RISK BASED CONTROLS IN ACCOUNTING, PAYROLL AND PAYMENTS PROCESSES—A CONCEPTUAL FRAMEWORK
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Background

1. IFAD’s Controller’s and Financial Services Division has played a leading role in rolling out best practice in the area of internal controls by the introduction of the Management Assertion on Internal Controls over Financial Reporting in 2011. This was accompanied by an independent external auditor’s attestation on the 2012 financial statements. The Division is continuing to move forward to apply principles of risk based internal controls on processes and procedures.

2. This conceptual framework adopts the approach outlined in the COSO\(^1\) report, which underpins the assessment of the benefits and explores the implementation of risk based internal controls in the Accounting Unit’s process driven areas, such as payments and payroll, as well as accounting and reporting processes.

3. The COSO framework defines internal controls as a process designed to provide reasonable assurance regarding the achievement of objectives in relation to the following:

   a. Effectiveness and efficiency of operations
   b. Reliability of financial reporting
   c. Compliance with applicable laws and regulations

4. The time and costs associated with certain control improvement programs may be too high and not justifiable compared to the underlying risk. Given the reduced head count levels in the Accounting Unit’s process driven areas over a number of years, coupled with an increasing level of volume and complexity in transactions to be processed, it has become imperative that principles of risk based controls be applied. More specifically, a higher level of controls should be applied to areas and processes with relatively higher risk, while lower risk areas may be managed adequately through the periodic conduct of ex-post controls on a sample basis.

Objectives of the Conceptual framework

5. The principle objective of this conceptual framework is to set out the principles within which the existing internal controls structure for the CFS accounting processes will be critically evaluated. In so doing, the said structure will be revisited with a view to identify high risk areas and re-focus the controls accordingly. The assessment of the underlying risks (high/low risk, probability and impact) will then influence the nature (ex-ante or ex-post) and extent (100% vs sample) of controls to be put in place in order to reduce the risks to an acceptable level. This approach is intended to result in the following benefits:

   - Optimised internal control frameworks which is both more efficient on staff time and other resources and more effective in risk mitigation.
   - Efficient leverage of Information technology by the Accounting Unit in meeting expectations of external and internal stakeholders
   - Reduction in the number of controls to be performed per transaction.

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\(^1\) IFAD considers that the report, Internal Control-Integrated Framework, issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) in the United States (May 2013), contains a definition of internal control and a conceptual framework that are constructive and relevant.
• Acceptable and appropriate risk coverage with a focus on key risks that really matter
• Improvement of the risk assessment process overall on an on-going basis
• Better return on IT investments due to increasing reliance on application controls developed with their assistance

Internal controls requirements in process execution and reporting

6. In CFS’ Accounting Unit, like most finance functions, reporting and compliance are core to reliable business processes. As such, significant effort and time have been spent over time to build controls that address potential key risks in processes. The review of the current control environment and implementation of risk based controls strives to achieve a more effective control environment. A general balance has to be struck between the potential loss from the crystallisation of risks, and the cost of creating an optimal control environment. In this case, the cost of optimizing the control environment may not go beyond costs of hiring ERP PeopleSoft consultants as applicable, besides regular staff time.

7. Key requirements and target characteristics of effective internal controls are as follows:

- Clearly, visible or easily understood controls which reduce multiple, overlapping and duplicating controls.
- Avoidance of too many controls to address risks in some areas, and not enough controls to address others.
- Compliance or alignment to overall organizational, departmental and divisional priorities and risk register.
- Maximising automation of controls

Applicability and scope of the conceptual framework

8. Below is a description of the approach to be taken to review and assess the control environment with a view to introducing a risk based control strategy. The main steps will include but not limited to identification, diagnosis, design, deployment and sustainment of control environment improvements.

Identification of potential internal control efficiencies

9. In order to identify potential efficiencies, it is important to:

i. Define the number of processes to be reviewed, identify the associated risks and the controls that are/should be in place in order to mitigate them (refer to CFS’s existing ICFR\(^2\) documentation of process flows).

ii. Understand the composition of controls (manual vs. automated) and the nature of the IT applications supporting the automated controls

iii. Gather information related to the level of effort around performing, documenting and testing current controls. This will help identify high-impact areas (effort, cost and potential benefits) for prospective pilots.

\(^2\) ICFR – Internal Controls Over Financial Reporting
Manual Versus Automated Controls

10. A control environment is usually made up of both manual and automated controls. Manual controls are affected by, and rely on, people and are typically independent of IT processes. By nature they are prone to being overridden, bypassed or ignored. Automated controls, on the other hand, rely on computers/technology to identify, prevent or correct errors, variations or risks. They are considered more reliable and robust as they cannot be overridden, ignored or bypassed. Most of the transactions in CFS Accounting are processed in PeopleSoft but there is still a significant number of manual processes with related manual controls that are performed around processes which we aim at automating to the extent feasible.

Risk Analysis and Management

11. In reviewing controls for purposes of establishing a risk based controls framework. It is vital to understand the nature of risks in a particular process and controls that have been put in place to mitigate them.

12. The process of identifying and assessing risks, developing strategies to manage the risks and monitoring and evaluating the risks and the controls in place to address them is known as risk management.

13. In adopting a risk based controls approach in the CFS Accounting Unit, the focus is on identifying the key risks and related key controls, documenting them and monitoring compliance thereof by testing them for compliance (refer to CFS’s existing ICFR documentation of process flows).

Embedding Risk Based Controls in Process execution

14. The goal of embedding risk based controls in process execution is to attain a single, global, streamlined set of controls aligned to key risks, leveraging technology and implementing continuous monitoring capabilities. This results in a more efficient use of resources (both human and financial). The following steps should be taken in the process of embedding risk based controls in CFS Accounting process execution:

- Understand the control environment and alignment of risks with key process objectives
- Collect and collate risk and controls data (based on existing ICFR documentation of process flows)
- Analyze risk and control data to determine the criticality of individual controls with a view to confirming whether the controls absolutely had to be performed with value adding impact.
- Identify gaps and improvement opportunities and incorporate recommended changes.
15. Individual process controls will be measured against the following attributes:

**Process execution**

- Internal controls make process execution more effective and mitigate risks
- Statistics and reporting are used to monitor process effectiveness against objectives
- Processes and initiatives directly support process and Divisional objectives
- Policies and operating procedures are periodically reviewed and updated when needed
- Resources and competencies are sufficient to support process objectives and expedite processes
- Information technology is used to make processes more efficient and reduce risks

**Alignment with strategy**

- Risks taken are aligned to Divisional and corporate objectives
- Risk management activities are integrated with planning and execution
- Acceptance level of risk are defined and communicated
- Change management is employed and tracked to support new strategies
- Plans and initiatives are documented and communicated

**Responsibility for Internal Controls**

16. The Director and Controller, Controller’s and Financial Services Division is prima facie responsible for ensuring that an effective system of internal controls is in place within the Accounting Unit, ensuring adequate coverage of risks. This is delegated authority from the President who has overall oversight responsibility on the Fund’s internal controls and risk management. Staff are also responsible for the performance of controls in the respective areas and processes that they manage and execute.

**On-going review of Risks and Controls in Process Execution**

17. Effective monitoring on a continuous basis is an essential component of a sound system of internal control. To this end, the CFS Accounting unit reviews and updates the ICFR documentation of all processes in their portfolio of functions (as should all process owners) on an annual basis to ensure that they represent the actual processes as currently being executed. A key objective of the review is the assessment of the risks and controls to ensure that they are complete, accurate, valid and relevant. All key controls are then tested for operational effectiveness the results of which is the basis for the Management Assertion on Internal Controls over Financial Reporting.

18. A review should be conducted at least once a year and any controls identified to be redundant or duplicated, should be reviewed with a view to removal to attain a single, global, streamlined set of controls aligned to significant risks that matter.

19. CFS coordinates with the office of Internal Audit and Oversight (AUO) for testing of key controls identified/documentated to ensure that they have been satisfactorily performed
20. AUO and External Auditors also provides relevant improvement recommendations or considerations as to the appropriate design and functioning of the controls in place that will assist the Fund to effectively enhance the internal controls in place.