

Lecture 6: Internal Control

Learning Objectives

1. To understand the components of an organization's internal control structure.
2. To know the objectives and limitations of internal control.
3. To discover which characteristics of a control environment promote an effective accounting system.
4. To learn how an accounting system aids in communicating information.
5. To describe effective control activities.

The users of information provided by an accounting system rely on the accuracy of the system's reports and displays. Organizations adopt **internal control** policies and procedures to maintain accurate information and reliable operations.

Features of Internal Control

A general definition of internal control states that it is a *process* affected by *people* to provide *reasonable assurance* that *objectives* are achieved.

Process

Internal control is a combination of many processes that occur as a part of the organization's activities. Internal control is effective when the processes achieve their objectives and when the control system is built into the organization's structure during system design.

People

People implement the processes of any organization – they make internal control work. Management determines how it works by approving the design of the organization's system.

Objectives

Most organizational objectives relate to one of three categories:

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

Reasonable assurance

Internal control cannot guarantee that management's objective will be attained. They can only provide reasonable assurance of attaining them. Any organization's internal controls have limitations. The major limitations are:

- **Errors** – they arise when employees exercise poor judgment or have a breakdown in their attention to the job.
- **Collusion** – it occurs when two or more employees conspire to commit a theft from their employer.
- **Management override** – the ability of managers to overcome control policies or procedures that are effective with operations-level employees.

Threats to accurate accounting data

We identified two sources of threats to accounting data – errors and irregularities. **Errors** are accidental and arise from *carelessness* and *poor judgment*. **Irregularities** are intentional and arise from *management fraud* and *defalcation*.

Components of Internal Control

The Control Environment

The control environment sets the tone of the organization. Providing discipline and structure, it is a foundation for the other components of internal control. It is influenced by the organization's history and culture and has a pervasive influence on how to organization achieves its objectives.

Illustration 6.1: Factors Affecting the Control Environment



Risk Assessment

Risk assessment is the identification and analysis of risks that might prevent the organization from achieving its objectives. Risks arise from both external and internal factors. Risks from external factors affect the organization as a whole and they include risks from economic and technological change, competition or natural catastrophes. Risks from internal factors relate to specific activities of the organization. They include disruption of the information system, errors due to untrained employees or to changes in management responsibilities.

Control Activities

Control activities are policies and procedures adopted by management to provide reasonable assurance that the organization achieves its objectives. The categories of control activities are:

1. Procedures for authorizing transactions (general, specific authorization)
2. Security for assets and records (physical security, fixed responsibility)

3. Segregation of duties
4. Adequate documents and records (forms control, numbered documents)

Information and Communication

Information and communication is needed at all levels of the organization for making operation decisions, for financial reporting and for compliance with laws. Information systems communicate both internal and external information. The accounting systems implement double-entry accounting methods which includes features that prevent and detect errors and irregularities:

- Debit and credit analysis
- Chart of accounts
- Standard journal vouchers
- Trial balance
- Control accounts

Monitoring

Monitoring is a process of assessing the quality of a system's performance over time. It may focus on:

- **Ongoing activities** – e.g. clerical checks, reconciliations or management review of accounts
- **Separate evaluations** – performed by independent or internal auditors

Lecture 6 - Questions and exercises

Q 6-1: What are the components of internal control?

Q 6-2: What are the two threats to accurate and reliable accounting data? Describe and distinguish between them.

Q 6-3: Identify seven factors that affect an organization's control environment.

Q 6-4: What are the four categories of control activities?

Q 6-5: Which features of double-entry accounting system prevent and detect errors and irregularities?

E 6-1: Control Procedures

The following is a list of control procedures discussed in this chapter. Identify to which of the four categories of control activity each belongs.

- a) Separating custody from recordkeeping.
- b) Merchandise price tags.
- c) Prenumbered documents.
- d) Prompt recording.
- e) Locks.
- f) Fixing responsibility to avoid incompatible functions.

The main source:

BOCKHOLDT, J. L. *Accounting Information Systems: transaction processing and controls*. 5th edition, Boston: McGraw Hill Education 1999, ISBN 0-07-116098-1

The supplementary sources:

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