

FMM 02.4 Establishing Internal Controls

A key responsibility for the department head is the establishment of internal controls and much of the understanding of PFM and its contribution to governance is captured in the establishing a control environment with effective internal controls.

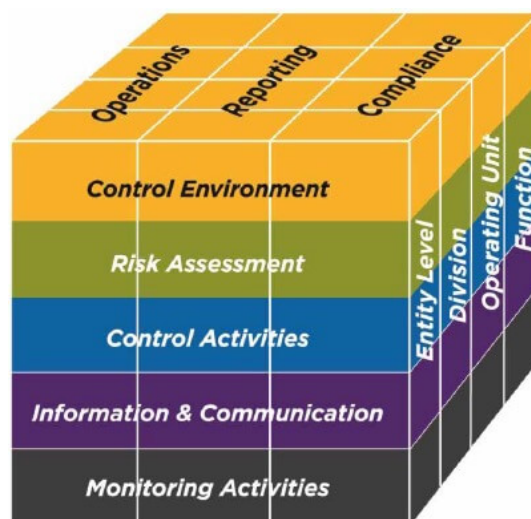


Figure 2 COSO Internal Control Framework - Five Pillars

4.1 What is a control environment

Internal controls are the mechanisms, rules, and procedures implemented by an agency to safeguard assets, ensure accurate financial reporting, promote accountability, and prevent fraud and errors. These controls are essential for achieving organizational objectives and enhancing service delivery.

4.1.1 Objectives of Internal Controls

Internal controls serve the following purposes:

- Ensuring operational efficiency – Streamlining processes and eliminating redundancies to maximize resource utilization.
- Maintaining financial integrity – Ensuring the accuracy and reliability of financial statements and management reports.
- Enhancing compliance – Adhering to applicable laws, regulations, and policies.

- Managing risks – Identifying, assessing, and mitigating financial, operational, and compliance risks.
- Preventing and detecting fraud and errors – Implementing checks and balances to reduce the likelihood of financial misconduct.

4.1.1.1 Common Examples of Internal Controls

Internal control mechanisms vary across organizations but commonly include:

- Segregation of Duties – Dividing key responsibilities among different individuals to minimize the risk of errors or fraudulent activities.
- Authorisation and Approval Procedures – Requiring multiple levels of approval for financial transactions to ensure accountability.
- Reconciliations – Regularly comparing financial records with external statements (e.g., bank reconciliations) to detect discrepancies.
- Access Controls – Limiting access to sensitive financial systems, documents, and assets to authorized personnel only.
- Audit Trails – Maintaining logs and records of transactions to facilitate tracking and review.
- Regular Internal Audits – Conducting periodic assessments to identify weaknesses and implement corrective actions.

4.1.1.2 Limitations of Internal Controls

While internal controls are vital, they are not foolproof. The effectiveness of internal controls can be limited by various factors, including:

- Human Error – Mistakes due to carelessness, lack of training, or misunderstanding of procedures.
- Collusion and Fraud – Employees working together to override controls for personal gain.
- Management Override – Senior officials bypassing established controls, undermining their effectiveness.
- Resource Constraints – Limited staffing, technology, or funding affecting the implementation and monitoring of controls.

- **Outdated Controls** – Failure to update control mechanisms in response to changes in the operating environment, regulations, or risks.

To mitigate these limitations, management must foster a culture that values internal controls, provide regular training to staff, and continuously review and update control processes. Routine audits and risk assessments can help in identifying control weaknesses and ensuring timely corrective actions.

It is the department head and the management team who are responsible for the development and implementation of internal controls. The internal audit team are only responsible for the testing of the internal controls framework and cannot be involved in the development and implementation of internal controls.

4.1.2 The COSO Internal Control Framework

The Committee of Sponsoring Organizations of the Treadway Commission (COSO) Internal Control Framework outlines five interrelated components that provide a structured approach to designing, implementing, and evaluating internal controls within an organization. These components are:

1. **Control Environment** – Establishes the foundation for internal control through ethical values, leadership commitment, governance structures, and a strong organizational culture.
2. **Risk Assessment** – Identifies and evaluates potential risks that could impact an organization's ability to achieve its objectives.
3. **Control Activities** – Defines specific policies, procedures, and mechanisms to mitigate risks and ensure compliance.
4. **Information and Communication** – Ensures accurate and timely dissemination of relevant financial and operational information.
5. **Monitoring Activities** – Establishes mechanisms for assessing the performance of internal controls and making improvements as necessary.

The FMM Volume 5 discusses in more detail the role of internal controls and the purpose of Internal Audit and Audit Committees to test and ensure a strong system of internal controls within an agency.

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