Internal Controls
What are they and why are they important?

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Internal Control is...

• A process designed to provide **reasonable** assurance regarding the achievement of objectives in the categories of:
  
  • Achievement of strategic objectives
  • Reliability and integrity of information
  • Effectiveness and efficiency of operations and programs
  • Safeguarding of assets
  • Compliance with applicable laws and regulations
Everyday Examples of Internal Controls

• You lock your home and your vehicle (safeguarding assets);
• You look both ways before you cross the road (safeguarding assets);
• You call the police when you witness a crime (compliance with applicable laws and regulations and reliability and integrity of information);
• You keep your ATM/debit card pin number separate from your card (safeguarding assets);
• You review bills and credit card statements before paying them (reliability and integrity of information);
• You don’t leave blank checks or cash just lying around (safeguarding assets);
• You reconcile your bank account on a monthly basis (achievement of strategic objectives and reliability and integrity of information);
• You set-up instant alerts for your debit/credit cards (reliability and integrity of information);
• You expect your children to ask permission before they can do certain things (Compliance with applicable laws and regulations);
University Internal Controls

- Offices, buildings, labs and state vehicles are kept locked when unoccupied (safeguarding of assets)
- Computer passwords are periodically changed and shouldn’t be written down by the computer (safeguarding of assets, integrity of information)
- Checking management reports and purchase card charges against source documents (reliability and integrity of information and effectiveness and efficiency of operations and programs)
- Locked cash drawers and secure storage for checks (safeguarding of assets)
- Authorizations required for certain activities (effectiveness and efficiency of operations and programs, achievement of strategic objectives)
- Separation of incompatible duties (effectiveness and efficiency of operations and programs, safeguarding of assets, achievement of strategic objectives)
- Performing research in accordance with grant terms and conditions (compliance with applicable laws and regulations, achievement of strategic objectives)
Internal Controls are meant to:

- Protect assets
- Ensure that records are accurate
- Promote operational efficiency
- Encourage adherence to policies, rules, regulations, and laws
Five Types of Internal Controls

- Preventive
- Compensating
- Detective
- Directive
- Corrective
Preventive Internal Controls

The first line of defense, are designed to **prevent** errors and irregularities in the first place

**Examples**

- Segregation of duties, remember the “ARC” (separates Accountability (or Authorization) from Reconciliation, from Custody (of asset). No person should perform more than one function
- Access controls (passwords, physical controls over assets)
- Authorized signers
- Pre-approvals (purchases, travel authorizations, etc.) University payables review and approval of travel vouchers prior to processing
- Policies, procedures, and expectations
Detective Internal Controls

Designed to detect errors or irregularities that may have occurred.

Examples

- Account reconciliations (including management review)
- Physical inventories
- P-Card logging, reconciliation, and approval
- Review of budget to actual
- Year to year expenditure trending
Corrective Internal Controls

Designed to correct errors or irregularities that have been detected

Examples

• Error communication and reporting
• Systems Documentation or processes
• Improvement initiatives
• Software patches or modifications
• New policies or procedures
Directive Internal Controls

Designed to direct actions to ensure a particular outcome is achieved

Examples

- Policies and procedures
- Training
- Job descriptions
- Organizational structure
Compensating Internal Controls

Used to **compensate** for controls that are otherwise lacking – meant to be temporary

**Examples**

- Close supervision for improper segregation of duties
- E-mail encryption
### Who is Responsible for Internal Control?

<table>
<thead>
<tr>
<th>University Administration</th>
<th>University Employees</th>
<th>University Internal Audit</th>
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</table>
| • Promote and maintain an environment in which strong internal controls are mandated and monitored.  
• Support fraud prevention and detection efforts, including the development of strong fraud and conflict of interest policies. | • Upholding values and ethics in their actions.  
• Examine internal controls in their own operations and work with their supervisors to strengthen weak controls.  
• Report any suspicion or knowledge of unethical or fraudulent actions to the University's Office of Internal Audit. | • Appraise the adequacy and effectiveness of internal controls.  
• Evaluate whether controls provide reasonable assurance objectives are being met.  
• Investigate reported fraud and actively search for fraud during audit engagements. |
Components of Internal Control

- **Control Environment**: Overall tone from management (people, integrity, ethics, values, competence)
  - e.g., approvals, completeness, accuracy, reconciliation, segregation of duties, security, error handling, validity
- **Risk Assessment**: Identify the things that “keep me up at night”
  - e.g., approvals, completeness, accuracy, reconciliation, segregation of duties, security, error handling, validity
- **Monitoring**: Is it working?
  - e.g., approvals, completeness, accuracy, reconciliation, segregation of duties, security, error handling, validity
- **Control Activities**: 
  - e.g., approvals, completeness, accuracy, reconciliation, segregation of duties, security, error handling, validity

*Image source: Kansas State University*
Five Key Internal Control Activities...
1. Separation of Duties

• Divide responsibilities between different employees so one individual doesn’t control all aspects of a transaction.

• Reduce the opportunity for an employee to commit and conceal errors (intentional or unintentional) or perpetrate fraud.
2. Documentation

Document & preserve evidence to substantiate:

• Critical decisions and significant events...typically involving the use, commitment, or transfer of resources.

• Transactions...enables a transaction to be traced from its inception to completion.

• Policies & Procedures...documents which set forth the fundamental principles and methods that employees rely on to do their jobs.
3. Authorization & Approvals

- Management documents and communicates which activities require approval, and by whom, based on the level of risk to the organization.
- Ensure that transactions are approved and executed only by employees acting within the scope of their authority granted by management.
4. Security of Assets

• Secure and restrict access to equipment, cash, inventory, confidential information, etc. to reduce the risk of loss or unauthorized use.

• Perform periodic physical inventories to verify existence, quantities, location, condition, and utilization.

• Base the level of security on the vulnerability of items being secured, the likelihood of loss, and the potential impact should a loss occur.
5. Reconciliation & Review

- Examine transactions, information, and events to verify accuracy, completeness, appropriateness, and compliance.
- Base level of review on materiality, risk, and overall importance to organization’s objectives.
- Ensure frequency is adequate enough to detect and act upon questionable activities in a timely manner.
# Internal Control Myths and Facts

<table>
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<tr>
<th>MYTHS:</th>
<th>FACTS:</th>
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<tr>
<td>Internal control starts with a strong set of policies and procedures.</td>
<td>Internal control starts with a strong control environment.</td>
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<tr>
<td>Internal control: That’s why we have internal auditors!</td>
<td>While internal auditors play a key role in the system of control, management is the primary owner of internal control.</td>
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<td>Internal control is a finance thing.</td>
<td>Internal control is integral to every aspect of business.</td>
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<td>Internal controls are essentially negative, like a list of “thou-shalt-nots.”</td>
<td>Internal control makes the right things happen the first time.</td>
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<td>Internal controls take time away from our core activities of teaching, researching, and serving customers.</td>
<td>Internal controls should be built “into,” not “onto” business processes.</td>
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Why don’t Internal Controls always work?

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<th>Inadequate knowledge of University policies or governing regulations. “I didn’t know that!”</th>
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<td>Inadequate segregation of duties. “We trust ‘A’ who does all of those things.” Remember, in general only people we trust can steal from us, we watch the others.</td>
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<td>Inappropriate access to assets. Passwords shared, offices left unlocked, cash not secured . . .</td>
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<td>Form over substance “You mean I’m supposed to do something besides initial it.”</td>
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<td>Control override. “I know that’s the policy, but we do it this way.” “Just get it done, I don’t care how.”</td>
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<td>Inherent limitations. People are people and mistakes happen. You can’t foresee or eliminate all risk.</td>
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Questions?

“Contemplating any business act, an employee should ask himself whether he would be willing to see it immediately described by an informed critical reporter on the front page of his local paper and thus be read by his spouse, children, and friends.”

-Warren Buffett
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