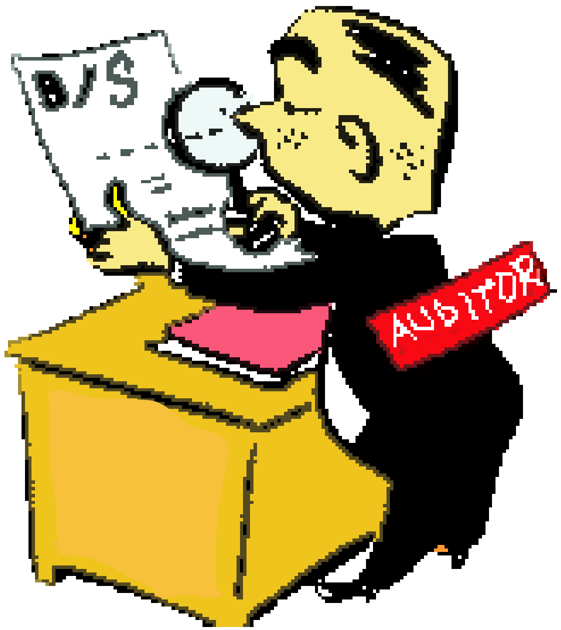
Internal Controls

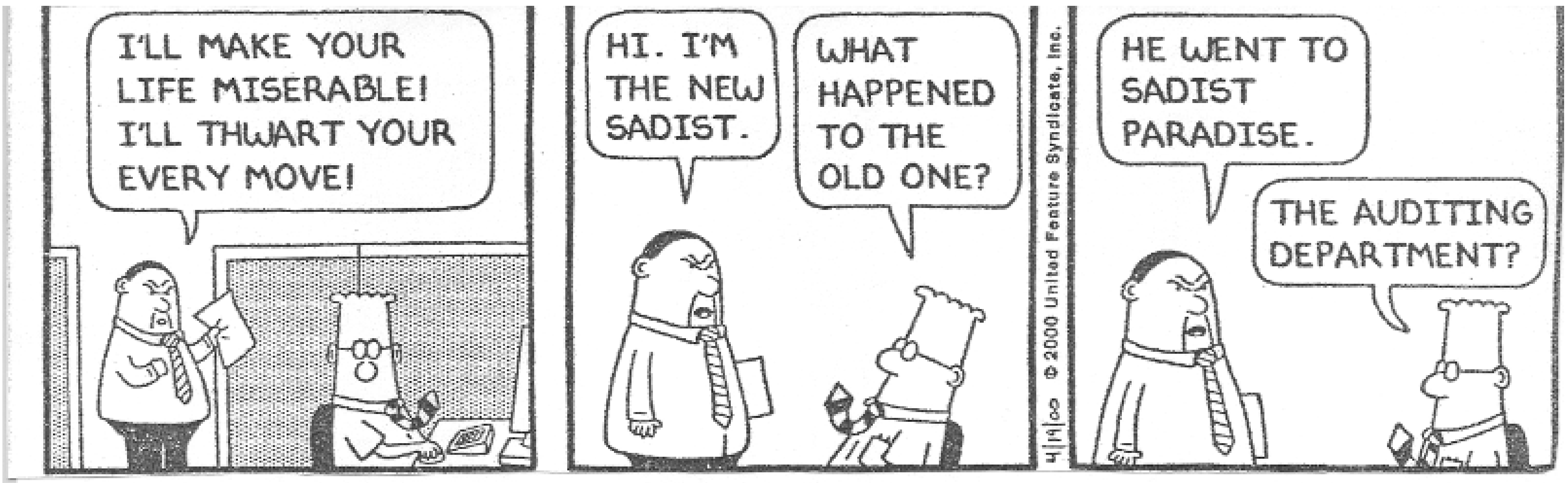


A short presentation

from

Your Internal Audit Department

The Old Internal Audit Department



The New Internal Audit Department

"We're here to help!"

Teach + Train = Change

Our goal:

Promote effective, efficient and ethical practices and procedures

Let’s start with some Basics –

What are some terms we will use in discussing Internal Controls?

Definitions

Process: a group of logically related activities that transform inputs into outputs.

Process Owner: a person who is ultimately responsible for the process.

Process Inputs: the material, capital, human resources and information that a business process receives and acts upon in order to transform it into its output.

Process Activity: a specific deed, action or function designed on its own or with other related activities to turn input into output.

Process Outputs: those things transformed by a process for the benefit of the customer or for use as an input in a later process or activity.

Some more definitions

Policy: the principles that guide the actions and decisions in an organization. Policies do not tell "how" to do something, but specify what is acceptable, unacceptable, right and wrong.

Procedures: the established or prescribed methods to be followed. They describe "how it should be done."

Routine transactions: recurring activities performed in the normal course of business. Example: Cash disbursements

Non-routine transactions : activities that occur periodically that are not part of the routine flow of transactions. Example: Sale of fixed assets

What are internal controls and who is responsible for them?

What are Internal Controls?

Process steps installed **by Management** to provide reasonable assurance of the following objectives:

- ✓effectiveness and efficiency of operations
- ✓reliability of financial reporting
- ✓accomplishment of established goals and objectives
- ✓compliance with laws and regulations

<u>Why do we want them?</u>

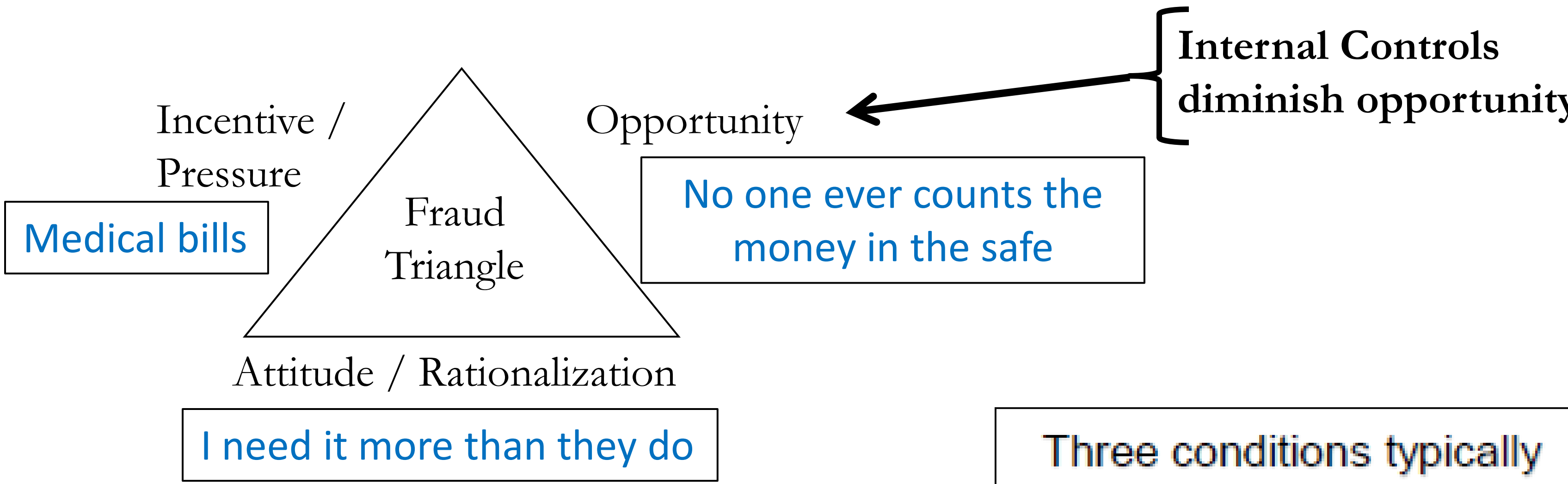
To minimize RISK.

What is risk?

The possibility that an organization will NOT:

- achieve its goals
- operate effectively and efficiently
- protect itself from loss (fraud)
- provide reliable financial data
- comply with laws and defined policies

How and Why Fraud Occurs



Three conditions typically present when fraud occurs:

- Incentives or pressures on management
- Opportunity exists (i.e., control weaknesses)
- Ability to rationalize and/or justify the perpetration

How do you determine if and where controls needed?

Document the Process!

1. Pick a method that suits the process: Flowchart or Narrative

2. Identify policies that impact the process; identify standards that may specify mandatory controls.

3. Identify process owner and activity owners

4. Identify the key inputs, activities, outputs, risk points

Points of Risk

Higher Risk Transactions

- Purchase of Goods
- Purchase of Services
- Cash Receipts
- Payroll operations
- Inventory operations

Critical Functions

- Authorizing transactions
- Reconciling transactions
- Custody of assets
- Recording transactions

Segregation of duties is a *preventive* control that aids in the timely detection of errors and irregularities in the normal course of business.

Key to Defeating Opportunity for Fraud:

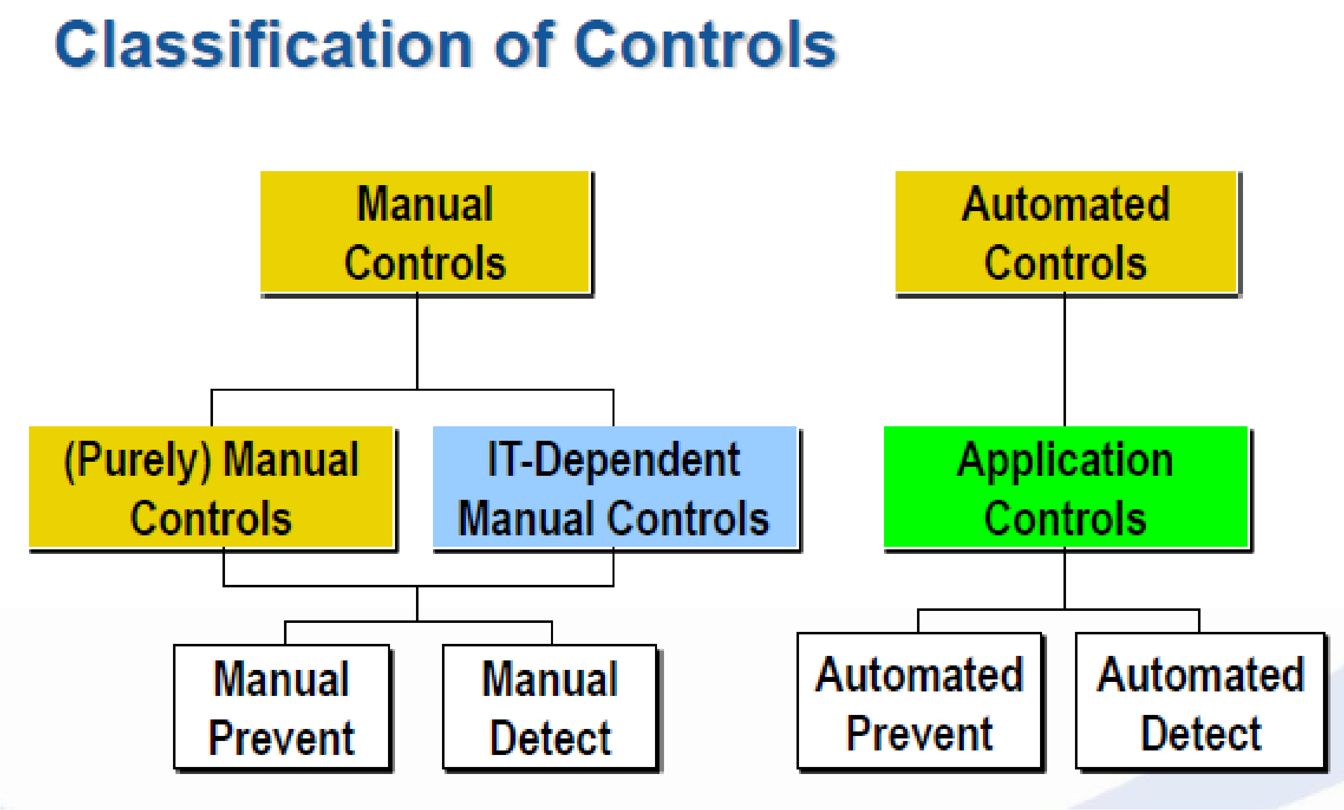
Divide key functions so that no one person has control over all parts of a transaction.

Entity-Level Controls

- Entity-level controls set the tone and establish the expectations of the organization's control environment, often referred to as "tone at the top".
  - Indirect: cross-functional and affect the achievement of the entity's control objectives in indirect, but important ways
    - Examples: hiring practices, training efforts, tone at the top, code of conduct or code of ethics
  - Direct: designed to have a specific and direct effect on the control objectives related to financial reporting elements
    - Examples: monthly reviews of operational results which measure performance and analytics (e.g., variance analysis)

Higher Level Controls designed to frame organizational behavior and performance

Design controls to mitigate identified risks



How to document a control: who, what, when, why, how

Internal Controls -Types to Consider

Policies and Procedures
Policies are rules established to reduce risk. A procedure is instruction that outlines a series of steps taken to ensure that an internal control is followed.

Education and Awareness Training
Methods used to periodically inform (e.g., job-specific training, faculty / staff meeting topics, orientation for new employees, email or web site information, simulations, newsletters, or postings).

Operational Controls
DOCUMENTATION that confirms a particular policy or procedure was followed (e.g., receipts, tracking for mandatory training, account reconciliations).
PHYSICAL or SYSTEM CONTROLS that are built-in (e.g., access controls such as keys, door locks, restricted space, computer passwords or programs, standardized contracts to ensure compliance with UW policy, or a system-edit that is a pre-established control that will activate when certain thresholds or events occur).
ADMINISTRATIVE CONTROLS refers to organization structure or the roles associated with a risk (e.g., segregation or division of duties, where different people authorize, record and/or handle a transaction process for it to be complete, competency reviews).

Oversight, Monitoring or Executive Controls
These controls refer to the individual, office, or persons who have been delegated responsibility to verify internal controls are used and effective:
REVIEW & DOCUMENTATION is the most common (e.g., a supervisor's initial on an account reconciliation, sampling or cross checking activities).
OBSERVATIONS / INSPECTIONS / INTERVIEWS formally or informally observe the control environment (e.g., scheduled or unscheduled inspections, surveys, or a walk-thru to observe activities).
TRACKING such as summary reports, longitudinal studies or trend analysis are all activities that track compliance indicators or breakdowns.
BENCHMARKING & PEER REVIEWS compares the quality and effect of controls in your risk area with another.

Audit Controls
Formal methods usually employed long after the fact, to analyze compliance. Audits may take the form of forensic analysis of documents, sampled transactions, or a variety of other methods.

Testing

A control is only a control if it works

A **walkthrough** traces **one** representative transaction through a process from beginning to end.

Ask the “what could go wrong?” question:

- What if the cash register breaks down?
- What if we run out of change?
- What if we can’t make the deposit today?

Develop and distribute written procedures describing operational guidelines

Mitigating controls when segregation of duties is lacking

In a small organization where the IS support may only consist of a few people, compensating control measures must exist to mitigate the risk resulting from a lack of segregation of duties. Mitigating controls might include:

- **Audit trails** : Audit trails are an essential component of all well-designed systems. They help by providing a map to retrace the flow of a transaction. They enable the ability to recreate the actual transaction flow from the point of origination to its existence on an updated file. In the absence of adequate segregation of duties, good audit trails may be an acceptable compensating control. It is desirable to be able to determine who initiated the transaction, the time of day and date of entry, the type of entry, what fields of information it contained, and what files it updated. Best Practice would also involve a process for regular review of audit trails.
- **Reconciliation**: Reconciliation is ultimately the responsibility of the user. In some organizations, limited reconciliation of applications may be performed by the data control group with the use of control totals and balancing sheets. This type of independent verification increases the level of confidence that the application ran successfully and that the data are in proper balance.
- **Exception reporting**: Exception reporting should be handled at the supervisory level and should require evidence, such as initials on a report, noting that the exception has been handled properly. Management should also ensure that exceptions are resolved in a timely manner.
- **Transaction logs**: A transaction log may be manual or automated. An example of a manual log is a record of transactions (grouped or batched) before they are submitted for processing. An automated transaction log or journal provides a record of all transactions processed, and it is maintained by the computer system.
- **Supervisory reviews**: Supervisory reviews may be performed through observation and inquiry or remotely.
- **Independent reviews**: Independent reviews are carried out to compensate for mistakes or intentional failures in following prescribed procedures. Such reviews will help detect errors or irregularities.

The never-ending journey

- Internal Controls are:
  - a means to an end, not an end in themselves.
    - ➢Promote Integrity and Ethical Behavior
    - ➢Display a commitment to competence
  - effected by an entity’s management and other personnel. Are not merely policy statements and procedure manuals, but people at every level of an organization.
  - pervasive throughout an organization, impacting all aspects of operations - people, process and technology.
  - expected to provide only reasonable assurance, not absolute assurance, to an organization’s management.

Any questions or comments, don't hesitate to call or write

UNC CHARLOTTE

Internal Audit Department

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Welcome

The Internal Audit Department was established at UNC Charlotte in September 1973 in response to a recommendation by the North Carolina Governor's Efficiency Study Commission that internal auditing be coordinated and expanded at all state universities. D. Ronald Whitley, a former state auditor, was hired as the first Internal Auditor for the University.

The Internal Audit Department serves the Board of Trustees and administrators of the University of North Carolina at Charlotte as an independent, objective assurance and consulting activity designed to add value and improve the University's operations. The Department assists the University in accomplishing its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, internal control, and governance processes.

Quick Links

- Report Fraud, Waste, & Abuse
- Internal Audit Standards
- Self Assessment of Internal Controls - Aug 2012
- Department Self Assessment Review Guide - Aug 2012
- Ethics
- Project Feedback
- The Basics of Internal Controls
- Segregation of Duties

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