

LESSON 4.1

INTERNAL CONTROLS

Internal controls are the mechanisms, rules, and procedures implemented by a company to ensure the integrity of financial and accounting information, promote accountability and prevent fraud.

Besides complying with laws and regulations, and preventing employees from stealing assets or committing fraud, internal controls can help improve operational efficiency by improving the accuracy and timeliness of financial reporting.

Understanding Internal Controls

Internal controls have become a key business function for every U.S. company since the accounting scandals in the early 2000s. In their wake, the [Sarbanes-Oxley Act of 2002](#) was enacted to protect investors from fraudulent accounting activities and improve the accuracy and reliability of corporate disclosures. This has had a profound effect on corporate governance, by making managers responsible for financial reporting and creating an [audit trail](#). Managers found guilty of not properly establishing and managing internal controls face serious criminal penalties.

The [auditor's](#) opinion that accompanies financial statements is based on an audit of the procedures and records used to produce them. As part of an audit, external auditors will test a company's accounting processes and internal controls and provide an opinion as to their effectiveness.

[Internal audits](#) evaluate a company's internal controls, including its corporate governance and accounting processes. They ensure compliance with laws and regulations and accurate and timely financial reporting and data collection, as well as helping to maintain operational efficiency by identifying

problems and correcting lapses before they are discovered in an external audit. Internal audits play a critical role in a company's operations and corporate governance, now that the Sarbanes-Oxley Act of 2002 has made managers legally responsible for the accuracy of its financial statements.

No two systems of internal controls are identical, but many core philosophies regarding financial integrity and accounting practices have become standard management practices. While internal controls can be expensive, properly implemented internal controls can help streamline operations and increase operational efficiency, in addition to preventing fraud.

Regardless of the policies and procedures established by an organization, only reasonable assurance may be provided that internal controls are effective and financial information is correct. The effectiveness of internal controls is limited by human judgment. A business will often give high-level personnel the ability to override internal controls for operational efficiency reasons, and internal controls can be circumvented through collusion.

Reasons for Internal Control

- Minimizing the company's business risk
- Ensuring the continuing effective functioning of the company.
- Ensuring the company complies with relevant laws and regulations.
- Most of these reasons funnel back to the ultimate objective that the company continues to operate.
- For example, if the company failed to comply with relevant laws and regulations, it might be forced to stop operations.

Detective >> Preventive >> Corrective

Types of Internal Control

1. **Detective:** Designed to detect errors or irregularities that may have occurred.
2. **Corrective:** Designed to correct errors or irregularities that have been detected.
3. **Preventive:** Designed to keep errors or irregularities from occurring in the first place.

Principles of Internal Control

Internal control is based on the following principles:

1. **Principle of Separation** - Financial and accounting operations must be separated, i.e., handling of cash and the recording of the movement thereof should be done by different persons.
2. **Principle of Responsibility** - Responsibility for the performance of the job must be clearly stated so that there may be no room for doubt or confusion subsequently.
3. **Principle of Skepticism** - Too much confidence should not be pinned on one individual. Nearly all frauds have been committed by trusted officials or employees.
4. **Principle of Rotation** - The rotation principle relating to the transfer of an employee from one job to another should be the inflexible guiding rule.
5. **Principle of Review** - The work should be so arranged that work done by one employee should be promptly checked by another independent employee.
6. **Principle of Clarification** - Clear and well-defined rules should be laid down and practically followed, relating to dealing

with cash, ordering, receiving and issuing goods, etc.

7. **Principle of Documentation** - The arrangement of the work should be in such a manner that a written record of the part played by each employee should be maintained, and the work should pass through several hands in a well-defined manner.

Advantages of Internal Control

Application of internal control provides the following benefits to the various parties:

- Internal control helps to protect the assets of the business from misuse, theft, accident, etc.
- Internal control helps to implement management policies to attain corporate goals.
- Internal control helps the auditor in his/her work, detecting all the errors and frauds which are committed in the books of accounts.
- Internal control helps to increase the accuracy and reliability of financial statements and books of accounts.
- Internal control helps to regulate the work of staff through a division of work among the staff in a scientific manner, which helps to make the daily works of staff effective.
- Internal control helps the management to prepare and implement effective plans by providing correct and factual information.
- Internal control helps to put moral pressure on staff.

Internal Control – Accounting, Administrative Controls

Internal control areas spread over accounting and non-accounting spheres. Internal control, as it applied to the accounting system, implies control over accounting system to achieve the following objectives:

1. Efficient and orderly conduct of [accounting transactions](#).
2. Safeguarding the assets in adherence to management policy.
3. Prevention of error, detection of an error.
4. Prevention of fraud, detection of fraud.
5. Ensuring accuracy, completeness, reliability, and timely preparation of accounting data.

On the other hand, administrative controls seek to achieve the aim of management inefficient and orderly conduct of transactions in non-accounting areas.

It seeks to ensure adherence to management policy in various areas of business operations.

- For example, in a manufacturing system of a business enterprise, the internal control may be established to ensure the adherence of management policy as to quality (quality control) safeguarding assets (control over wastages, ABC control over raw materials) prevention of errors (monitoring production methods, maintenance program for machines), prevention of frauds (security system) and timely supply of reliable management information (MIS).

An auditor is mainly concerned with good accounting control of the internal control system.

If a good internal control system exists in the accounting system, an auditor can put greater reliance on the financial data generated in the system with a test checking of select items.

If the accounting control is not strong, the auditor may have to resort to a detailed checking of transactions, events, and practices in the accounting system.

Concerning administrative controls, the auditor may evaluate those parts of administrative controls as may have a bearing on the financial information of the entity.

For example, before certifying the valuation of stocks, the auditor may refer to the reports of consumption patterns prepared by the manufacturing segment to administration, if the auditor feels material discrepancy in the physical quantity of stocks.

On the other hand, he may not be concerned no more than a matter of general interest with the quality report of chemical A used in operation X.

LESSON 4.2 INTERNAL CONTROLS

Components of an Internal Control Structure
Committee of Sponsoring Organizations (COSO) identifies five interrelated internal control structure components as follows:

1. Control Environment

The control environment sets the tone of an organization, influencing the control consciousness of its people. It is the foundation for all other components of internal control, providing discipline and structure.

Numerous factors comprise the control environment in an entity, among which are the following:

- Integrity and ethical values
- Commitment to competence
- Board of directors and audit committee
- Management philosophy and operating style
- Organizational structure
- Assignment of authority and responsibility
- Human resource policies and practices

2. Risk Assessment

Risk assessment for financial reporting purposes in an entity's identification, analysis, and management of risks relevant to the preparation of financial statements that are fairly presented in conformity with generally accepted accounting principles.

Management's risk assessment should include special consideration of the risks that can arise from changed circumstances, such as new areas of business or transactions, changes in accounting-standards, new laws or regulations, the rapid growth of the entity, and changes in personnel involved in the information processing and reporting functions.

3. Information and Communication

The information system relevant to financial reporting, objectives, which includes the accounting system, consists of the methods and records established to identify, assemble, analyze, classify, record, and report entity transactions and to maintain accountability for the related assets and liabilities.

Communication involves providing a clear understanding of individual roles and responsibilities about the internal control structure over financial reporting.

4. Control Activities

Control activities are those policies and procedures that help ensure that management directives are carried out.

They help ensure that necessary actions are taken to address risks to the achievement of the entity's objectives.

Control activities have various objectives and are applied at various organizational and functional levels.

Control activities relevant to a **financial statement audit** may be categorized in different ways as follows:

- Information processing controls
- General controls
- Application controls
- Proper authorization
- Documents and records
- Independent checks
- Segregation of duties
- Physical controls
- Performance reviews

5. Monitoring

Monitoring is the process that assesses the quality of the internal control structure's performance over time.

It involves assessment by appropriate personnel of the design and operation of controls on a suitably timely basis to determine that the ICS is operating as intended and that it is modified as appropriate for changes in conditions.

Limitations of Internal Control

No matter how well internal controls are designed, they can only provide reasonable assurance that objectives have been achieved. Some limitations are inherent in all internal control systems. These include:

1. Judgment

The effectiveness of controls will be limited by decisions made with the human judgment under pressure to conduct business based on the information at hand.

2. Breakdowns

Even well-designed internal controls can break down. Employees sometimes misunderstand instructions or simply make mistakes.

Errors may also result from new technology and the complexity of computerized information systems.

3. Management Override

High-level personnel may be able to override prescribed policies and procedures for personal gain or advantage.

This should not be confused with management intervention, which represents management actions to depart from prescribed policies and procedures for legitimate purposes.

4. Collusion

Control systems can be circumvented by employee collusion. Individuals acting collectively can alter financial data or other management information in a manner that cannot be identified by control systems.

5. Costs versus Benefits

The costs of an entity's internal control structure may exceed the benefits that are expected to be ensured.

6. Unusual Transactions

Finally, a limitation of internal controls is that they are generally designed to deal with what normally or routinely happens in a business.

However, it may be the case that an unusual transaction may occur which does not fit into the normal routines, in which case standard controls may not be relevant to the unusual transaction. Hence, mistakes may be made about that unusual transaction.

Documenting the Understanding of Internal Control Structure Components

1. Questionnaires

A questionnaire consists of a series of questions about ICS policies and procedures that the auditor considers necessary to prevent material misstatements in the financial statements.

The questions are usually phrased so that either a 'yes,' 'no,' or 'not applicable' answer results, with a Yes answer indicating a favorable condition. Standardized questionnaires are used on a majority of audits.

2. Flowcharts

A flowchart is a schematic diagram using standardized symbols, interconnecting flow lines, and annotations that portray the steps involved in processing information through the accounting system. Flowcharts vary in the extent of detail.

3. Decision Tables

Decision tables are a precise yet compact way to model complicated logic. Decision tables associate conditions with actions to perform, but in many cases, do so in a more elegant way to present data.

4. Narrative Memoranda

A narrative memorandum consists of written comments concerning the auditor's consideration of the ICS.

A memorandum may be used to supplement the other forms of documentation by summarizing the auditor's overall understanding of the control structure, individual components of the control structure, or specific control policies or procedures.

In an audit of a large entity involving a combination of audit strategies, all four types of documentation may be used for different parts of the understanding. In an audit of a small entity where the primarily substantive approach predominates, a single memorandum may suffice to document the understanding of all the components.

