University Audit and Compliance

Internal Controls
Enterprise-Wide Risk Assessment
In order to achieve goals and objectives, management needs to effectively balance risks and controls.

Control procedures need to be developed so that they decrease risk to a level where management can accept the exposure to that risk.
In order to achieve a balance, internal controls should be:

- Proactive
- Value-added
- Cost-effective
- Address exposure to risk
Balancing Risk and Controls

Being out of balance, as it relates to financial and compliance goals, can cause the following problems:

<table>
<thead>
<tr>
<th>Excessive Risks</th>
<th>Excessive Controls</th>
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</thead>
<tbody>
<tr>
<td>Loss of assets, donor, grant</td>
<td>Increased bureaucracy</td>
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<tr>
<td>Poor business decisions</td>
<td>Reduced productivity</td>
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<tr>
<td>Non-compliance</td>
<td>Increased complexity</td>
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<tr>
<td>Increased regulations</td>
<td>Increased cycle time</td>
</tr>
<tr>
<td>Public scandals</td>
<td>Increase of no-value added activities</td>
</tr>
</tbody>
</table>

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# The Internal Control Mystique

<table>
<thead>
<tr>
<th>Myth</th>
<th>Fact</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Internal control starts with a strong set of policies and procedures.</td>
<td>• Internal control starts with a strong control environment.</td>
</tr>
<tr>
<td>• Internal control—that’s why we have internal auditors.</td>
<td>• Management is the owner of internal control.</td>
</tr>
<tr>
<td>• Internal control is a finance thing. We do what the Controller’s Office tells us to do.</td>
<td>• Internal control is integral to every aspect of the business.</td>
</tr>
</tbody>
</table>

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The Internal Control Mystique

Myth

• Internal controls are a necessary evil. They take time away from our core activities—serving students, research, health, football.

• Internal controls are a list of “thou shalt nots.”

Fact

• Internal controls should be built into, not on to business processes.

• Internal control makes the right things happen the first time, and every time.
The Internal Control Mystique

**Myth**

• If controls are strong enough, we can be sure there will be no fraud, and financial statements will be accurate.

**Fact**

• Internal controls provide reasonable, but not absolute assurance that objectives will be achieved.
COSO

• Committee of Sponsoring Organizations of the Treadway Commission (COSO)
  – A private sector initiative established in 1985 by five financial professional organizations:
    o American Accounting Association
    o AICPA
    o Financial Executives Institute
    o IIA
    o Institute of Management Accountants
COSO’s goal:

- To improve the quality of financial reporting by focusing on corporate governance, ethical practices, and internal control.

  - Establishes a common definition of internal control
  - Provides a standard by which organizations can assess and improve their control systems.
COSO defines internal control as a process affected by an entity’s board of directors, management and other personnel, and designed to provide reasonable assurance regarding the achievement of objectives in the following categories:

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

Fundamental concepts:

• Internal control is a process.
• It’s a means to an end, not an end in itself.
  – Geared toward the achievement of objectives
• Internal control is affected by people at every level.
  – Not merely policy manuals and forms
• Provides reasonable, not absolute assurance.
Key Components

Five Key Components of the Internal Control System:

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

• First line of defense is to mitigate risks
• Build control-consciousness throughout the organization’s culture.
  – Philosophy & operating style
  – Commitment to integrity & ethical values
  – Competency
  – Authority & responsibility
  – Organization & development
Risk Assessment - ERM

Impact to business objectives:

- Strategic – high-level goals, aligned with and supporting its mission
- Financial – safeguarding assets
- Operational – processes that achieve goals
- Compliance – laws & regulations
- Reputation – public image
Control Activities

Actions, supported by policies and procedures that, when carried out properly and timely, manage or reduce risks.

- Approvals
- Verifications
- Segregation of duties
- Performance reviews
- Authorizations
- Reconciliations
- Security of assets
- Information system controls
Control Activities

Controls can be either preventive or detective:

• Preventive – attempt to deter or prevent undesirable events from occurring.
  – Separation of duties, approvals, proper authorization, adequate documentation, physical control over assets.

• Detective – attempt to detect undesirable acts.
  – Provide evidence that a loss has occurred.
  – Reviews, variance analyses, reconciliations, physical inventories, and audits.
Information and Communication

All organizations must identify, capture, and communicate pertinent information in a form and timeframe that enables people to carry out their responsibilities.
Monitoring

Effective monitoring consists of:

• Ongoing monitoring
• Separate evaluations
• Reporting deficiencies
Monitoring

• Confirms that all 5 components are in place, properly designed, and functioning effectively.

• We can reduce the cost of monitoring by building it into processes.
What is an “effective” system of controls?

✓ Emanates from an ethical tone at the top.
✓ Policies & procedures are in place, understood, and followed.
✓ Organization-wide commitment to strong internal controls, effective risk management, and to meeting expectations of all stakeholders.
Limitations

Internal controls cannot ensure success.

• Bad decisions
• Poor managers
• Unethical behavior
• Collusion
• Override of controls
• Competition