

Alaska Association of School Business Officials

Why Bother With

INTERNAL CONTROLS?

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1:15 – 2:00



WHY ARE WE
HERE?

Here's What You Want to Learn Today (Yes, You Do)

- Understand how having a sufficient system of internal control can benefit you
 - Not only should you *have* a system of internal control, but...
 - ...that system should also be documented
- Understand how to go about documenting your system of internal control
- Get an overview of Entity Level & IT general controls
- Get some ideas on various formats that can be used

WHY DO I NEED
TO WORRY ABOUT
INTERNAL
CONTROLS?

Why the Increased Emphasis on Internal Controls?

■ Sarbanes Oxley Section 404:

- Financial scandals such as Enron and WorldCom brought about the Sarbanes Oxley Act of 2002. Section 404 of the Act (aka SOX 404) focuses on management's documentation and assessment of their internal controls over financial reporting.
- Much of the lessons being learned in the public company world are now being picked up by non-public companies

■ SAS 109:

- Directly links the auditor's understanding and evaluation of internal control to the assessment of risk and design of further audit procedures

■ SAS 112:

- Establishes standards and provides guidance on communicating matters related to an entity's internal control over financial reporting identified in an audit of financial statements

External Audit Requirements

■ SAS 109:

- Requires your external auditor to obtain a sufficient understanding of you and your environment, which includes your internal controls, as part of their assessment of the risk of a material misstatement to your financial statements.

■ SAS 112:

- Requires your external auditor to evaluate deficiencies in your system of internal controls over financial reporting.
- Requires your external auditor to communicate those findings to you in writing.
- The Appendix of SAS 112 implies that “inadequate documentation of the components of internal control” is a circumstance that may represent a control deficiency, significant deficiency or a material weakness.

Internal Benefits

- Documentation of your processes and internal controls will:
 - Provide a roadmap of responsibilities and expectations for your staff
 - Allow you identify gaps in controls – areas that are not sufficiently protected from error and/or fraud
 - Provide a framework for your management to monitor the efficiency and effectiveness of your processes
 - Provide additional assurance to your board of directors
 - Make your audit less painful...

Formal written documentation of your internal controls will generally increase your entity's efficiency and effectiveness.

Why Take the Time to Put This Stuff in Writing?

- Formalizing your processes and internal controls puts a higher level of accountability on your organization to follow appropriate procedures and, when appropriate, update the documentation
 - The documentation should evolve with your business
 - Everyone should have access to the documentation

Any Questions?



SO NOW WHAT?

Where Do I Start?

1. Identify who will be responsible for ensuring the documentation gets completed (pick a project manager)
2. Identify the material transaction cycles to be documented
3. Assign documentation responsibility to staff
4. Document away!
5. Maintain your documentation

1. Pick a Project Manager

- Identify a project champion
 - Responsible to ensure the project stays on track
 - Report on project status to management and/or board of directors
 - Obtain stakeholder buy-in (including external auditor)
 - Disseminate completed documentation to staff

2. Identify Material Transaction Cycles

- Common transaction cycles include:
 - Entity level processes – the high level “tone at the top” or management philosophy – i.e. high level monitoring processes and board or audit committee oversight
 - Cash receipts
 - Cash disbursements/wire transfers
 - Budgeting
 - IT
 - Payroll
 - Fixed assets
 - Grants
 - Credit cards
 - Investments
 - Journal entries

3. Decide Who Will Do What

■ Considerations:

- Time resources to get the job done
 - This may require re-allocating work loads for a period of time
- Knowledge/skills to do a good job
 - Do not necessarily need to have an in-depth knowledge of the process, but must to be able to gain an understanding through talking with others, and put that understanding in writing

4. Document Your Processes

- The form of your documentation should make sense to your entity
 - Documentation should be at a high level
 - Key steps in the process
 - Key control points that will help prevent or detect material misstatements
 - Key controls should be clearly identified

4. Document Your Processes, cont.

- Various methods can be used to understand the process
 - Documenter's personal knowledge of the process
 - Interview staff who are involved in the process
 - “Walk through” the process with staff – observe a transaction while it is being processed
- Ask personnel who are involved in the process to review the documentation and provide recommendations for changes

5. Maintain Your Documentation

- The time and effort you will spend in the initial documentation phase will be meaningless if you do not “disseminate and maintain”
 - Make sure your organization’s personnel have access to the documentation
 - Management
 - Accounting personnel
 - Operations personnel
 - Periodically revise your documentation as your business evolves

WHAT THE HECK
IS A CONTROL?

What Should My Company Deem a Control?

- An internal control over financial reporting is an activity that can be relied on to catch a *material* error to your financial statements
 - Can be preventative: prevent the error from occurring
 - Can be detective: detect an error that has already happened before it makes it into the financial statements
 - Focus on high-level, material activities (risk-based approach)
 - Activities that prevent or detect fraud
- Don't forget to consider information technology general controls!

Give Me Some Examples, Please

- IT-controlled
 - Restricted access to applications
- Segregation of duties
 - Initiation, recording, approval
- Authorization and approval
 - Review and approval at an appropriate level
- Reconciliations
 - Accuracy of account balances at month-end
- Monitoring and review
 - Final review of month-end financial results



Any

Questions?



WHAT'S AN
ENTITY LEVEL
CONTROL?

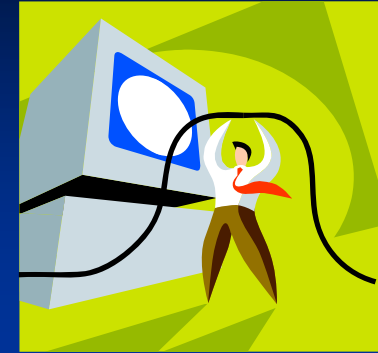
Tone at the Top Controls

- Entity level controls represent your organization's management philosophy:
 - Communication of your company's ethical values to your personnel
 - Oversight by your board of directors and committees
 - Commitment to hiring and keeping competent staff
 - Assessment of business risk
 - Monitoring of business performance

WHY DO WE HAVE
TO WORRY ABOUT
IT GENERAL
CONTROLS?

Information Technology Can Represent Risk to your Financial Statements

- Change Management
 - How do you know that changes in programming are still processing transactions correctly?
- User Security
 - How do you know that only authorized personnel are accessing transaction processing?
- Physical Protection
 - How do you know your business can continue in the aftermath of a crisis?



Any

Questions?



WHAT SHOULD
THIS STUFF LOOK
LIKE?

Your Documentation Should Look How You Want It To

(This is important, so let's review it again)

- The form of your documentation should make sense to your entity!!
 - Documentation should be at a high level
 - Key controls should be clearly identified

Okay, But *WHAT* Should It Look Like?

■ Possible Layouts

- Narrative
- Flowchart
- Combination

■ Possible Programs

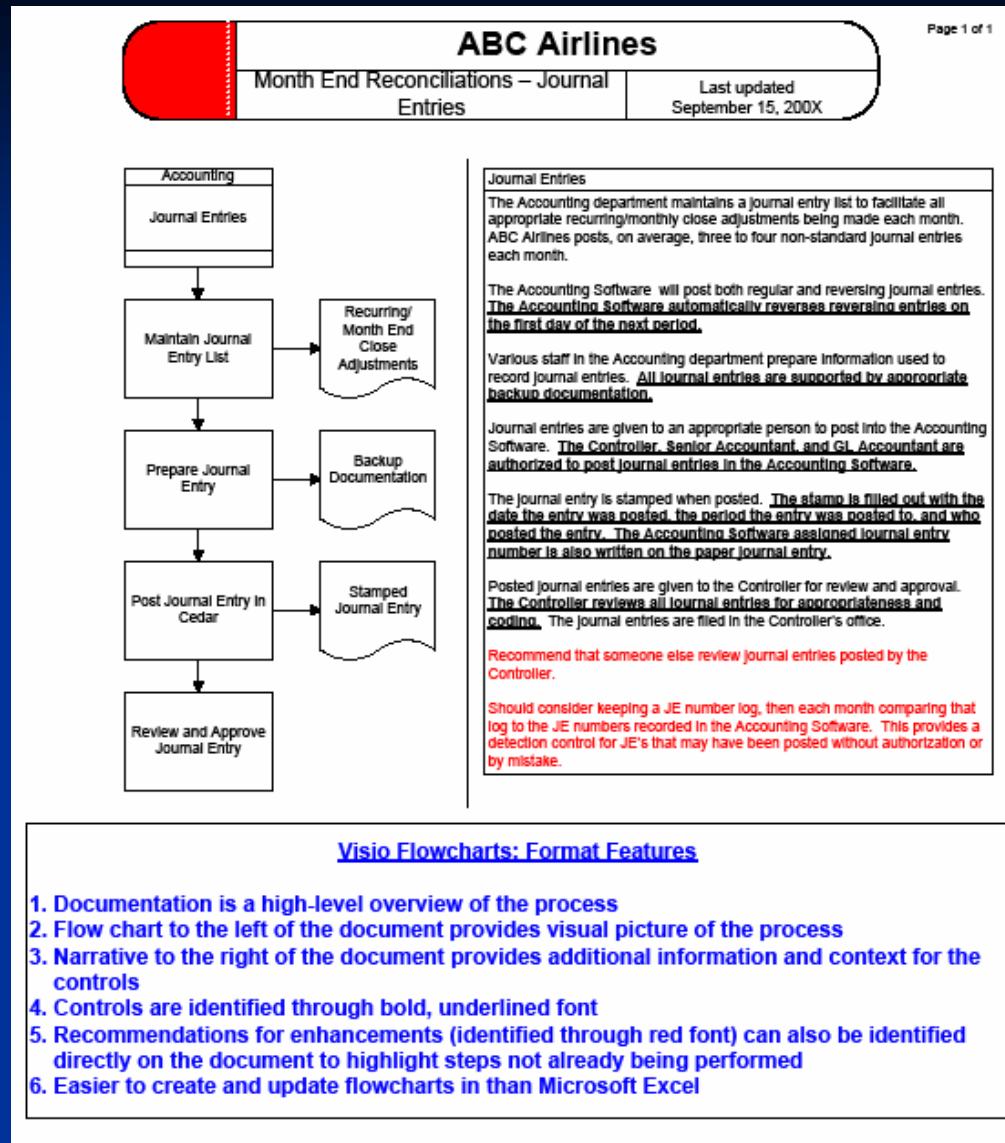
- Microsoft Visio
- Microsoft Excel
- Microsoft Word
- Combination

■ Clearly identify the transaction cycle

■ Consistently and clearly identify your controls

- Bold
- Underline
- Italicize
- Colored font

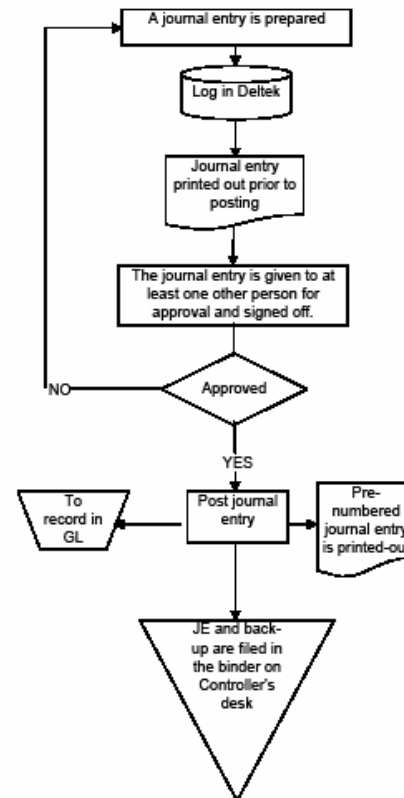
Sample #1



Sample #2

Last update September 15, 200X

Sample Company Journal Entries



A journal entry is prepared. Journal entries can be prepared by the Controller, AP or Payroll Clerks. The journal entry is entered into Dellek and printed out for review prior to posting.

The journal entry and supporting documentation are approved and signed off by a second person prior to posting.

Once approved the preparer posts the entry into the general ledger. **Dellek (the accounting software) shows who created the journal entry. The accounting software can generate a report detailing what journal entries have been posted.**

Journal entries are pre-numbered by the system once posted.

The approved journal entry, pre-numbered journal entry printed out from the system and supporting back-up are filed. The documentation is filed in a binder on the Controller's desk.

Excel Flowcharts: Format Features

1. Documentation is a high-level overview of the process
2. Flow chart to the left of the document provides visual picture of the process
3. Narrative to the right of the document provides additional information and context for the controls
4. Controls are identified through bold, underlined font
5. Recommendations for enhancements (identified through red font) can also be identified directly on the document to highlight steps not already being performed
6. Do not need to have Microsoft Visio to update documents

Sample #3

123 Company
Journal Entries
Documented August 17, 200X

Narratives: Format Features

1. Documentation is slightly more detailed than the other formats
2. Controls are identified through bold, underlined font
3. Recommendations for enhancements (identified through red font) can also be identified directly on the document to highlight steps not already being performed
6. Easy to use and no additional software is required

Updated (date/by): _____

Updated (date/by): _____

123 Company Journal Entry Process:

Interviewed: Wanda Wonderwoman, Controller

Background:

123 Company's (the Company) Accounting Department is responsible for maintaining the Company's general ledger. This is accomplished by recording transactions, reconciling accounts, and posting adjusting (journal) entries as needed.

Because posting journal entries represents an area at risk for error and/or fraud, 123 Company has identified this as a material process to its financial accounting and reporting system. As such, the Company has documented, and will maintain, its internal controls over journal entries.

Journal entries (JE) fall into three basic categories: standard, reversing, and adjusting. Standard journal entries (SJE) are recurring in nature and generally consist of allocations and accruals. Reversing journal entries (RJE) are also recurring in nature and generally consist of reversals of accruals. Adjusting journal entries (AJE) are non-recurring in nature and represent non-standard adjustments. AJEs are 123 Company's highest-risk journal entry type.

There are approximately seven employees in the Accounting Department. Any of the seven employees in the Accounting Department can prepare journal entries for posting, however, only the Accounting Supervisor and the Controller can post journal entries.

Preparing and Approving Journal Entries:

Journal entries can be prepared by any of the seven employees in the Accounting Department. The need for journal entries is identified through various normal-course-of-business processes, including but not limited to:

1. Recurring adjustments
 - a. Allocations
 - b. Accruals
 - c. Reversals

Sample #3, cont.

2. Reconciliation processes
 - a. Cash
 - b. Accounts receivable
 - c. Accounts payable
 - d. Payroll
 - e. Fixed assets
 - f. Other
3. Communication with various department managers

Accounting personnel fill out the JE Entry Form, which requires the following information, and attach supporting documentation.

- Date prepared
- Name of person preparing
- Posting date
- Entry information (account numbers, account descriptions, amounts)
- Reason for entry

The JE Entry Form and supporting documentation are given to the Accounting Supervisor for review and approval. All entries over \$10,000 are also reviewed and approved by the Controller. The Accounting Supervisor and/or Controller evidence their approval by signing and dating the JE Entry Form on the approval lines. The Accounting Supervisor and Controller also maintain a log of all journal entries that they have approved.

Recommend that 123 Company utilize appropriate separation of duties by implementing the following: All journal entries prepared by the Accounting Supervisor are reviewed and approved by the Controller. All journal entries prepared by the Controller are reviewed and approved by the CFO.

Posting Journal Entries:

Once the journal entry has been approved, it is given to another employee in the Accounting Department for posting. **123 Company ensures that the person who posts the entry is always different from the person who prepared the entry in order to maintain appropriate separation of duties.** The person posting the entry signs and dates the JE Entry Form on the posting line, notes the system-assigned transaction number on the JE Entry Form, prints the journal entry report from the accounting software, and attaches the printout to the JE Entry Form. They then file the packet in the JE Binder in the Accounting Supervisor's office.

Month-End Review:

At the end of each month, the Accounting Supervisor runs a JE Report from the accounting software that lists all journal entries posted for the month. **The Accounting Supervisor and Controller compare their logs of journal entries approved to the JE Report to ensure all posted journal entries have been approved.**

Recommend that 123 Company maintain a monthly list of all SJE and RJE, with the name of the JE, the name of the person responsible for preparation, and a line to initial once the JE is complete. This will help ensure that all standard and reversing journal entries are posted each month.

Summing It All Up

- Documenting your internal processes and controls will benefit your organization
- Develop a project plan so you stay on track during the documentation process
- Choose a format that makes sense to your organization
- Focus on material activities
- Obtain buy-in from the persons affected by the documentation
- Update the documentation as your business evolves

Thank you!



Any Questions?