

MODULE 1 - INTERNAL CONTROLS

Real life story

As Director of the Forestry Development Project of Syldavia, I was heading a team of agronomists responsible for EU funded activities.

The accounting records for our project were kept by the Project's bookkeeper with the help of a junior administrative assistant. My Deputy Director and myself fully trusted our bookkeeper. He was a very efficient, highly motivated individual. His deliverables were always submitted well in time, and he required very little supervision from my Deputy Director or myself.

His tasks consisted of keeping the accounting records of the project and preparing the payment orders. He also kept the petty cash and controlled the cheques and payments. In view of his high competence and trustworthiness, we had also granted him a proxy signature on the bank account. He was a very conscientious accountant, who performed all cash and bank reconciliations on a weekly basis.

After some 18 months of good service, he asked for a few days' vacation, from which he never returned. We hired a replacement bookkeeper, who discovered on his arrival that a very significant sum of money was missing from our bank account. We reported it to the local police, who have not yet managed to locate our missing bookkeeper.

Lesson learnt: Had we segregated basic financial duties, the theft would most likely not have occurred...



WHY IS INTERNAL CONTROL A KEY FINANCIAL MANAGEMENT AREA?

Key Message:

Better safe than sorry: set up internal controls.

Internal Control is designed to provide reasonable assurance that operations are effective and efficient, that financial information is reliable and that the Contractual Conditions have been met.

If proper internal controls are not in place, there is a high risk that EU funds will not be spent efficiently and as agreed in the Contract. Project assets may be lost and the use of funds may not be properly accounted for.

Lack of adequate internal controls: a key risk

It is essential to have an internal control system that provides reasonable assurance of achieving the objectives.

Content of this module

- ▶ Minimum contractual conditions.
- ▶ Basic tips.
- ▶ Specific issue - Importance of the internal control environment.
- ▶ Specific issue - Multilocation/multipartner projects.
- ▶ Tools and templates.

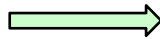


MINIMUM CONTRACTUAL CONDITIONS

Contracts for EU funded external actions do not include exhaustive internal control requirements. They do, however, contain certain specific requirements which are internal control-related.

The main ones are:

- Segregation of duties between the authorising and the accounting officer



For programme estimates, the Practical Guide for Programme Estimates:

- ▶ requires the duties of the imprest administrator and the duties of the imprest accounting officer to be kept separate (see “Roles and responsibilities” - Section 2.5);
- ▶ defines the roles and responsibilities of these two officers (see “The imprest administrator” and “The imprest accounting officer”- Sections 2.5.1 and 2.5.2).

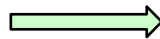
These requirements aim to segregate the duties of authorising expenditure and handling payment (this is known as the ‘four eyes’ principle).

The Practical Guide for Programme Estimates can be found at:

http://ec.europa.eu/europeaid/work/procedures/financing/work_programmes/index_en.htm


Most Financing Agreements and Technical and Administrative Provisions require authorisation and payment duties to be segregated.

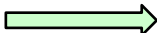
- Prohibition of conflicts of interest and confidential payments



All Contracts for EU funded external actions prohibit conflicts of interest, confidential payments (e.g. secret commissions, bribes) and other unethical practices.

MINIMUM CONTRACTUAL CONDITIONS (continued)

- Regular checks  In actions implemented through 'delegated cooperation' (for example contributions to international organisations or delegation agreements with public sector bodies), the Contract will generally require the delegatee to conduct regular checks to ensure that the action has been implemented correctly.

- Measures to prevent irregularities, fraud and corruption  In actions implemented through 'delegated cooperation', the Contract will generally require the delegatee to set up measures to prevent irregularities, fraud and corruption.

BASIC TIPS

Internal Control is an ongoing process which requires the continuous attention of management. This section covers important, basic measures concerning control activities.

Key Message:

Ensure sufficient segregation of duties.

A key measure is to ensure that no single transaction or chain of transactions is in the hands of a single person.

A transaction or chain of transactions may often involve many different tasks. By assigning these tasks to different people, Recipients will reduce the risk of individuals being in a position to commit fraud or conceal errors in the normal course of their duties.

Examples of activities that can usefully be segregated include:

- ▶ physical control of assets versus verification tasks (for example, cash custody versus cash reconciliation tasks);
- ▶ management tasks versus authorisation tasks (for example, following procurement procedures versus authorising the contract with the supplier);
- ▶ management tasks versus accounting tasks (for example, approving the purchase invoice versus accounting for it);
- ▶ accounting tasks versus payment tasks (for example, preparing payment versus signing the bank transfer order).



BASIC TIPS (continued)

Key Message:

Consider the most effective way of segregating duties.

There may be several ways of segregating tasks, and some may be more effective than others.

It may be possible to organise the tasks so that the individuals performing them will control each other. This would enhance controls and mitigate risks.

Recipients should take the time to think about the most effective way of segregating tasks, depending on the nature of the project.

Key Message:

Foresee effective approval points.

Approving also means checking.

Appropriate authorisation procedures enhance controls. Identify approval points that are relevant to the project and assign responsibility for carrying out such tasks to the most appropriate individuals.

These individuals must understand that they are responsible for checking anything they approve.

For example, for a service contract the team leader may be asked to approve the timesheets for the project staff.

Approval will usually be shown by the team leader's signature on the timesheets. However, to provide effective control, the team leader must effectively check the timesheets before signing them.

BASIC TIPS (continued)

Key Message:

Staff must understand their responsibilities.

For the segregation of duties to work as intended, every person concerned must understand what his/her responsibilities are.

To avoid misunderstandings, it is important to describe all responsibilities and tasks in writing, for example by means of:

- ▶ written job descriptions;
- ▶ a clear organisation chart, showing responsibilities and tasks;
- ▶ descriptions (or flow-charts) of the intended flow of transactions, indicating control points and the frequency of controls.

An effective way to cover these topics is to put them into a specially designed project or programme manual.

Key Message:

Small organisations must also segregate duties and controls.

Organisations with few staff may find it difficult to segregate duties. However, a minimum level of segregation (for example, separation between the most important functions such as authorisation and accounting) is needed.

Sometimes only limited segregation of duties is possible and economically feasible. Recipients should compensate this by introducing a close control and review system, run by management.

SPECIFIC ISSUE - IMPORTANCE OF THE INTERNAL CONTROL ENVIRONMENT

The primary foundation of a good internal control system is the Recipient's own internal environment, as set up by the Recipient's management.

This control environment includes:

- ▶ integrity, ethical values and the behaviour of key executives;
- ▶ management's operating style;
- ▶ management's commitment and competence;
- ▶ the organisational structure and assignment of responsibility and authority;
- ▶ human resources policies and practices.

By setting up the control environment, management "sets the tone" of the entire organisation, influencing the control consciousness of its staff. By promoting key values such as integrity, ethics, transparency, competence and dedication to good management practices, management provides a framework for discipline and structure.

The internal control framework devised by the "Committee on Sponsoring Organizations" of the Treadway Commission (COSO) is currently the most widely accepted internal control framework.

This framework identifies several layers and dimensions of internal control:

- ▶ the internal control environment
- ▶ objective setting
- ▶ risk assessment and management
- ▶ control activities
- ▶ communications
- ▶ monitoring.

Information on the COSO internal control framework can be obtained from: www.coso.org

SPECIFIC ISSUE - MULTILLOCATION / MULTIPARTNER PROJECTS

In multilocation projects, the project is often carried out by several independent partners, each with its own internal control structure.

In such cases, a single entity will usually lead and coordinate the entire project.

In Contracts for EU funded external actions, the lead entity will usually be the main Recipient, which is considered responsible for the entire project.

The lead (coordinating) entity in such a project will generally be considered liable for poor execution of activities by the project partners.

In order to mitigate this risk, the lead (coordinating) Recipient should consider the following basic measures:

- ▶ at project design stage, evaluate whether the entities taking part in the project have adequate internal controls in place, in line with the general principles outlined in this Module;
- ▶ during project execution, closely monitor the performance of the project partners to ensure that their internal controls remain adequate and that execution remains under control;
- ▶ at regular intervals during the project, obtain copies and / or review the accounting records and supporting documents of those activities managed by participating entities to ensure they meet the contractual conditions.



TOOLS AND TEMPLATES

MODULE 1

INTERNAL

CONTROLS

The following tool can be downloaded from the EuropeAid website at:

http://ec.europa.eu/europeaid/financial_management_toolkit/

FMT - MODULE 1 - INTERNAL CONTROL CHECKLIST

Recipients are encouraged to use the Internal Control Checklist compiled with this toolkit.

Since internal control is an ongoing process, it is highly recommended that Recipients update their answers to the Internal Control Checklist at regular intervals.

