

# Understanding Internal Controls

A Reference Guide for Managing University Business Practices

# Purpose

- Assist employees in their stewardship role
- Provides guidance for existence of basic and consistent business controls
- Defines our responsibilities for managing them
- Tool to identify and assess operating controls, financial reporting and regulatory compliance

# What do Internal Controls do?

- Provides reasonable not absolute assurance that objectives will be met
- Reasonable assurance – appropriate balance between risk and level of control
- Cost of control should not exceed the benefit to be derived from it

# Who's Responsible?

- All employees of University are responsible for managing internal controls
- Internal controls are operated by people and people make the system work at every level of the organization
- Communicate identified operational problems, deviations from established standards and violations of policy or law
- Need Help - Resources include:
  - Campus Controller – Area Accountant
  - Internal Audit Department

# Definition

- Internal Control is a process designed to provide reasonable assurance regarding the achievement of objectives in the following categories:
  - Effectiveness and efficiency of operations
  - Reliability of financial reporting
  - Compliance with applicable laws and regulations

# What does that mean?

- Internal controls designed to achieve objectives in three categories
  - Operating
    - Safeguarding assets
  - Financial Reporting
    - All transactions are recorded and all recorded transactions are real
  - Compliance
    - Protects organization from increases legislation or loss of grants, gifts and donations

# History of Internal Controls

- 1985: 5 organizations sponsored the National Commission on Fraudulent Financial Reporting – A.K.A. Treadway Commission
- 1987: Treadway Commission suggested committee be formed to study internal controls
- 1992: Committee of Sponsoring Organizations (COSO) issued “Internal Control – Integrated Framework”

# Internal Control Process

- Five Interrelated Components
  - Control Environment
  - Risk Assessment
  - Control Activities
  - Information and Communication
  - Monitoring
- All five must be present to conclude internal control is effective
- COSO model – recognizes throughout the world as a significant standard for discussing internal controls

- **Control Environment**

- Control consciousness of an organization
- Atmosphere in which people conduct their activities and carry out their control responsibilities
- Tone at the top
- Foundation for all other components – provides discipline and structure
- Greatly influenced by the extent to which individuals recognize that they will be held accountable

# Enhances the Control Environment

- Dept policy and procedure manuals
- Employees acquainted with University policies and procedures
- Code of ethics/ Conflict of Interest Policies
- Hire qualified individuals
- Adequate training for employees
- Performance evaluations
- Appropriate disciplinary action taken

# Case Study – Control Environment

- Tone of department
  - Dr. Lax's attitude regarding procurement cards statements
  - Employees held accountable – work records
  - Budget issues – deficit growing
- Training – new staff member hasn't received adequate training
- Manuals
  - Completely updated set on shelf
  - Consolidated web-site for University policies and procedures

## 2. Risk Assessment

- Identify risks to the achievement of dept objectives and manage those risks
- Objectives:
  - Operating – achievement of basic mission
  - Financial reporting – prepare reliable financial reports
  - Compliance – adhere to applicable laws and regulations (State Fiscal Rules)

# Identify Risks

- Ask questions:
  - What could go wrong?
  - Where are we vulnerable?
  - What assets do we need to protect?
  - How could someone steal from the dept?
  - What information do we most rely?
  - What activities are regulated?
  - What's our greatest legal exposure?

# High Risk Transactions

- Examples:
  - Petty cash
  - Travel Expenditures
  - Payroll
  - A-card transactions
  - Equipment moved off-campus
- Deserve conscious risk review

# Conduct Risk Analysis

- Assess likelihood of the risk occurring
- Estimate potential impact if risk occurs
- Determine how risk should be managed

# Case Study – Risk Assessment

- Cash handling procedures
- Dr. Lax's attitude regarding his approval of P-card monthly statements
- The new financial reporting system
- Procurement and sharing passwords
- The overpaid instructor
- Unlocked faculty and staff files

# 3. Control Activities

- Defined: actions, supported by policies and procedures that, when carried out properly and in a timely manner, manage or reduce risk
- Preventive and Detective Controls
  - Preventive – attempt to deter or prevent undesirable events
  - Detective - attempt to detect undesirable events

# Controls Activities Include

- Approvals, authorizations, verifications (preventive)
- Reconciliations (detective)
- Review of Performance (detective)
- Security of Assets (preventive and detective)
- Segregation of duties (preventive)

# Control Activity - Approvals, Authorizations, and Verifications

- Management authorizes employees to perform certain activities and execute certain transactions
- Approval of a transaction means the approver has reviewed the supporting documentation and is satisfied the transaction is appropriate
- Under so circumstances should approver tell someone they can sign the approver's name on behalf of the approver – disrupts idea of control activity
- Approval authority may be linked to specific dollar amount

# Control Activity -Reconciliation

- Comparison of different sets of data to one another, identify and investigate differences and take corrective action, when necessary
- Helps to ensure the accuracy and completeness of transaction
- Critical element of reconciliation process is to resolve differences

# Examples of Reconciliations

- Financial statements to file copies of supporting documentation
- Compare vacation and sick leave balances per department records to vacation and sick leave balances per payroll system
- Comparing cash receipts log to deposit slips

# Control Activity - Review of Performance

- Management should review reports, statements, reconciliations for consistency and reasonableness
- Compare budget to actual or current period activity to prior period activity
- Measure extent to which goals/objectives are being met
- Identify unexpected results or conditions

# Control Activity - Asset Security

- Liquid assets and assets with alternative use must be safeguarded against unauthorized acquisition or use
- Access controls best way to safeguard assets
  - Locked doors
  - Locking file cabinets
  - Computer passwords

# Control Activity - Segregation of Duties

- No one person should:
  - Initiate the transaction
  - Approve the transaction
  - Record the transaction
  - Reconcile balances
  - Handle assets
  - Review reports
- Two sets of eyes

# Control Activity - Segregation of Duties

- Critical to internal controls
- Reduces risk of both erroneous and inappropriate actions
- In general, approval, accounting, reconciliation and asset custody should be separated
- When function cannot be separated, compensating control activity necessary

# Examples of Segregation of Duties

- Person who requisition the purchase of good should not be the person to approve the purchase
- Person who approves the purchase should not be the person who reconciles monthly statements
- Person who opens the mail and prepares a list of checks received should not be the person who makes the deposit

# Case Study – Control Activities

- Dr. Lax gave up approval authority
- Elaborate shadow system not reconciled to the financial reporting system
- Sally did a quick review of the statements
- Dr. Strict reviews questionable charges
- Missing computers/ unlocked faculty and staff files
- Cash handling/procurement problems

## 4. Information and Communication

- Pertinent information must be identified, captured and communicated
- Must be communicated up, down and across the organization
- Formal or informal
  - Formal – sophisticate computer technology to simple staff meeting
  - Informal – conversations with faculty, students, employees

# Case Study – Information and Communication

# 5. Monitoring

- Assessment of internal controls performance over time
- Accomplished by ongoing monitoring activities
- Purpose to determine if internal control is adequately designed, properly executed and effective
- Separate evaluations of internal controls by internal audits

# Conclusion

- Management's role in the internal control system is critical to effectiveness
- Don't need to look at every piece of information to determine controls are functioning
- Spot checks of transaction can provide reasonable assurance controls are working
- All employees of University are responsible for managing internal controls
- Help is available

# Bibliography

- “Understanding Internal Controls”, University of California, Office of the President, Department of Controls and Accountability
- Robertson, Jack C., 1997. *Fraud Examination for Managers and Auditors*, Viesca Books: Austin, TX
- Davia, Howard; Coggins, Patrick C.; Wideman, John C.; Kastantin, Joseph T., 2000. *Accountant’s Guide to Fraud Detection and Control*. 2<sup>nd</sup> Ed. John Wiley and Sons, Inc. New York
- “Internal Controls: A Guide for Managers”, Indiana University, Internal Audit Department
- “Internal Controls Checklist”, The Institute of Internal Auditors
- “Internal Control Factors”, Stanford University, Internal Audit Department

# Bibliography – cont.

- “Internal Controls/Compensation Controls”, University of Colorado, CU Systems
- “Segregation of Duties”, University of Utah, Dept of Internal Audit
- “Internal Control – Integrated Framework Executive Summary”, The Committee of Sponsoring Organizations of the Treadway Commission
- “Internal Control Concept”, University of Memphis, Dept of Internal Audit