Chapter Quote

- Under Sarbanes-Oxley, CEOs and CFOs must certify the effectiveness of their internal controls. Thus, the industry has to address the question: “How do the CEO and CFO actually know that there are no improprieties at some distant operation?”

A. Wayne Avellanet, Strategic Finance, September 2003, p. 26

Chapter 4
Introduction to Internal Control Systems

- Introduction
- Internal Control Systems: Definition and Components
- Control Procedures Analyzed
- Control Activities Within an Internal Control System
- Cost-Benefit Concept for Developing Controls

Internal Control

- An internal control system consists of the various methods and measures designed into and implemented within an organizational system to achieve four main objectives.

Objectives of the Internal Control Structure

1. Safeguarding assets
2. Checking the accuracy and reliability of accounting data
3. Promoting operational efficiency
4. Encouraging adherence to prescribed managerial policies
Background Information on Internal Controls

- 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 the Securities and Exchange Commission became aware of foreign bribes paid by publicly held companies to secure export sales.
- These bribes were made possible due to lax internal controls.
- The goal of the FCPA was 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 that provide reasonable 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

Committee of Sponsoring Organizations

- As a result of the FCPA, a study was done by the Treadway Commission to examine the causes of fraudulent financial reporting and give recommendations to reduce its occurrence.
- The Committee of Sponsoring Organizations (COSO) was formed to develop a common definition for internal control and provide guidance for judging its effectiveness.

Information Systems Audit and Control Foundation

- The ISACF examined the internal control area and produced Control Objectives for Information and Related Technology (COBIT).
- COBIT’s definition of internal control: "The policies, procedures, practices, and organizational structures that are designed to provide reasonable assurance that business objectives will be achieved and that undesired events will be prevented, detected and corrected.

Components of Internal Control

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

- The Control Environment establishes the tone of a company, influencing the control awareness of the company's 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 of the board of directors

Risk Assessment

- Consider when designing controls for a company.
- Recognizes that every organization faces risks to its success.
- Risks come from internal and external sources.
- Risks that appear to affect the accomplishment of a company’s goals should be identified, analyzed, and acted upon.

What are risks?

- 4 key areas:
  - Strategic
  - Operations
  - Reporting
  - Compliance
- What drives the Company?
  - Stock price / return to shareholders?
  - Market position?
  - Leverage position?

Assessing Risk & Evaluating Controls

- What could go wrong?
- Audit control objectives also apply here
  - Real - Posted
  - Recorded - Classified
  - Valued - Timely
  - Summarized

Control Activities

- The policies and procedures that help ensure that management directives are carried out are the focus of control activities.

Information and Communication

- Information refers to the accounting system, which includes the methods and records used to record, process, summarize and report a company’s transactions and maintain accountability for assets, liabilities and equity.
- Communication - providing a company’s personnel with an understanding of their roles and responsibilities pertaining to internal control over financial reporting.
Monitoring

• Assesses the quality of internal control performance over time.
• Monitoring involves
  – evaluating the design and operation of controls
  – on a timely basis
  – initiating corrective action (when controls are not functioning properly)

Control Procedures Analyzed

• Control Procedures may be classified according to their intended uses in a system:
  – Preventive Controls - designed to prevent some potential problem from occurring when an activity is performed
  – Detective Controls - discover the occurrence of adverse events such as operational inefficiency
  – Corrective controls are designed to remedy problems discovered through detective controls.

Control Activities Within an Internal Control System

• 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

Enterprise Risk Management Framework

Interrelationship of Preventive and Detective Controls

• Preventive and detective control procedures ARE NOT mutually exclusive.
• Rather, these controls are interrelated.

Good Audit Trail

• An audit trail enables auditors and accountants to follow the path of transaction data
  – from the initial source documents
  – to the final disposition in a financial report
  – and vice-versa.
• Without a good audit trail, it is more likely that errors and irregularities in processing data will not be detected.
Sound Personnel Policies and Competent Employees

Examples of sound personnel policies are:
1. Specific hiring procedures
2. Training programs
3. Good supervision
4. Fair and equitable guidelines for employees’ salary increases
5. Rotation of certain key employees in different jobs
6. Enforced vacations
7. Insurance coverage on those employees who handle liquid assets – “Bonding”
8. Regular performance reviews

Separation of Duties

- Segregating activities and responsibilities of a company’s 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
  - authorizing transactions

Physical Protection of Assets

- Keeping a company’s assets in a safe physical location minimizes the risk of damage to the assets or theft by employees or outsiders.
- A voucher system is an example of an accounting control procedure that protects against unauthorized cash disbursements.
- A petty cash fund may be used for small expenditures where writing a check would be inefficient.

Physical Protection of Assets

- Key is reasonable control of access to asset
- Other examples
  - Lock up check stock
  - Limit access to check signer
  - Controlled disbursement accounts
- Think “what can go wrong?”

Internal Reviews of Controls by Internal Audit Subsystem

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

Timely Performance Reports

- Performance reports provide information to management on how efficiently and effectively its company’s internal controls are functioning.
- These reports should provide timely feedback to management on the success or failure of the company’s internal controls.
Cost-Benefit Concept for Developing Controls

- A cost-benefit analysis should be conducted in order 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.
- A measure of loss should include both the exposure (potential loss associated with a control problem) and risk (probability that the control problem will occur).
- Expected loss = risk * exposure