

GREEN
CLIMATE
FUND

Administrative Guidelines on the Internal Control Framework and Internal Audit Standards

GCF/B.09/18

18 February 2015

Meeting of the Board

24–26 March 2015

Songdo, Republic of Korea

Agenda item 24

Recommended action by the Board

It is recommended that the Board:

- (a) Take note of the information presented in document GCF/B.09/18 *Administrative Guidelines on the Internal Control Framework and Internal Audit Standards*; and
- (b) Adopt the draft decision presented in Annex I to this document.

Administrative Guidelines on the Internal Control Framework and Internal Audit Standards

I. Introduction

1. The Board approved the administrative policies of the Green Climate Fund (the Fund) (decision B.06/03) covering human resources, administrative budget, procurement and asset management, information and communication technology, and audit and internal controls. Policies shall be supplemented by administrative guidelines endorsed by the Board and promulgated by the Executive Director (ED).

2. In addition, in decision B.07/02, the Board has decided to adopt the initial fiduciary principles and standards for the Fund, including the Internal Audit (Annex II, sub-item 1.1.3 B) and Control Framework (Annex II, sub-item 1.1.4).

3. Decision B.06/03, Administrative Policies of the Fund states that:

...The Executive Director will take all necessary actions to establish and implement effective internal controls (Annex I, paragraph 67).

...The Executive Director will make the necessary arrangements for a regular internal audit and controls in the Secretariat and will establish an independent internal audit to oversee the daily operations, to ensure that the controls designed to manage risk and efficient use of resources are implemented effectively, and to suggest improvements in the effectiveness of risk management and control processes (Annex I, paragraph 71).

4. The administrative guidelines on the internal control framework and internal audit standards is set out in Annex II to this document.

II. Internal control

5. Internal controls are an essential element of the Fund's governance, risk and compliance oversight responsibilities and are integral to the Fund's fiduciary responsibilities.

6. Internal control is also a key management tool for helping to ensure operational effectiveness and efficiency, reliable financial reporting and compliance with laws, regulations and policies. The Fund's system of controls will constitute one of the safeguards by which the Fund assesses and manages its risks.

7. Internal control and its related activities are generally guided by a framework of fundamental principles, core values and concepts. The Fund must determine which internal control framework to adopt.

8. The Secretariat, for the purposes of selecting the most appropriate control framework for the Fund, considered the following frameworks:

- (a) *Internal Control – Integrated Framework* of the Committee of Sponsoring Organizations of the Treadway Commission (2013) (COSO framework);
- (b) Canadian Institute of Chartered Accountants' (CICA's) Criteria of Control Framework (CoCo); and
- (c) Report of the Committee on the Financial Aspects of Corporate Governance (1992) (Cadbury Report).

9. The Secretariat determined that globally the COSO framework was the most widely recognized and accepted standard used by international development organizations such as the

United Nations Development Programme, The Global Fund, Global Environment Facility, International Bank of Reconstruction and Development, the International Finance Corporation, the Multilateral Investment Guarantee Agency, the Asian Development Bank among many others.

10. In addition, the COSO framework is the designated control framework used for ensuring compliance with the Sarbanes-Oxley Act of 2002 by United States Securities and Exchange Commission listed companies operating nationally and internationally.
11. The Secretariat recommends to the Board that the COSO framework be adopted as the internal control framework for the Fund as set out in Annex II to this document.

III. Internal audit standards

12. The Fund must also determine which internal auditing standards to adopt. There is one international standard: the International Internal Auditing (IIA) standards promulgated by the International Internal Audit Standards Board (IASB).
13. The IIA standards are principle-focused and provide a framework for performing and promoting internal auditing. The standards are mandatory requirements and consist of:
 - (a) Statements of basic requirements for the professional practice of internal auditing and for evaluating the effectiveness of its performance. The requirements are internationally applicable at organizational and individual levels; and
 - (b) Interpretations, which clarify terms or concepts within the statements.
14. The Secretariat recommends to the Board that the IIA standards be adopted as the internal auditing standards for the Fund.

Annex I: Draft decision

The Board, having considered the information contained in document GCF/B.09/18 *Administrative Guideline on Internal Control Framework and Internal Audit Standards*:

- (a) Adopts the Committee of Sponsoring Organizations of the Treadway Commission (COSO) framework as the internal control framework for the Green Climate Fund (the Fund);
- (b) Also adopts the International Internal Auditing (IIA) standards as the internal audit standards for the Fund; and
- (c) Requests the Executive Director to implement the internal control framework and the internal audit standards in line with Annex II to this document.

Annex II: Green Climate Fund administrative guidelines on the internal control framework and internal audit standards

I. Internal control framework

1.1 Purpose of the internal control framework

1. The primary purpose of the internal control framework is to:
 - (a) Provide the Fund with a systematic approach to implementing a system of internal controls over its processes and activities;
 - (b) Help to provide internal and external stakeholders with the assurance that the Fund's financial and operational processes are managed in a manner that supports the achievement of its strategic plans and priorities as set out by the Board;
 - (c) Identify the requirements for establishing an effective internal control system for the Fund, with the requisite objectives, components and concepts;
 - (d) Provide a mechanism for identifying and managing systemic risks that could affect the achievement of its business objectives and/or expose the Fund to financial risk and potential loss;
 - (e) Set a baseline for establishing a system of control activities that is proportionate to the level of risk required to safeguard the Fund's assets, taking into account the Fund's risk profile, including its risk appetite; and
 - (f) Establish an organizational climate and enabling culture within the Fund that will enhance its mission based on ethical values and a well-defined code of conduct.

1.2 Definition of internal control

2. Internal control is defined as a process designed to provide reasonable assurance regarding the achievement of objectives relating to operations, reporting and compliance.
3. Specifically, internal control:
 - (a) Is a process, not a single event that is part of each activity undertaken by the Fund and is inherent in the manner in which management operates. Within each business process are policies and procedures which define management's statement of requirements relating to the controls over the activity. Control processes will be integrated with the Fund's business processes and are continuously reviewed and adapted such that they do not impede the efficiency of the business process;
 - (b) Is designed and approved by the Board and management, and operationalized by staff. The effectiveness of internal control is reliant on the tone and organizational climate generated by the Board and management, and on staff for applying the Fund's control policies and procedures;
 - (c) Provides reasonable assurance, rather than absolute assurance, in the achievement of the Fund's objectives. Reasonable assurance acknowledges that there are limitations inherent in all internal control systems such as human error, errors of judgment and economic uncertainties; and

- (d) Focuses on the achievement of objectives, in areas of operations, reporting and compliance. These three categories of objectives broadly define where internal controls will be expected to be applied, although controls are not limited to these areas.

1.3 Relevance of internal control

4. Internal controls are used to manage risks and as a result are fundamental to how the Fund operates. They are designed, implemented and continuously adapted to the Fund's systems and processes. In particular:

- (a) Internal controls are an inseparable part of the day-to-day activities of the Fund, from information technology and travel to hiring and processing transactions. Internal controls provide an environment that helps management to efficiently manage resources and to achieve operational goals and objectives;
- (b) Internal controls are designed to assist managers and Fund staff with the effective discharge of their responsibilities; and
- (c) Controls are embedded within the internal control processes which consist of guidelines and procedures.

1.4 Nature of control

5. The purpose of establishing controls is to mitigate risks which could prevent the Fund from achieving its objectives. The implementation of controls will take into consideration the following:

- (a) Design of any controls or control processes will be adaptable to the structure of the Fund and the dynamic nature of the risk environment within which the Fund operates;
- (b) New measures or changes to controls will be reviewed as part of a process, taking into consideration any compensating controls to ensure there is an optimum balance between control and efficiency; and
- (c) Costs incurred for the implementation of a control will not ordinarily outweigh its benefits although exceptions could occur where the cost of a key control would not be a factor for consideration.

1.5 Roles and responsibilities

6. The Board, the Executive Director, management and staff of the Fund have distinct roles and responsibilities under the framework. Clarity over roles will ensure accountability over assigned responsibilities for internal controls. These roles and responsibilities are as follows:

1.5.1 The Board

7. As part of its governance, risk and compliance oversight responsibilities, the Board has a critical role in ensuring the effectiveness of internal controls by:

- (a) Setting the "tone at the top" and organizational climate for the Fund;
- (b) Providing oversight for the system of internal control;
- (c) Overseeing the adequacy of the Fund's system of internal controls; and
- (d) Being informed of any significant control deficiencies or breakdowns in the Fund.

1.5.2 The Executive Director

8. The Executive Director will have overall responsibility for the Fund's system of internal controls by:

- (a) Creating a sound control environment by ensuring internal control systems are effectively designed to mitigate risks;
- (b) Providing assurance to the Board on the overall effectiveness of controls in the Fund; and
- (c) Assigning authority and holding management accountable for internal controls.

1.5.3 The management

9. Delegated by the Executive Director, management will be responsible for:

- (a) Ensuring the effectiveness of internal controls by conducting ongoing reviews and assessments of control activities;
- (b) Monitoring and following up on identified risks and control gaps within their business units;
- (c) Ensuring Fund staff have the requisite knowledge and skills to perform their duties and understand their role;
- (d) Promoting compliance with the Fund's control policies and procedures; and
- (e) Providing direction and training to Fund staff on the internal controls through the issuance of procedures and instructions.

1.5.4 The staff

10. Fund staff are the first line of defence for ensuring the effectiveness of the Fund's system of internal controls by applying control policies, guidelines and procedures in the conduct of their day-to-day activities.

11. Staff responsibilities will include:

- (a) Being vigilant with regard to the changing risks associated with business processes and activities;
- (b) Identifying and escalating to management control related issues such as deficiencies or control gaps in their work processes;
- (c) Participating in the implementation of controls in their work units;
- (d) Understanding workflow and applying control procedures in their assigned duties within their work units; and
- (e) Maintaining current knowledge of internal control as it applies to their business processes.

1.6 Type of controls

12. Controls can be grouped into entity-wide and process-level controls preventative and detective controls and manual and automated controls, as follows:

1.6.1 Entity-wide and process-level controls:

- (a) Entity-wide controls are controls that are designed to operate and mitigate risks at the organization-wide level. These controls have a pervasive effect on the Fund's overall system of internal control and effect the achievement of its objectives. Entity-wide controls include: controls related to the control environment such as "tone at the top" and organizational climate, delegation of authority and code of conduct; and
- (b) Process-level controls are control activities that are applied at a transaction level in the Fund's business processes. These controls are applied on individual and on groups of transactions where timeliness and accuracy of processing are important. Process-level controls include approval, verification recalculation, confirmation, reconciliation and authorization of various types of transactions. Examples of the types of transaction-level processes include accounts payable, bank reconciliations, travel authorizations, procurement and operational reporting.

1.6.2 Preventative and detective controls:

- (a) Preventative controls are controls designed to avoid errors and discrepancies or prevent them from occurring. The Fund's code of conduct is an example of a preventative control; and
- (b) Detective controls are controls designed to identify or uncover errors, discrepancies or unintended outcomes after processing has occurred but before completion of the objective. An example of a detective control would be the generation of a duplicate payments report.

1.6.3 Manual and automated controls:

- (a) Manual controls are controls that are performed by staff at the time of processing a transaction. Examples include verification of approvals for consulting services prior to payment, and physical confirmation of goods received by procurement staff; and
- (b) Automated controls are performed using information technology systems. These controls are coded into the systems software and workflow of the Fund's business systems. Automated controls can range from controls over authorizing user access to application-level controls over electronic banking transfers.

1.7 Implementing the COSO framework

13. The Committee of Sponsoring Organizations of the Treadway Commission (COSO) framework consists of three categories of objectives and five components. The objectives are what the Fund sets out to achieve, while the components represent what is needed to achieve the objectives within the Fund's structure and hierarchy (entity, division, work unit, task team). These objectives and components are as follows:

14. **Objectives:** The Board formulates business strategies to achieve the Fund's mission and define its performance goals. The COSO framework focuses on three objectives; namely, operations, reporting and compliance. These three areas are directly linked to the achievement of the Fund's business strategies; and

15. **Components of internal control:** The Fund's internal control framework will consist of five integrated components. The system of internal controls for the organization is

considered to be effective once all of the following five components have been implemented and are functioning:

- (a) Control environment:
 - (i) The control environment is the overarching component on which all other components of internal control rest; it sets in place the Fund's organizational climate;
 - (ii) It will be based on the "tone at the top" that is established and promulgated by the Board, the Executive Director and the Secretariat's management team in the conduct of the Fund's business operations. It is directly related to their attitudes and behaviour towards the importance of internal controls, integrity, ethical values and expected conduct;
 - (iii) It defines the awareness level of internal controls by Fund staff as they perform their day-to-day activities;
 - (iv) Factors that affect the control environment include Fund guidelines, policies and procedures, management operating style and staff development; and
 - (v) The control environment has a pervasive impact on the Fund's system of internal control and as a result is considered an entity-wide control.
- (b) Risk assessment:
 - (i) Risk is the effect of uncertainty (positive, negative or a deviation from the expected). It may be operational, financial or both;
 - (ii) The prerequisite to risk assessment is the formulation of objectives associated with the various levels and functions of the Fund;
 - (iii) Risk assessment is the process of identifying and assessing risks that could affect the achievement of objectives and forms the basis for how the risks are to be managed;
 - (iv) The risk assessment will take into consideration the Fund's risk profile and risk management process, including its risk appetite and risk threshold; and
 - (v) The assessment of risk and controls will be overseen by the Fund's Risk Management Committee.
- (c) Control activities:
 - (i) Internal controls are in response to the identification and assessment of the risks to the Fund which could affect its ability to achieve its business objectives;
 - (ii) Control activities will ensure that identified risks are mitigated and monitored;
 - (iii) Controls consist of approved policies, guidelines and procedures that ensure that management guidelines are implemented;
 - (iv) Control activities occur throughout the organization, across all levels and in all functions of the Fund; they cover the range of products and services provided by the Fund; and
 - (v) Controls can be manual or automated, preventative or detective, and include a range of activities such as approvals, authorizations, verifications, reconciliations and reviews of operating performance, including technology systems.

- (d) Information and communication:
- (i) This component focuses on the nature and quality of information needed for effective internal control, the systems used to develop such information and the reports to communicate the information;
 - (ii) Information is necessary at every level of the Fund in order to effect internal controls over activities and processes;
 - (iii) Communication is the dissemination of information internally to ensure achievement of objectives and compliance with policies and procedures; and
 - (iv) Communications generally include reports and presentations to the Board, management, Fund staff and stakeholders on the functioning of the components of internal control.
- (e) Monitoring activities:
- (i) Regular assessments of the Fund's system of internal control will determine whether controls are adequately designed and effective;
 - (ii) This component will include the follow-up of remediation for control gaps or deficiencies identified in the assessments of controls; and
 - (iii) These activities will provide a basis for determining the reliability and quality of the Fund's internal control processes over time as a part of regular management and oversight activities.

1.8 Assessing internal controls

16. The criteria for determining the effectiveness of internal control are based on whether the five components of control indicated above are present and operating in an integrated manner such that risks are being mitigated sufficiently to allow achievement of the objectives. In order to determine if the components in each category are jointly effective, each component must be individually assessed.

17. As shown in the figure below, there are five steps in assessing effectiveness of internal controls based on the COSO framework, as follows:

- (a) Establish scope and accountability:
- (i) Gain an understanding of the key activities that support the objectives and deliverables of the entity or business unit;
 - (ii) Determine the relevant processes and systems linked to the key activities; and
 - (iii) Determine the business owner accountable for the activity and related internal controls.
- (b) Identify and document risks and controls:
- (i) Document the relevant business processes in flowcharts or narratives;
 - (ii) Identify the risks and controls in the business unit's processes and systems across various risk categories;
 - (iii) Map specific control activities to control objectives and risks; and
 - (iv) Classify controls as key controls, secondary controls or compensating controls.
- (c) Evaluate effectiveness of controls:
- (i) Rank and prioritize risks based on financial impact and likelihood of occurrence;

- (ii) Evaluate the mitigating controls for effectiveness by reviewing the control’s design and operating effectiveness; and
 - (iii) Rate controls as effective or ineffective based on their ability to mitigate the relevant risks.
- (d) Identify control gaps and deficiencies; develop remediation plan(s):
- (i) Review the ineffective controls to determine the nature of the control deficiencies (a deficiency is defined as a shortcoming in some aspect of the system of internal control that has the potential to adversely affect the ability of the entity to achieve its objectives);
 - (ii) Assess the impact and severity of the deficiency;
 - (iii) Evaluate the deficiency as to its materiality; and
 - (iv) Develop a remediation plan for the identified deficiencies.
- (e) Monitor and report on issues and report to management:
- (i) Monitor and track control issues and remediation plans;
 - (ii) Report to management highlighting the key risks faced by the unit, status of remediation plans and areas requiring management attention; and
 - (iii) Establish regular status reporting to management until remediation is complete.

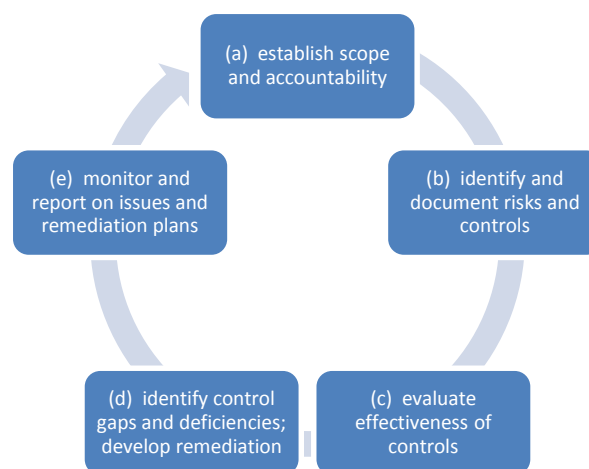


Figure 1: Key steps in assessing internal controls

II. Internal audit standards

18. Internal auditing is conducted in diverse legal and cultural environments; within organizations that vary in purpose, size, complexity, and structure; and by persons within or outside the organization. While differences may affect the practice of internal auditing in each environment, conformance with the IIA's International Standards for the Professional Practice of Internal Auditing (Standards) is essential in meeting the responsibilities of internal auditors and the internal audit activity.

19. The purpose of the Standards is to:

- (a) Delineate basic principles that represent the practice of internal auditing;

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- (b) Provide a framework for performing and promoting a broad range of value-added internal auditing;
- (c) Establish the basis for the evaluation of internal audit performance; and
- (d) Foster improved organizational processes and operations.
20. The IIA standards are principle-focused and provide a framework for performing and promoting internal auditing.
21. Internal auditing assists the Fund by providing the management with an objective assessment of the adequacy and effectiveness of the Fund's system of internal controls over its operations.
22. **Definition of internal auditing:** Internal auditing is an independent, objective assurance and consulting activity designed to add value and improve an organization's operations. It helps an organization to accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control and governance processes (Institute of Internal Auditors, *International Professional Practices Framework (2013)*).
23. The objective of internal auditing is to determine whether the Fund's risk management, controls and governance processes provide reasonable assurance on the following:
- (a) Effective and economic use of the resources;
- (b) Accuracy and reliability of the Fund's financial and operational information;
- (c) Safeguarding of Fund assets;
- (d) Compliance with Fund decisions, policies and guidelines; and
- (e) Achievement of the Fund's programmes, plans and business objectives.
24. Internal auditing is responsible for:
- (a) Developing annually a risk-based audit plan for approval by management. The audit plan will include both assurance and advisory engagements designed to assist management with their internal control responsibilities;
- (b) Establishing an audit approach and methodology which will augment and improve the Fund's internal control activities, including audit procedures, programmes and guidelines;
- (c) Reviewing and assessing the adequacy of management's internal controls over financial reporting and operations, including their design and operation;
- (d) Coordinating audit efforts with the Fund's external auditors, Integrity Unit and Evaluation Unit to optimize audit coverage and use of audit resources;
- (e) Reporting to the management on significant deficiencies or issues related to risk management, control and governance processes; and
- (f) Providing annually to the Executive Director and the Board a report on internal auditing's review of the adequacy and effectiveness of the Fund's internal control framework and related control activities.
25. **Authority:** For the purpose of performing its responsibilities, internal auditing will have complete and unrestricted access to Fund staff, all records and documents (i.e. physical and electronic), excluding documents of a confidential nature relating to issues of privacy such as staff medical records.

26. **Independence:** To maintain internal auditing's objectivity, and to ensure its independence, internal auditor reports to the Fund's Risk Manager.
 27. The Risk Manager reports to the Executive Director and advises both Executive Director and the Board on risk matters as per decision B.07/05, Annex XI, Table 2 footnote.
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