

## INTERNAL CONTROLS

Dave Tate, CPA, Esq.  
<http://davidtate.us>

Author's Note: The majority of the materials provided below were originally written several years ago before internal controls started receiving the notice that they are now receiving because of Sarbanes-Oxley Section 404, and other developments. However, the primary materials were based on the COSO framework, and are arguably more timely today than when originally written. Internal controls always have been very important; however, Sarbanes-Oxley, and the SEC regulations do not specify a particular internal control framework, but, instead, state that each entity must adopt the internal control framework that is most appropriate for that entity. Of course, that lack of specificity might not be realistically workable within the accounting/auditing profession, for the companies as they work toward satisfy legal requirements, or for shareholders who want transparency, comparability, and reasonable assurance.

The following is a simple chart that provides a possible layout for risk evaluation and corresponding controls:

	Control 1	Control 2	Control 3	Control 4, etc.	Likelihood of Breach	Magnitude of Breach
Risk 1						
Risk 2						
Risk 3						
Risk 4, etc.						

Internal accounting controls and fraud prevention are receiving increasing attention from businesses, nonprofit organizations and governmental entities. The management of every enterprise that has financial transactions is dependent on reliable and timely accounting and financial information for decision-making purposes. No enterprise can exist for long without appropriate internal accounting controls.

### INTERNAL CONTROL COMPONENTS

The accounting function significantly depends on the senior manager's ability to receive timely, competent, and complete accounting information. For this reason, internal control is the first and primary element of the accounting system. The importance of internal control cannot be overemphasized. An analysis of internal control helps quantify the extent to which the accounting records of the enterprise can be relied upon. Internal

control is one of the first areas that a CPA evaluates before beginning what is generally considered the substantive portion of the audit process.

Internal control is designed to provide reasonable, cost-effective assurance of safeguards against unauthorized access to or use of the enterprise's assets, that the financial records and accounts are sufficiently reliable for reporting and management purposes, and of compliance with applicable laws and regulations. Management of the business is responsible for the design and operation of the accounting, reporting and internal control systems of the business--the independent auditors may express an opinion on various aspects of the business's systems, but management remains responsible for those systems.

Internal control can only provide reasonable assurance of achieving the business's internal control objectives--internal control can be breached by unintentional noncompliance or neglect, management override, intentional noncompliance, or collusion.

The American Institute of Certified Public Accountants Statements on Auditing Standards recently adopted the definition and description of internal control contained in the report of the Committee of Sponsoring Organizations of the Treadway Commission (the COSO report). Internal control is comprised of five primary components: control environment, risk assessment, control activities, information and communication, and monitoring.

### Control Environment

Control environment primarily relates to the enterprise's politics, management philosophy, structure, method of assigning authority and responsibility, and operating style. From an accounting point of view, the optimum enterprise environment is one in which management and employees are knowledgeable and exhibit honesty and integrity; there is a regular flow of information both up and down the corporate structure; teamwork is emphasized at all levels; employees receive regular evaluation, education and training, have access to and consult with necessary resources, use good judgment, are properly supervised, complimented, or rewarded when appropriate and warranted and commensurately compensated; voluntary recognition of mistakes is encouraged and considered part of the solution process; employees are fairly reprimanded in confidence; there is a commitment to competence, integrity and ethical values; and the board of directors actively and objectively performs its duties. Those policies will substantially increase the integrity of the accounting system. In the alternative atmosphere, the likelihood of error, misinformation, and cover-up in the accounting system is substantially increased. Of course, it is possible, given a particular circumstance, that any one of the above-listed policies may not be the best course of action from an enterprise viewpoint and should not be followed at a particular time; nevertheless, those policies should remain in overall practice to maintain the integrity of the accounting system.

## Risk Assessment

Risk assessment includes the identification, analysis, and management of risks relevant to the preparation of proper financial statements that are fairly presented in conformity with Generally Accepted Accounting Principles. Possible risks might include internal or external factors that may adversely affect the business's ability to appropriately record, process, summarize, and report all financial occurrences and data. Management must consider the significance or magnitude of identified risks, the likelihood that the risk will occur, and how the possibility of risk should be managed, or whether to accept certain risk levels because of cost or other considerations.

Risk can arise from an unlimited number of possible circumstances. In fact, it is impossible to eliminate all internal control risks, let alone attempt to eliminate all risks cost effectively. Statement on Auditing Standards 78, amending SAS 55, identifies the following circumstances as possibly causing an increase or change in internal control risk: changes in regulatory or operating environment; new personnel with different focus on internal control; changes in information systems; rapid business expansion; new lines, products, activities or technologies; corporate restructuring (including changes in management or staff reductions); expansion or acquisition of foreign operations; and new or changes in accounting principles.

## Control Activities

Control activities are the policies and procedures that help ensure that management directives are carried out, such as financial performance reviews, information processing (to check the accuracy, completeness, and authorization of transactions), physical controls (primarily to safeguard assets from theft or loss), and segregation of duties (such as between persons who are responsible for authorizing and recording transactions, and maintaining custody of assets). For example, broad policies and procedures may include:

1. Adoption of a documented hierarchical structure of authority and responsibility within the enterprise and the accounting/financial function.
2. Required receipt of informed authorization for specific transactions and activities.
3. Segregation of duties and responsibilities within the transactional process.
4. Design and use of adequate transaction documents and records.
5. Maintenance of secured and limited access facilities.
6. Periodic independent verification, testing, or investigation of the operations of the accounting records and internal control system.

## Information and Communication

Information and communication refers to the methods and records established to accurately, completely, and timely identify, classify, value (or revalue), record (including in the proper period), process, summarize, and report all entity transactions, events and conditions, and to maintain accountability for the assets, liabilities, and equity.

## Monitoring

Monitoring refers to the long-term assessment of the design and operation of internal control performance on a regular and timely basis, and taking corrective actions.

## AUDIT/EVALUATION OF INTERNAL CONTROLS

An audit of the financial statements is not an audit of internal control. However, the independent auditor may give a report to management or the board of directors evaluating internal control within the limitations of the audit procedures performed on internal control during the enterprise's financial audit; that is, during the audit, the internal control system, although not specifically audited, is evaluated to determine the extent to which it may be relied on by the auditors. The independent auditor can also be specifically engaged to perform an audit of internal control. However, AICPA AU Section 642.12 and AICPA Statement on Standards for Attestation Engagements No. 2 provide that an auditor's opinion on management compliance with laws, regulations, rules, contracts or grants does not provide a legal determination of that enterprise's compliance. That same proposition may be extended to hold that an audit of internal control does not provide assurance of a enterprise's compliance with any legal standard or requirement relating to internal control. However, an accountant performing an audit is required to include procedures designed to provide reasonable assurance of detecting material fraud and irregularities.

## INTERNAL CONTROL SAFEGUARDS

Many accounting resources provide extensive lists or charts of possible internal control safeguards. Those resources are helpful and may be consulted for suggestions and to save time when developing or reviewing a enterprise's internal control system. However, it is more beneficial to understand the basic concept of internal control: to have different employees perform different key duties or activities in the transactional process to prevent mistakes and intentional breaches. A not uncommon breakdown of internal control safeguards occurs when a bookkeeper is given responsibility for recording transactions in the accounting records, has access to checks, and has bank statement reconciliation duties, thus allowing the bookkeeper to forge checks without detection. Proper internal controls would have at least required that the bank statement reconciliation be performed by a person other than the bookkeeper and that a person other than the bookkeeper

routinely justify a sampling of the checks written by reviewing supporting documentation such as bills and expense vouchers.

The transactional process generally can be divided into five broad functional areas, each of which should, if possible, be staffed by employees who are independent of the other functional areas:

1. The transaction. For example, the sale of merchandise by a clerk.
2. Authorization. For example, credit department or other approval when required by the enterprise's policies.
3. Accounting recordation.
4. Asset custody. For example, cash, checks, or inventory custody.
5. Verification/reconciliation. For example, intra-departmental account reconciliation and/or verification by independent personnel such as internal auditors.

An enterprise may not have sufficient personnel to permit different employees to perform each of the five functional areas. In that circumstance, the enterprise should attempt to achieve maximum employee independence within the functional areas, and depend more heavily on the fifth function, verification/reconciliation, and analytic procedures designed to compare significant fluctuations in account balances between the accounting period for which the review is being prepared and prior periods, and previously developed budgeted targets.

Most of the specific personnel duties within the transactional process generally can be classified into the following activity areas:

- General ledger
- Cash receipts
- Cash disbursements
- Sales
- Purchasing
- Credit
- Billing
- Payroll
- Shipping
- Internal control/internal auditors
- Receiving
- Accounts receivable
- Accounts payable

- Mail
- Banking deposits
- Banking reconciliation
- Payroll delivery
- Petty cash
- Personnel
- Asset/cash custodian
- Inventory
- Management authority

Rather than completely relying on lists or charts of possible internal control safeguards, for any given transaction it is possible to trace the transactional process and to staff personnel so that broad functional areas and key personnel duties or activities are performed by independent/different personnel.

A typical sales transaction may involve the following personnel activities:

- Credit
- Sales
- Accounts receivable
- Inventory/shipping
- Billing
- Mail
- Collections/cash receipts
- Bank deposits
- Bank reconciliation

A typical purchase transaction may involve the following personnel activities:

- Purchasing
- Accounts payable
- Receiving
- Inventory
- Cash disbursements
- Bank reconciliation

A typical payroll transaction may involve the following personnel activities:

- Personnel
- Payroll
- Cash disbursement/check preparation
- Payroll delivery
- Bank reconciliation

For the sales, purchase, and payroll transactional process just described, each personnel activity should, if possible, be performed by a different employee. Cash custody personnel should be independent of general ledger, accounts receivable, accounts payable, cash disbursements, cash receipts, and banking personnel. General ledger personnel should at least be independent of cash custody, cash receipts, and cash disbursements personnel and as many other employees performing activities in the transaction process as possible. Employees responsible for making bank deposits should be independent of cash custody, cash receipts, cash disbursements, and bank reconciliation personnel.

In some enterprises, such as small- and medium-sized enterprises, it is more likely there may be insufficient personnel to allow the various activities to be performed by the most advised number of independent personnel. In that circumstance the enterprise should attempt to achieve maximum separation of activities with the employees available and may consider hiring additional personnel if it is deemed necessary. As maximum separation of activities becomes less possible, more emphasis must be placed on documentation, limiting unnecessary personnel access to facilities/assets, transactional and asset custody authorization, intradepartmental reconciliations, and independent verifications by internal auditors or other sources.

Each enterprise must analyze its particular internal control needs and requirements. Although the following list does not include all possible safeguards, and in fact the number of possible safeguards is endless, the list includes many of the important safeguards and, more importantly, in conjunction with the previous discussion, provides a reference that you can apply to most any internal control situation. The list also should be considered in conjunction with the fraud discussion.

#### 1. General Safeguards

- a. The enterprise maintains an organizational chart of personnel and a chart of accounts.
- b. The enterprise has adopted and documented its ethics and policies, and the responsibilities and authority of each significant participant or group of participants in the accounting and internal control system.
- c. Procedures have been adopted and documented safeguarding access to and storage of the accounting records, including computerized records.
- d. The enterprise has adopted procedures for testing and investigating the integrity and reliability of its accounting and internal control systems (including the use of individuals outside the enterprise, such as attorneys, when necessary for independence or confidentiality purposes with respect to discovery by outside third-party persons, entities, or agencies, or people inside the enterprise).

- e. The enterprise requires preventative pretransactional due diligence in all appropriate situations to help avoid later disputes or unexpectancies.
- f. Transactions between the enterprise and related parties (e.g., management, owners, the immediate families of management and owners, and other persons or entities that can significantly influence the management or policies of the enterprise) receive appropriate authorization and are conducted at arm's length similar to transactions between the enterprise and unrelated parties.
- g. Employees who handle cash, checks, securities, and other valuables are bonded.
- h. Employee functions and duties are regularly rotated; vacations are enforced.
- i. Budgets are used and at least significant deviations from those budgets are investigated.
- j. Adjusting and special accounting journal entries require approval or at least are routinely reviewed by independent personnel.
- k. To the extent possible, management has knowledge of the employees who participate in the various accounting functions and their relationships to other employees in those functions.
- l. When a corporation owns or controls 20 percent or more of another corporation, including a foreign corporation, and also perhaps in some circumstances when the corporation owns or controls less than 20 percent of another corporation, the owning or controlling corporation investigates the internal control of the owned or controlled corporation to ensure that the internal control satisfies the provisions of the Foreign Corrupt Practices Act.
- m. The enterprise employs an in-house public relations person who is the only designate responsible for public disclosures, except in special or limited circumstances. Further, each time the enterprise makes a statement of opinion interpreting or estimating its existing or expected future financial situation, that statement first must be evaluated and approved by designated, competent, and knowledgeable personnel or professional advisors.
- n. Accounting policies and practices relating to accounting areas in which material errors or irregularities tend to occur, such as with respect to estimates, contingencies, reserves, allowances, returns, expense deferrals, revenue accruals and whether the earnings process is complete, inventory, off balance sheet entities and transactions, unusual transactions, period cutoff procedures, and related party transactions are designed, implemented, approved and reviewed or reconciled by designated, competent, and knowledgeable personnel.

#### INTERNAL CONTROLS

## 2. Cash Receipts and Disbursements Safeguards

- a. Personnel who open the mail place restrictive endorsements on checks and make a list of cash, checks, and other payments received.
- b. The list referred to in Item 2a is verified against daily deposit slips and the cash receipts journal.
- c. Prenumbered receipts or other transactional documentation records are prepared for cash sales, and cash sales are reconciled daily with cash collections and receipts records.
- d. Personnel independent of the sales, accounts receivable, and cash functions review customer discounts and allowances.
- e. Expense and other payments (other than payments from petty cash) are made by prenumbered check.
- f. Checks are signed by an appropriately authorized person who is independent of the employee(s) who prepares the checks.
- g. Payments are made only if a check or a request for payment from petty cash is accompanied by supporting documentation and the documentation then is marked as paid.
- h. Petty cash and check disbursements above specified amounts require approval.
- i. Payments from petty cash, as all other payments, are, in some manner, recorded on prenumbered slips.
- j. Petty cash fund balances are small, requiring frequent reimbursement.
- k. Access to and authority over company credit card use is strictly controlled. Credit card bills are routinely reconciled with supporting vouchers and bills.

## 3. Receivables: Notes and Accounts Safeguards

- a. Notes require proper authorization.
- b. The notes custodian is independent of the cashier and other accounts receivable personnel.
- c. An aging of accounts is maintained and reviewed by an employee who is

independent of credit and accounts receivable personnel.

d. Write-offs and prenumbered credit memoranda require approval by a designated employee who is independent of the credit manager and accounts receivable personnel.

e. Employee advances require authorization.

#### 4. Inventory Safeguards

a. Inventory access is limited to authorized personnel and, when necessary, is controlled by a documented log.

b. Inventory receiving, issuance, and shipping reports are maintained.

c. Inventory records are maintained by personnel who do not have access to the inventory.

d. Physical inventories with the use of prenumbered tags are taken by personnel who are independent of inventory personnel.

#### 5. Securities/Investments Safeguards

a. Securities are stored in a vault that requires at least two authorized persons for access.

b. A log is maintained of all persons visiting the vault.

c. A log of securities placed in and taken out of the vault is maintained by personnel who are independent of personnel who have access to the vault.

d. Prenumbered vault deposit and withdrawal vouchers are required.

e. Physical securities inventories are taken periodically by personnel who do not have access to the vault or the vault records.

f. The securities custodian is independent of the securities records, general ledger, and cash receipts and disbursements functions.

#### 6. Property, Plant, and Equipment Safeguards

a. Purchases, retirements, and dispositions of property or equipment require authorization, and a work order or voucher system is maintained for such.

- b. A record is kept of assets assigned for use by employees, and that record is periodically verified by physical confirmation.
- c. Property and equipment inventories are taken periodically by employees who do not have access to inventory records.

#### 7. Payables: Notes and Accounts Safeguards

- a. Significant borrowing is approved by management and requires at least two signatures.
- b. An employee who does not have authority to sign checks or notes keeps the payables register.
- c. Paid notes, interest coupons, bonds, and other documents indicating a liability are marked as canceled or paid.
- d. Account payable adjustments or corrections require approval.

#### 8. Capital Securities Safeguards

- a. A registrar and a transfer agent, both of whom are independent of the enterprise, are employed to control capital stock custody, transfers, and dividend payments, or those duties are assigned to a designated officer.
- b. Surrendered or retired certificates are canceled.
- c. Corporate stamps and seals are controlled by a designated officer.

#### 9. Sales, Shipping, and Receiving Safeguards

- a. Sales orders, sales invoices, and shipping memoranda are prenumbered.
- b. All sales orders, or those above a specified amount, are approved by designated personnel.
- c. The receiving department prepares prenumbered receiving reports.
- d. Prenumbered credit memoranda are prepared for returns and require appropriate approval.
- e. Sales to employees are handled in the same manner as sales to customers (e.g., they receive no special treatment, unless appropriately authorized).

10. Purchases Safeguards

- a. Purchase orders and invoices are prenumbered.
- b. Purchase orders and invoices, or those above a specified amount, require approval.

11. Payroll Safeguards

- a. Payroll is periodically verified with personnel records by employees who are independent of payroll.
- b. Payroll is signed by the payroll employee preparing it and authorized or approved by a designated officer, or it is prepared by the payroll department and signed by a designated officer.
- c. Employees are paid by check.

---

The information provided herein does not provide legal, accounting or other professional advice, does not constitute solicitation for or engagement of services inside or outside of California, and does not apply to any particular person, entity or circumstance. This material is a summary of information, is not an exhaustive reference source, and is subject to modification at any time. You should not rely on the information contained herein, and I specifically disclaim liability for information contained herein. You should seek appropriate professional advice if you are involved in a situation that relates to these or similar issues.

\* \* \* \* \*