

Internal Controls – The Basics

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Internal controls are specific policies and procedures designed to provide reasonable assurance that the goals and objectives of the organization will be met. Many government agencies mistakenly believe that their outside auditors are responsible for monitoring the effectiveness of internal controls when in fact the primary responsibility for maintaining internal controls falls on the government's management and governing body. In today's environment of high accountability expectations governments must ensure that public resources are protected and that financial information is reliable. Because of this emphasis on accountability, the internal control function has become a major area of accounting and having an effective control structure is one of the most significant steps an organization can take in preventing fraud. There are four essential components of an effective internal control structure: (1) the control environment, (2) risk assessment, (3) control activities, and (4) monitoring.

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(1) The *control environment* consists of the actions that reflect the overall behavior and attitude of management. If management behaves in a manner which reflects the importance of controls, employees are more likely to observe the controls established. Likewise, if management exhibits an attitude or behavior that indicates controls are not important, it will also reflect in the behavior of employees. Organizations can develop a strong control environment by evaluating the impact of the following:

Integrity and Ethical Values – these are a product of an organization's standards and how they are communicated. Exhibiting strong ethical values in the workplace encourages employees to behave more ethically. These values can be reinforced through management's example of proper behavior, ethics training, communicated behavioral standards, a written code of conduct, and the expectation of discipline for violating the standards.

Management's Philosophy – this sets the tone of the workplace. When management's expectations are set at an unrealistic level, employees are more likely to circumvent controls to avoid failure. Creating a positive work environment and a culture of openness, honesty and assistance increases compliance with controls.

(2) *Risk assessment* is an evaluation process in which management identifies areas of financial risk and designs internal

control procedures and policies to minimize errors and fraud. This typically involves reviewing financial functions such as cash receipting, disbursements, billing, and reporting. The level of controls put in place will be dependent upon the level of risk assigned to each function. Once the level of risk is determined, specific control activities can be developed.

(3) *Control activities* are the specific policies and procedures that help ensure the identified risks are minimized. Although there are potentially hundreds of control activities in any one organization they typically fit into the following general categories:

Adequate Segregation of Incompatible Duties – an incompatible duty is one that would put a single individual in the position of being able to both commit an irregularity and then to conceal it. A good example of incompatible duties would be a single employee issuing checks and preparing the bank reconciliation.

In some situations such as small offices with only one or two employees, complete segregation of incompatible duties is not always possible. In these cases other control methods can be utilized such as secondary authorizations for issuing checks, periodic rotation of duties, and periodic reconciliations by management.

Proper Authorization of Transactions – every transaction should be properly authorized if controls are to be effective. General authorizations are policies management has established for the organization to follow. Employees are instructed to implement these policies within the limit of the authorization. For example, if utility customers are required to pay a deposit for services but this requirement can be waived if they provide proof of good payment history with another utility company, the utility clerk is operating under a general authorization to waive the deposit when a certain criteria is met. Specific authorization involves individual transactions such as equipment purchases or sale of an asset.

Adequate Documents and Records - Documents and records perform the function of transmitting information throughout the organization and between different organizations. Their use and control should be adequate enough to provide reasonable assurance that all assets are properly controlled and all transactions are correctly recorded. Certain documents are more relevant to financial transactions and require a higher degree of control. For example, cash receipts should be pre-numbered consecutively to prevent misuse.

(4) *Monitoring activities* deal with the ongoing or periodic assessment of internal control environment and its effectiveness. Although internal controls are designed to provide a reasonable level of assurance they are not infallible. Continued monitoring and revising is necessary to maintain the minimum level of assurance through independent checks on performance. Information for assessment and revision can come from a variety of sources including studies of existing controls, auditor reports, feedback from employees, management observation, and customer complaints.

Although the internal control function is a very important component of accounting it can never be regarded as 100% effective in preventing all fraud. Maintaining an effective control structure requires a high degree of evaluation, communication, and monitoring to ensure reasonable assurance that financial integrity is maintained at an acceptable level within the organization.

WAM's sincere thanks to Leslie Brumage for writing this article for us!

