

FMM 05.2 Designing Internal Controls

2.1 Introduction

Internal controls are the backbone of an effective public sector agency, ensuring financial integrity, compliance with laws, and efficient delivery of services. A well-designed internal control systems supports risk management, fosters accountability, and protects agencies against misuse of public resources.

Understanding how to design internal controls is important and internal auditors and management should also refer to **Finance Management Manual Volume 2** which outlined governance and what internal controls entails:

- FMM 01.1 (Introduction to Governance and Control) sets the stage for understanding why comprehensive and standardised approaches are required across PNG's public sector.
- FMM 02.4 (Establishing Internal Controls) provides additional guidance on creating the overarching control environment, complementing the practical details in this Volume.

All these sections emphasise that internal controls are non-negotiable pillars of good governance.

2.2 Policy

- 1. Internal audit units are not responsible for designing, implementing, or operating internal controls within agencies.**
- 2. Internal audit may provide advice, raise awareness of control weaknesses, and recommend improvements—but ownership of internal controls rests solely with agency management.**
- 3. Internal audit can:**
 - a. review and test controls, and recommend improvements.**
 - b. offer advisory input (e.g. on draft policies or systems), but must remain independent and not take responsibility for control design.**
 - c. not create procedures, perform reconciliations, set delegations, or operate control systems (e.g. procurement, payroll, inventory).**

- d. help design a control or policy, but they must not audit that area within 12 months (IPPF Standard 1130.A1).**

2.3 Non-mandatory Guidance

2.3.1 Why Internal Controls Matter

Internal controls matter most as it protects public resources, strengthen compliance and support good governance.

To support the design of internal control, COSO (Committee of Sponsoring Organizations of the Treadway Commission) outlines five pillars of internal control:



FIGURE 1 COSO INTERNAL CONTROL FRAMEWORK - FIVE PILLARS

- Control Environment – The “tone at the top”: ethical leadership, clear governance structures.
- Risk Assessment – Identifying and understanding agency risks.
- Control Activities – Specific policies/procedures to mitigate identified risks.
- Information & Communication – Ensuring relevant data is shared, and staff know procedures.
- Monitoring – Ongoing checks to confirm controls are functioning as designed.

2.3.2 Understanding the Types of Internal Controls

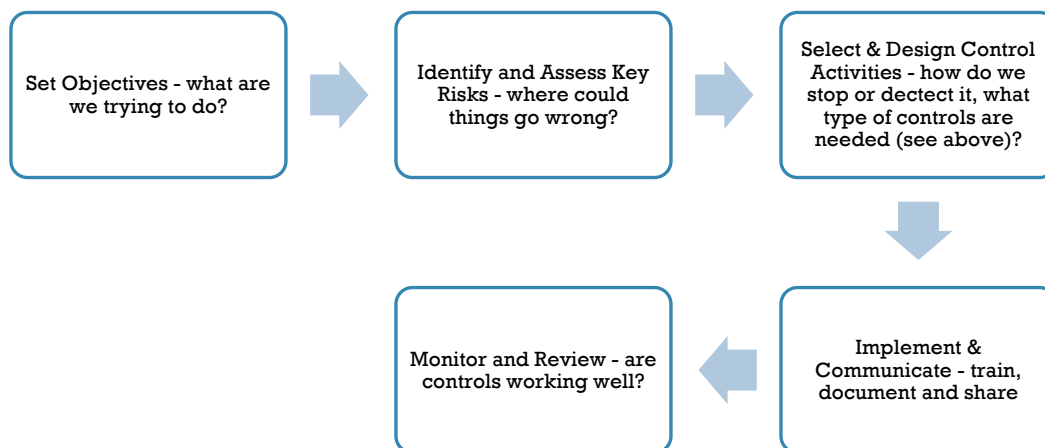
Internal controls are established to either prevent, direct, detect or correct non-compliance.

- Preventive Controls: Stop undesired events before they occur such as requiring two (2) bank signatures for payments.
- Detective Controls: Identify issues after they occur such as ensuring regular bank reconciliations that identify anomalies.
- Directive Controls: Guide actions to achieve desired outcomes such as departmental head directions on delegations, or issuing checklists, or standard operating procedures.
- Corrective Controls: Identify and correct problems discovered such as follow-up investigations, disciplinary actions, or revised processes.

When designing controls, agencies should use a balanced mixture of these controls for comprehensive coverage.

2.4 Designing Internal Controls - A Step-by-Step Approach

Below is a simplified visual of how an agency typically designs its internal control framework:



2.4.1 Set Clear Objectives

Internal controls are designed with the structure, services, nature and scope of the agency that implements them – one size does not fit all and not all internal

controls are directly related to financial compliance. You need to align with the agency’s mandate (e.g. health service delivery, road maintenance).

You then define what success looks like both financially and operationally (correct treatment provided to patients or roads repaired with a useful life of twenty (20) years).

2.4.2 Identify & Assess Key Risks

Risk identification and mitigation should be an annual process and generally you can use brainstorming, process walk-throughs, or prior audit findings to identify vulnerabilities (e.g. procurement, payroll). You can also look at other agencies or similar agencies overseas on identified key risks.

Part of this process is also evaluating risk likelihood and potential impact (financial loss, lack of service delivery or reputational harm).

2.4.3 Select & Design Control Activities

Based on the risk assessment, choose the best preventive, detective, directive, and corrective controls (and a combination of these). In doing so, consider the cost–benefit of each control—some high-risk areas might need stronger controls.

2.4.3.1 Preventative controls

Preventative controls are those that are designed to prevent undesirable events such as loss, errors, fraud, theft, misuse, inefficiencies, ineffectiveness, waste, and general anomalies and irregularities. The following table provides some examples of preventative internal controls.

Internal control	Explanation
Separation of duties, which is also commonly known as segregation of duties. For example, the process for expenditure and payment of public money is divided into separate steps which are allocated to different officers, as provided under Divisions 5 and 6 of Part 5 (Budget and Expenditure Control) of the Financial Instructions:	Dividing the expenditure and payment process into separate steps allows for different people to be involved in the process. It means that each officer is protected from the possibility of allegations of fraud and the temptation to commit fraud by having other officers to check his or her tasks and also undertaking the other steps. Involving different

<p><u>Authorised Requisitioning Officer</u> – completes the Requisition for Expenditure form FF3, or the Integrated Local Purchase Order and Claim form FF4A;</p> <p><u>Financial Delegate</u> – controls allocated funds so that over commitment does not take place and authorises the FF3 or FF4A that funds are available;</p> <p><u>Section 32 Approving Officer</u> – makes the expenditure decision by approving the expenditure by authorising the FF3 or FF4A;</p> <p><u>Certifying Officer</u> – certifies that the claims rendered are correct and can be paid and thus authorises the FF3s or ;</p> <p><u>Authorising Officer</u> – first ensures that the accounts are duly certified and then authorises the payment of the accounts.</p>	<p>officers is aimed at preventing any alleged or actual lost or improper payments. This preventative control will not be effective where there is collusion, i.e. the different officers secretly arrange between themselves to commit a fraud.</p> <p>Collusion may be difficult to prevent but would be easy to detect through effective detection internal controls, e.g. frequent monitoring of expenditure, internal auditing, reconciliations etc.</p>
<p>Locked safe</p>	<p>Prevents unauthorised access to cash and classified information.</p>
<p>Restricted access to the payroll system – to assigned and authorised officers.</p>	<p>Prevents unauthorised alteration of payroll records.</p>
<p>Arrangement that requires every cheque to be signed by two or more officers.</p>	<p>Similar reasoning as the separation of duties.</p>

2.4.3.2 *Detective controls*

Detective controls are those measures that are designed to detect in a timely manner any breakdowns in the preventative controls. It would allow for timely actions to recover any loss, rectify any anomalies and irregularities, reduce and prevent any further occurrences.

Internal control	Explanation
Bank Reconciliation – assigned to an officer who is not involved in the receiving and banking of money, custody of money, or processing of expenditure and payment of money.	This process compares the details in an organization’s (e.g. a Department, Provincial Government, or Local-level Government) cash book to the details in its bank account as shown in the bank statements. When this is done frequently and in a timely manner, it allows for the detection of irregularities such as any receipts that have not been deposited, any cheque that has been paid for more than the amount recorded in the cash book, any cheque that has been paid through the bank but not recorded in the cash book, or bank charges and fees that are shown in the bank statements but are yet to be entered into the cash book.
Stock take - assigned to an officer(s) who is not involved in the maintenance of the asset register or custody of inventory.	Verifies the records in the asset register and detects any loss or error.

The cost and impact of operating an internal control measure should be assessed against the associated benefits.

2.4.3.3 *Control weaknesses*

One of the purposes of an internal audit is to identify weaknesses in the internal control system, the cause of the weakness, and the effect of the

weakness on the agency in order for appropriate actions to be taken. It is useful to distinguish between:

- **system weakness** - a situation where there is insufficient, or absence of, internal control mechanisms in the system; and
- **operational weakness** – a situation where there are control mechanisms but are not effective (e.g. a Certifying Officer not checking the claims properly).

2.4.4 Implement & Communicate

Once these controls are identified, document each control (e.g. flowcharts, SOPs, finance forms) and train staff on roles, procedures, and the importance of following them.

For example, the Finance Management Manual is a designed internal control – a collection of directive controls – and are implemented into daily operations (e.g., sign-off procedures, logs, IFMS system authorisations).

2.4.5 Monitor & Review

The role and responsibility of internal audit is most recognised here. Internal controls must be constantly and consistently monitored and tested to ensure that they are still operating. Depending on the nature and structure of the agency, an internal audit unit may not be feasible, therefore the same function can be provided through management oversight, or continuous monitoring to assess if controls remain effective.

It is equally important to ensure that an agency updates controls as conditions change (e.g. new laws, new systems, or emerging risks). For example, the transition from cheques to EFT or the introduction of government visa debit cards has introduced significant changes to the design of internal controls for agencies.

Practical Tips & Considerations for Agencies

PFMA and Finance Instructions require that delegations be documented.

Ensure the right person at the right level approves transactions (e.g. no manager approves their own reimbursement).

Overly complex controls can confuse staff and lead to non-compliance, so simplicity matters. Focus on essential steps that meaningfully mitigate the risk.

Where possible, use IFMS or other approved digital solutions. System-based controls (passwords, workflow approvals) often minimises manual errors or manipulation.

Staff in rural and remote areas might lack stable internet or advanced training. Provide simpler, manual offline forms, plus extra support to ensure consistent compliance.

If the agency has a Risk Management Team or elements of this in their planning division, coordinate to avoid duplicated effort. Let them share major risk registers to inform your control design.

Even strong controls can fail if senior managers override them. Reinforce a “tone at the top” that emphasises no exceptions to established procedures.

Keep records of control designs, approvals, policy changes, etc. This helps with audits, continuity, and staff transitions.

2.5 Quick Checklist

1. Have we identified our core operational and financial objectives?
2. Did we systematically analyse the biggest risks (fraud, errors, wastage)?
3. Did we choose a balanced set of preventive, detective, directive, and corrective controls?
4. Are staff properly trained and aware of their control responsibilities?
5. Do we monitor internal controls (through checklists, IA reviews, or daily supervision) to ensure continued effectiveness?
6. If any of these are missing or weak, design (or redesign) your internal controls now, using this FMM volume as a minimum requirement.

Further Information	iacd@finance.gov.pg
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