

Introduction to Internal Control Systems

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- **Preventive, Detective, and Corrective Controls**
- **Control Activities within an Internal Control System**
- **Cost-Benefit Concept for Developing Controls**

Introduction

An organization's financial resources can be protected from loss, waste, or theft by

- developing an internal control system
- implementing it within its AIS

An internal control system

- ensures reliable data processing
- promotes operational efficiency

Introduction

This presentation defines:

- corporate governance,
- IT governance, and
- internal controls.

Internal Control

An internal control system consists of

- various methods
 - designed and
 - implemented
- several measures
 - planned and
 - executed

Internal Control

It aims to achieve four main objectives:

- to safeguard assets,
- to check the accuracy and reliability of accounting data,
- to promote operational efficiency, and
- to encourage adherence to prescribed managerial policies.

Internal Control

Internal Control is a process

- **effected by an entity's**
 - **board of directors,**
 - **management, and**
 - **other personnel.**
- **providing reasonable assurance in:**
 - **effectiveness and efficiency,**
 - **reliability of financial reporting, and**
 - **compliance with applicable laws and regulations**

Objectives of the Internal Control Structure

The objectives of the Control Structure are:

- Safeguarding assets
- Checking the accuracy and reliability of accounting data
- Promoting operational efficiency
- Encouraging adherence to prescribed managerial policies

Background Information on Internal Controls

The key laws, professional guidance, and reports that focus on internal controls are:

- Foreign Corrupt Practices Act 1977
- Treadway Commission Report
- SAS No. 55 1988
- Committee of Sponsoring Organizations (COSO) Report 1992
- SAS No. 78 1995
- Control Objectives for Business and IT (COBIT) 1995
- Information Federation for Information Processing 2001

Foreign Corrupt Practices Act

In 1977 the Foreign Corrupt Practices Act (FCPA) was passed

- after awareness that foreign bribes were paid by publicly held companies to secure export sales
- understanding that bribes were made possible due to lax internal controls
- to heighten awareness in a sound internal control structure.

Provisions of the Foreign Corrupt Practices Act

The FCPA requires that

- publicly held companies
 - design and
 - implement a system of control procedures

The control system must provide assurance that:

- assets are accounted for appropriately
- transactions are in conformity to GAAP
- access to assets is properly controlled
- periodic comparisons of existing assets to the accounting records are made

Background of Internal Controls

Results of the FCPA:

- **The Treadway Commission**

- to examine the causes of fraudulent financial reporting
- to give recommendations to reduce its occurrence

Background of Internal Controls

- **The Committee of Sponsoring Organizations (COSO)**
 - to develop a common definition for internal control
 - to provide guidance for judging its effectiveness

Background of Internal Controls

The ISACF

- to examine the internal control area
- to produce Control Objectives for Information and Related Technology (COBIT).

COBIT's definition of internal control:

- The policies, procedures, practices, and organizational structures are designed to provide assurance that
 - business objectives will be achieved
 - undesired events will be prevented, detected and corrected.

Components of Internal Control

- **Control Environment**
- **Risk Assessment**
- **Control Activities**
- **Information and
Communication**
- **Monitoring**

The Control Environment

The Control Environment

- establishes the tone of a company,
- influences the control awareness of the employees.

Factors included within the control environment are:

- Integrity, ethical values and competence of employees
- Management philosophy and operating style
- Assignment of authority and responsibility
- The attention and direction provided by the board of directors

Risk Assessment

Risk assessment involves

- the consideration of the risk factor
- recognition that every organization faces risks to its success
- recognition that the sources are internal and external
- Identification, analysis and action to achieve the company's goals

Control Activities

Control activities:

- **are the policies and procedures that ensure**
 - management directives are carried out,
 - protection of the assets of the firm
- **include a combination of**
 - manual controls
 - automated controls.

Control Activities

- **Can be categorized as**
 - approvals,
 - authorizations,
 - verifications,
 - reconciliations,
 - reviews of operating performance, and
 - segregation of duties.

Information and Communication

Information refers to the accounting system, which

- records,
- processes,
- Summarizes,
- reports a company's transactions, and
- maintains accountability for assets, liabilities, and equity.

Information and Communication

Communication helps personnel understand their

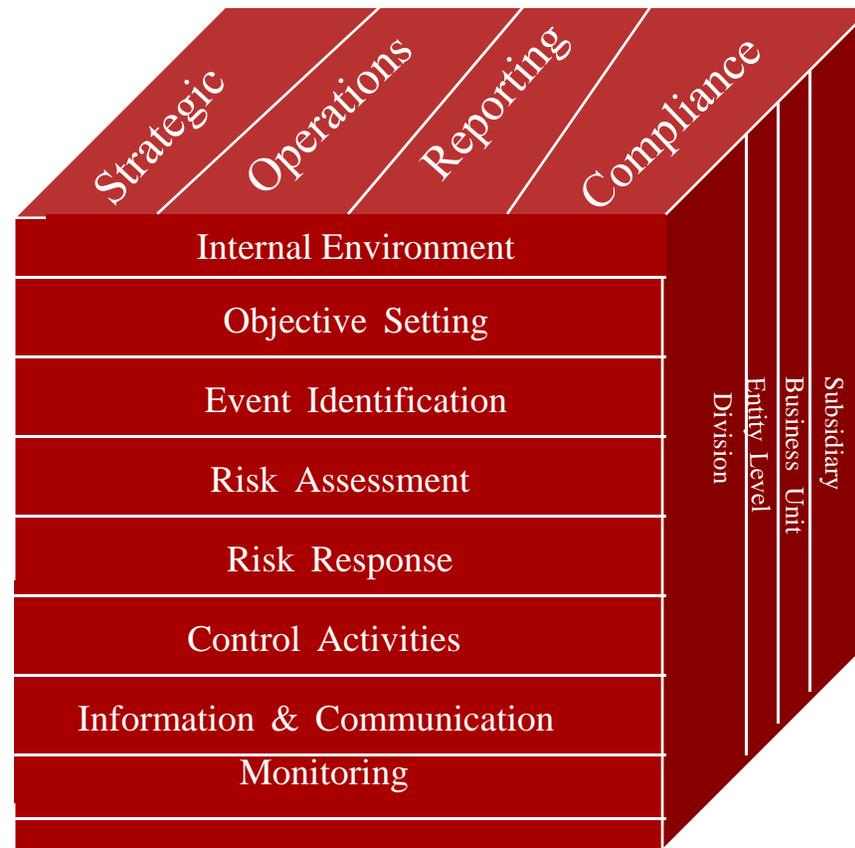
- roles and responsibilities
 - to internal control and
 - over financial reporting.

Monitoring

Monitoring

- is the process that assesses the quality of internal control performance over time
- involves evaluating the design and operation of controls on a timely basis,
- initiating corrective action when specific controls are not functioning properly.

Enterprise Risk Management Framework



Control Procedures Analysis

Control Procedures can be classified as

- **Preventive Controls**
 - to prevent some potential problem from occurring when an activity is performed
- **Detective Controls –**
 - to discover the occurrence of adverse events such as operational inefficiency
- **Corrective controls**
 - to remedy problems discovered through detective controls.

Interrelationship of Preventive and Detective Controls

Preventive and detective control procedures

- should not be treated as mutually exclusive.
- are interrelated.

Control Activities

Within an Internal Control System are the following features

- a good Audit Trail
- sound personnel policies and competent employees
- separation of duties
- physical protection of assets
- internal reviews of controls by internal audit subsystem
- Timely Performance Reports

Good Audit Trail

An audit trail enables auditors and accountants

- **to follow the transaction data**
 - from the initial source documents
 - to the final disposition in a financial report and vice-versa.
- **to detect, in the processing data**
 - errors and
 - irregularities

Sound Personnel Policies

Examples of sound personnel policies are:

- Specific hiring procedures
- Training programs
- Good supervision
- Fair and equitable guidelines for employees' salary increases

Sound Personnel Policies

- Rotation of certain key employees in different jobs
- Enforced vacations
- Insurance coverage on those employees who handle liquid assets
- Regular performance reviews

Separation of Duties

Segregating activities and responsibilities of employees

- allows different people to perform various tasks of a specific transaction.

The main functions that should be kept separate are

- *custody* of assets
- *recording* transactions, and
- *authorizing* transactions.

Physical Protection of Assets

Protection of assets is

- keeping a company's assets in a safe physical location
- minimizing the risk of damage to the assets or
- avoiding theft by employees or outsiders

Physical Protection of Assets

Examples of accounting control procedure

- a voucher system protects against unauthorized cash disbursements.
- a petty cash fund is used for small expenditures where writing a check would be inefficient.

Internal Reviews of Controls

Internal audit

- is a service function within many large companies
- report to high-level management or to the board of directors in order to remain independent and objective as a separate subsystem
- perform periodic reviews, called operational audits, on each department to evaluate the efficiency and effectiveness of that particular department

Timely Performance Reports

Performance reports

- provide information to management on
 - efficiency of the internal controls and
 - effectiveness of the internal controls

These reports

- should provide *timely feedback* to management on the
- success of the internal controls or
- failure of the internal controls.

Cost-Benefit Concept for Developing Controls

A cost-benefit analysis

- should be conducted to make sure that the benefits of planned controls exceed the cost of implementing them in the system.
- Controls are considered cost-effective when their anticipated benefits exceed their anticipated costs.
- An ideal control is a control procedure that reduces to practically zero the risk of an undetected error or irregularity.

Cost Benefit Analysis

The benefits of additional control procedures

- result from *risk of loss reductions*.
- should include a measure of loss
 - the exposure (potential loss associated with a control problem) and
 - risk (probability that the control problem will occur).
- are calculated as
 - Expected loss = risk * exposure