

SECTION V –INTERNAL CONTROLS

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A. OVERVIEW

The District’s accounting system should be designed to assemble, analyze, classify, record and report financial data as well as maintain adequate control over district assets. District administration is charged with providing the leadership necessary for the district to achieve the following:

- Effectiveness- is the District achieving its objectives?
- Efficiency- is optimal use being made of District resources?
- Compliance- are policies, laws and regulations being followed?
- Reporting- are financial reports for the benefit of interested parties being prepared on a regular basis?

The administration creates and maintains a framework of internal control to ensure that the District will meet its responsibilities.

The scope of internal control is very broad, encompassing all management activities, both programmatic and financial. The following discussion, however, focuses solely on internal control as it relates **directly to accounting and financial reporting**. It is generally recognized that any truly comprehensive framework of internal control must possess five essential elements.

1. **Favorable control environment**

The key element in a favorable control environment is administration’s attitude, as demonstrated through its actions. Administration must lead by example, creating a “tone at the top” that sets the standard for the entire organization. The importance of internal controls must be communicated to staff at all levels and there must be swift and appropriate disciplinary actions for employees who violate standards of conduct.

2. **Continuing assessment of Risk**

On an ongoing basis, administration must attempt to identify and assess potential risks that could prevent the administration from fully meeting its responsibilities. Risks generally arise either as a result of changes in the District’s operating environment or as a result of inherent risk.

3. **Design, implement and maintain effective control-related policies and procedures**

The District must have a system that provides for the design, implementation and maintenance of effective control-related policies and procedures. The key categories of control-related policies and procedures for accounting and financial reporting are as follows:

- Authorization- who can initiate a transaction
- Properly designed records- sequentially numbered, etc.

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- Security of assets and records- minimize the danger of loss or misuse
- Segregation of incompatible duties- in practice, three types of functions are commonly considered to be mutually incompatible
 - Authorization of transactions
 - Record-keeping
 - Custody of assets
- Periodic reconciliations- it is important that related accounting records be compared periodically.
- Periodic verifications- administration should periodically compare data contained in the accounting records to what those data purport to represent (for example, taking a physical inventory)
- Analytical review- the process of determining the reasonableness of financial data by comparing their behavior with other financial and non-financial data.

4. **Communication**

For internal control to function properly, it is essential that there be clear lines of communication throughout the organization. For example, a well designed and properly maintained system for documenting finance-related policies and procedures enhances both accountability and consistency.

5. **Monitoring**

It is essential that District administration continuously monitor control-related policies and procedures to ensure that they are continuing to function properly. In addition, it is important that the administration carefully monitor the resolution of audit findings to ensure that any weaknesses, once identified, are promptly and effectively corrected.

The cost of internal control; of course, should never exceed related benefits. Thus, a key limitation on internal control is that cost considerations will prevent district administration from ever installing a “perfect” system. Instead, the administration will deliberately and properly choose to run certain risks because the cost of preventing such risks cannot be justified.

Another limitation of internal control is management override. That is, if the administration has the power to establish a control-related policy or procedure, the same administration probably has the ability to override that same policy or procedure. Likewise, the risk of collusion is a limitation of internal control.

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B. RESPONSIBILITIES

The Board of Education oversees district administration’s performance; so while the District administration is primarily responsible for internal control, the school board is ultimately responsible for ensuring that the administration fulfills its duty in this regard.

The School Board’s oversight role is particularly important because of administration’s ability to override controls.

The District’s independent auditors can play a valuable role in helping the administration and the Board fulfill their respective responsibilities for internal control, but auditors cannot themselves assume either primary or ultimate responsibility.

Independent auditors must gain an understanding of the District’s internal control framework as part of the process of assessing audit risk. Accordingly, districts have sometimes reached the understandable but mistaken conclusion that the independent audit of the financial statements is sufficient to ensure that the internal control framework is adequately designed and functioning properly. In fact, however, the purpose and scope of the independent auditor’s assessment of internal control is quite limited.

The objective of the independent audit is to assure potential users of financial statements that they can reasonably rely on those statements to be free from errors that could change the users’ overall assessment of the entity’s finances. A properly designed and conducted financial statement audit should uncover all internal control weaknesses (auditors call them material weaknesses) that could have such a major impact on financial reporting. However, while most internal control weaknesses are important to management they are not significant enough to potentially affect a user’s overall assessment of the entity’s finances. So there is no assurance that all immaterial weaknesses will be uncovered, even in a thorough and well-conducted financial statement audit. Thus, the independent auditor’s assessment of internal control should *not* be viewed as a substitute for management’s own ongoing monitoring of the effectiveness of its control-related policies and procedures.

The AICPA Auditing Standards Board has issued a series of Statements on Auditing Standards SAS (#104 to #114) that require the independent auditor to:

- Obtain a deeper understanding of the district and its internal control for purposes of identifying the risks of material misstatement in the financial statements and what the district is doing to mitigate those risks
- Develop a more rigorous assessment of the risks of material misstatement based on that understanding
- Create better linkage between the assessed risks and the audit procedures performed
- Ensure the open and candid communications with the Board of Education regarding significant findings and issues related to the audit.

As part of these new standards, SAS #112 “Communication of Internal Control Related Matters Noted in an Audit” creates a big change in the extent of internal control “deficiencies” that are required to be reported in writing. For example, SAS #112 indicates that “ineffective oversight of the entity’s financial reporting and internal control by those charged with governance” should be

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regarded as at least a significant deficiency and a strong indicator of a material weakness in internal control.

Likewise, SAS #112 identifies “employees or management who lack the qualifications and training to fulfill their assigned functions” as an indicator that a control deficiency should be regarded as at least a significant deficiency and a strong indicator of a material weakness.

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C. Internal Control and Fraud Protection

Auditors have identified three conditions that generally are present when fraud occurs:

- Incentive/pressure;
- Opportunity; and
- Attitude/rationalization

It is important to emphasize the special role played by *opportunity*. No matter how great the incentive or pressure to commit fraud, fraud simply cannot occur without opportunity. Conversely, opportunity, *by itself*, can produce the incentive needed to commit fraud. Therefore, opportunity not only *permits* fraud to occur, but actually promotes fraud by creating a potential trap for otherwise honest individuals.

Individual control-related policies and procedures can be divided between those that are designed to *prevent* the occurrence of errors and irregularities and those that are designed to *detect* errors and irregularities after they have occurred. Controls involving periodic verifications and analytical review fall into the second category. Controls designed to *detect* errors and irregularities also can be highly effective in *preventing* their occurrence, as the prospect of prompt detection and exposure can be a powerful disincentive to fraud. Thus, educating employees at all levels about the purpose and operation of control-related policies and procedures can help to minimize irregularities.

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D. DESIGNING AN INTERNAL CONTROL SYSTEM

The typical approach to designing a system of internal control starts with a comprehensive checklist. A quick search of the internet can provide the district with a wide variety of such checklists. Some possible sites for the district to consider would be:

- Government Finance Officers Association (GFOA) – www.gfoa.org
- The committee of sponsoring organizations of the Treadway Commission (COSO) www.coso.org
- The American Institute of Certified Public Accountants (AICPA) www.aicpa.org
- The United States Government Accountability Office (GAO) www.gao.gov
- Michigan Department of Education (MDE) *Federal Fiscal Requirements Power Point Presentation* at:
http://www.michigan.gov/documents/mde/FederalFiscalRequirements_187377_7.ppt

The key factor is to recognize that no internal control discussion or checklist should be considered as being all-inclusive nor is it likely that all suggested procedures in all areas would be desirable. The district **must** tailor the available information to fit the individual district's facts and circumstances.