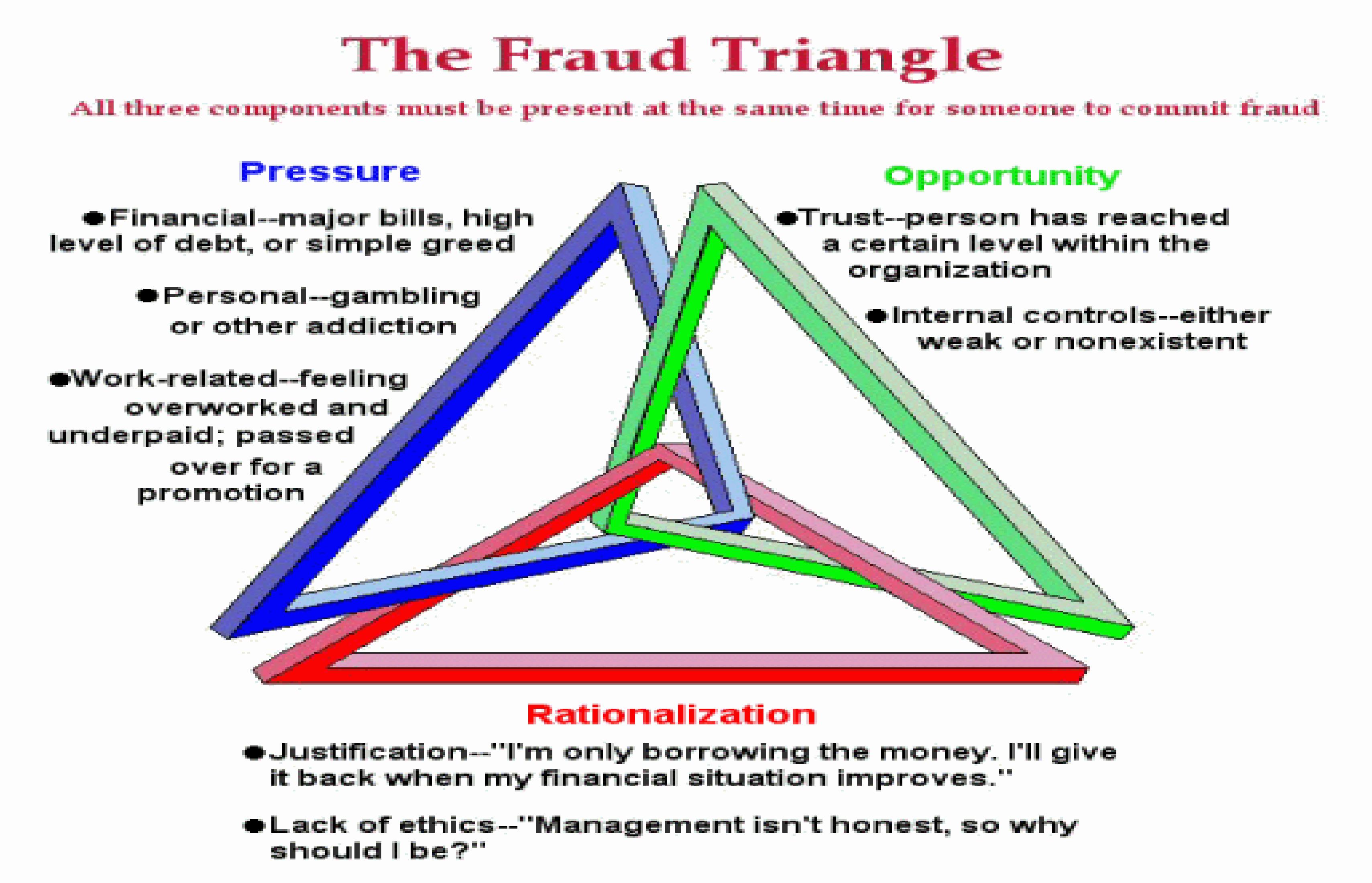
Fraud


The Fraud Triangle
All three components must be present at the same time for someone to commit fraud
Pressure
●Financial--major bills, high level of debt, or simple greed
●Personal--gambling or other addiction
●Work-related--feeling overworked and underpaid; passed over for a promotion
Opportunity
●Trust--person has reached a certain level within the organization
●Internal controls--either weak or nonexistent
Rationalization
●Justification--"I'm only borrowing the money. I'll give it back when my financial situation improves."
●Lack of ethics--"Management isn't honest, so why should I be?"

Governance Best Practices

- **The board includes in its governance principles its responsibility to**
  - Ensure that HR policies and procedures exist and are reviewed and approved by the board
  - Evaluate and monitor risks, especially the risk of fraud by senior management.
  - Actively, or by delegation evaluate and monitor the risk of management fraud by overriding of internal controls.
  - Ensure the organization’s charter or bylaws requires a critical mass of independent directors on the board.
  - The board holds an executive session at certain intervals
  - The charter for the board authorizes the board to retain outside advisers or counsel as needed.

Governance Best Practices

- **What Happens When Internal Controls Fail**

- **Poor Judgement in decision-making-** Competency issues due to inexperience or lack of knowledge
- **Inadequate Protection of Assets-**Unauthorized use or disposal of assets
- **Fraud-**Asset Misappropriation
- **Human Error-**Internal Control is heavily dependent on human judgement
- **Collusion-**Deliberate circumvention of rules or laws by employees and others
- **Management Override of Controls-**Belief that the rules do not apply to them
- **Occurrence of unforeseeable circumstances-**Internal control system not capable of coping with unforeseen circumstances
- **Not Monitored-**No ongoing reviews and update (no one’s watching)
- **Obsolescence-**Controls and processes no longer match business processes or its operating environment

Reputation Risk

- **Corporate culture is key to success**
- **Bad culture can limit or ruin an organization**
- **Considered one of the biggest risk an entity faces**
  - *Triggers of reputation risk*
    - *Unethical behavior*
    - *Vendor Risk*
    - *Third-party risk*
    - *Loss of intellectual property*

Reputation Risk-Who?

- **The Entity-CFCHS**
- **Board Members**
- **CFCHS Management and Staff**
- **Department of Children & Families**
- **State of Florida**

Fraud Facts-Examples

- Financial Statement Disclosures & Findings

- After the year ended XXXX, the Organization identified certain lease, ***credit card, and payroll-related*** transactions made ***by executive management employees*** that were considered to be improper and unauthorized. These ***employees appear to have colluded to circumvent the Organization's financial controls and misappropriate funds in excess of $125,000*** for the year ended XXXXX. These unauthorized transactions are classified as unallowable costs for the year ended XXXX.

Fraud Facts-Examples

- Financial Statement Disclosures & Findings

- Certain ***executive management positions integral to providing segregation of duties and integral control procedures for the authorization*** and review of certain lease, credit card, and payroll transactions ***disregarded their duties and obligations***, ***created fraudulent documents***, and appear to have ***colluded***.

- ***Collusion at the executive management level*** that circumvents internal controls and can be ***difficult to detect***. Personnel ***actions are required*** to ***emphasize and strengthen the Organization's culture and control environment. Board of Directors oversight should be performed*** for CEO credit card statements, significant company contracts and agreements, and CEO compensation and benefits.

- **Questioned Costs**:

  Unauthorized transactions were identified as charges to direct program cost or allocated costs to calculate the amount that was charged to each program. ***Questioned costs for the year were approximately $61,000.***

Internal Control Failures-Examples

- Financial Statement Disclosures & Findings
- Control Environment-Commitment to Competency

1. A ***key element of financial reporting*** is the ability of management to select and ***apply the appropriate accounting principles to prepare the financial statements*** in accordance wit h generally accepted accounting principles. For the year ended June 30, 2013, ***there was no one on staff with sufficient knowledge to prepare GAAP-based financial statements.***
2. A ***system of internal control over financial reporting*** should ***allow*** the ***Organization to prepare financial statements***, including note disclosures in ***accordance with generally accepted accounting principles (GAAP}***. While auditors can assist with the preparation of financial statements and related footnotes, ***the financial statements are the responsibility of management.*** A ***control deficiency exists in instances where the Organization is not positioned to draft the financial statements and all required disclosures*** in accordance with GAAP.
3. **Finding 20XX-01: Segregation of Duties-Internal *controls is designed to safeguard assets*** and help ***or detect losses from employee dishonesty or error***. A fundamental concept in a good system of internal control is the segregation of duties. We recommend that the following practices be implemented to improve existing internal controls.

A sound, ethical ***tone at the top*** *permeates and inspires an organization. It must, however, be supported and enforced by checks and balances that, in times of temptation, would strengthen those inclined to stray!*