

# INTERNAL CONTROL

## Internal Control

- Internal control is a process---effected by those charged with
  - Governance,
  - Management,
  - And other personnel

## Internal Control

- designed to provide reasonable assurance about the achievement of the entity's objectives with regard to reliability of
  - Financial reporting,
  - Effectiveness and efficiency of operations, and
  - Compliance with applicable laws and regulations.

## Five Components

- Internal control consist of five interrelated components:
  - Control environment
  - Risk assessment
  - Information and communication
  - Control activities
  - Monitoring

## Five Components

- The control environment is:
  - Referred to in the private sector as “the corporate culture”
  - Create a tone-at-the-top to set the standard
  - Encourage training for board and staff
  - Communicate the importance of I/C to staff
  - Swift disciplinary action to violators

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## Five Components

- Risk Assessment - Entities must assess the risks associated with their ever changing environment. Examples of changes are:
  - New staff
  - Software upgrades
  - New grants
  - Statutory changes

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## Five Components

- Risk Assessment continued
  - Inherent risk in a process can indicate that special attention may be warranted. Examples of inherent risk are:
    - The sheer complexity of a process
    - A process with high volume
    - The presence of “cash” receipts
    - A history of prior problems

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## Five Components

- Information and Communication
  - Does the board communicate with the staff
  - Does the staff communicate with the board
  - Monthly staff meetings, task force, committee
  - Policies enhance consistency and uniformity
    - Who has authority over a transaction type
    - Who is responsible for safe-keeping of assets
    - Are there limits or caps
    - Where can it be transacted (investment policy)

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## Five Components

- Control Activities
  - Authorization
    - Department level
    - Finance
    - Governing Board

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## Five Components

- Control Activities continued
  - Properly designed records (voucher)
    - Signatures
    - Coding
    - Perjury statement
    - Check number
    - Vendor number
    - Description.....etc.

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## Five Components

- Control Activities continued
  - Safeguarding of Assets and Records
    - Protect records with proper backup procedures
    - Passwords restrict access
    - Security cameras
    - Fences
    - Locks on fuel caps
    - Asset listings for insurance and recovery

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## Five Components

- Control Activities continued
  - Segregation of duties – Each accounting system should be established so that one person does not have access to authorization, record-keeping and custody of assets. This not only increases accuracy but is also a deterrent to fraud. In smaller entities, the governing board will have to take a more active part in the internal control system.

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## Five Components

- Control Activities continued
  - The accounting system is kept in balance by periodic reconciliations such as the following:
    - Cash – Book balance to bank balance
    - Edit checks when entering data into the computer
    - Comparing control accounts to subsidiary-supplies, receivables, payables, customer deposits
    - DOCUMENT, DOCUMENT, DOCUMENT

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## Five Components

- Control Activities continued
  - An entity should periodically compare data contained in the accounting records to what that data purports to represent.
    - Capital asset physical inventory
    - Inventory of supplies
    - Confirmation of taxes receivable

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## Five Components

- Control Activities continued
  - Analytical reviews are an excellent tool to determine the reasonableness of certain financial data.
    - Concession stands
    - Revenues from fund raisers
    - Proprietary operations – food services, internal service

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## Five Components

- It is essential that an entity continuously monitor control-related policies and procedures to ensure that they are continuing to function properly. It is too easy to have internal controls on “auto pilot”. Monitoring takes finances to the next level to *resolve* discrepancies noted from various control activities.

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### Five Components

- Monitoring activities may resolve –
  - Is a bank reconciliation variance a human error or evidence of kiting?
  - Are inventory discrepancies just adjusted or are they investigated?
  - Is a budget over-expenditure a posting error or did we just spend too much?
  - Prior audit findings should be resolved.

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### Internal Control - Types

- Some controls are designed to **prevent** the occurrence of errors and irregularities
- Other controls **detect** the presence of errors and irregularities after they have occurred

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### Internal Control - Responsibility

- While management is *primarily* responsible for I/C, the governing board is *ultimately* responsible. The governing boards oversight role is particularly important because of management's ability to override controls.

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### Internal Control - Responsibility

- The governing board can strengthen internal controls by:
  - Reviewing monthly treasurer's reports
  - Reviewing monthly budget reports
  - Requesting prompt annual reports
  - Arranging for timely audits
  - Follow-up of audit criticisms

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### Internal Control - Limitations

1. Cost/benefit will keep entities from designing a “perfect” system of I/C
  2. Management override
  3. Collusion
- A properly designed I/C system will only lower the risk of loss .....not eliminate.

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### Internal Control - Evaluation

- An entity must periodically evaluate their own system of I/C because:
  - Of changes to policies, software and laws
  - Because there is a natural tendency for policies and procedures to deteriorate over time

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### Internal Control - Documentation

- When a control procedure is performed, always document evidence of this action.
  - Governing board members should initial vouchers that they have reviewed.
  - When loading rev and exp documents to the software, retain edit printouts used for balancing
  - Make notations on records to provide proof of periodic balancing of subsidiary to control record

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### Internal Control - Fraud

- At first glance, I/C is thought to exist solely as a means of detecting “fraud”.
- But the primary use of a sound I/C system is to detect errors.

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### Internal Control - Fraud

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- Three conditions are generally present when a fraud occurs:
  - Incentive/Pressure
  - Opportunity; and
  - Attitude/rationalization

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### Internal Control - Cycles

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- The first step in evaluating your policies and procedures is to break your accounting system down into “cycles”.
  
- Cycles may be large or small.

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### Internal Control - Cycles

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- Large Cycles –
  - Revenue
  - Expenditure
  - Payroll
- Small Cycles –
  - Credit Card
  - Inventory
  - ADM

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### Internal Control - Cycles

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- New auditing standards require independent auditors to analyze I/C to an even higher level.
- Entities should be an integral part of this process by performing self analysis of your cycles AND documenting this analysis.

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### Internal Control - Cycles

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- One way to perform this self analysis is through the use of spreadsheets to document each step of a cycle.....then using separate columns .....identify WHO performs each step.

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### Internal Control - Cycles

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- Once a cycle has been documented, set back and ask yourself the following:
  - Do I have segregation of duties?
  - How do we know that the transaction actually took place?
  - How do we know that nothing has been omitted?
  - Have all items been properly classified?
  - Are assets reasonably protected against loss or misuse?

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### Internal Control - Cycles

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- Entities that perform self analysis and document their I/C cycles will –
  - Have the potential for lowering audit costs
  - Potentially reduce the number of audit findings
  - Will result in greater confidence that the accounting system is a fine tuned machine

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