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INTERNAL CONTROLS

Enterprise-Wide Risk Management

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Balancing Risk and Controls

- 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.

Balancing Risk and Controls

In order to achieve a balance, internal controls should be:

- ✓Proactive
- ✓Value-added
- ✓Cost-effective
- ✓Address exposure to risk

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

Balancing Risk and Control

Excessive Risks	*Excessive Controls*
Loss of assets, donor, grant	Increased bureaucracy
Poor business decisions	Reduced productivity
Non-compliance	Increased complexity
Increased regulations	Increased cycle time
Public scandals	Increase of no-value added activities

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The Internal Control Mystique

Myth	*Fact*
Internal control starts with a strong set of policies and procedures.	Internal control starts with a strong control environment.
Internal control—that's why we have internal auditors.	Management is the owner of internal control.
Internal control is a finance thing. We do what the Controller's Office tells us to do.	Internal control is integral to every aspect of the business.

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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.

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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.

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COSO

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

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COSO

COSO's goal:

- To improve the quality of financial reporting by focusing on corporate governance, ethical practices, and internal control.
- In 1992, published *Internal Control—Integrated Framework*.
  - Establishes a common definition of internal control
  - Provides a standard by which organizations can assess and improve their control systems.

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Definition

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:

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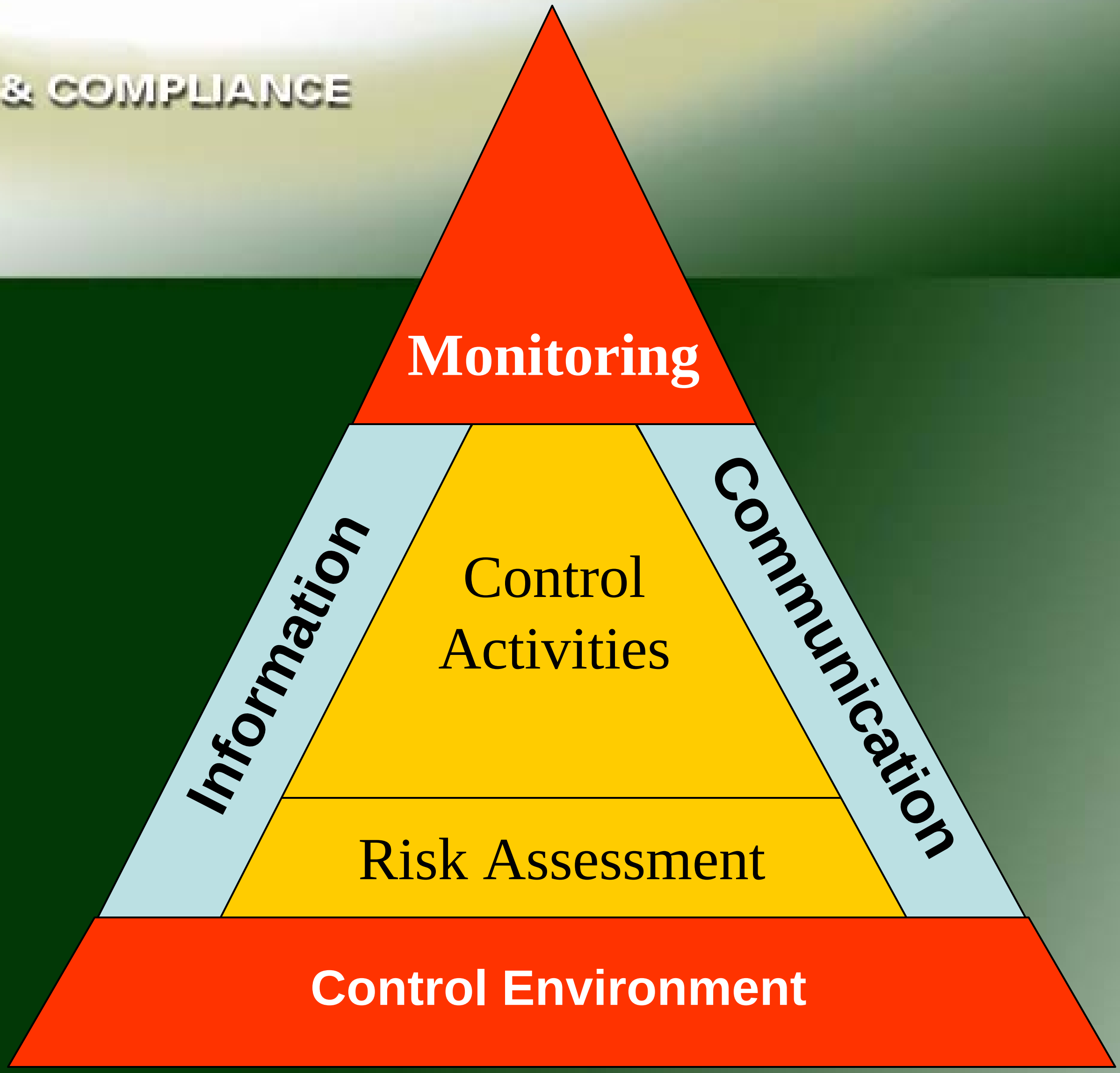
Monitoring
Information
Control Activities
Communication
Risk Assessment
Control Environment

Definition

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

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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.

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Key Components

5 Key Components of Internal Control System:

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

Control Environment

- First line of defense to mitigate risks
- Build control-consciousness throughout the organization's culture.
  - Philosophy & operating style
  - Commitment to integrity & ethical values
  - Competency
  - Authority & responsibility
  - Organization & development

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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

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Control Activities

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

- Approvals
- Authorizations
- Verifications
- Reconciliations
- Segregation of duties
- Security of assets
- Performance reviews
- 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.

Control Activities

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

Information & 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.

Success Factors

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