

## **INTERNAL CONTROL NARRATIVE**

There is always the risk in discussing internal controls that the discussion will turn into a piecemeal examination of specific control-related policies and procedures. When this occurs, it is easy to become lost or confused, because individual controls may appear isolated and unrelated to one other. **However, internal controls are actually a coordinated set of policies and procedures that reflect a comprehensive strategy for achieving management objectives.** When internal controls are approached from this perspective, it is much easier to understand how individual controls function and work together.

### What is internal control?

All entities, including governments, share three basic objectives:

- To operate effectively and efficiently and to safeguard their assets (operational).
- To provide reliable information to those who need it (reporting)
- To comply with all applicable constraints (compliance)

A governing body, which is responsible for overseeing management, is ultimately responsible for ensuring that management achieves all three of the objectives. Managers, in turn, must be able to provide reasonable assurance that each of these objectives is being achieved. To do so, managers need to have some defensible basis for answering each of the following questions:

- *How do you know* that the entity is operating effectively and efficiently and is safeguarding its assets?
- *How do you know* that financial statements and other reports can be relied upon?
- *How do you know* that the entity is complying with applicable laws, regulations, and policies?

Internal control is the combination of people, policies, and procedures that managers rely upon to be able to provide a positive response to each of the questions above.

The internal control framework is an **integrated set of policies and procedures** designed to assist management to achieve its goals and objectives. To be truly comprehensive, a government's internal control framework musts 1) provide a favorable control environment, 2) provide for the continuing assessment of risk, **3) provide for the design, implementation, and maintenance of effective control-related policies and procedures**, 4) provide for effective communication of information, and 5) provide for the ongoing monitoring of the effectiveness of control-related policies and procedures as well as the resolution of potential problems identified by controls.

As noted above (#3) the design, implementation, and maintenance of effective control related policies and procedures is an important part of the internal control framework. I should be noted that this is only one part of the overall internal control framework; however it often gets the most attention.

A *category* of control related to policies and procedures that gets a lot of attention is the segregation of incompatible duties. An "incompatible" duty is one that would put a single individual in a position of being able to commit an irregularity and then to conceal it. For instance, receiving reports are used to ensure that goods ordered have actually been received before payment is made. If a single individual were able to place orders and prepare receiving reports, that person could then fabricate fictitious orders resulting in improper

payments. Accordingly, such incompatible duties should be segregated. In larger governments, incompatible duties may be segregated among different departments. In smaller governments, incompatible duties may be segregated among individuals within the same department.

In practice, three types of functions are commonly considered to be mutually incompatible: authorization, record-keeping and custody. Thus, ideally, no single individual should be able to 1) authorize a transaction, 2) record the transaction in the accounting records, 3) maintain custody of the assets resulting from the transaction. Of course, there is always the risk that the segregation of incompatible duties could be circumvented if individuals who are supposed to function as a check upon each other decide instead to work together to bypass controls (collusion).

As with anything the cost of internal controls have to be evaluated against expected benefits. In some situations it may not be practical to segregate incompatible duties. In that case, management should implement compensating controls where and whenever possible (e.g. mandatory vacation, periodic rotation of duties, periodic reconciliations, periodic verifications, analytical reviews, etc.)

If an entity finds itself in a position where their auditors have issued a comment or finding relating to the segregation of incompatible duties, I think the most advantageous thing to do would be to consult directly with the CPA firm that wrote the comment and performed the audit to find out the best course of action. Without having direct knowledge of the exact procedures currently in place at the entity it would be difficult to give specific directions on how to resolve this. Below is some additional guidelines on the segregation of duties and how it relates to different transaction cycles (revenues, expenditures, etc.).

Inflows Cycle (Revenues): Segregation of Incompatible Duties.

- A. The following duties should be segregated as much as possible
  - The handling and listing of cash receipts
  - The posting to accounts receivable and general ledgers
  - The maintenance of cash receipts book
  - The making of deposits
- B. Incoming cash items listed for subsequent reconciliations to deposits by someone independent of recording cash receipts.
- C. The independent investigation and follow-up on overdue account receivable balances.
- D. Use of an individual independent of the billings and receivable functions for investigating complaints from taxpayers.
- E. Independent review of BANK RECONCILIATIONS.

Outflows Cycle (Expenditures): Segregation of Incompatible Duties.

- A. Independent checks of expense analysis and account coding on invoices.
- B. Independent follow-up of the serial continuity of checks or warrants.
- C. Independent reconciliation and review of vendor/supplier statements.
- D. Receipt of ordered goods must be confirmed by a receiving report issued by a separate department before payment is authorized
- E. The receipt of services must be confirmed in writing by an individual other than the one who requisitioned the service before payment is authorized
- F. Allocation of wages and salaries independently reviewed.

G. Independent review of BANK RECONCILIATIONS.

Records: Segregation of Incompatible Duties.

- A. Regular independent review of journal entries and supporting documentation.

*Rod Fortin*

Director of Local Government Assistance

Department of Legislative Audit

Email: [rod.fortin@state.sd.us](mailto:rod.fortin@state.sd.us)

Phone (605) 367-5810