

The Importance of Internal Controls

*How Internal Controls Help
Reduce Risk, Waste and Abuse*



Certified Public Accountants
Tax, Audit and Business Strategy

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What is Internal Control?

Internal control is defined as a process determined by an entity's board of directors, management and other personnel, designed to provide reasonable assurance regarding the objectives in the following areas:

- Effectiveness and efficiency of operations
- Reliability of financial reporting
- Compliance with applicable laws and regulations

Internal controls assure that the processes companies want to happen will and things they don't want to happen won't.

Why Are Internal Controls Important?

The overall purpose of internal control is to help a department achieve its mission and accomplish certain goals and objectives. An effective internal control system helps a department to:

- Promote orderly, economical, efficient and effective operations
- Produce quality products and services consistent with the department's mission
- Safeguard resources against loss due to waste, abuse, mismanagement, errors and fraud.
- Promote adherence to statutes, regulations, bulletins and procedures
- Develop and maintain reliable financial and management data, and accurately report that data in a timely manner

What Are The Components Of An Internal Control System?

The Committee of Sponsoring Organizations (COSO) internal control framework identifies five inter-related components:

1. **Control Environment:** The control environment, sometimes referred to as "tone at the top", is the foundation for all other components of internal control. The control environment is influenced by management's philosophy, operating style, integrity, ethical values, and commitment to competence. If this foundation is strong and if the control environment is positive, the overall system of internal control will be more effective.
2. **Risk Assessment:** Risk assessment is the identification, analysis, and management of risks relevant to the achievement of the department's goals and objectives. Risks include internal and external events or circumstances that may occur and adversely affect operations. Once risks are identified, management should consider their impact (or significance), the likelihood of their occurrence, and how to manage them.
3. **Control Activities:** Internal control activities are tools - policies, procedures, techniques, and mechanisms - that help ensure management's directives are carried out. Control activities help identify, prevent or reduce the risks that can impede accomplishment of the department's objectives. Control activities occur throughout the department, at all levels and in all functions. They include activities such as approvals, authorizations, verifications, reconciliations, documentation, separation of duties, and safeguarding of assets.
4. **Communication and Information:** For a department to run and control its operations, it must have relevant, valid, reliable, and timely communications relating to internal and external events. Managers must be able to obtain reliable information to make informed business decisions, determine their risks, and communicate policies and other important information to those who need it.

5. **Monitoring:** The department's internal control system needs to be monitored to assess whether controls are effective and operating as intended. Ongoing monitoring occurs through routine managerial activities such as supervision, reconciliations, checklists, comparisons, performance evaluations and status reports. Monitoring may also occur through separate internal evaluations (e.g., internal audits/reviews) or from use of external sources (e.g., comparison to peer groups or industry standards, surveys, etc.). Deficiencies found during monitoring need to be reported to those responsible for the function, with serious deficiencies being reported to top management.

Who Is Responsible For Internal Controls?

Management is ultimately responsible and should assume ownership of the system. Leadership and direction should be provided by the management team and each department is responsible for specific internal control policies and procedures. All employees have some responsibility as it is developed by people to guide people with a means of accountability.

What Can Each Department Do To Improve Its Internal Controls?

- Implement *separation of duties* among different employees to reduce the risk of error or inappropriate actions; ensure no one person has complete control over all aspects of any financial transaction
- Ensure records are routinely reviewed and reconciled by someone other than the preparer to determine that transactions have been processed accurately and appropriately
- Ensure that cash, equipment, inventories, and other property are secured physically, counted periodically, and compared to control records; limit access only to authorized persons
- Provide employees with the appropriate training, direction, and supervision to ensure they have the necessary knowledge and skills to carry out their duties; inform employees of the proper channels for reporting suspected improprieties
- Make sure company-wide and department-level policies and procedures are formalized, documented, communicated and readily available to employees; document day-to-day operating procedures and practices to provide staff with guidance to ensure management's directives are carried out and to help maintain continuity of operations in the event of prolonged employee absences or turnover

Does Having Strong Internal Controls Guarantee Success?

No. Due to limitations inherent in all internal control systems, internal controls only provide reasonable assurance that a department will be successful and achieve its objectives. Breakdowns in internal controls can occur due to simple mistakes or faulty judgments, or controls can be circumvented through collusion or management override. However, lack of internal controls puts any company at risk for fraud, waste and abuse.

Contact SVA to discuss the benefits of an internal control audit.

Source: Committee of Sponsoring Organizations (COSO) of the Treadway Commission and American Institute of CPAs (AICPA). *The information contained herein is confidential and proprietary to SVA Certified Public Accountants, SC. It is not to be disclosed, in whole or in part, without the expressed written consent of SVA Certified Public Accountants, SC. It shall not be duplicated or used, in whole or in part, for any purpose other than to evaluate the suggestions of SVA Certified Public Accountants, SC.*