

# Internal Control Systems



# What are Internal Controls?

- Internal Controls are a set of rules, policies, and procedures a municipality can implement to provide reasonable assurances that:
  - its financial reports are reliable,
  - its operations are effective and efficient, and
  - that its activities comply with applicable laws and regulations.



These objectives can be classified  
as the main objectives of an  
Internal Control System



# Who is responsible for Internal Control Systems?

- The governing body and staff.



# What is a Control Environment?

- A control environment sets a municipality's tone, which influences the control consciousness of staff. It provides discipline and structure upon which other components of internal control are built.
- Control environment includes:
  - Integrity and ethical behavior,
  - A commitment to competence,
  - Governing body and finance participation,
  - Management philosophy and operating style,
  - Organizational structure,
  - Assignment of authority and responsibility, and
  - Human resource policies and practices.



# How is risk assessment involved in internal controls?

- Risk assessment identifies and analyzes risks associated with the municipality achieving its objectives.
- Risk assessment forms the basis for determining what risks need to be controlled and the controls required to manage the risks.
- For municipalities, risk assessment can be influenced by federal, state, and local laws.



# What are control activities?

- Control activities refer to policies and procedures the municipality uses to ensure actions are taken to minimize risks associated with the municipality's objectives. Control activities have various objectives and can be applied at all levels of an organization.
- Preventative controls focus on preventing errors or irregularities.
- Detective controls focus on identifying when an error or irregularity has occurred.
- Corrective controls focus on recovering from, repairing damages, or minimizing the costs of an irregularity.



# What are control activities?

- Physical controls include security over assets, limiting access to assets by authorized people, and periodic reconciling quantities on hand with quantities on the municipality's records.
- Information processing controls are used to check accuracy, completeness, and authorization of transactions. They can be general to cover data center operation, system software application, acquisition and maintenance, access security, and applications systems development and maintenance or they can be specific applications, for example, running a computer software program for payroll.





# **Performance reviews are reviews of an entity's performance and is a control activity.**

- Comparing actual data to budgeted data or prior period data, operating data to financial data, and data within and across functional areas of the organization are types of reviews.



**A municipality's information system consists of methods and records used to record, maintain, and report events of a municipality as well as to maintain accountability for related assets, liabilities, equity and functions.**



# Information and communication systems should :

- Identify and record events timely
- Describe each event in sufficient detail
- Measure proper monetary value for the event
- Determine a time period in which the event occurs
- Present properly the events and related disclosure of financial statements



**Communication deals with providing an understanding of rules and responsibilities pertaining to internal controls. This includes staff understanding how their activities relate to the work of others and how exceptions should be reported to management. Communication channels must be open and communications can include policy manuals, accounting manuals, and financial recording manuals.**



**Monitoring is the process of assessing the quality of your internal control performance over time. Ongoing monitoring activities by management to determine where corrective action is needed is part of monitoring.**



# Traditional internal control environment

## Control Environment

- *Sub-Elements of a Control Environment*
- Management philosophy and operating style
- Organizational structure
- Audit Committee
- Methods to communicate the assignment of authority and responsibility
- Management control methods
- Internal Audit function
- Personnel Policies and procedures

## Accounting System

- *Objectives That Must Be Satisfied*
- Validity
- Authorization
- Completeness
- Valuation
- Classification
- Timing
- Posting and summarization

## Control Procedures

- *Categories of Control Procedures*
- Adequate separation of duties
- Proper authorization of transactions and activities
- Adequate documents and records
- Physical control over assets and records
- Independent checks on performance



# Traditional Control Philosophy

- Extensive use of hard copy documents to capture information and frequent printouts of intermediate processes as accounting transactions flow through the process
- A separation of duties and responsibilities so one person checks the work of another person
- Duplicate recording of data and extensive reconciliation of duplicate data



# Traditional Control Philosophy

- Accountants with a role viewed as being independent, reactive, and detective
- Heavy reliance on year-end review of financial statements and checklists of required controls
- Emphasis more on internal control and operational efficiency and avoidance of tolerance toward advances in information technology





# Updated control philosophies

- Finance or accounting must become control consultants with real time, proactive control philosophy that focuses on preventing business risks more than detecting and correcting errors and irregularities.



**Modern information technology should be used to achieve objective of recording, maintaining and producing accurate, complete, and timely outputs of information by:**

- Evaluating risks associated with the updated mode of collecting, storing, and reporting data
- Designing specific control procedures that help control the risks applicable to the new design



**Control procedures must be tailored to the municipality's practices or processes so as to improve quality of the system while enhancing organizational effectiveness.**



**Finance and accountants must become familiar with IT capabilities and risks and recognize the opportunities IT can provide to prevent, detect, and correct errors and irregularities.**



**Recognize that processes that make extensive use of paper inputs and outputs in visible records of intermediate processes are not less risky than more complex systems if they are properly constructed with the proper controls built into them.**



**An electronic audit trail can be as effective as or more effective than a paper audit trail and if designed properly, can be less complicated than a traditional paper trail.**



**Those in finance and IT must be actively involved during design and development of information systems.**



**Small organizations can have strong internal control systems by integrating controls into information systems and using information technology to monitor and control business information processes.**





Questions?

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