

Assessing and Establishing Internal Controls

Presented by

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This presentation should help you:

- ◆ Become familiar with internal control concepts
- ◆ Understand the five components of internal control
- ◆ Determine who is responsible for internal controls
- ◆ Understand the risks if internal controls are ineffective

Internal controls

- ◆ Integral component of an organization's management that provides reasonable assurance that agencies achieve:
 - Effective and efficient operations, including the use of its resources
 - Reliable financial reporting
 - Compliance with applicable laws and regulations

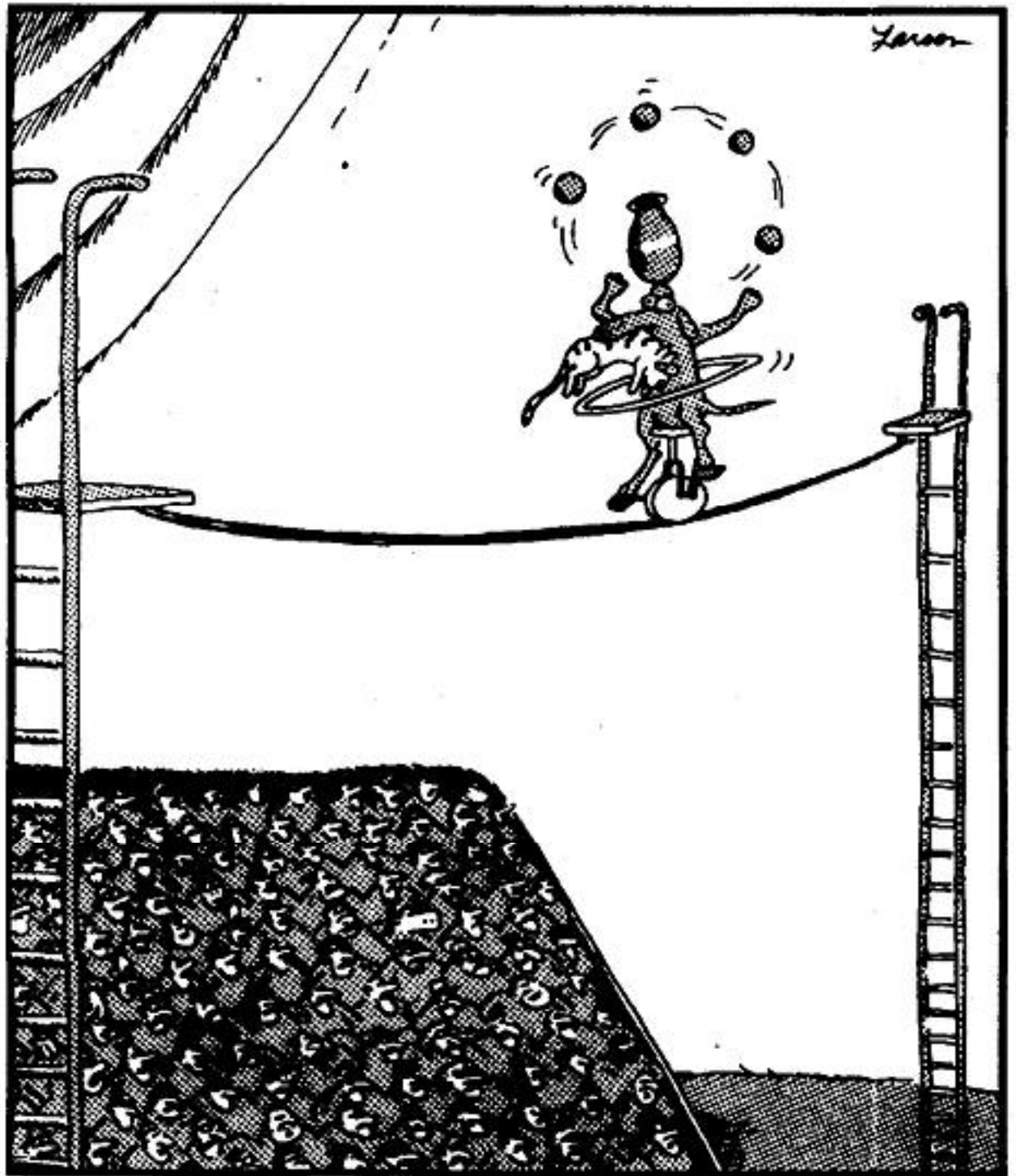
Internal control has three fundamental concepts

- ◆ It is a continuous, built-in component of operations
- ◆ It is effected by people
- ◆ It provides reasonable assurance, not absolute assurance

Reasonable assurance

- ◆ Confidence that risks are reasonably reduced
- ◆ Not a “money-back” guaranty
- ◆ Costs should not exceed benefits
- ◆ Costs can be non-financial

High above the hushed crowd, Rex tried to remain focused. Still, he couldn't shake one nagging thought: he was an old dog and this was a new trick.



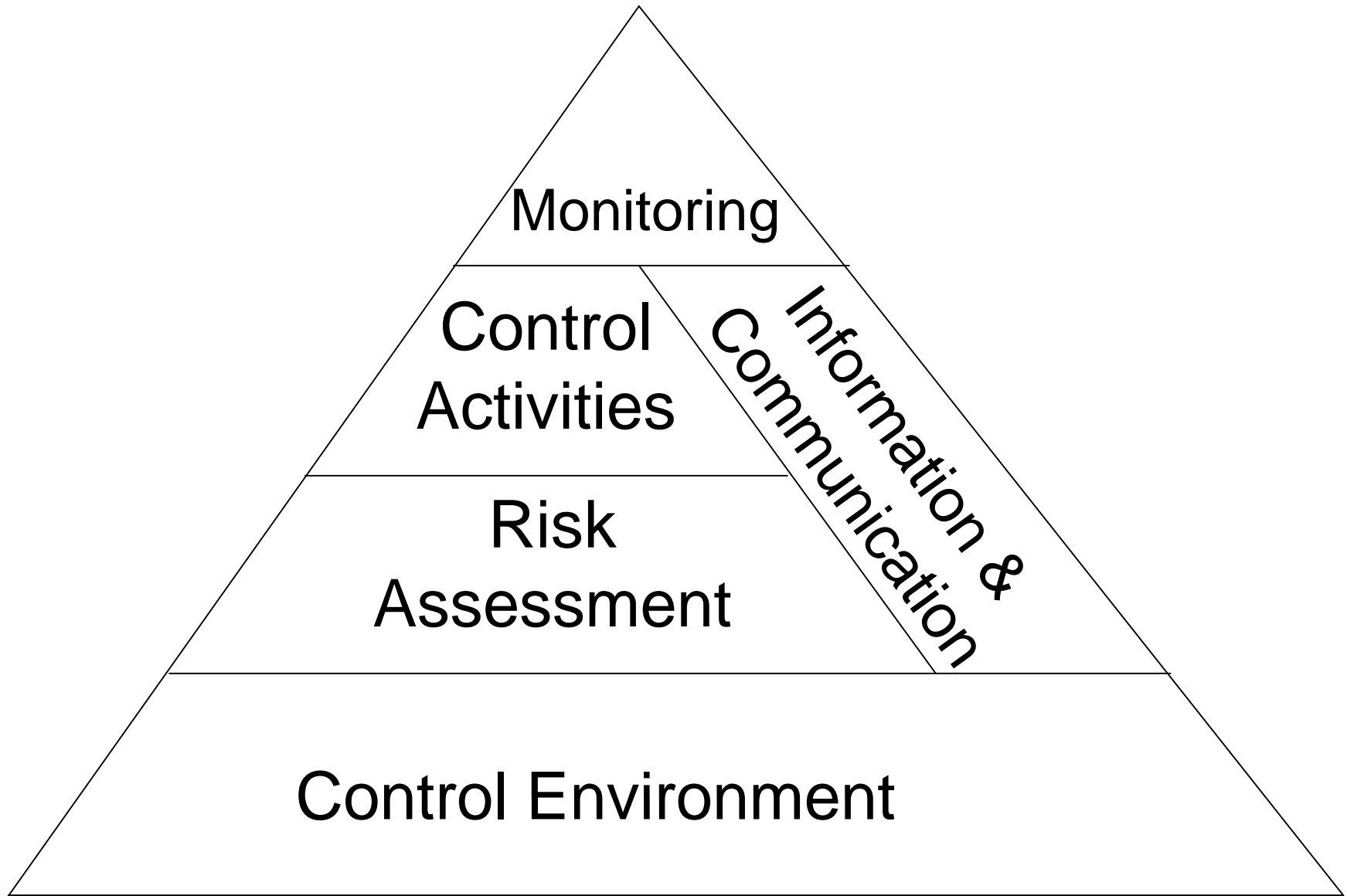
There are two types of internal control

- ◆ Prevention techniques
- ◆ Detection techniques

Internal Control Components

Five interrelated components of internal control

- ◆ Control environment
- ◆ Risk assessment
- ◆ Control activities
- ◆ Information and communications
- ◆ Monitoring



The control environment

- ◆ Comprises the foundation for the other internal control components
- ◆ Establishes how the organization functions
- ◆ Determines how trustworthy are the people and the records
- ◆ Includes the incentives set for management and employees

The control environment includes

- ◆ Integrity and ethical values
- ◆ Commitment to competence
- ◆ Independent oversight
- ◆ Management's philosophy and operating style
- ◆ Human resources policies and practices



S. Adams

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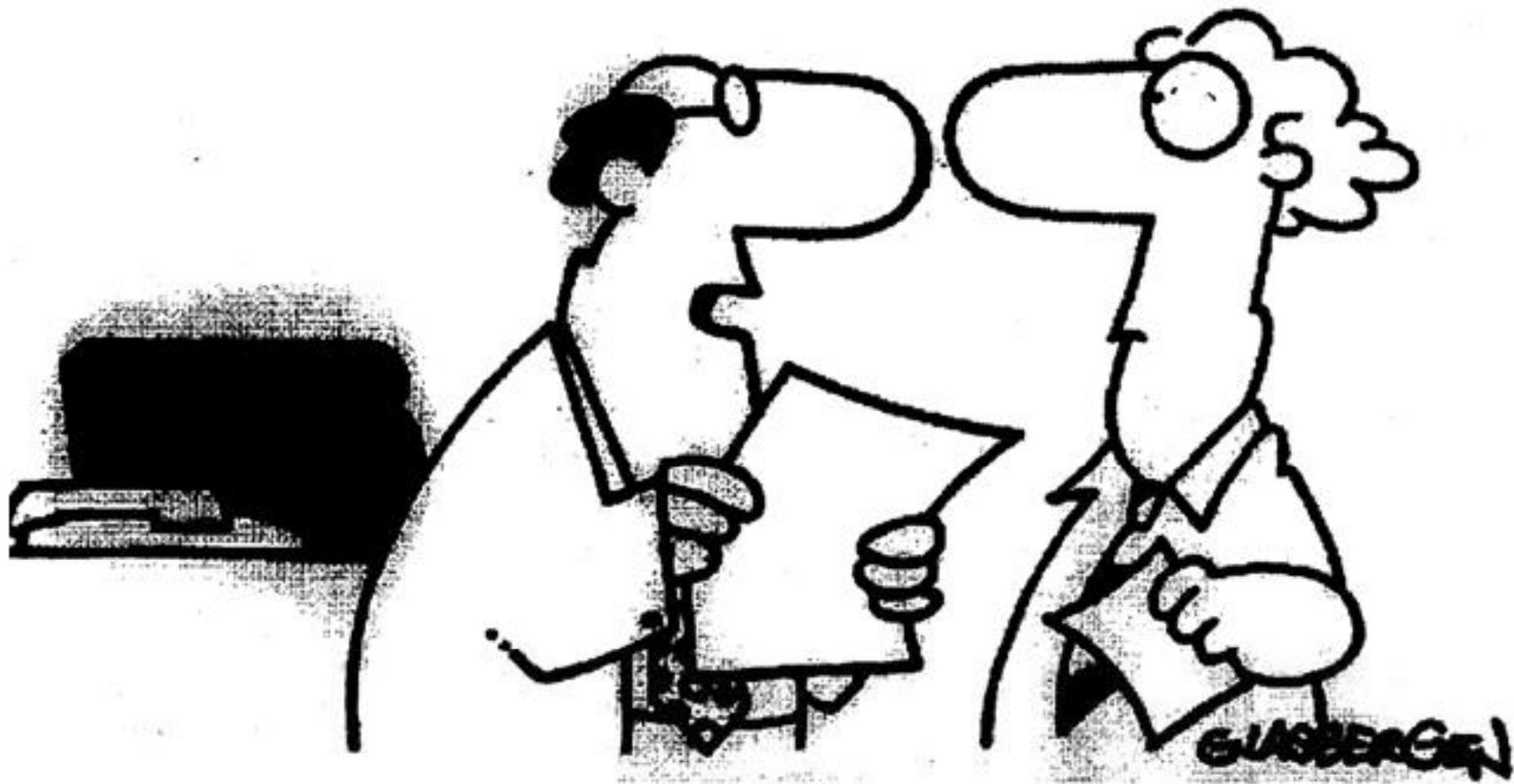
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Independent oversight

- ◆ Board of Directors or audit committee
- ◆ Should include non-management representatives
- ◆ Should have adequate knowledge of organization and industry
- ◆ Involved with significant management decisions

Some specific indicators of independent oversight

- ◆ Oversight body meets regularly
- ◆ Board includes “outsiders”
- ◆ Board is willing to raise difficult questions with management
- ◆ Board members have adequate knowledge and experience
- ◆ Management provides the board with timely and sufficient information
- ◆ Board is concerned with “tone at the top”



“I want the public to think of us as ‘The Company With a Heart.’ But I want you to think of us as the company that will chew you up, spit you out and smear you into carpet if you screw up.”

Risk assessment

- ◆ “Internal control should provide for an assessment of the risks the agency faces from both external and internal sources.”
- ◆ Clear, consistent objectives are a precondition for risk assessment
- ◆ Identify and analyze relevant risks and determine how risk will be managed
- ◆ Consider impact and the likelihood of the risk
- ◆ Not just a one-time activity, but a continuous process

Objective setting

- ◆ First step in risk assessment
- ◆ Need to know what the entity's goals are
- ◆ Risks are that the goals will not be realized

Need to balance the various risks

- ◆ How likely is the occurrence?
- ◆ How much impact would the occurrence have?
- ◆ What are the “fatal flaws?”
 - What could go wrong that would have major impact?
 - Preventing such problems is the major control objective

Review the controls to prevent the “fatal flaws”

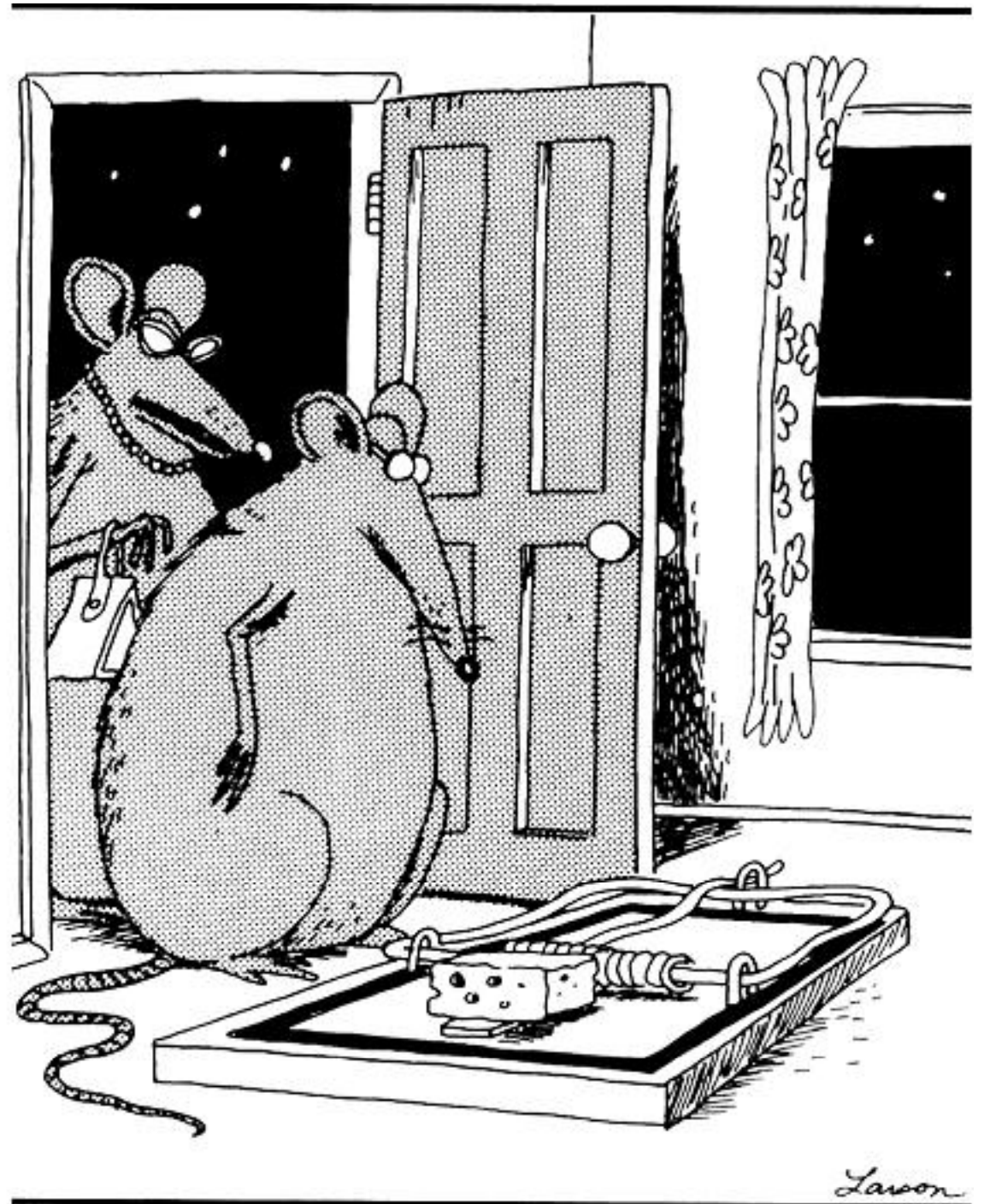
- ◆ Are they in place?
- ◆ Does management take them seriously?
- ◆ Will they be effective?
- ◆ How can you test them?

One way to evaluate risk

Risk item	Chance of Occurrence	Impact of Occurrence	Assessment of Risk
Risk 1	H/M/L	H/M/L	H/M/L
Risk 2	H/M/L	H/M/L	H/M/L
Risk 3	H/M/L	H/M/L	H/M/L

**Risk
Assessment:
A bad example.**

“Well, heaven knows what it is or where it came from. Just get rid of it, Fred. But save the cheese first.”



Who is responsible
for internal controls?

Everyone in
the process!

What can happen if effective controls are not put in place?

- ◆ The program may be ineffective
- ◆ Organization funds may be misspent
- ◆ Grant programs may be reduced, or even eliminated
- ◆ Individual managers may be subject to criticism, or even fired
- ◆ Trustees and board members can be subject to criticism or replaced

Thank you!

Any questions?