Introduction to Internal Control Systems

- Introduction
- Internal Control Systems
  - Definition
  - Framework
- 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.
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

- 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

Strategic
- Internal Environment
- Objective Setting
- Event Identification
- Risk Assessment
- Risk Response
- Control Activities
- Information & Communication
- Monitoring

Operations

Reporting

Compliance
- Subsidiary
- Business Unit
- Entity Level
- Division
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.
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