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What are Internal Controls and are they needed?

As you know from previous articles and our workshops, we've identified internal controls as any activity that you perform to ensure that what you want to happen, happens. By defining and designing strong, appropriate controls, both large and small entities can improve their compliance posture and should recognize benefits across their organization. A properly designed internal control will provide numerous benefits, a few of which are: identifying areas of risk prior to the risk escalating to an event; providing a paper trail (tangible or electronic) substantiating compliance for any compliance oversight engagement; identifying areas of interdependence that you may not be aware of; and providing organizational transparency to help reduce silos and increase cross functional awareness.

Types of Internal Controls and their benefits:

Preventive Controls. These are proactive controls. Preventive Controls are focused on quality and function to identify misinformation, irregularities, or errors. They are often considered extremely effective because they are based on company objectives, are usually inexpensive to implement, and assist in maintaining assets.

Examples of preventive controls include:

- ▶ Segregation of duties: more than one individual completing a task
- ▶ Approvals: confirmation of calculations, transactions, or activities by independent review
- ▶ Authorizations: delegation of duties
- ▶ Verifications: ensure the accuracy, correctness, or truth of the information
- ▶ Asset management: inventory of assets with defined attributes

Detective Controls. These are controls that are designed to identify errors and irregularities after they have occurred. They help identify issues when a

preventive control has failed.

Examples of detective controls include:

- ▶ Peer reviews
- ▶ Data reconciliations
- ▶ Internal audits

Corrective Controls. These controls are triggered when a detective control has identified an issue. Corrective controls help to identify activities that should be implemented to rectify an issue and hopefully prevent it from happening again. Corrective controls often become the new preventive control.

Examples of corrective controls include:

- ▶ Implemented procedures
- ▶ Data backups used for recovery

A dynamic internal control program would consist of controls from all three types.

Components of an Internal Control and Internal Control Program

A properly designed internal control will:

1. Identify the line of demarcation; what event triggers the internal control activity to commence and when is the control completed
2. Sequence all activities that must occur to perform the internal control, focusing on only 'key' activities
3. Determine information or data needed to perform those activities and where to get that information
4. Determine internal control output
5. Identify all stakeholders (internal and external) the control outcome must be reported to
6. Assign ownership of each internal control to the appropriate position
7. Be documented, either as a procedure, checklist or flowchart

A strong internal control program possesses:

1. Competent, empowered personnel
2. Clear flow of communication, both vertically and horizontally
3. Segregation of Duties or appropriately implemented reviews, in order to reduce the likelihood of errors or irregularities
4. Appropriate documentation and record retention
5. Monitoring of the internal control program to ensure controls are appropriate and operating as designed.

Internal Control Limitations

No internal control or internal control program is ever perfect. The largest risk to any internal control program is human error. Humans are inherently fallible. For example, cognitive bias, or seeing what you expect to see while performing a mundane or frequent task, poses a large risk to the organization. However, this risk can be mitigated either by Segregation of Duties or inserting a performance review between key processes.

Balancing the cost of a specific control for the expected benefit of the control should be considered when designing an internal control program. Some controls cost next to nothing to implement (reviews, standardized documentation, reconciliation of supporting documentation to information captured within software programs). However, that is not true for all controls.

Finally, internal controls should be assigned to a position, not a person. This ensures a continuation of the control when a person is absent from their position, establishing a practice where specific tasks assigned to a position continue to be performed. By implementing this process, you shift the posture of the organization from being 'Person Dependent' to 'Process Dependent,' reducing some of the risk faced by the organization.