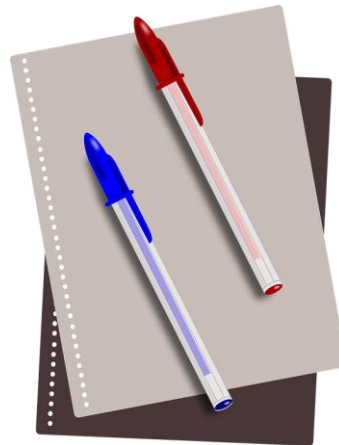


# Internal Control: A Refresher

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## Class Materials

- Presentation slides
- Exercises



## Governmental Entities

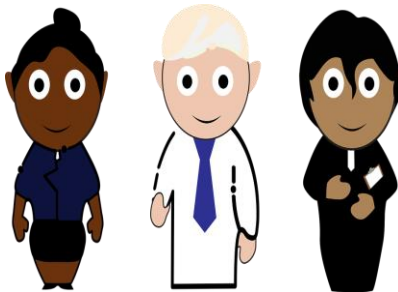
- Entrusted with large responsibilities
  - For assets and other resources
  - For providing essential services to the public, e.g., police and fire protection



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## Government Employees



- Play a key role in ensuring that resources are protected and used properly
- Have a stewardship role in ensuring that governmental objectives are achieved

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# An Effective System of Internal Control

- Enables governmental entities to properly manage governmental resources
- Enables employees to protect and properly utilize government assets
- Enables governmental entities and governmental employees to achieve objectives in efficient and effective manner

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# Each and Every Official, Manager, and Employee

- Has a responsibility to
  - Understand the importance of the IC system
  - Ensure controls are working properly
  - Speak up when control weaknesses are identified



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## Managers on the Front Line

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- Managers are increasingly charged with
  - Designing
  - Implementing
  - Maintaining
- internal controls needed in their areas of responsibility
- to ensure objectives are met

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## Today's Objectives

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1. Understand the objectives of an IC system as well as its limitations
2. Refresh understanding of COSO internal control framework
3. Review common high risk areas and internal controls used to address those risks
4. Practice identifying and applying internal controls to address specific problems or concerns.

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## An Effective Control System

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- Provides **reasonable**, but not absolute, assurance for
  - Protection of assets
  - Reliability of financial reporting
  - Compliance with laws and regulations
  - Effectiveness and efficiency of operations
- Absolute assurance = insurance

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## An Effective Control System

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### Reasonable assurance

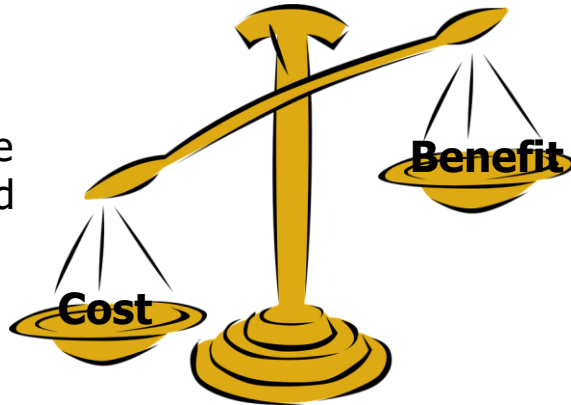
- Control systems should be developed and implemented to provide management with the appropriate **balance between risk** of a certain business practice **and** the level of **control** required to ensure business objectives are met.

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# An Effective Control System

The cost of a control should not exceed the benefit derived from it.



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# Cost vs. Benefit



Hiring 4 people to supervise 1 person

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## An Effective Control System

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- The degree of control employed is a matter of good business judgment.
- When weaknesses are found, your choices are:
  - Increase supervision and monitoring
  - Institute additional or compensating controls.
  - Accept the risk inherent with the control weakness (assuming management approval)
  - Share the risk, e.g., purchase insurance

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## Balancing Risk and Control

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- Risk = probability that an event or action will adversely affect the entity
- Primary risk categories
  - Errors
  - Omissions
  - Delay
  - Fraud

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## Balancing Risk and Control

- In order to achieve objectives, management must balance risks and controls.
- Controls are developed so that they decrease risk to an acceptable level.



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## The Balance

### **Excessive Risks**

- Loss of assets, donors, or grants
- Poor business decisions
- Noncompliance
- Increased regulations
- Public scandals

### **Excessive Controls**

- Increased bureaucracy
- Reduced productivity
- Increased complexity
- Increased cycle time
- Increase in no-value activities

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## In Order to Achieve Balance Between Risk and Control

- Internal controls should be
  - Proactive
  - Value-added
  - Cost-effective
  - Address exposure to risk



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## Fraud: A Particular Area of Concern for IC Systems

- Remember the objectives of IC?
  - ***Protection of assets***
  - ***Reliability of financial reporting***
  - ***Compliance with laws and regulations***
  - Effectiveness and efficiency of operations
- Fraud - a big concern!!

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# Fraud Triangle



Fraud occurs when three elements are present:

1. Pressure or motivation
2. Opportunity
3. Rationalization

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# Pressure or Motivation

- The perceived cause or reason to commit fraud
- Need for money, personal satisfaction, or to alleviate a fear of failure
- Most often, a significant financial need/problem, one that is non-sharable with others, that must be solved in secret

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## Opportunity

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- The ability to commit fraud and the belief that the fraud will not be detected
- Created by weak internal controls, poor management oversight, and/or through use of one's position and authority



## Rationalization

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How the person committing the fraud convinces him/herself that it is OK

- Must be done to save a family member
- If not done, will lose everything
- No help available
- It's just borrowing and will be paid back
- The entity "deserves" it

## Opportunity

- Of the three elements, most controllable is opportunity
- It is essential that entities build processes, procedures, and controls that do NOT place employees in a position to commit fraud and that detect fraud if it occurs.



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## COVID-19 and Risk



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## COVID-19

- World Health Organization (WHO) declared public health emergency – Jan. 30, 2020
- Government responses
  - Different times
  - Different levels

RMI banned international travel



<https://www.rnz.co.nz/international/pacific-news/409150/marshall-islands-bans-overseas-govt-travel-over-coronavirus>

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## COVID-19

- U.S. states issued stay-at-home orders in March and April
- Office closure
- Remote work

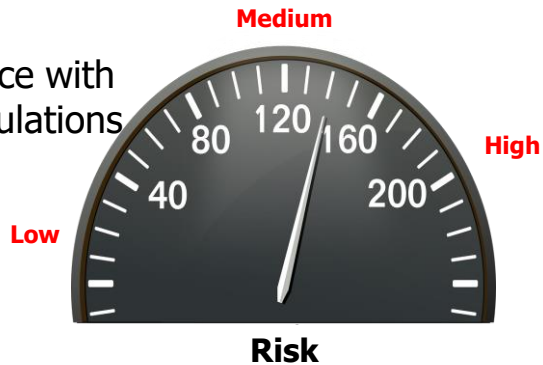


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## Areas of Increased Risk

- Internal control
- Fraud
- Noncompliance with laws and regulations



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## Internal Control

- Remote workforce
- Controls?
  - Before pandemic
  - After pandemic
- How did operations change?
  - If Treasury stopped accepting cash, cash controls less relevant



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## Fraud

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- COVID-19 creates “perfect storm” for fraud
- Incentive – layoffs, financial pressure on government as well as employees
- Opportunity – accountants at home, management override?
- Rationalization – whatever it takes to survive

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## Noncompliance with Laws and Regulations

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- Stimulus programs
  - Hastily conceived
  - Rules missing or vague
  - Increased risk of inadvertent noncompliance
- Federal grants
  - Difficult to comply with ongoing requirements

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## What is Internal Control?


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A process designed to provide reasonable assurance regarding the achievement of objectives in the following categories:

- Effectiveness and efficiency of operations
- Reliability of financial reporting
- Compliance with laws and regulations
- Safeguarding of assets

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## Key Points About Internal Control

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1. People at every level affect internal control
  - Internal control is EVERYONE's responsibility
2. Effective internal control helps an organization achieve its objectives.
  - Keeps entity on course
  - Minimizes surprises

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# Key Points About Internal Control

- 3. Internal control is subject to inherent limitations
  - Cost/benefit
  - Collusion among employees
  - Management override
  - External events beyond control

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# COSO Internal Control Framework



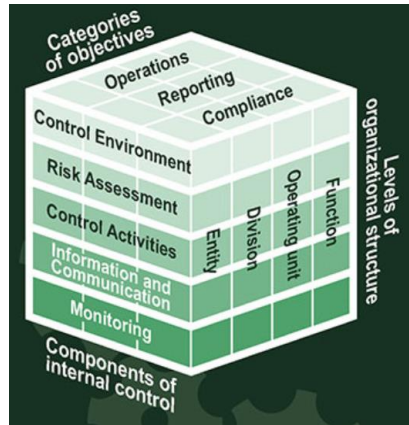
- COSO – Committee of Sponsoring Organizations of the Treadway Commission
- Expanded IC considerations
- Widely accepted framework

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# Green Book Standards for Internal Control in the Federal Government

- Standards for an effective IC system for federal agencies
- Overall framework for designing, implementing, and operating an effective IC system



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## Five Interrelated Components

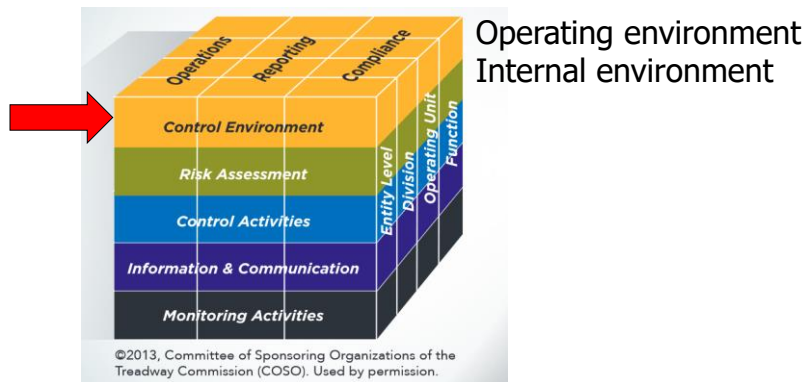
1. Control (or operating) environment
2. Risk assessment
3. Control activities
4. Information and communication
5. Monitoring

**All 5 must be present for an effective system of internal control!!**

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# Control Environment



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# Control Environment

- Control consciousness of an organization; the atmosphere in which people conduct their activities and carry out their control responsibilities



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## In an Effective Control Environment

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- Competent people are hired
- They understand their responsibilities and the limits to their authority
- They are knowledgeable, mindful, and committed to doing what is right and doing it the right way.

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## In an Effective Control Environment

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### The governing board and management

- Establish and effectively communicate written policies and procedures, a code of ethics, and standards of conduct.
- Create a positive ‘tone at the top’
- Require the same standard of conduct from everyone

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## Management

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- Is responsible for “setting the tone” for the organization
- Should establish and maintain a control environment that encourages
  - The highest levels of integrity and personal and professional standards
  - A leadership philosophy and operating style that support strong internal controls
  - Assignment of authority and responsibility



## Management Communication

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***All personnel need to receive a clear message from top management that internal control and individual control responsibilities must be taken seriously.***

## Leading Through Example



I'll wash them next time. It's not that important.



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## Accountability

The control environment is greatly influenced by the extent to which individuals recognize that they will be held accountable.



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# Tips to Enhance Your Control Environment

- Effective human resource policies and procedures

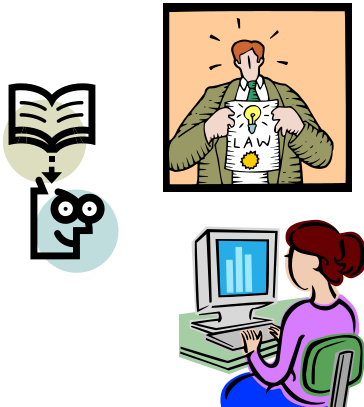
- Hiring
- Orientation
- Training
- Evaluations
- Counseling
- Promotions
- Compensation
- Disciplinary action



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# Tips to Enhance Your Control Environment



- Identify KSA (knowledge, skills, abilities) for key positions and hire qualified people
- Provide adequate training programs
- Review and evaluate performance

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## Tips to Enhance Your Control Environment



- Have policies and procedures readily available (hard copy or via internet)
- Discuss ethical issues with employees

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## Tips to Enhance Your Control Environment

Day-to-day actions  
demonstrate integrity  
Interactions with  
suppliers fair and honest  
Carefully designed  
incentives to minimize  
temptation



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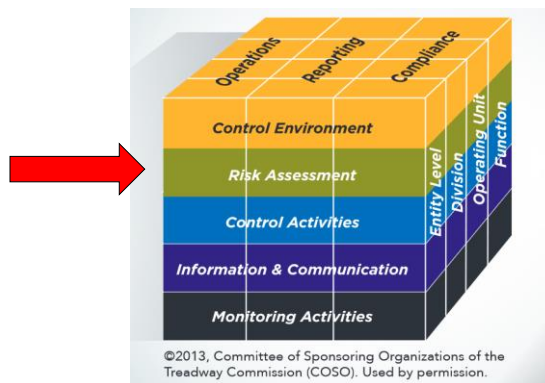
# Tips to Enhance Your Control Environment

- Anonymous hot line
  - Third party provider
  - Direct report to audit committee and general counsel
- Taking action
  - Full investigation
  - Formal charges filed
  - Resolution communicated to all employees

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# Risk Assessment



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# Risk Assessment

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- Every organization faces risks
  - External
  - Internal
- Risk = Possibility that an event will occur and adversely affect the achievement of objectives
- Risk assessment - how risks will be identified, evaluated, and managed

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## Step 1: Determine goals and objectives

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- Highest level – strategic plan that includes mission statement and broadly defined strategic initiatives
- Departmental level – goals and objectives that support strategic plan
  - Operations objectives
  - Financial reporting objectives
  - Compliance objectives

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## Step 2: Identify risks after determining goals



- Risk = anything that could jeopardize achievement of an objective



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## Questions to help you identify risks

- What could go wrong?
- How could we fail?
- What must go right for us to succeed?
- Where are we vulnerable?
- What assets do we need to protect?
- Do we have liquid assets or assets with alternative uses?

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## Questions to help you identify risks

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- How could someone steal from the department?
- How could someone disrupt our operations?
- How do we know whether we are achieving our objectives?
- On what information do we most rely?
- On what do we spend the most money?
- How do we bill and collect our revenue?

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## Questions to help you identify risks

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- What decisions require the most judgment?
- What activities are most complex?
- What activities are regulated?
- What is our greatest legal exposure?

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## Higher Risk Transaction Types

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- Petty cash (if high volumes processed)
- Assets with alternative uses
- Cash receipts
- Consultant payments and other payments for services
- Travel expenditures
- Scholarships

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## Higher Risk Transaction Types

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- Payments to non-vendors
- Equipment delivered directly to department
- Purchase exemptions (sole source)
- Payroll (rates, changes, terminations)
- Equipment
- Equipment moved off-location

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## Higher Risk Transaction Types

- Software licensing issues
- Intellectual property
- Confidential information
- Grants (meeting terms, not overspending)

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## Costs

When evaluating potential impact of risk, need to address both quantitative and qualitative costs



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## Quantitative Costs

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- Cost of property, equipment, or inventory
- Cash dollar loss
- Damage and repair costs
- Cost of defending lawsuit
- Cost of employee time to assess, repair, and/or replace
- Etc.

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## Qualitative Costs

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- Loss of public trust
- Loss of future grants, gifts, donations
- Injury to organization's reputation
- Increased legislation
- Violation of laws
- Default on a project
- Bad publicity

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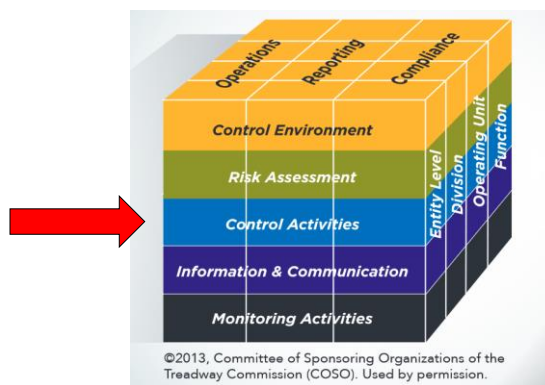
## Step 3: Analyze risks

- Need to prioritize risks
  - Assess likelihood (or frequency) of risk occurring
  - Estimate potential impact if risk occurs (both quantitative and qualitative costs)
  - Determine how risk should be managed
    - What do you need to do?

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## Control Activities



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## Control Activities

- Actions, supported by policies and procedures, that, when carried out properly and in a timely manner, manage or reduce risks



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## Preventive or Detective

- Preventive controls = attempt to deter or prevent undesirable events from occurring
  - Segregation of duties
  - Proper authorization
  - Adequate documentation
  - Physical control over assets

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## Preventive or Detective

- Detective controls = attempt to detect undesirable acts
  - Reviews
  - Analyses
  - Variance analyses
  - Reconciliations
  - Physical inventories
  - Audits

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## Preventive **and** Detective – You Need Both!!



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## Types of Controls

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- Approvals, authorizations, and verifications
- Reconciliations
- Reviews of performance
- Security of assets
- Segregation of duties
- Controls over information systems

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## Approvals, Authorizations, and Verifications

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- Employees authorized by management to perform certain activities and to execute certain transactions within specified limits
- Management identifies those transactions requiring supervisory approval before execution
- Supervisor approval = verified and validated transaction in accordance with established policies and procedures

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## Approvals

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- Written policies and procedures
- Limits to authority
- Supporting documentation
- Question unusual items
- No “rubber stamps”
- No blank signed forms



## Reconciliations

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- Two sets of data agreed to one another, differences identified and investigated, corrective action taken if needed
- Help to ensure accuracy and completeness of transactions in both sets



## Reconciliations

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- Examples
  - Comparing monthly financial reports from Finance to file copies of supporting documentation or departmental records
  - Comparing vacation and sick leave balances per departmental records to payroll system
  - Agreeing outstanding encumbrances per Finance to supporting documentation in department

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## Reconciliations

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- Need proper segregation of duties – reconciler must be different from person who approves transactions or handles cash receipts
- Critical element – **Must resolve differences!**
  - If expenditure incorrectly charged to department, request a correcting journal entry and then verify that it has been posted
- Reconciliations should be documented and approved by management

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## Reviews of Performance

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- Comparison of information about current performance to budgets, forecasts, prior periods, or other benchmarks
- Enables measurement of extent to which goals and objectives achieved
- Identifies unexpected results or unusual conditions that require follow-up



## Reviews of Performance

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- Budget to actual comparison
- Current to prior period comparison
- Performance indicators
- Follow-up on unexpected results or unusual items



## Reviews of Performance

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- Provide a basis for detecting problems
- Provide measure of achievement of goals and objectives
- Management should document reviews as well as resolution of items noted for follow-up

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## Security of Assets

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- Access to equipment, inventories, securities, cash and other assets is restricted
- Assets are periodically counted and compared to amounts shown in control records

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## Security of Assets

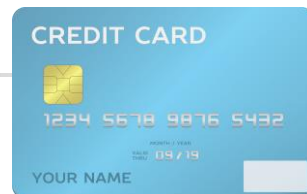
- Security of physical and information assets
- Physical safeguards
- Information system safeguards
- Perpetual records are maintained
- Periodic counts/physical inventories
- Compare counts to perpetual records
- Investigate/correct differences

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## Valuable Assets

- Liquid assets (cash!!!)
- Assets with alternative uses
- Dangerous assets
- Vital documents
- Critical systems
- Confidential information



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## Valuable Assets

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- Must be safeguarded against unauthorized acquisitions, use or disposition
  - Typically – through access controls
    - Locked door
    - Key pad systems
    - Card key system
    - Badge system
    - Locked filing cabinet
    - Guard
    - Terminal lock
  - Computer password
  - Menu protection
  - Automatic callback for remote access
  - Smart card
  - Data encryption

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## Capital Assets or Significant Inventories

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- Establish perpetual inventory control, i.e., record purchases and issuances
- Periodically counted by independent person (someone who doesn't have purchase, authorization, and custody duties)
- Physical count compared to perpetual records
- Missing items investigated, resolved, and analyzed for possible control deficiencies
- Perpetual records corrected to physical count if missing items not located

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## Segregation of Duties

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- Separate
  - Authorizing transactions
  - Recording transactions
  - Custody (handling related asset)
  - Reconciliation
- Fraud deterrent – requires collusion for fraud to occur

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## Segregation of Duties

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- Ideally, no one person should
  - Initiate the transaction
  - Approve the transaction
  - Record the transaction
  - Reconcile balances
  - Handle assets
  - Review reports

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## Segregation of Duties

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- In small organizations, may not be able to separate CARR
- Detailed supervisory review needed as compensating control



## Specific Examples

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- The person who requisitions the purchase of goods or services should not be the person who approves the purchase
- The person who approves the purchase of goods or services should not be the person who reconciles the monthly financial reports



## Specific Examples

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- The person who approves the purchase of goods or services should not be able to obtain custody of checks
- The person who maintains and reconciles the accounting records should not be able to obtain custody of checks

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## Specific Examples

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- The person who opens the mail and prepares a listing of checks received should not be the person who makes the deposit
- The person who opens the mail and prepares a listing of checks received should not be the person who maintains the accounts receivable records

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# Information Systems (Computer) Controls

## General controls

- Apply to entire information systems and to all the applications that reside on the systems
- Broad and include controls over access, change management, systems development, data backup and recovery, third party vendor management, and physical security

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# General Controls

- User access management
- Change management



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## User Access Management

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- Access to business applications based on roles and responsibilities of users
  - Begins with new user access
  - Continues with periodic review of user access
  - Modified when employee job duties change
  - Ends with access deletion upon employment termination

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## User Access Management

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What can go wrong

- If an employee has access to
  - Approve PO
  - Create receiving report
  - Process vendor invoice for payment
- Possibility of unauthorised vendor payment processing
  - In excess of what is due
  - For fraudulent purchase

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## User Access Management

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- Creation of generic user IDs
  - Time-saving measure
- Results in
  - Accountability issues (who processed the transaction)
  - Potential misuse (if administrator privileges included)

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## User Access Management

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What can go wrong

- A generic user ID with administrator privileges is used for background job processing
  - Noninteractive process that runs behind normal interactive operations, reduces manual effort and automates the task, used for time-consuming programs that can be scheduled to run at night
- User with access to generic ID makes changes to background job so that it posts unauthorized financial entries

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## Change Management

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- Ability to make direct changes in a program
  - Results in serious data integrity issues
  - Direct changes usually untested
  - May override existing controls
  - Problems resulting may not be detected and/or hard to fix

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## Change Management

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What can go wrong

- A direct change is made to the depreciation program that affects how depreciation is calculated
- Inappropriate depreciation entries result
- If change made shortly before YE, MM may result

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## Change Management

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- Approval of emergency changes
  - Normal process – change initiated, developed, tested, and implemented
  - Emergency changes for immediate fix
    - Limited or no testing
    - Impact unknown

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## Change Management

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### What can go wrong

- An emergency change is implemented in the Tax Office to adjust the rates used in computing tax due
- It is not tested so the effect of the change on other computations and elements of tax due unknown

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## Change Management

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- Duties not adequately segregated
- Failure to do so can result in unauthorized and/or inappropriate changes
  - Unauthorized/inappropriate changes
    - Incomplete transaction processing
    - Bundled with other changes – unintended effects
    - Fraud

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## Change Management

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What can go wrong

- Programmer develops, tests, and implements the change
- Lack of knowledge about operations results in bad implementation
  - Programmer not aware of business requirements that need to be evaluated before changes are deemed OK

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## Application Controls

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- Built into computer programs and support manual procedures
- Designed to provide completeness and accuracy of information processing, authorization, and validity.

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## Application Controls

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- Designed to prevent, detect, and correct errors as transactions are processed
- Ensure that
  - Transactions and programs are secured
  - Systems can resume processing after a business interruption
  - All transactions are corrected and accounted for when errors occur
  - System processes data in an efficient manner

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## Input Controls

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- Ensure the complete and accurate recording of authorized transactions by only authorized users
- Identify rejected, suspended, and duplicate items
- Ensure resubmission of rejected and suspended items

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## Input Controls

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- Error listings
- Field checks
- Limit checks
- Self-checking digits
- Sequence checks
- Echo check
- Size check
- Validity checks
- Key verification
- Matching
- Completeness checks
- Closed-loop verification

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## Processing Controls

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- Ensure complete and accurate processing of authorized transactions
  - Run-to-run control totals
  - Posting checks
  - End-of-file procedures
  - Concurrency controls
  - Control files
  - Audit trails
  - Balance tests

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## Output Controls

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- Ensure that a complete and accurate audit trail of processing results is reported to appropriate individuals for review
  - Listings of master file changes
  - Error listings
  - Distribution registers
  - Reviews of output

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## End-User Computing

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- Today
  - Computers smaller and more powerful
  - Many applications run by end-user
    - Word processing
    - Desk-top publishing
    - **Spreadsheets!!!**
    - Database management systems

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## End-User Computing

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- End-user computing processes
  - Including spreadsheets and other user-developed programs
  - Need to be documented, secured, backed up, and regularly reviewed for processing integrity
- End-user department responsibility!

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## E-mail Fraud and Governments

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- Local governments targeted
- Thousands of dollars lost!!!
- Phishing scam e-mails
  - Proliferating
  - Look more and more legitimate
  - Getting results for fraudsters

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## College Community System of New Hampshire

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- 7 community colleges in New Hampshire
- System contacted by e-mail
  - From existing vendor who receives progress payments
  - Request to change to EFT via ACH
  - Included proper, complete, and authentic documentation
- Processed ACH and paid \$130,000 to vendor
- Fraud! Online scammers targeted colleges and pretended to be construction company vendors

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## City of El Paso, Texas

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- 2 misdirected payments – all for construction projects
  - \$2.9 mm payment for streetcar project
  - \$312 m for city projects
- Now – change in vendor payment process to paper checks

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## Sedgewick County, Kansas

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- Received email from construction company vendor changing ACH info
- Electronic payment sent \$566 m to company for road project
- Payment never received

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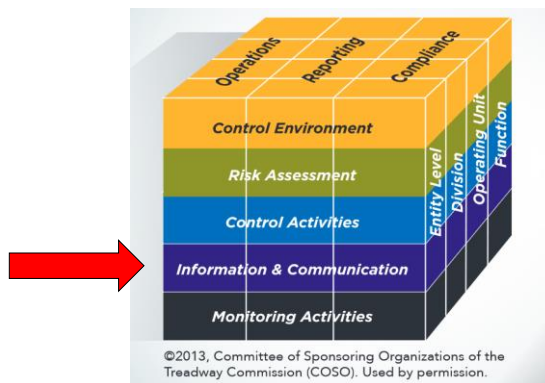
# Government Construction Contracts

- Government contracting process
  - Request for proposal
  - Submissions
  - Approvals
- Contract information publicly available
  - Names, titles
  - Project information
- Enables fraudsters to convincingly pose as vendors

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# Information and Communication



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# Information and Communication

- You have to have information in order to conduct, manage, and control operations
- Information and communication systems capture and exchange this info



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# Information and Communication Systems

- Include systems that
- Obtain or generate relevant, high quality information needed to support internal control
  - Communicate internally to support internal control
  - Communicate externally to support internal control

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# Accounting Information System (AIS)

- Key information system
- Purpose: To gather, record, process, store, summarize and communicate info about an organization



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# Accounting Information System

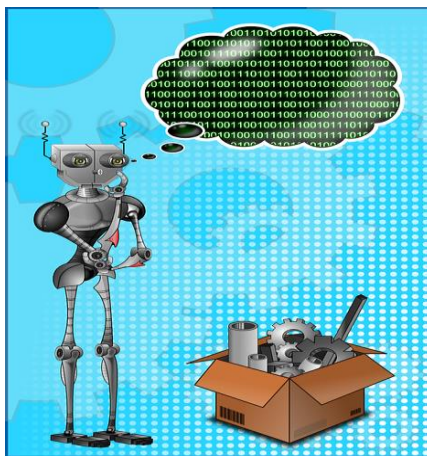
## Includes

- Transaction initiation
- Data capture
- File access and update
- Data processing
- Reporting
- Accounting records
- Accounting procedures
- Supporting documents
- Financial statements

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## How Does This Apply to You?



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## Assessment of a Significant Activity

- Does our department get the information it needs from internal and external sources in a form and timeframe that is useful?
- Does our department get information that alerts it to internal or external risks, e.g., legislative, regulatory, and developments)?

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## Assessment of a Significant Activity

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- Does our department get information that measures its performance – information that tells the department whether it is achieving its operations, financial reporting, and compliance objectives?
- Does our department identify, capture, process, and communicate the information that others need, e.g., information used by other departments or customers, in a form and time frame that is useful?

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## Assessment of a Significant Activity

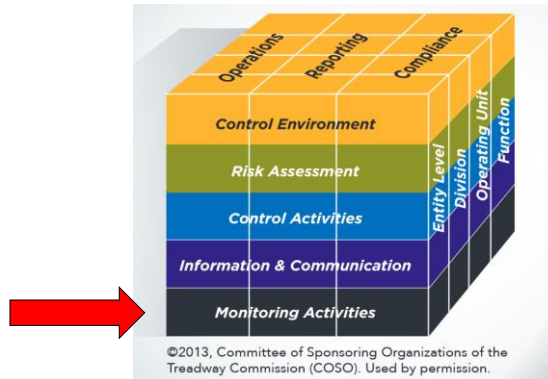
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- Does our department provide information to others that alerts them to internal or external risks?
- Does our department communicate effectively – internally and externally?

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# Monitoring



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# Monitoring

- Entire IC system requires monitoring
  - Enables modifications needed
  - Evaluates whether each component is present and functioning effectively
  - Requires communication of deficiencies
- Accomplished through ongoing monitoring activities and separate evaluations, e.g., self-assessments, peer reviews, internal audits

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## Internal Controls Over Time

- May become ineffective
  - Due to lack of knowledge or training
  - Due to changes in process
  - Due to new processes

Electronic Funds Transfer



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## Monitoring

- Purpose – to determine whether IC is adequately designed, properly executed, and effective.
- Adequately designed – if all 5 components of IC present and functioning as designed

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## Monitoring

- Effective – if management and stakeholders have reasonable assurance that
  - They understand the extent to which operations objectives are being achieved.
  - Published financial statements are prepared reliably.
  - Applicable laws and regulations are being complied with.

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## Ongoing Monitoring: Activities

Supervisory activities

Monitoring control charts

Operations metrics

Focus on high-risk areas

- Spot checks of transactions
- Sampling



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## Ongoing Monitoring: Examples

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- Use of operating information
  - Grant expenditures report
  - Reconciled to GL
  - Review by Program Administrator or Department Head
- Firsthand knowledge of Director or Manager
  - Weekly payroll summary reports
  - Investigation of cause
  - Documentation

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## Key Takeaways

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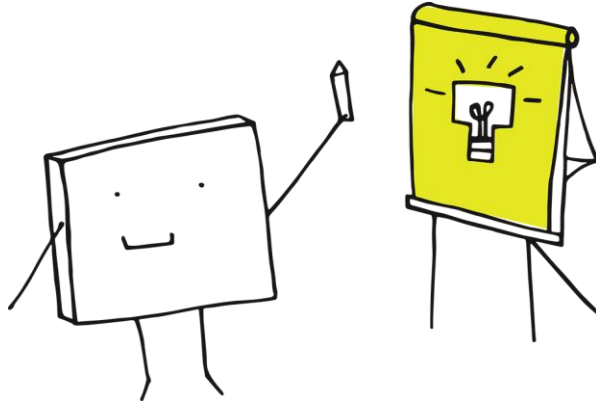
- Internal control is important to effective and efficient operations
- We are all responsible for ensuring that our IC system is operating effectively
- In order to carry out that responsibility
  - Set a good example
  - Find out where the risks are
  - See if there are controls to address the risks
  - See if the controls are working properly

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# To make the info stick ...



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