Chapter 7 – Internal Controls

Establishment of and adherence to *internal controls* is a major part of managing an organization. Internal controls serve as the first line of defense in safeguarding assets and preventing and detecting errors and fraud.

The United States General Accounting Office provides this definition:

Internal Control is an integral component of an organization's management that provides reasonable assurance that the following objectives are being achieved:

- Effectiveness and efficiency of operations, including the use of the entity's resources
- Reliability of financial reporting, including reports on budget execution, financial statements, and other reports for external and internal use
- Compliance with applicable laws and regulations
- A subset of these objectives is the safeguarding of assets.

Objectives of Internal Control and Audit Program

Objectives of an internal control and audit program for MWR/Services include determining whether:

- Financial reports are accurate, reliable, and fairly present the financial position of the program.
- The organization is maintaining effective internal controls.
- The accounting system used is providing reliable information and recording financial transactions accurately.
- Adequate safeguards exist to protect cash, inventories, and other assets.
- Accounting procedures are in accordance with accepted accounting policies and regulations.
- Sound management practices have been established and are being followed.

Fundamental Concepts of Internal Control

Internal control:

1. Is a continuous built-in component of operations.

Internal control is not one event, but a series of actions and activities that occur throughout an entity's operations and on an ongoing basis.

2. Is affected by people.

People are what make internal control work. Managers set the objectives, put the control mechanisms and activities in place, and monitor and evaluate the control. However, all personnel in the organization play important roles in making it happen.

3. Provides *reasonable* assurance, not *absolute* assurance.

Human mistakes, judgment errors, and acts of collusion to circumvent control can affect meeting objectives. Management should design and implement internal control based on the related cost and benefits.

The Five Standards for Internal Control

These standards, promulgated by the Comptroller General, define the minimum level of quality acceptable for internal control in government and provide the basis against which internal control is to be evaluated.

1. Control environment

Management and employees should establish and maintain an environment throughout the organization that sets a positive and supportive attitude toward internal control and conscientious management. A positive control environment is the foundation for all other standards.

Factors Which Affect the Control Environment of an Organization

- The integrity and ethical values maintained and demonstrated by management and staff
- Management's commitment to competence in human resources
- Management's philosophy and operating style, including the accepted degree of risk
- The organizational structure of the activity/program
- The manner in which authority and responsibility are delegated throughout the organization
- Good human capital policies and practices throughout the human resource environment
- The organization's relationship with supervisors and higher headquarters

2. Risk assessment

Internal control should provide for an assessment of the risks the organization faces from both external and internal sources. A precondition to risk assessment is the establishment of clear, consistent objectives.

3. Control activities

Internal control activities help ensure that management's directives are carried out. The control activities should be effective and efficient in accordance with the organization's control objectives. Control activities are the policies, procedures, techniques, and mechanisms that enforce management's directives.

Examples of Control Activities

- Top level reviews of actual performance
- Reviews by management at the functional or activity level
- Management of human capital
- Controls over information processing
- Physical control over vulnerable assets
- Establishment and review of performance measures and indicators
- Segregation of duties

- Proper execution of transactions and events
- Accurate and timely recording of transactions and events
- Access restrictions to and accountability for resources and records
- Appropriate documentation of transaction and internal control
- Specific control activities for information systems

4. Information and communications

Information should be recorded and communicated to management and others within the entity who need it and in a form and within a time frame that enables them to carry out their internal control and other responsibilities. For an organization to run and control its operations, it must have relevant, reliable, and timely communications.

5. Monitoring

Internal control monitoring should assess the quality of performance over time and ensure that the findings of audits and other reviews are promptly resolved. Monitoring occurs continually, ingrained in the organization's daily operations.

Audit Program

Monitoring is often accomplished through an audit. Internal and External Audits are key in preventing fraud, waste, and abuse. Basic principles of such a program include:

- Responsibilities of employees must be fixed and clearly defined.
- Accounting and operation functions must be separated.
- Internal checks and balances are necessary. No one person should be in charge of a complete business transaction.
- Physical inventories of merchandise, supplies, and fixed assets should be taken periodically by independent individuals.
- Employees should be carefully selected, trained, and supervised to discourage collusion.
- A double entry system is not a substitute for internal accounting control.
- Operating instructions should be available in written form to prevent misunderstanding.
- Whenever a transaction occurs, some record must be created.
- Examination by independent audit personnel, including periodic audits, surprise cash counts, and other visible forms of review are essential to establish a "control conscious" attitude on the part of employees.

Once an audit is complete, managers must promptly determine proper actions in response to findings and recommendations, and then complete such actions within an established time frame.

Common Fraud Methods

Fraud can be perpetuated in a wide variety of ways, which are ever expanding and changing. We cannot hope to cover all circumstances in this guide. However, some more common include:

Failure to account for cash receipts by:

- Failure to record sales on cash register or pre-numbered sales slips
- Altering or voiding cash register totals or sales slips totals
- Failure to record receipts received from sources not controlled by cash registers
- Falsifying the bank statement and bank reconciliation to cover up a shortage
- Abstracting checks received and forging endorsements
- Writing off good account receivable to bad debts and retaining cash and receipts when collected

Making of fraudulent disbursements by:

- Forging approvals on petty cash vouchers and attaching dummy invoices
- Drawing checks in payment of fictitious invoices
- Forging checks, cashing them, and destroying the records
- Re-using paid invoices of previous periods
- Understating purchase discounts
- Over footing the cash disbursement book to cover a cash shortage
- Padding payrolls with dummy employees
- Charging personal expenses to MWR/Services

Conversion of merchandise by:

- Removing merchandise from premises because of inadequate safeguards
- Checking in correct merchandise, but putting lesser amount in stock
- Charging merchandise to a department, but not delivering
- Collecting deposits on returnable containers without recording income
- Over counting inventories to cover shortage
- Raising quantities on requisitions after delivery of merchandise
- Selling property without recording the cash received
- Changing sell prices on merchandise without documentation
- Charging for one item when several were actually removed from inventory

Managers must be aware of these various methods of fraud so as to know whether their internal controls will help prevent such occurrences.

Key Internal Control Terms

Annual Statement of Assurance – an annual report in memorandum format, providing a broad assessment of internal controls within the organization.

Area of Concern – a problem with internal controls that does not meet the criteria of a *material weakness,* and will be corrected internally by the identifying organization.

Comptroller General or GAO Standards – the five principles (see above) issued by the Comptroller General to be applied to all Federal managers in developing, establishing, and maintaining internal controls.

Fraud – any intentional violation of directives and policies or conscious deception that adversely affects the interest of MWR/Services. Losses resulting from fraud do not solely impact MWR/Services assets, but include the loss of productive time, and lower the effectiveness of the operation.

Internal Control Plan – the written plan that describes how and when an organizational unit will conduct required formal internal control evaluations.

Internal Control Weakness – a deficiency in an organization's process, function, or procedure that could lead to harm (e.g., waste, fraud or abuse of resources; unwanted media attention; safety concerns; hampered mission; etc.), but is not considered systemic or of headquarters-level significance.

Key Internal Controls – the essential rules, procedures, and techniques that must be executed and sustained within daily operations to ensure the organization operates safely, efficiently, and effectively, in compliance with laws and regulations, and without unreasonable risk of significant harm.

Material Weakness – a deficiency in an organization's process, function, or procedure that is systemic and could lead to severe harm (e.g., waste, fraud, or abuse of resources; media scandal and damage to an organization's credibility; accident, injury, or death; and mission failure). The weakness must be out of the organization's capability or jurisdiction to fix and warrant the action of the next level of command.

Reasonable Assurance – the minimum level of quality acceptable for an internal control system. *Absolute* assurance does not exist, nor can any organization afford to seek absolute assurance in every function. Reasonable assurance is a management judgment within the bounds of common sense, experience, education, and training.

Risk Assessment – an analysis to identify the significance or likelihood of a problem occurring and its probable impact. Managers decide how to manage risk, and identify specific actions to be taken to minimize or deter unwanted occurrences. The greater the risk, the greater the need for effective controls.

Statutory Requirements – The Federal Manager's Financial Integrity Act of 1982 requires that all managers implement adequate controls to prevent fraud, waste, and mismanagement of government resources. It further requires implementation of the *Comptroller General Standards.*

Validation – a process used to certify that all corrective actions were completed, justifying the closure of an *internal control weakness.*

Summary Chapter 7

Internal control is a major part of managing an organization, and effective internal controls are mandated by the United States General Accounting Office. There are three fundamental concepts of internal control and they are that it is a continuous built-in component of operations, it is affected by people, and it provides reasonable assurance, not absolute assurance.

The five standards for internal control, as promulgated by the Comptroller General, are:

1. Control environment
2. Risk assessment
3. Control activities
4. Information and communication
5. Monitoring