



Effective Bookkeeping and Payroll

Chapter 2 - Overview of Internal Controls

WORKBOOK



The Need for Internal Controls

- Buffalo, NY – A Lancaster woman (a bookkeeper for 16 years) who admitted she stole nearly \$2 million from her employer will spend the next four to 12 years in state prison. She had a history of depression and had bi polar disorder.
- Former Bank of America manager was sentenced to 37 months in prison for embezzling more than \$300,000 from his employer. He had developed a powerful gambling addiction.
- A former Kohler Co. employee charged with embezzling \$117,000. His attorney blamed a relapse to alcohol abuse after 14 years of sobriety for his sudden spiral.

Cases like these happen all the time! They remind that anyone could exercise poor judgment under the right set of circumstances.

Overview of Internal Control

Definition of Internal Controls

Internal Controls - A process affected by management and other personnel to provide reasonable assurance that the company will achieve:

- ✓ Safeguard of it's assets
- ✓ Accurate and reliable accounting records
- ✓ Compliance with applicable laws and regulations
- ✓ Effective and efficiency operations

Overview of Internal Control

Principles of Internal Control

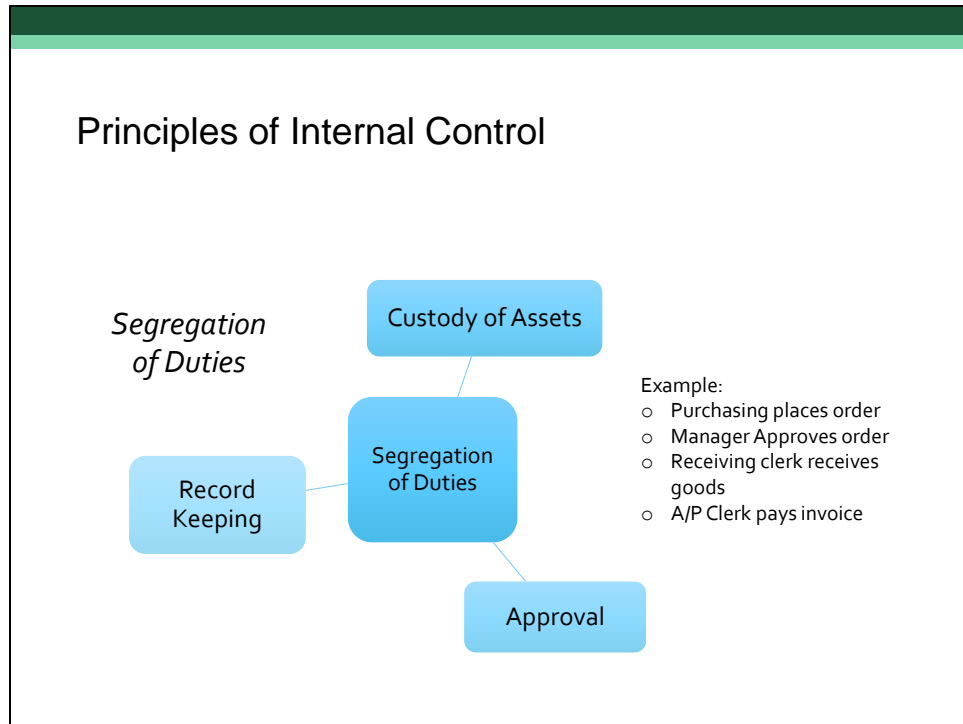
- Establish Responsibility
- Segregation of Duties
- Documentation
- Physical, mechanical and electronic controls
- Independent internal verification

Principles of Internal Control

Establish Responsibility

A control is most effective when only one person is responsible for a given task. For example:

- A cash drawer is assigned to only one person.
- Only one person has access to the safe and petty cash.
- One person performs the inventory reconciliation.
- Two customer service representatives are allowed to enter customer orders and the order has their name on it.



Principles of Internal Control

Documentation

Documents provide evidence that transactions have occurred.

- Sales invoices support recording sales
- Shipping documents support recording sales revenue (initialed by shipper)
- Purchase receipts support expenses
- Signatures or initials holds an individual responsible for performing a function or control.

Authorization and Accountability

- Purchasing Manager approves an order and signs her name.
- Shift supervisor reviews weekly pay sheet and signs name approving payment to the employee

Principles of Internal Control

Physical, mechanical and electronic controls include:

- Badge access
- Security checkpoints
- Passwords for computer access
- Video surveillance
- Limited storeroom access
- Time clocks for hours worked
- Garment sensors on retail goods

Principles of Internal Control

Independent internal verification

Many companies conduct internal audits of various documents and processes so they have confidence internal controls are adhered to.

Sometimes formal audits are performed and other times just independent reviews by independent employees.

Control Concepts

Control Layers

◆ **Preventive Controls**

- ◆ Controls designed to prevent a financial statement error from occurring
- ◆ These are typically transaction-processing and IT-related controls. Segregation of duties, passwords, badge access, alarms etc...

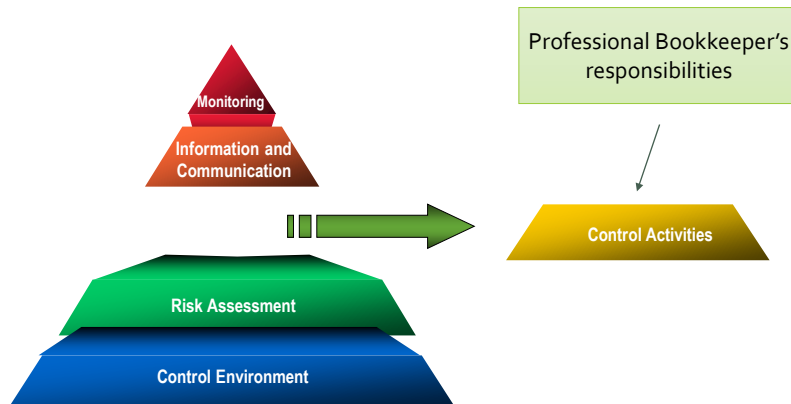
◆ **Detective Controls**

- ◆ Controls designed to identify failures in preventive controls, and reduce the likelihood that a financial statement error could occur and not be detected in a timely manner
- ◆ Examples include reconciliations, camera monitoring, trend analysis

Both controls are required for effective control management

Overview of Internal Control

5 Key Elements of Control



Examples of Controls Across the Organization

- Purchase requisitions, Approval and Receiving must be segregated – Electronic or physical signatures on all
- Receiving must not see quantities ordered, must inspect the goods, enter into system and sign receiving documentation
- A process must be in place to authorize the removal of any asset from the facility
- Prepare budgets annually and track spending monthly
- Password protect & restrict access to computers and files
- Review and analyze financial results
- Human Resources and Payroll process must be segregated
- A fixed asset physical must be done periodically.
- Inventory counting must be done blindly
- An inventory obsolescence review must be done annually and updated quarterly.

Section 302

- Are responsible for disclosure controls
- Have designed controls to ensure that material information is known to them
- Have evaluated the effectiveness of controls
- Have presented their conclusions in the filing
- Have disclosed to the audit committee and auditors significant control deficiencies and acts of fraud
- Have indicated in the report significant changes to controls

- Broadens the current emphasis of integrity and completeness controls relating to financial reporting
- Examples: Executive compensation, legal matters, and MD&A of financial condition and results of operations

Section 404

- State their responsibility for establishing and maintaining an adequate internal control structure and procedures for financial reporting

- Provide a separate opinion on the effectiveness of the company's internal controls over financial reporting

Implications of SOX

- ✦ Necessary compliance with the regulations and mitigation of legal risk
- ✦ Stronger control structure
 - Common control framework deployed globally
 - Increased awareness and ownership of controls
 - Processes better defined and monitored
 - Gaps in existing controls fixed (process and IT areas)
- ✦ Cost effective and efficient internal control structure
 - Manual, labor intensive processes automated and streamline
 - Duplicative/decentralized processes sometimes combined
 - Compliance and Business Performance Reporting improved
- ✦ Cost of SOX compliance and excessive documentation

Control Concepts

Control Layers

- ◆ **Design Effectiveness**

Involves evaluating whether internal control is suitably designed to **prevent or detect material misstatement on a timely basis**. Controls will **not** be designed effectively if there are missing controls, or if implemented controls do not meet the appropriate control objective.

- ◆ **Operating Effectiveness**

Involves evaluating whether internal control is operating as designed. Was the control performed? Was the control consistently performed? Was the control performed by a person who had the necessary authority and qualifications to perform the control effectively?

- ◆ **Both** of these elements are necessary for an effective control environment

Control Concepts

Characteristics of Key Controls

- ♦ **What is key control?**

A key control is a control that, if it fails, means there is at least a reasonable likelihood that a material error in the financial statements would not be prevented or detected on a timely basis. In other words, a key control is one that is required to provide reasonable assurance that material errors will be prevented or timely detected.

- ♦ **How to identify key control?**

- ♦ Starts with the significant general ledger accounts
- ♦ Defines the relevant financial assertions for each significant account
- ♦ Lists all the risks to achievement of the assertions.
- ♦ Those controls required to address each risk such that a material error is not likely.

Audit Process and Conduct

Responsibilities

Bookkeepers contribute support for the following within any organization:

- Ongoing audit support
- Documentation updates for changes in control
- Key control management
- Creation and retention of evidence
- Diligence against fraud
- Communication of control issues to Controller

Internal Controls – Bottom Line

Controls are critical to the success of ANY business and must be maintained. The accounting group is responsible for designing, implementing and carrying out many of these controls as well as supporting others in the business that perform controls.



Questions

and

Answers

Review Questions:

1. True or False: When individuals embezzle money, they always have an illness, gambling addiction or abuse alcohol.
2. Principles of internal control include the following:
 - A. Establish Responsibility
 - B. Segregation of Duties
 - C. Documentation
 - D. All of the above
3. When a cash drawer is assigned to only one person it is an example of which principle?
 - A. Documentation
 - B. Physical, mechanical and electronic controls
 - C. Independent internal verification
 - D. Establish responsibility
4. True or False: Segregation of duties means you must segregate custody of assets, approval of purchases and warehousing.
5. True or False: Preventative controls will not stop an error from occurring.
6. True or False: Bookkeepers are very involved in control activities.

Answer Key:

1. B
False. It is common for an individual to have extenuating circumstances but not always.
2. D
Principles of internal control include establishing responsibility, segregation of duties, and documentation.
3. D
When we establish responsibility, we assign a task to one person who we hold accountable for the task.
4. B
False. You must segregate custody of assets, approval of purchases and record keeping.
5. B
False. They are designed to stop errors from occurring.
6. A
True. Bookkeepers are very involved in control activities.