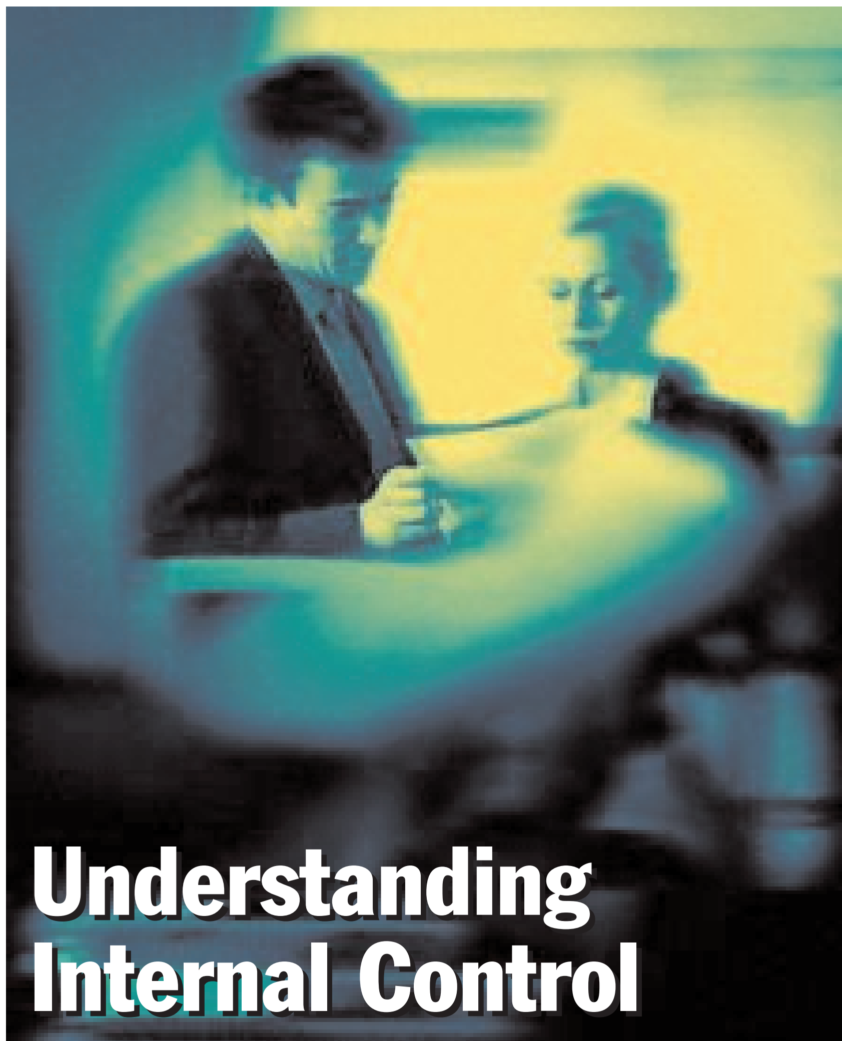
Financial Reporting Plain English Guide



Understanding Internal Control

A Guide for the Small Business Audit Client

The Plain English Guide series of publications is written for owners, boards, and managers of small business audit clients. The objective of these publications is to explain in non-technical terms, some of the most important business and financial reporting matters that auditors need to communicate to their clients.

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Understanding Internal Control

Since the Enron scandal, auditors, regulators and financial statement users have placed a renewed emphasis on evaluating financial accounting control. Business owners are being called upon to understand and explain their company's internal control, and, in some cases, to attest to its reliability. The purpose of this publication is to help the small business owner better understand

- The key elements of internal control,
- The auditor's responsibilities with regard to internal control testing, and
- How to improve internal control at his or her company.

What is Internal Control?

Internal control is a *process*, an interconnected web of policies, procedures, attitudes and actions that work together to achieve a desired result. Businesses, not-for-profit organizations, state and local governments and other entities often are required to produce financial statements for third parties. These entities all seek to produce reliable financial reports, and to do that requires a reliable system of control.

Auditors analyze an internal control system by breaking it down into its five component parts.

Identifying "What Can Go Wrong"

Good internal control begins with management's assessment of the risks facing the entity. With regard to preparing reliable financial reporting, management should have a working knowledge of "what can go wrong" in the capture, processing and reporting of financial information.

Implementing Controls to Manage Risk

Control activities are designed to address the specific risks that management has identified. For example, if the business owner is concerned about fraudulent cash disbursements, then control procedures should be designed and implemented to specifically address this risk.

Monitoring Control Performance

Management should supervise the performance of the control activities it puts in place. On a more general level, business owners and those responsible for preparing reliable financial information should monitor the performance of the system as a whole and be alert for signs that the system is functioning poorly. If management becomes aware of control weaknesses, it should take appropriate, corrective action.

Communicating Information

Information must be effectively communicated throughout the organization. For example, the person responsible for preparing a report or performing an important control procedure must have a clear understanding of their responsibilities. Errors in the processing of financial information need to be communicated to the person who can correct them.

Implementing a Reliable Financial Information System

Business owners, management and employees use the information generated from the company's system to perform their job functions and make important decisions. Accordingly, all organizations must have a reliable system to ensure that the information used in the business is—

- Accurate
- Complete, and
- Timely

Establishing an Effective Control Environment

Management must establish a proper "tone at the top," one that consistently reinforces the company's commitment to complete, transparent, and accurate financial reporting. The control environment is comprised of a variety of attitudes, policies, procedures and the conduct of its employees, which range from the company's personnel policies to how management responds to reports of potential unethical business practices. The control environment is the foundation of the organization's internal control. Without a solid foundation, all other control components quickly are rendered ineffective.

Implementing and Maintaining Internal Control

Internal Control Isn't Just for the Accounting Department

The five components of internal control span many aspects of an entity's operations and involve individuals outside the accounting department. For example—

- The entity's hiring, training, and promotion policies are an important element of the control environment, helping to ensure that qualified personnel perform key procedures.
- Operations personnel may observe non-financial inaccuracies in the information they use to run the business, and the reporting of these inaccuracies is critical if management is to effectively monitor control performance.
- Sales personnel may negotiate special terms with certain customers, and these terms should be communicated to others within the organization so that the sale can be authorized and properly accounted for.

Understanding Internal Control

Internal control is defined very broadly. In implementing and maintaining their entity's control system, management should consider how the entire organization is managed, and how the various elements of control work together to prevent or to detect and correct errors in the information system.

Management's Responsibilities

The business owner, the board of directors (if one exists) and company management share the ultimate responsibility for establishing and maintaining the organization's internal control system. Only management has the ability and the authority to analyze the various elements of internal control, make decisions, supervise, and otherwise ensure that the system functions effectively. The responsibility for internal control can not be outsourced or delegated.

Auditors may make observations and suggestions about internal control as part of performing their financial statement audit. Business owners may see the annual audit as a deterrent, a means to help control the risk of loss due to fraud. But the independent auditor is not—can not—be part of their client's internal control. Management should not rely on the financial statement audit, which is performed only once a year, to be the first line of defense in finding and correcting errors in the information used every day to manage the organization.

Auditors and Internal Control

As part of a financial statement audit, your organization's independent auditors evaluate the design of some of the entity's internal controls. This evaluation—though rigorous—is significantly less in scope than the audit of internal control that is required of publicly held companies.

When evaluating internal control design as part of the audit of a non-public entity, the auditor's primary objectives are to obtain an understanding of control that will enable him or her to—

- Identify the types of misstatements that could occur in the capture, processing and reporting of important information
- Assess the likelihood that these misstatements could occur and, if they did, their magnitude, and
- Based on that assessment, the design of further audit tests.

How Auditors Achieve Their Internal Control Objectives

Auditors are required to evaluate the design of each component of internal control. Typically, the auditor will gather information about the entity-wide controls that affect the entire organization. For example, the auditor will assess characteristics of the control environment to determine whether it pro-

vides an appropriate level of control consciousness within the organization and supports the effective functioning of other control activities. Auditors also will evaluate other entity-wide control elements such as communication and the preparation of the financial statements.

After evaluating the design of entity-wide controls, the auditor will then focus attention on the more specific controls related to significant classes of transactions, material accounts, and those areas that seem most vulnerable to fraud. At this more specific activity level, auditors will perform a "what can go wrong" analysis to determine what control activities the organization should have in place. They will then determine which controls the organization actually has implemented to see if there are any gaps in internal control design.

Audit Procedures Related to Internal Control

Inquiries of management and company personnel constitute a significant portion of the procedures auditors typically perform to gather information about the design of internal controls. However, professional auditing standards require auditors to corroborate the responses they receive by performing additional procedures, such as reading related documentation, observing the performance of control activities, or performing "walkthroughs" of the entity's information processing and related controls.

Auditors are allowed to use the information they have gained in previous audits to evaluate the design of internal control in the current audit. They do not have to start from scratch. However, in order to rely on previously obtained information, the auditor must perform procedures to determine that the information is still relevant. These procedures focus on determining what changes, if any, the company has made to its controls, its operating practices, or its financial reporting system. Again, professional standards dictate that the auditor perform procedures in addition to inquiry to verify verbal representations about what has or has not changed.

Identification and Communication of Internal Control Deficiencies

The independent auditor's evaluation of internal control allows the auditor to identify some, but not all, the deficiencies that may exist in the design of the company's internal control. Keep in mind that there is a difference between the design of a control procedure and its operation. In a financial statement audit, the scope of the auditor's evaluation is limited to internal control design. Your organization may have deficiencies in the way a control procedure was performed during the year, but the nature of the auditor's work is

such that these deficiencies in control operation probably will not be detected as part of the financial statement audit.

Evaluating the Severity of a Control Deficiency

When an auditor identifies a gap in the design of internal control, he or she must evaluate the relative significance of that gap by determining whether it is a "material weakness (severe)," a "significant deficiency (less severe)," or "inconsequential."

To make this determination auditors will assess—

- The *likelihood* that a misstatement to the financial statements could exist as a result of the control deficiency, and
- The *magnitude* of the misstatement that would occur.

In general, as the likelihood and magnitude of the misstatement increases, the relative severity of the control deficiency also rises. A control deficiency that makes it *probable* that a *material* misstatement of the financial misstatements could occur is much more significant than a control deficiency that results in a *remote* chance that a misstatement could occur.

Determining the relative significance of a control deficiency requires auditors to exercise a great deal of professional judgment. However, professional auditing standards require auditors (or in some instances, "strongly encourage" them) to classify certain conditions in a prescribed manner. For example, an ineffective control environment or a lack of management oversight of the financial reporting process are at minimum significant deficiencies and most likely material weaknesses. Conditions such as these that are clearly spelled out in the standards afford auditors little if any room for interpretation.

Written Communication of Internal Control Deficiencies

Auditors must communicate in writing all material weaknesses and significant deficiencies identified during the audit. In many instances, the auditor will communicate these matters in a letter at the conclusion of the engagement; however the auditor also may communicate the existence of control deficiencies as they are identified.

Management may be required to submit these letters to third parties. If so, the company may wish to prepare a written response to provide further insight into the deficiencies noted in the auditor's letter, including the entity's plans for correcting the noted deficiencies.

Management may already know that the entity's control system contains a significant deficiency or a material weakness, and those deficiencies may represent a conscious decision by management to accept the risk posed by that deficiency because of cost or other considerations. Nevertheless, professional

auditing standards require the auditor to issue a letter to management informing them of the existence of these control gaps or deficiencies.

What You Can Do to Improve Your Organization's Internal Control

How Management Contributes to Internal Control Effectiveness

In order to establish and maintain internal control, management should actively be involved in matters such as—

- Identifying and assessing what can go wrong in preparing reliable financial information. (See sidebar, below.)
- Determining how best to mitigate or control these risks, based on the magnitude and likelihood of the threat.
- Monitoring others in the performance of their control functions.
- Setting an appropriate "tone at the top" for employees to follow by displaying the proper attitude toward financial reporting and internal control matters.
- Exercising proper oversight of the financial reporting process.

Remember that internal control is not a one-size fits all. Your organization's internal control should be designed to fit the particular circumstances of your organization, including its people, its information system and its organizational structure.

"What Can Go Wrong?"

Seven Questions Management Should Ask About Internal Control

A key step in establishing a reliable system of control is to identify and respond to the risks relating to financial reporting. This process should begin by asking the question "what can go wrong" in the capture, processing and reporting of information.

Here are seven questions management should ask about each class of transactions that is significant to the company's operations (for example, sales, payroll, or cash disbursements).

- Are the transactions that have been captured valid and properly authorized transactions?
- Have *all* valid transactions been captured?
- Have transactions been recorded at their proper amounts?
- Have the transactions been captured in the proper accounting period?
- Have individual transactions been properly summarized?
- Have the transactions been classified properly for accounting purposes? That is, if an expense is a marketing expense, are there controls in place to make sure it has been classified as a marketing expense?
- Have all summarized transactions been posted correctly to the accounting records?