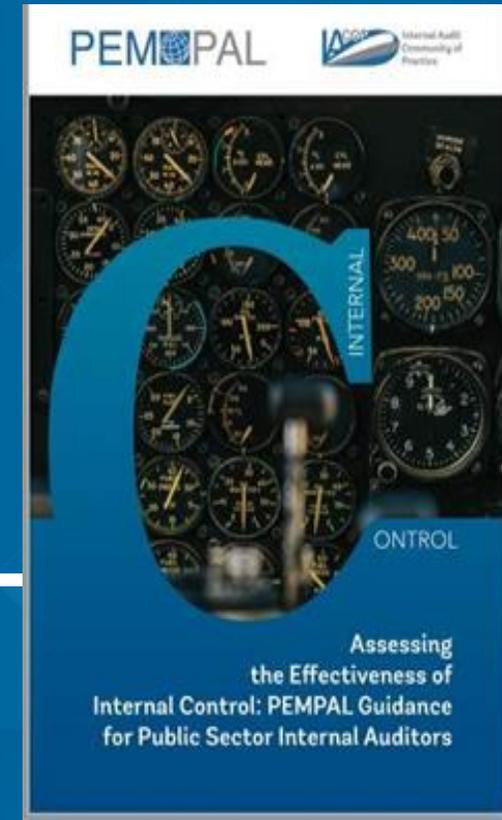


# Assessing the Effectiveness of Internal Control: PEMPAL Guidance for Public Sector Internal Auditors

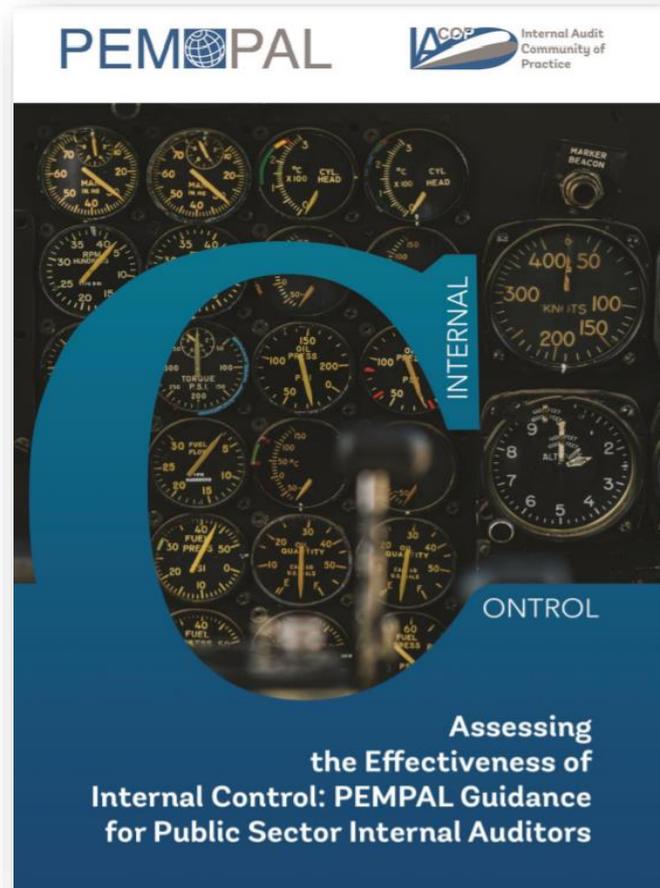
October 12, 2021

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You can Find the document:



Link:

<https://www.pempal.org/knowledge-product/assessing-effectiveness-internal-control-pempal-guidance-public-sector-internal>

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## **PART 1. INTRODUCTION**

## Idea of the Guidance

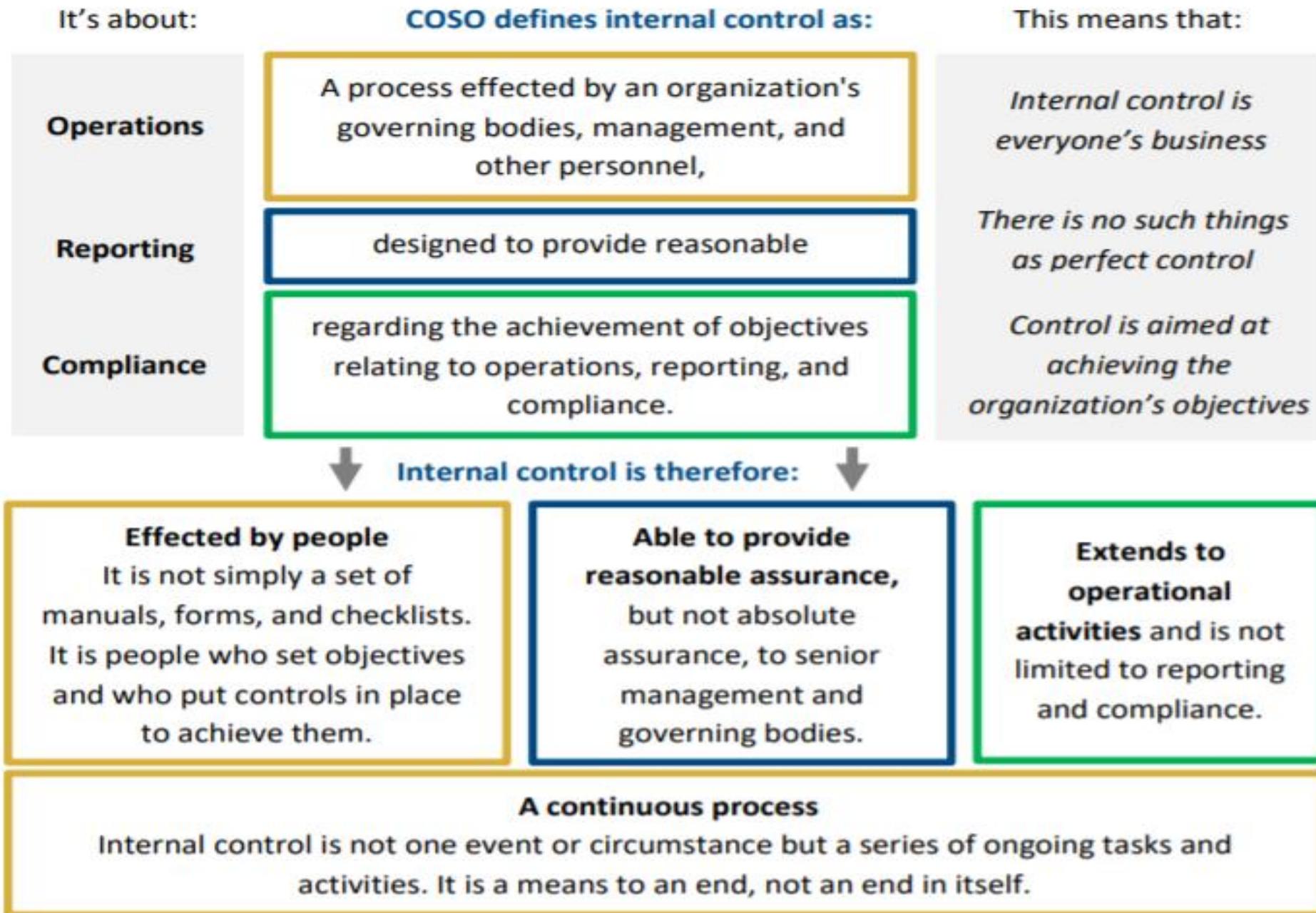
- This guidance has been developed to help internal auditors better understand the main features of effective internal control and how to assess and evaluate the functionality of internal control systems.
- It includes a series of criteria for assessing the maturity of internal controls. These may be useful for internal auditors working in organizations that are in the process of developing/refining public financial management (PFM) systems.

## The guidance:

- Outlines the main features of internal control as promoted by the Committee of Sponsoring Organizations of the Treadway Commission (COSO)1 (Part 2 and Annex A).
- Explains the five components of internal control and the 17 underlying principles of internal control that need to be met for internal control to be effective, tailored to the public sector context (Part 3 and Annexes B1-B5).
- Identifies criteria for assessing the extent to which each of the principles has been met (Annexes B1-B5).
- Promotes a model for a four-level assessment of the maturity of internal control (Part 4).
- Presents a detailed framework for assessing the maturity of internal controls at the four levels, drawing on PEMPAL assessment criteria (Annex C).

## **PART 2. WHAT IS INTERNAL CONTROL?**

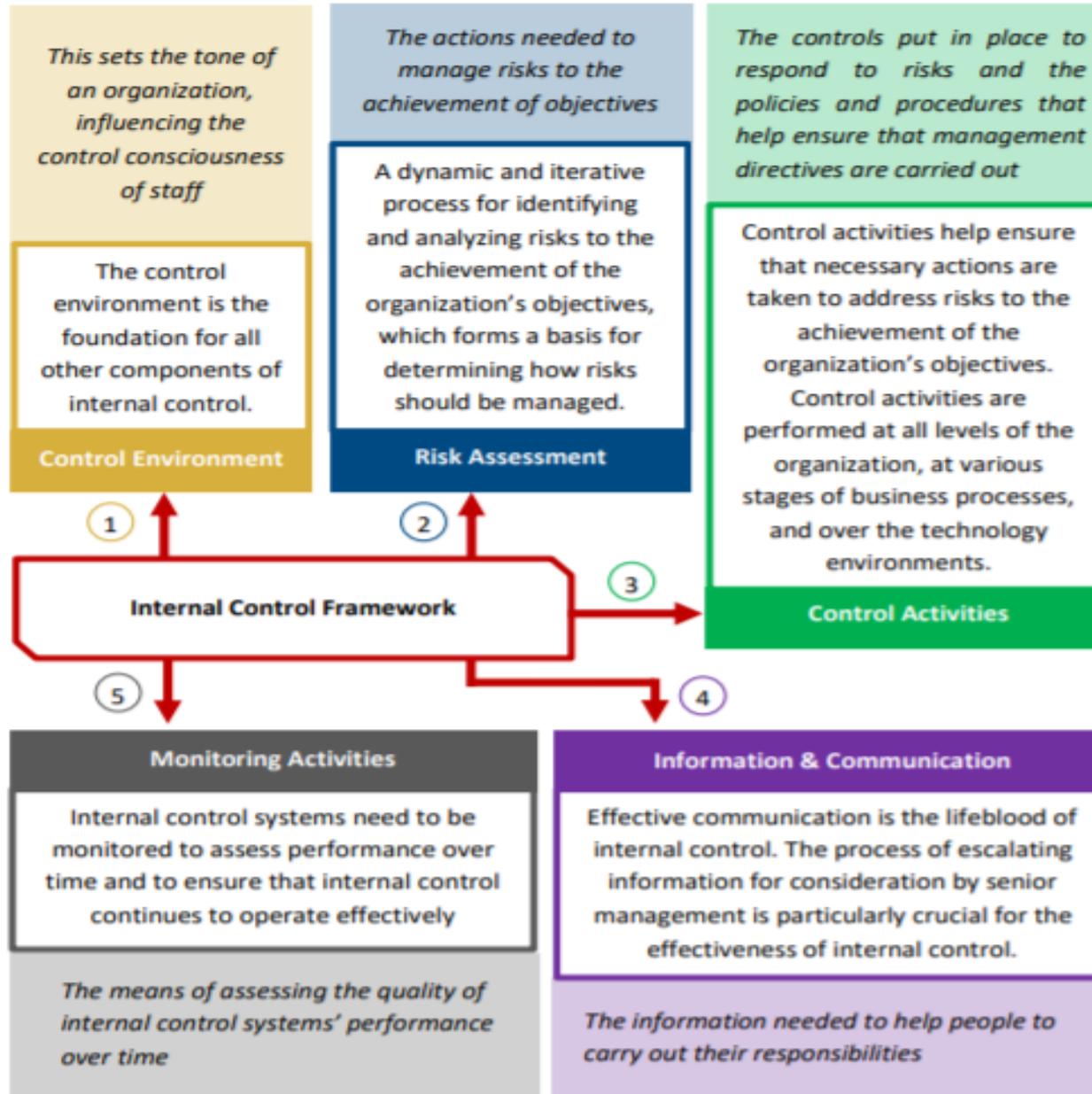
**Figure 1. The definition of internal control explored**



## This limitations of Internal Control

- ❑ Internal control is a process of providing reasonable assurance on the achievement of objectives.
- ❑ Internal control cannot change a poor manager into a good one.
- ❑ Internal Control cannot influence external factors or severe operational constraints that may significantly impact operations, e.g. COVID-19.
- ❑ Inherent limitations of internal control include faulty human judgment in decision-making; simple human error and mistakes; and the need to balance the cost of controls against the risks and benefits involved.
- ❑ Internal controls provide limited protection in certain situations relating to fraudulent actions, such as collusion between two or more individuals.

**Figure 2. The five components of internal control**



## **PART 3. APPLYING INTERNAL CONTROL IN PEMPAL COUNTRIES**

This guidance aims to support public sector internal auditors in PEMPAL countries to implement effective systems of internal control using the framework developed by COSO.

- ▣ In **Moldova** these have been framed as a set of internal control standards which have legal force through their issuance in the public Gazette.
- ▣ In **Georgia**, all five COSO components are identified in the “Law on Public Internal Financial Control”, which obliges the heads of state organizations to ensure the development, formation, and operation of financial management and control components. There is additionally an instruction on the implementation of the requirements of this law, which also refers to COSO 2013.

## **PART 4. INTERNAL CONTROL MATURITY MODEL**

Level	Characteristics
<b>Level 1: Informal</b> <i>Ad-hoc /Chaotic</i>	The characteristics of internal controls at this level are that they are (typically) undocumented and in a state of dynamic change. They are driven in an <i>ad hoc</i> , uncontrolled, and reactive manner by users to events. This provides a chaotic or unstable environment for internal control.
<b>Level 2: Defined</b> <i>Standard / Repeatable</i>	The characteristics at this level of maturity are that some internal controls are in place and are repeatable, possibly with consistent results. Internal control discipline is unlikely to be rigorous, but where it exists it may help to ensure that internal controls are maintained during times of stress. Over time, sets of defined and documented standard control processes will be established and subject to improvement. <b>This could be a lengthy <i>developmental stage</i> and is the level where most organizations will probably sit.</b>
<b>Level 3: Managed &amp; Monitored</b> <i>Predictable</i>	At this level of maturity, the majority of internal controls are repeatable and generate consistent results. Internal control discipline is rigorous and ensures that internal controls are maintained in times of stress. Designed and documented standard processes exist and the focus is on continually improving internal control performance through both incremental and innovative changes and improvements.
<b>Level 4: Optimized</b> <i>Efficient / Effective</i>	The characteristics of internal control at this level are that the effectiveness of internal control is measured and benchmarked against best practice to ensure strong performance across different situations.

***A four-level model for assessing the maturity of internal control***

## THE DETAILED ANNEXES

## **ANNEX A. INTERNAL CONTROL PRINCIPLES AND POINTS OF FOCUS**

This annex outlines the 17 principles together with the points of focus that may be relevant in understanding the application of each principle in the public sector.

### **ANNEXES B1 - B5 THE COMPONENTS EXPLAINED**

**Annexes B1 to B5 provide additional explanations to help internal auditors interpret and apply the five components and 17 principles of internal control.**

**Each annex focuses on one of the components, illustrating how the points of focus might be interpreted, outlining the purpose and main features of each principle, and providing a set of criteria for assessing internal control effectiveness.**

## **ANNEX B1 CONTROL ENVIRONMENT**

**This Annex focuses on Component 1 – Control Environment.** Which is the foundation of all other components of internal control. The control environment reflects the tone at the top of an organization.

## **ANNEX B2. RISK ASSESSMENT**

**This annex focuses on Component 2 – Risk Assessment,** which allows an organization to consider the extent to which potential events have an impact on the achievement of objectives.

## **ANNEX B3. CONTROL ACTIVITIES**

**This annex focuses on Component 3 – Control Activities,** which are the controls put in place to respond to risks, and the policies and procedures that help ensure that management directives are carried out.

#### ANNEX B4. INFORMATION & COMMUNICATION

This annex focuses on Component 4 – Information & Communication which ensures that pertinent information about an entity's activities is identified, captured, and communicated in a form and timeframe that enables people to carry out their responsibilities.

#### ANNEX B5. MONITORING & EVALUATION

This annex focuses on Component 5 – Monitoring & Evaluation which encompasses the ongoing evaluation of internal control systems and the process of separate evaluations.

## ANNEX C. ASSESSING THE MATURITY OF INTERNAL CONTROLS

This annex presents a framework for assessing the maturity of internal controls at four levels drawing on the criteria developed by PEMPAL for each principle and the points of focus as presented in Annexes B1-B5.

Principle 1. The organization demonstrates a commitment to integrity and ethical values

Level 1: Informal <i>Ad-hoc/Chaotic</i>	Level 2: Defined <i>Standard/ Repeatable</i>	Level 3: Managed & Monitored <i>Predictable</i>	Level 4: Optimized <i>Efficient/ Effective</i>
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### PF1.1 Sets the tone at the top

Behavior, values and operating style of senior management are not known by staff.	Staff have a general awareness of senior management behavior and operating styles.	Senior management inform all staff about their operating style and expected behavior. Values are published and well understood across the whole organization.	Managers have demonstrably high standards of personal behavior. They "walk the talk".
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# Illustrating the guidance by focusing on principle 9

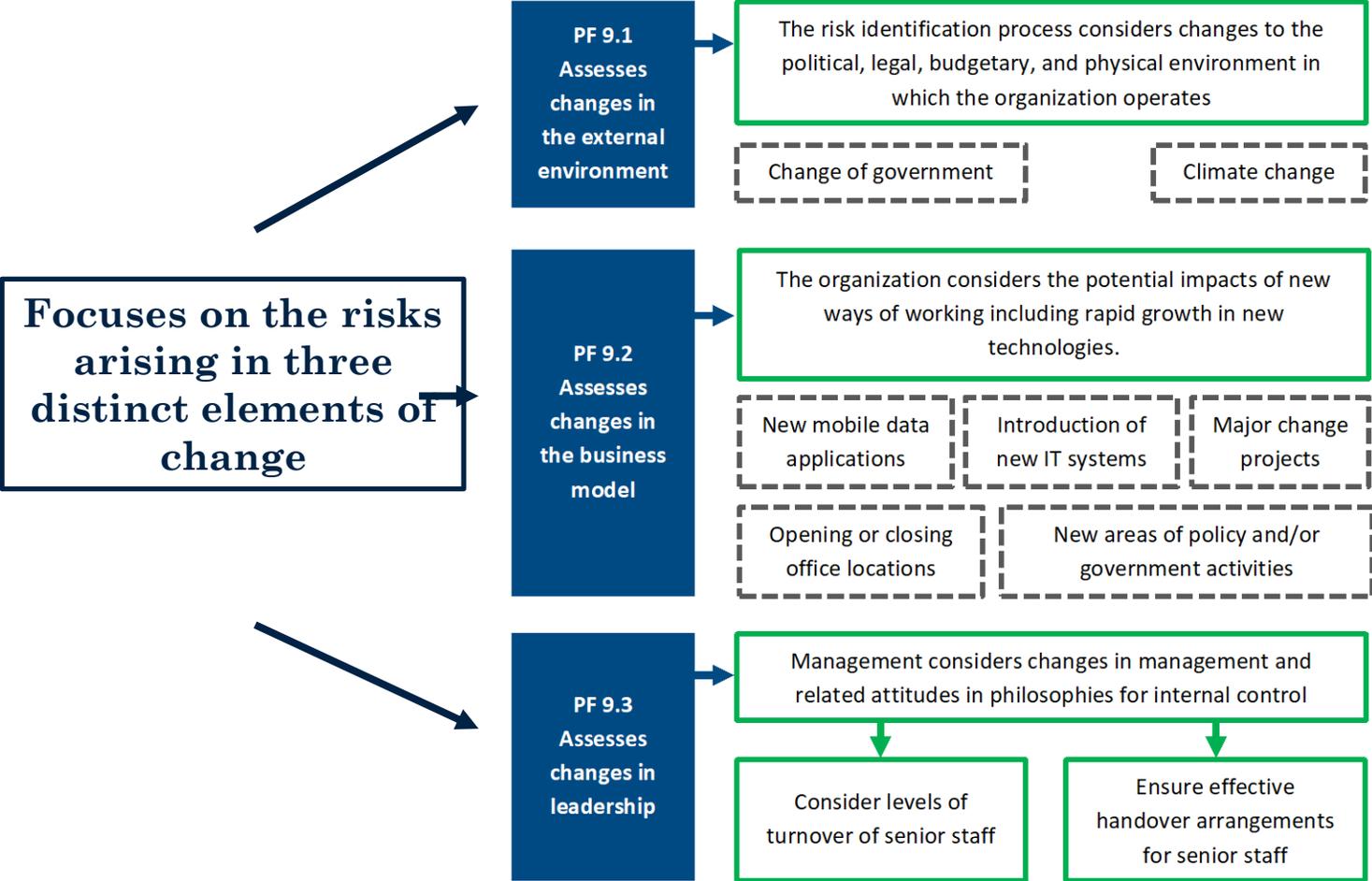
## Assessing Change

- ❑ The two following slides take a closer look at the PEMPAL Guidance provided by looking in more detail at one principle – Principle 9 - Assessing Change
- ❑ The risks arising from change are so wide ranging and pervasive that COSO recommends that they are considered as a separate principle of internal control.
- ❑ Annex B2 explores the principle and the three points of focus in more detail and then Annex C considers what the internal auditor may find at different levels of maturity for each of the three points of focus.

**Exploring the three Points of Focus in Annex B2**

**Principle 9. The organization identifies and assesses changes that could significantly impact the system of internal control**

**Figure 12. Interpretation of Principle 9**



**Focuses on the risks arising in three distinct elements of change**

**Assessing Maturity  
for one point of  
focus – 9.2 - the  
risks arising from  
changes in the  
business model**

Level 1: Informal <i>Ad-hoc/Chaotic</i>	Level 2: Defined <i>Standard/ Repeatable</i>	Level 3: Managed & Monitored <i>Predictable</i>	Level 4: Optimized <i>Efficient/ Effective</i>
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**PF 9.2 Assesses changes in the business model**

There is limited consideration of major changes in the business model.	<p>Management considers major change projects resulting in changes in the key structures, functions, roles, services, and products delivered.</p> <p>Management considers changes to new technology -disruptive technologies including mobile data and their impact on internal processes and internal control.</p>	<p>There are clear processes to deal with information and communication technologies/ cyber security risks and operational availability through business continuity planning and/or disaster recovery planning.</p> <p>Management considers the staffing capacity relevant to new roles and objectives.</p>	There is a unit within the organization that is responsible for monitoring change.
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**THANK YOU!**

