

Internal Controls Guidelines

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Introduction

Internal Controls are to be an integral part of any organization's financial and business policies and procedures. Internal controls consists of all the measures taken by the organization for the purpose of; (1) protecting its resources against waste, fraud, and inefficiency; (2) ensuring accuracy and reliability in accounting and operating data; (3) securing compliance with the policies of the organization; and (4) evaluating the level of performance in all organizational units of the organization. Internal controls are simply good business practices.

Responsibility

Everyone within the University has some role in internal controls. The roles vary depending upon the level of responsibility and the nature of involvement by the individual. The Utah State Board of Regents, University President and senior executives establish the presence of integrity, ethics, competence and a positive control environment. University deans, directors, and department heads have oversight responsibility for internal controls within their units. Managers and supervisory personnel are responsible for executing control policies and procedures at the detail level within their specific unit. Each individual within a unit is to be cognizant of proper internal control procedures associated with their specific job responsibilities.

Elements of Internal Control

Internal control systems operate at different levels of effectiveness. Determining whether a particular internal control system is effective is a judgment resulting from an assessment of whether the five components - Control Environment, Risk Assessment, Control Activities, Information and Communication, and Monitoring - are present and functioning. Effective controls provide reasonable assurance regarding the

accomplishment of established objectives.

Control Environment

The control environment, as established by the organization's administration, sets the tone of an institution and influences the control consciousness of its people. Leaders of each department, area or activity establish a local control environment. This is the foundation for all other components of internal control, providing discipline and structure. Control environment factors include:

- Integrity and ethical values;
- The commitment to competence;
- Leadership philosophy and operating style;
- The way management assigns authority and responsibility, and organizes and develops its people;
- Policies and procedures.

Risk Assessment

Every entity faces a variety of risks from external and internal sources that must be assessed. A precondition to risk assessment is establishment of objectives, linked at different levels and internally consistent. Risk assessment is the identification and analysis of relevant risks to achievement of the objectives, forming a basis for determining how the risks should be managed. Because economics, regulatory and operating conditions will continue to change, mechanisms are needed to identify and deal with the special risks associated with change.

Objectives must be established before administrators can identify and take necessary steps to manage risks. Operations objectives relate to effectiveness and efficiency of the operations, including performance and financial goals and safeguarding resources against loss. Financial reporting objectives pertain to the preparation of reliable published financial statements, including prevention of fraudulent financial reporting. Compliance objectives pertain to laws and regulations which establish minimum standards of behavior.

The process of identifying and analyzing risk is an ongoing process and is a critical component of an effective internal control system. Attention must be focused on risks at all levels and necessary actions must be taken to manage. Risks can pertain to internal and external factors. After risks have been identified they must be evaluated.

Managing change requires a constant assessment of risk and the impact on internal controls. Economic, industry and regulatory environments change and entities' activities evolve. Mechanisms are needed to identify and react to changing conditions.

Control Activities

Control activities are the policies and procedures that help ensure management directives are carried out. They help ensure that necessary actions are taken to address risks to achievement of the entity's objectives. Control activities occur throughout the organization, at all levels, and in all functions. They include a range of activities as diverse as approvals, authorizations, verifications, reconciliations, reviews of operating performance, security of assets and segregation of duties.

Control activities usually involve two elements: a policy establishing what should be done and procedures to effect the policy. All policies must be implemented thoughtfully, conscientiously and consistently.

Information and Communication

Pertinent information must be identified, captured and communicated in a form and time frame that enables people to carry out their responsibilities. Effective communication must occur in a broad sense, flowing down, across and up the organization. All personnel must receive a clear message from top management that control responsibilities must be taken seriously. They must understand their own role in the internal control system, as well as how individual activities relate to the work of others. They must have a means of communicating significant information upstream.

Monitoring

Internal control systems need to be monitored - a process that assesses the quality of the system's performance over time. Ongoing monitoring occurs in the ordinary course of operations, and includes regular management and supervisory activities, and other actions personnel take in performing their duties that assess the quality of internal control system performance.

The scope and frequency of separate evaluations depend primarily on an assessment of risks and the effectiveness of ongoing monitoring procedures. Internal control deficiencies should be reported upstream, with serious matters reported immediately to top administration and governing boards.

Internal control systems change over time. The way controls are applied may evolve. Once effective procedures can become less effective due to the arrival of new personnel, varying effectiveness of training and supervision, time and resources constraints, or additional pressures. Furthermore, circumstances for which the internal control system was originally designed also may change. Because of changing conditions, management needs to determine whether the internal control system continues to be relevant and able to address new risks.

Components of the Control Activity

Internal controls rely on the principle of checks and balances in the workplace. The following components focus on the control activity:

Personnel need to be competent and trustworthy, with clearly established lines of authority and responsibility documented in written job descriptions and procedures manuals. Organizational charts provide a visual presentation of lines of authority and periodic updates of job descriptions ensures that employees are aware of the duties they are expected to perform.

Authorization Procedures need to include a thorough review of supporting information to verify the propriety and validity of transactions. Approval authority is to be commensurate with the nature and significance of the transactions and in compliance with University policy.

Segregation of Duties reduce the likelihood of errors and irregularities. An individual is not to have responsibility for more than one of the three transaction components: authorization, custody, and record keeping. When the work of one employee is checked by another, and when the responsibility for custody for assets is separate from the responsibility for maintaining the records relating to those assets, there is appropriate segregation of duties. This helps detect errors in a timely manner and deter improper activities; and at the same time, it should be devised to prompt operational efficiency and allow for effective communications.

Physical Restrictions are the most important type of protective measures for safeguarding University assets, processes and data.

Documentation and Record Retention is to provide reasonable assurance that all information and transactions of value are accurately recorded and retained. Records are to be maintained and controlled in accordance with the established retention period and properly disposed of in accordance with established procedures.

Monitoring Operations is essential to verify that controls are operating properly. Reconciliations, confirmations, and exception reports can provide this type of information.

Internal Control Limitations

There is no such thing as a perfect control system. Staff size limitations may obstruct efforts to properly segregate duties, which requires the implementation of compensating controls to ensure that objectives are achieved. A limited inherent in any system is the element of human error, misunderstandings, fatigue and stress. Employees are to be encouraged to take earned vacation time in order to improve operations through cross-training while enabling employees to overcome or avoid stress and fatigue.

The cost of implementing a specific control should not exceed the expected benefit of the control. Sometimes there is no out-of-pocket costs to establish an adequate control. A realignment of duty assignments may be all that is necessary to accomplish the objective. In analyzing the pertinent costs and benefits, managers also need to consider the possible ramifications for the University at large and attempt to identify and weigh the intangible as well as the tangible consequences.

Internal controls should reduce the risks associated with undetected errors or irregularities, but designing and establishing effective internal controls is not always a simple task and cannot always be accomplished through a short set of quick fixes.

Questions

For further assistance or questions, please contact Krista Bodrero in the Controller's Office, telephone number (435)797-2447 or by e-mail krista.bodrero@usu.edu.