Audit of the Policy on Internal Control Implementation

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Natural Sciences and Engineering Research Council of Canada
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1 EXECUTIVE SUMMARY

Background

Effective 2009, the Treasury Board Secretariat of Canada (TBS) instituted the Policy on Internal Control ("PIC", "the Policy") for all government departments as defined in section 2 of the *Financial Administration Act*. The Policy requires departments and agencies to produce two expected results:

i. An effective risk-based system of internal control; and
ii. An effective system of internal control over financial reporting.

Why it is important

As part of the Risk-Based Audit Plan exercise for 2012 to 2015, management requested an audit of the Policy on Internal Control to provide assurance that the Policy requirements were being appropriately implemented. In addition, considering that the grants and scholarships funding envelopes for NSERC (approximately $1 billion) and SSHRC (approximately $700 million) are highly material, it is critical that the system of internal control over these funds be examined.

Audit objective and scope

The objective of this audit was to examine the implementation of the Policy by NSERC and SSHRC and to provide reasonable assurance that the agencies had appropriately addressed the expectations of an effective, risk-based system of internal control and an effective system of internal control over financial reporting. The audit work placed greater focus on how NSERC and SSHRC implemented a system of control over financial reporting. The scope of the audit included both implementation activities completed to date and the project plan established to complete future implementation activities.

Key audit findings

PIC implementation activities to date demonstrate that the agencies have established a sound foundation for an effective system of internal control over financial reporting. The audit noted key areas of progress, which include

- The development of a plan to implement PIC by 2013-14. This plan was communicated to management and to the Independent Audit Committees through each agency's "Statement of Management Responsibility Including Internal Controls Over Financial Reporting";

- The identification and assessment of the key risks that could impact NSERC and SSHRC's financial accounts;

- The identification, documentation and assessment of internal controls over financial reporting to meet the expected outcomes of the PIC; and

- The initiation of an assessment of the capacity required to monitor internal controls over financial reporting, along with the financial resources necessary to support implementation of the PIC over the next few fiscal years (2012 to 2014).

In addition, the audit also noted key areas of improvement intended to build on the progress achieved by the agencies to date. These areas include

- Further defining the roles and responsibilities of the broader senior management cadre (and oversight bodies) for internal controls to ensure there is a wider understanding of the state of control over the financial accounts. This also includes clarifying and communicating expectations for testing, remediation and monitoring of selected key controls to ensure their effectiveness; and

- Consider aligning the monitoring of internal controls over financial reporting with the agencies' respective risk management frameworks to support a more comprehensive and integrated risk-based system of internal control.

Conclusion

An effective system of internal control is critical to ensuring the effectiveness and efficiency of operations, safeguarding assets and complying with legislative requirements, and is therefore key in achieving corporate objectives. NSERC and SSHRC have demonstrated significant progress towards the implementation of a system of internal control during a period of limited resources due to competing corporate priorities. The work done to date has established a solid foundation for achieving full compliance with the PIC in the coming years, and the audit recommendations are intended to support the agencies on their paths of continuous improvement.

2 BACKGROUND

Effective 2009, the Treasury Board Secretariat of Canada (TBS) instituted the Policy on Internal Control ("PIC"; "the Policy") for all government departments as defined in section 2 of the *Financial Administration Act*. This Policy recognizes that Parliament and Canadians expect the federal government to be well managed, with the prudent stewardship of public funds, the safeguarding of public assets, and the effective, efficient and economical use of public resources. TBS also expects reliable reporting that provides transparency and accountability for how government spends public funds to achieve results for Canadians, similar to expectations found in other private and public sector organizations and jurisdictions. To mitigate the risks related to achieving these goals, organizations must establish and maintain broad systems of internal control. Specifically, the PIC requires departments and agencies to produce the following results:

i. An effective risk-based system of internal control is in place in departments and is properly maintained, monitored and reviewed, with timely corrective measures taken when issues are identified (section 5.2.1); and
ii. An effective system of internal control over financial reporting is operating in departments as demonstrated by the departmental *Statement of Management Responsibility Including Internal Control Over Financial Reporting* (section 5.2.2).

Both NSERC and SSHRC have been implementing the Policy as members of PIC implementation Group II/Cluster II, which represents the 23 medium-sized departments and agencies of Parliament.

As part of the Risk-Based Audit Plan exercise for 2012 to 2015, management requested an audit of the PIC to provide assurance that the requirements of the Policy were appropriately implemented. In addition, considering that the grants and scholarships funding envelopes for NSERC (approximately $1 billion) and SSHRC (approximately $700 million, $330 million of which is dedicated to the tri-council Indirect Costs Program and managed by SSHRC) are highly material, it is critical that the system of internal control over these funds be examined.

3 AUDIT OBJECTIVE AND SCOPE

The objective of this audit was to examine the implementation of the Policy by NSERC and SSHRC and to provide reasonable assurance that the agencies had appropriately addressed the expectations as outlined in sections 5.2.1 and 5.2.2 (see Section 2). As recommended by TBS, the audit work placed greater focus on how NSERC and SSHRC implemented Expected Result 5.2.2 for an effective system of internal control over financial reporting. The scope of the audit included both implementation activities completed to date and the project plan established to complete future implementation activities.

The audit criteria were based on guidelines provided by the Office of the Comptroller General (OCG) for auditing core management controls within government. This guidance closely follows the internationally recognized Committee of Sponsoring Organizations of the Treadway Commission (COSO)[1] framework. Acknowledged by TBS as leading guidance for federal government departments and agencies, COSO provides generally accepted standards for assessing the implementation of risk-based systems of internal control. (See Appendix I for COSO-based criteria.)

4 AUDIT METHODOLOGY

The Corporate Internal Audit Division (CIAD) used the following methodology to conduct its work:

- File and document review of various sources of information from NSERC and SSHRC, including financial account flow charts, descriptions, risk and control matrices, corporate risk and control information, committee terms of reference, committee minutes, plans, etc.; and
- Conduct interviews with key internal NSERC and SSHRC stakeholders (i.e., Financial Awards and Administration Division, NSERC's Corporate Planning and Policy Division, SSHRC's Corporate Strategy and Performance Division, etc.).

In the professional judgment of the Chief Audit Executive, sufficient and appropriate audit procedures have been conducted and evidence gathered to provide a high level of assurance on the findings contained in this report. The conclusions were based on a comparison of the situations as they existed at the time against the audit criteria. This internal audit was conducted in accordance with the Treasury Board Policy on Internal Audit and the International Professional Practices Framework of The Institute of Internal Auditors.

[1] The Committee of Sponsoring Organizations of the Treadway Commission (COSO) is an internationally recognized and joint initiative of five leading financial and audit organizations dedicated to providing thought leadership through the development of frameworks and guidance on enterprise risk management, internal control and fraud deterrence.

5 KEY AUDIT FINDINGS

Internal controls operate at all levels throughout an organization and can be defined as policies, practices or procedures designed to mitigate risks and provide reasonable assurance on the achievement of objectives. Internal controls are intended to promote efficiency and effectiveness by minimizing error, avoiding duplication of effort and promoting consistency. Controls can include segregation of duties, sign-offs, approvals, manual or electronic reconciliations, verification activities, etc.

According to COSO, effective internal control has five components: a corporate environment that supports control; the identification and prioritization of risks; effectiveness testing of controls linked to key risks and remediation; dissemination of key control information; and monitoring. Audit findings relating to these five components are described in the following sections.

5.1 Control environment

A control environment is the foundation of all other components of internal control. It is the organization’s set of standards, processes and structures to implement an effective system of control. In a strong control environment, senior management sets a tone regarding the importance of internal control, establishes clear authorities and responsibilities for oversight, and clarifies expectations for control at various levels of the organization. An effective control environment is particularly important for ensuring that weaknesses that could adversely impact corporate objectives are remediated in a timely manner.

5.1.1 ***NSERC and SSHRC are establishing an environment that supports internal control over financial reporting***

While roles and responsibilities with respect to internal control over financial reporting have been clearly defined for the Finance and Awards Administration Division (FAAD), the broader control environment for financial reporting outside of the Division is still evolving. While the responsibility of the Deputy Head and Chief Financial Officer (CFO) has been clarified, the responsibility of other senior management (i.e., members of SSHRC’s Senior Management Committee and NSERC’s President’s Management Committee) for internal control over financial reporting could be more clearly defined. This could be achieved by clarifying management’s accountability regarding internal control over financial accounts and its involvement in the assessment and maintenance of key controls (e.g., receiving assurance on effectiveness of key controls over the grants and scholarships account and remediation activities when controls are found to be weak). Until now, internal control over financial reporting and the PIC initiative have been considered primarily a responsibility of the FAAD.

Without clearer responsibilities and expectations set by senior management, its assurance on the efficacy of the controls that ensure the accuracy and safeguarding of accounts critical to NSERC and SSHRC's business (i.e., grants and scholarships) cannot be optimized.

Recommendation 1: To support the Deputy Heads in fulfilling their role as accounting officer under the *Financial Administration Act*, senior managers should assume greater accountability for establishing, maintaining and reporting on a risk-based system of internal control for their specific areas of responsibility. Additionally, the agencies could further strengthen the control environment by having management committees provide oversight of the effectiveness of internal controls within their respective organizations to ensure that control weaknesses are being monitored and addressed in a timely manner and key risks mitigated. In SSHRC, this may be achieved through clarifying the role of the Management Accountability Committee (MAC). In NSERC, management should identify the most appropriate committee for providing oversight in this area.

5.1.2 ***Greater assurance on PIC implementation could be achieved through more detailed planning***

NSERC and SSHRC have developed a plan to implement PIC by 2013-14. This plan was communicated to management and to the Independent Audit Committees through each agency's "Statement of Management Responsibility Including Internal Controls Over Financial Reporting." The plan could be enhanced to provide management with greater assurance that PIC will be fully implemented in a timely manner. Such enhancements would include specific definitions of milestones, timing, human resource requirements and detail on project risks (such as ongoing commitment of senior management, proper planning and communication, and ongoing availability of dedicated resources and qualified personnel) and on mitigation measures.

5.2 Risk assessment

Risk assessment is the identification and evaluation of risks that could impact the achievement of corporate objectives. Within an effective system of internal control, strong risk assessment involves management, considers the complete range of risks — operations, compliance, safeguarding of assets and financial reporting — and systematically assesses and prioritizes them in relation to corporate objectives.

Within specific financial business processes, risk assessment is critical in identifying where controls points are most needed, or which existing controls require the greatest amount of attention.

5.2.1 *NSERC and SSHRC have identified and assessed many of the key risks that could impact their financial accounts*

NSERC and SSHRC have assessed risks regarding their key financial accounts based on appropriate qualitative and quantitative factors. In addition, many key financial reporting risks identified for the in-scope business processes were documented. However, risk assessments of key in-scope accounts have not considered a full range of risks related to financial reporting. For example, the control/risk matrix for the grants and scholarships finance process addresses risks identified with respect to inaccurate payments and payments to the wrong recipient, but risks related to determining the eligibility of grant and scholarship recipients are not explicitly documented. Ineligibility of recipients could have an impact on the financial statements and therefore could be included as part of a risk assessment exercise. Other potential risk areas that may require further consideration and could have an impact on financial statements include monitoring use of grant funds and recovering funds found to be used inappropriately.

Recommendation 2: The control/risk matrices documented for key business processes, particularly grants and scholarships, should consider a broader range of risks related to financial reporting. Testing of the controls resulting from the broader set of risks should be incorporated into the testing plan going forward.

5.3 Internal control activities

Important activities to ensure that internal controls operate as intended include documentation, testing and remediation. In an effective system of internal control, controls linked to key risks are periodically tested to determine their effectiveness and remediation activities are planned and executed when the performance of controls is found to be lacking.

5.3.1 *Substantial progress has been made in documenting and assessing internal controls over financial reporting*

NSERC and SSHRC have made substantial progress towards the documentation and assessment of internal controls over financial reporting to meet the PIC expected outcomes. NSERC and SSHRC formally documented internal controls over financial reporting for key in-scope business processes, following a consistent format based upon the internal control toolkit, *Draft Policy on Internal Control – Diagnostic Tool for Departments and Agencies* issued by the OCG. As well, documentation identifies key control points for financial reporting in the process flowchart and the control/risk matrix. NSERC and SSHRC have also performed walkthroughs, in conjunction with the tests of design and operational effectiveness for selected in-scope business processes, and identified necessary remediation actions. More complete testing and remediation is planned for specific business processes, information technology general controls (ITGC) and entity-level controls[2] through to 2014, to allow the agencies to implement a new grants system intended to establish new controls, which will then need to be assessed as well. Future planning must provide enough detail to offer management assurance that business processes, entity-level controls and ITGC are tested in a complete manner (i.e., comprehensive design and operational effectiveness testing and sampling methodology; established benchmarks for determining effectiveness; established frequency of testing and remediation; and reporting cycle).

Recommendation 3: NSERC and SSHRC should ensure that the 'internal controls over financial reporting' testing plan is complete, to address the documentation and assessment of all remaining components of internal controls over financial reporting, including entity-level controls and ITGC.

5.4 Information and communication

Information on the sufficiency of key controls, and on the flow of this information to and from strategic points in the organization, is important in supporting the achievement of corporate objectives. In an effective system of internal control, management receives timely, relevant and sufficient information to understand the effectiveness of key controls to enable sound decision-making.

5.4.1 *Internal control oversight could be strengthened by determining sufficient and relevant information on the reporting of control effectiveness and remediation*

NSERC and SSHRC have accurately reported key elements of their PIC implementation progress to senior management and the Internal Audit Committees. In addition, senior management has been provided with, and subsequently approved, each agency's "Statement of Management Responsibility Including Internal Controls Over Financial Reporting." While these activities demonstrate that NSERC and SSHRC have addressed a key requirement, oversight could be enhanced by determining the specific information required by the CFO and senior management to ensure that the agencies fulfill their ongoing responsibilities to monitor the effectiveness of internal controls over financial reporting (i.e., specific type of information, format and appropriate level of detail).

[2] Entity-level controls refer to controls and practices across the department that may have a direct or indirect impact or influence on the integrity of the department's financial reporting. They include the "tone from the top," the organization's culture, values and ethics, governance, transparency and accountability mechanisms, as well as the activities and tools put in place across the organization to raise staff awareness and ensure clear understanding of roles and responsibilities (Source: Policy on Internal Control-Diagnostic Tool for Departments and Agencies, Office of the Comptroller General, 2010).

Recommendation 4: NSERC and SSHRC should define the type of information needed, as well as what is considered relevant and sufficient by senior management to support its role in monitoring internal controls over financial reporting.

5.5 Monitoring

Monitoring involves ongoing tracking, separate evaluations, or a combination of the two, to ascertain whether each of the five components of internal control is present and functioning. In a strong system of internal control, results from monitoring activities are compared with management's expectations and/or benchmarks, and performance is communicated to senior management to ensure timely remediation if deficiencies exist.

5.5.1 *NSERC and SSHRC are in the early stages of assessing ongoing capacity to monitor internal controls over financial reporting*

NSERC and SSHRC are in the early stages of assessing capacity to monitor internal controls over financial reporting and have identified the financial resources necessary to support implementation of the PIC over the next few fiscal years (2012 to 2014). Determining how internal human resources will be leveraged to accomplish this and how internal controls will be monitored past the initial implementation of PIC to ensure continuous tracking will need to be further defined.

5.5.2 *Efficiencies may be achieved by aligning the monitoring of internal control over financial reporting with the broader corporate risk management process*

Through their corporate risk management frameworks, NSERC and SSHRC have made significant progress in establishing the foundations of a strong entity-level control environment, consistent with Expected Result 5.2.1 of PIC. While emphasis on internal control could be strengthened within these frameworks to bring them more in line with COSO (i.e., establishing expectations for effectiveness testing, remediation of key controls and reporting on control performance), roles, responsibilities and expectations with respect to risk and other elements of internal control (i.e., control identification) are articulated for risk owners, as well as for key oversight bodies. In addition, NSERC and SSHRC have made significant progress in developing their risk management reporting cycles, allowing senior management to begin ongoing monitoring of organizational risks and their related non-financial controls.

Currently, FAAD is monitoring internal controls over financial reporting, independent of NSERC and SSHRC's respective risk management processes, which have a broader focus on corporate risk and control. NSERC and SSHRC may consider integrating the monitoring of financial reporting controls with the broader corporate risk management process, by leveraging existing committees, resources and reporting cycles, to achieve greater efficiencies.

Recommendation 5: To support a more comprehensive risk-based system of internal control, NSERC and SSHRC should consider aligning the monitoring of risks and internal controls over financial reporting with their existing respective risk management frameworks. Greater alignment may also achieve efficiencies, especially in relation to the planned testing of entity-level controls.

6 CONCLUSION

An effective system of internal control is critical to ensuring the effectiveness and efficiency of operations, safeguarding assets and complying with legislative requirements, and is therefore key in achieving corporate objectives. NSERC and SSHRC have demonstrated significant progress towards the implementation of a system of internal control during a period of limited resources due to competing corporate priorities. The work done to date has established a solid foundation for achieving full compliance with the PIC in the coming years.

The audit recommendations in this report are intended to reinforce the progress accomplished to date and to support the agencies on their paths of continuous improvement. Key to these recommendations is the enhancement of the developing control environment within the agencies. Increasing awareness of internal controls and establishing expectations at the broader management level for testing, remediation and monitoring of key controls to ensure their effectiveness will enhance the achievement of the other audit recommendations. Furthermore, in moving towards full PIC implementation, the agencies would benefit from a more holistic, aligned approach with NSERC and SSHRC's respective corporate risk management processes.

AUDIT TEAM

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7 MANAGEMENT RESPONSE

Item	Recommendation	Action Plan	Target Date
1.	To support the Deputy Heads in fulfilling their role as accounting officer under the *Financial Administration Act*, senior managers should assume greater accountability for establishing, maintaining and reporting on a risk-based system of internal control for their specific areas of responsibility. Additionally, the agencies could further strengthen the control environment by having management committees provide oversight of the effectiveness of internal controls within their respective organizations to ensure that control weaknesses are monitored and addressed in a timely manner and key risks mitigated. In SSHRC, this may be achieved through clarifying the role of the Management Accountability Committee (MAC) role. In NSERC, management should identify the most appropriate committee for providing oversight in this area.	According to the “Annex to the Statement of Management Responsibilities including Internal Controls over Financial Reporting”, the CFO provides leadership for the coordination, coherence and focus on the design and maintenance of an effective and integrated system of ICFR, including its annual assessment. The CFO will inform senior management cadre and oversight bodies on the state of financial controls and roles and responsibilities (e.g. the tabling of the annual assessment (Annex)).	Ongoing
2.	The control/risk matrices documented for key business processes, particularly grants and scholarships, should consider a broader range of risks related to financial reporting. Testing of the controls resulting from the broader set of risks should be incorporated into the testing plan.	The broader range of risks will be considered as the Ongoing Monitoring Strategy is finalized, and the testing scripts will be amended accordingly.	The Ongoing Monitoring Strategy is scheduled to be completed by March 2013. The testing scripts will be amended by December 2013.
3.	NSERC and SSHRC should ensure that the “internal controls over financial reporting” testing plan is complete to address the documentation and assessment of all remaining components, including entity-level controls and ITGC.	Agreed.	March 2014

4.	NSERC and SSHRC should define the type of information needed and considered relevant and sufficient by senior management to support its role in monitoring internal controls over financial reporting.	The Ongoing Monitoring Strategy is scheduled to be completed in March 2013 and will address information requirements and the communication approach for dissemination of results and action plans.	March 2013
5.	To support a more comprehensive risk-based system of internal control, NSERC and SSHRC should consider aligning the monitoring of risks and internal controls over financial reporting with their existing respective risk management frameworks. Greater alignment may also achieve efficiencies, especially in relation to the planned testing of entity-level controls.	As both the implementation of the Policy on Internal Control continues and the Risk Management Frameworks mature, we will look for opportunities to align where appropriate.	Sept 2013

APPENDIX I – Audit Areas, Criteria and Sources

Audit Areas	Audit Criteria	Sources
Control environment	NSERC and SSHRC have established clear roles, responsibilities, accountabilities, delegation of authority, oversight and tone (at the senior management level) concerning internal control.	*Audit Criteria Related to the Management Accountability Framework: A Tool for Internal Auditors, Internal Audit Sector, Office of the Comptroller General, 2011*
Risk assessment	NSERC and SSHRC have conducted risk assessments to identify and prioritize risks impacting corporate objectives.	
Internal control activities	NSERC and SSHRC have identified their key internal controls for key risks, tested their effectiveness and developed remediation activities to strengthen weaknesses.	
Information and communication	NSERC and SSHRC have established expectations for the type of information required to gain assurance on the state of internal control. In addition, NSERC and SSHRC have documented and communicated testing results and remediation activities for key internal controls (for key risks) to senior management and the Independent Audit Committee of each organization.	
Monitoring	NSERC and SSHRC have established a process to assess key internal controls and track remediation activities periodically. In addition, NSERC and SSHRC have established an appropriate level of resourcing to support monitoring.	