

# ETF INTERNAL CONTROL PRINCIPLES



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# ETF Internal Control Principles

The components, principles and characteristics of the ETF's Internal Control Framework

## Introduction

Internal control helps the ETF to achieve its objectives and sustain operational and financial performance whilst respecting rules and regulations. In this way it is fully integrated into the ETF Performance Management Framework<sup>1</sup>. Internal control supports sound decision-making by taking into account risks in the achievement of objectives and where necessary reducing them to acceptable levels through cost-effective controls. Internal control applies to all activities, irrespective of whether they are financial or non-financial.

The revised internal control framework of the ETF is designed to provide reasonable assurance regarding the achievement of objectives, including the following:

- Effectiveness, efficiency and economy of operations,
- Reliability of reporting and safeguarding of assets and information,
- Prevention, detection, correction and follow-up of fraud and irregularities, and
- Adequate management of the risks relating to the legality and regularity of the underlying transactions.<sup>2</sup>

The ETF internal control framework is based on the framework of the European Commission which was revised in 2017 with a view to aligning Commission standards to the highest international standards set by the COSO framework<sup>3</sup>

The aim of the Commission was to move from a compliance-based system to a principle-based system and to ensure a more robust internal control framework through consistent assessment, while providing the necessary flexibility to enable the framework to be adapted to fit the specific characteristics and circumstances of the Commission<sup>4</sup>.

In order to keep up with these recent changes in the international best practices and following the Commission's revision in 2017, it is appropriate for the ETF to update its internal control framework. The revised framework consists 5 components and 17 Internal Control Principles. Characteristics of each principle have been included to help to define the principles.

**Components:** The components are the building blocks that underpin the structure of the framework. They are interrelated and must be present and effective at all levels of the organisation for internal control over operations to be considered effective.

**Principles:** Each component consists of several principles. Working with these principles helps to provide reasonable assurance that the ETF's objectives have been met. The principles specify the actions required for internal control to be effective.

**Characteristics of each principle:** The characteristics are based on those of the Commission, but have been defined in such a way as to take into account the specific governance arrangements and the specific situation of the ETF. There is no requirement for the ETF to assess whether each individual characteristic is in place. The characteristics have been defined to assist management in implementing internal control procedures and in assessing whether the principles are present and functioning.

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<sup>1</sup> ETF Performance Management Framework ref: ETF/17/DEC/005 of 26.04.2017. The CAF 2013 (Common Assessment Framework 2013)

<sup>2</sup> Art. 30 Internal Control of Budget Implementation, Financial Regulations of the ETF ref: GB/13/DEC/014 of 20.12.2013

<sup>3</sup> The full text of the Internal Control-Integrated Framework is available at [www.coso.org](http://www.coso.org).

<sup>4</sup> Communication to the Commission: Revision of the Internal Control Framework ref: C(2017) 2373 of 17.04.2017

Component I	Internal Control Principles 1-5
Control Environment	<ol style="list-style-type: none"> <li>1. Demonstrates commitment to integrity and ethical values</li> <li>2. Exercises oversight responsibility</li> <li>3. Establishes structure, authority and responsibility</li> <li>4. Demonstrates commitment to competence</li> <li>5. Enforces accountability</li> </ol>

The **control environment** is the set of standards of conduct, processes, and structures that provide the basis for carrying out internal control across the ETF. The Management Team set the tone at the top with respect to the importance of internal control, including expected standards of conduct.

### 1. We demonstrate a commitment to integrity and ethical values

Characteristics:

- **Tone at the top.** The Director and all management levels respect integrity and ethical values in their instructions, actions and behaviour.
- **Standards of conduct.** The ETF's expectations on integrity and ethical values are set out in ETF values and understood at all levels of the organisation and its partners.
- **Alignment with standards.** Processes are in place to assess whether individuals and departments are aligned with the ETF's expected standards of conduct and to address deviations in a timely manner.

### 2. ETF Management<sup>5</sup> exercises oversight of the development and performance of internal control.

Characteristics:

- **In their capacity as (Sub) Delegated Authorising Officers ((S)DAO),** each (S)DAO provides a Declaration of Assurance on the appropriate allocation of resources and their use for their intended purpose and in accordance with the principles of sound financial management, as well as on the adequacy of the control procedures in place
- **Each manager oversees the internal control systems within their department.** Each manager oversees the development and performance of internal control and is supported in this task by designated staff in charge of risk management and internal control.
- **Assurance cascading process:** To reinforce the assurance cascading process, each manager signs a declaration of assurance in which he/she reports on the use of his/her respective budgetary powers and related use of resources. This cascading declaration includes information both on the state of internal controls in his/her area of responsibility and the soundness of reporting on operational performance.

<sup>5</sup> 'ETF Management' refers to the level of managers in the ETF Enlarged Management Team (EMT)

### 3. Management establishes structures, reporting lines, and appropriate authorities and responsibilities in the pursuit of objectives.

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Characteristics:

- **Management structures are comprehensive.** The design and implementation of management and supervision structures cover all policies and activities to support the achievement of operational and control objectives.
- **Authorities and responsibilities.** The Director, as appropriate, delegates authority and use of appropriate processes and technology to assign responsibility and segregate duties as necessary at the various levels of the ETF.
- **Reporting lines.** The ETF designs and evaluates reporting lines within departments and units to enable the execution of authority, fulfilment of responsibilities and flow of information.
- **Deputising arrangements** for operational activities and financial transactions are in place to ensure continuity of operations.

### 4. We demonstrate a commitment to attracting, developing and retaining competent individuals in alignment with objectives.

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Characteristics:

- **Selection procedures.** The ETF publishes widely its vacancies, describing clearly core and technical skills needed and job profile in order to attract relevant and competent individuals
- **Staff skills.** The ETF defines core and technical skills necessary to support the achievement of objectives and regularly evaluates them, in particular through the appraisal of performance, taking action to address shortcomings where necessary.
- **Learning and development.** The ETF provides learning and development activities needed to develop and retain a sufficient number of competent staff in alignment with objectives and needs.
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### 5. We hold individuals accountable for their internal control responsibilities in the pursuit of objectives.

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Characteristics:

- **Enforcing accountability.** The ETF defines clear roles and responsibilities and holds individuals accountable for the performance of internal control responsibilities across the organisation and for the implementation of corrective action as necessary.
- **Staff appraisal.** Staff efficiency, abilities and conduct in the service are assessed annually against set objectives and Cases of underperformance are appropriately addressed.

Component II	Internal Control Principles 6-9
Risk Assessment	6. Specifies suitable objectives 7. Identifies and analyses risk 8. Assesses fraud risk 9. Identifies and analyses significant change

**Risk assessment** is a dynamic and iterative process for identifying and assessing risks which could affect the achievement of objectives, and for determining how such risks should be managed.

**6. We specify objectives with sufficient clarity to enable the identification and assessment of risks relating to objectives.**

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Characteristics:

- **Mission.** The ETF and its departments have up-to-date mission statements that are aligned across all hierarchical levels, down to the tasks and objectives assigned to individual staff members. Mission statements are aligned with the ETF's responsibilities set in the legal base.
- **Objectives are set at every level.** The ETF's objectives are clearly set and updated when necessary (e.g. significant changes in priorities, activities and/or the organigramme). They are consistently filtered down from the level of the Director to the various levels of the organisation, and are communicated and understood by management and staff.
- **Indicators measure the achievement of ETF objectives.** Objectives and indicators cover the ETF's most significant activities that contribute to the delivery of ETF priorities or other priorities relating to the core business, as well as operational management. Setting objectives and performance indicators make it possible to monitor progress towards their achievement.
- **Objectives form the basis for committing resources.** The ETF uses the objectives set as a basis for allocating available resources as needed to achieve, operational and financial performance goals.
- **Financial reporting objectives.** Financial reporting objectives are consistent with the accounting principles applicable in the ETF.
- **Non-financial reporting objectives.** Non-financial reporting provides management with accurate and complete information needed to manage the organisation.
- **Risk tolerance and materiality.** When setting objectives, management takes into account the acceptable levels of variation relative to their achievement (tolerance for risk) as well as the appropriate level of materiality for reporting purposes, taking into account cost-effectiveness.

7. We identify risks to the achievement of its objectives across the organisation and analyse risks as a basis for determining how the risks should be managed.

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Characteristics:

- **Risk identification.** The ETF identifies and assesses risks at the various organisational levels analysing internal and external factors. Management and staff are involved in the process at the appropriate level.
- **Risk assessment.** The ETF estimates the significance of the risks identified and determines how to respond to significant risks considering how each one should be managed and whether to accept, avoid, reduce or share the risk. The intensity of mitigating controls is proportional to the significance of the risk.
- **Risk identification and risk assessment** are integrated into the annual activity planning and are regularly monitored.

8. We consider the potential for fraud in assessing risks to the achievement of objectives.

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Characteristics:

- **Risk of fraud.** The identification and assessment of the risk of fraud is part of ETF risk management processes at all levels.
- **Anti-fraud strategy.** The ETF sets up and implements proportional measures to counter fraud and any illegal activities affecting the financial interests of the EU. The ETF does this by putting in place a sound anti-fraud strategy to improve the prevention, detection and conditions for investigating fraud.

9. We identify and assess changes that could significantly impact the internal control system.

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Characteristics:

- **Assess changes.** The risk identification process considers changes in the internal and external environment, in policies and operational priorities, as well as in management's attitude towards the internal control system.

Component III	Internal Control Principles 10-12
Control Activities	10. Selects and develops control activities 11. Selects and develops general control over technology 12. Deploys through policies and procedures

**Control activities** ensure the mitigation of risks related to the achievement of policy, operational and internal control objectives. They are performed at all levels of the organisation, at various stages of business processes, and across the technology environment. They may be preventive or detective and encompass a range of manual and automated activities as well as segregation of duties.

#### **10. We select and develop control activities that contribute to the mitigation of risks to the achievement of objectives to acceptable levels.**

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Characteristics:

- **Control activities** are performed to mitigate the identified risks and are cost-effective. They are tailored to the specific activities and risks of each department and their intensity is proportional to the underlying risks.
- **ETF processes and procedures includes** a variety of checks, including supervision arrangements, and where appropriate, should include a balance of approaches to mitigate risks, considering manual and automated controls, and preventive and detective controls.
- **Segregation of duties.** When putting in place control measures, management considers whether duties are correctly divided between staff members to reduce risks of error and inappropriate or fraudulent actions.
- **Business continuity plans** based on a business impact analysis following corporate guidance are in place, up-to-date and used by trained staff to ensure that the ETF is able to continue working to the extent possible in case of a major disruption. Where necessary, business continuity plans must include coordinated and agreed disaster recovery plans for time-sensitive supporting infrastructure (e.g. IT systems).

#### **11. We select and develop general control activities over technology to support the achievement of objectives.**

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Characteristics:

- **Control over technology.** In order to ensure that technology used in business processes, including automated controls is reliable and takes into account the overall corporate processes, the ETF management selects and develops control activities over the acquisition, development and maintenance of technology and related infrastructure.
- **Security of IT systems.** The ETF applies appropriate controls to ensure the security of IT systems of which they are the system owners. They do so in accordance with the IT security governance principles, in particular as regards data protection, professional secrecy, availability, confidentiality and integrity.

## 12. We deploy control activities through corporate policies that establish what is expected and in procedures that put policies into action.

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Characteristics:

- **Appropriate control procedures ensure that objectives are achieved.** The control procedures assign responsibility for control activities to the department or individual responsible for the risk in question.
- **Exception reporting** is one of the management tools used to draw conclusions about the effectiveness of internal control and/or the changes needed in the internal control system. A system is in place to ensure that all instances of overriding controls or deviations from established processes and procedures are documented in exception reports. All instances must be justified and approved before action is taken, and logged centrally.
- **The impact assessment and evaluation of ETF activities** are performed in accordance with the guiding principles of the Commission's better regulation guidelines.

Component IV	Internal Control Principles 13-15
Information & Communication	13. Uses relevant information 14. Communicates internally 15. Communicates externally

Information is necessary for the organisation to carry out internal control and to support the achievement of objectives. There is external and internal communication. External communication provides the public and stakeholders with information on the ETF's objectives and actions. Internal communication provides staff with the information it needs to achieve its objectives and to carry out day-to-day controls.

### 13. We obtain or generate and use relevant quality information to support the functioning of internal control.

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Characteristics:

- **Information and document management.** The ETF identifies the information required to support the functioning of the internal control system and the achievement of the ETF's objectives. Information systems process relevant data, captured from both internal and external sources, to obtain the required and expected quality information, in compliance with applicable security, document management and data protection rules.

### 14. We communicate information internally, including objectives and responsibilities for internal control, necessary to support the functioning of internal control.

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Characteristics:

- **Internal communication.** The ETF and the management communicate internally about their objectives, challenges, actions taken and results achieved, including but not limited to the objectives and responsibilities of internal control.

### 15. We communicate with external parties about matters affecting the functioning of internal control.

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Characteristics:

- **External communication.** All managers ensure that their external communication is consistent, relevant to the audience being targeted, and cost-effective. The ETF establishes clear responsibilities to align ETF's communication activities with the priorities and narrative of the institution.
- **Communication on internal control.** The ETF communicates with external parties on the functioning of the components of internal control. Relevant and timely information is communicated externally, taking into account the timing, audience, and nature of the communication, as well as legal, regulatory, and fiduciary requirements.

Component V	Internal Control Principles 16-17
Monitoring Activities	16. Conducts ongoing and/or separate assessments 17. Assesses and communicates deficiencies

Continuous and specific assessments are used to ascertain whether each of the five components of internal control is present and functioning. Continuous assessments, built into business processes at different levels of the organisation, provide timely information on any deficiencies. Findings are assessed and deficiencies are communicated and corrected in a timely manner, with serious matters reported as appropriate.

**16. We select, develop, and perform ongoing and/or separate assessments to ascertain whether the components of internal control are present and functioning.**

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Characteristics:

- **Continuous and specific assessments.** The ETF continuously monitors the performance of the internal control system with tools that make it possible to identify internal control deficiencies, register and assess the results of controls, and control deviations and exceptions. In addition, when necessary, the ETF carries out specific assessments, taking into account changes in the control environment. Ongoing assessments are built into business processes and adjusted to changing conditions. Both kinds of assessment must be based on the qualitative and quantitative assessment criteria to be measured through clearly defined indicators.
- **Sufficient knowledge and information.** Staff performing ongoing or separate assessments has sufficient knowledge and information to do this, specifically on the scope and completeness of the results of controls, control deviations and exceptions.
- **Risk-based and periodical assessments.** The ETF varies the scope and frequency of specific assessments depending on the identified risks. Specific assessments are performed periodically to provide objective feedback.

**17. We assess and communicate internal control deficiencies in a timely manner to those parties responsible for taking corrective action, including senior management as appropriate.**

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Characteristics:

- **Deficiencies.** With the support of the designated staff in charge of risk management and internal control, the ETF considers the results of the assessments of how the internal control system is functioning within the ETF.

Deficiencies are communicated to management and to the departments responsible for taking corrective action. They are reported in the Annual Activity Reports and to the responsible Member of the Governing Board and Commission, as appropriate. The term 'internal control deficiency' means a shortcoming in a component or components and relevant principle(s) that reduces the likelihood of the ETF achieving its objectives. There is a major deficiency in the internal control system if management determines that a component and one or more relevant principles are not present or functioning or that components are not working together. When a

major deficiency exists, the Director cannot conclude that it has met the requirements of an effective system of internal control. To classify the severity of internal control deficiencies, management has to use judgment based on relevant criteria contained in regulations, rules or external standards.

- **Remedial action.** Corrective action is taken in a timely manner by the staff member(s) in charge of the processes concerned, under the supervision of their management. With the support of the manager in charge of risk management and internal control, the Director monitors and takes responsibility for the timely implementation of corrective action.