

# Understanding Internal Control and Internal Control Services

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Over the last several years, practitioners in public practice have expressed confusion relating to the concept of internal control and, specifically, internal control over financial reporting.

For example, auditors may no longer default to a maximum control risk. Instead,

the auditor should obtain an understanding of the five components of internal control sufficient to assess the risk of material misstatement of the financial statements whether due to error or fraud, and to design the nature, timing, and extent of further audit procedures. The auditor should obtain a sufficient understanding by performing risk assessment procedures to evaluate the design of controls relevant to an audit of financial statements and to determine whether they have been implemented.<sup>1</sup>

This created a need for auditors to understand the concepts of internal control and, specifically, internal control over financial reporting.

Additionally, internal control deficiencies identified by an auditor that upon evaluation are considered significant deficiencies or material weaknesses should be communicated in writing to management and those charged with governance.<sup>2</sup> This standard also has led to a great deal of discussion about what is or is not a control and what role an auditor can play, with respect to the client's system of internal control.

Even if a practitioner in public practice does not perform audits but performs reviews and compilations, that practitioner must still understand internal control, due to the independence

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<sup>1</sup> Paragraph .40 of AU section 314, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement* (AICPA, *Professional Standards*, vol. 1).

<sup>2</sup> Statement on Auditing Standards No. 115, *Communicating Internal Control Related Matters Identified in an Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 325).



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ramifications, because a practitioner's independence would be impaired if he or she establishes or maintains internal control for a client.<sup>3</sup>

This paper describes the concepts of internal control (specifically internal control over financial reporting) and discusses the types of services related to internal control that may be performed by practitioners in public practice.

## What Is Internal Control?

Small business owners and management have long sought ways to better control the organization they manage. A system of internal control is put in place to keep the organization on course toward profitability goals and achievement of its mission and to minimize surprises along the way. An effective system of internal control enables management to deal with rapidly changing economic and competitive environments, shifting customer demands and priorities, and restructuring for future growth. Internal control promotes efficiency, reduces risks of asset loss, and helps ensure the reliability of financial statements and compliance with laws and regulations.

In 1992, the Committee of Sponsoring Organizations of the Treadway Commission (COSO) published a report titled *Internal Control—Integrated Framework* (the framework).<sup>4</sup> This document provides principles-based guidance for designing and implementing<sup>5</sup> effective internal control. COSO developed the framework in response to senior executives' needs for effective ways to better control their enterprises and to help ensure that organizational objectives related to operations, reporting, and compliance are achieved. This framework has become the most widely used internal control framework in the United States and has been adapted or adopted by numerous countries and businesses around the world.

The framework defines *internal control* as follows:

Internal control is a process, effected by an entity's board of directors, management and other personnel, designed to provide reasonable assurance regarding the achievement of objectives in the following categories:

- Effectiveness and efficiency of operations
- Reliability of financial reporting

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<sup>3</sup> Interpretation No. 101-3, "Performance of Nonattest Services," under Rule 101, *Independence* (AICPA, *Professional Standards*, vol. 2, ET sec. 101 par. .05).

<sup>4</sup> In addition to its original framework, the Committee of Sponsoring Organizations of the Treadway Commission (COSO) has subsequently issued *Internal Control over Financial Reporting—Guidance for Smaller Public Companies*. This document neither replaces nor modifies the original framework but rather provides guidance on how to apply it. Although it is directed at smaller public companies, its guidance also can be used by nonpublic entities, including not-for-profit entities.

<sup>5</sup> For purposes of this article, the phrase *design and implement*, as used by COSO, is assumed to mean the same as *establish and maintain*.

- Compliance with applicable laws and regulations

This definition reflects certain fundamental concepts:

- Internal control is a process. It's a means to an end, not an end in itself.
- Internal control is effected by people. It's not merely policy manuals and forms but people at every level of an organization.
- Internal control can be expected to provide only reasonable assurance, not absolute assurance, to an entity's management and board.
- Internal control is geared to the achievement of objectives in one or more separate but overlapping categories.

### **Management Objectives**

Internal control includes techniques used by management to achieve its objectives and meet its responsibilities in three distinct categories:

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

The first category addresses an entity's basic business objectives, including performance and profitability goals and safeguarding of resources. The second relates to the preparation of reliable published financial statements. The third deals with complying with those laws and regulations to which the entity is subject. These distinct but overlapping categories address different needs and allow a directed focus to meet the separate needs.

### **Internal Control Over Financial Reporting**

The term *reliability*, as used with financial reporting objectives, involves the preparation of financial statements that are fairly presented in conformity with the applicable financial reporting framework used by management.<sup>6</sup> Therefore, a system of internal control over financial reporting includes the design and implementation of those policies and procedures deemed necessary by management to provide reasonable assurance that the entity's financial statements are fairly presented in accordance with the basis of accounting chosen by management. Controls are those specific policies and procedures designed and implemented to prevent or detect and correct misstatements that, if not prevented or corrected, would cause the financial statements to not be fairly presented.

*Fair presentation* is defined as follows:

- The accounting principles selected and applied have general acceptance.

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<sup>6</sup> Applicable reporting frameworks include not only generally accepted accounting principles but also an other comprehensive basis of accounting (OCBOA) frameworks.

- The accounting principles are appropriate in the circumstances.
- The financial statements are informative of matters that may affect their use, understanding, and interpretation.
- The information presented is classified and summarized in a reasonable manner (that is, it is neither too detailed nor too condensed).
- The financial statements reflect the underlying transactions and events in a manner that presents the financial position, results of operations, and cash flows within a range of acceptable limits (that is, limits that are reasonable and practical to attain in financial statements).

Also inherent in fair presentation is the concept of materiality.

Supporting these objectives is a series of assertions that underlie an entity's financial statements. *Assertions* are management's implicit or explicit representations regarding the recognition, measurement, presentation, and disclosure of information in the financial statements and related disclosures. Assertions fall into three categories: (1) classes of transactions, (2) account balances, and (3) presentation and disclosure. Financial statement assertions include the following:

- *Existence or occurrence.* Assets, liabilities, and ownership interests exist at a specific date, and recorded transactions represent events that actually occurred during a certain period.
- *Completeness.* All transactions and other events and circumstances that occurred during a specific period and that should have been recognized in that period have, in fact, been recorded.
- *Rights and obligations.* Assets are the rights and liabilities are the obligations of the entity at a given date.
- *Accuracy, valuation, or allocation.* Asset, liability, revenue, and expense components are recorded at appropriate amounts in conformity with relevant and appropriate accounting principles. Transactions are mathematically correct and appropriately summarized and recorded in the entity's books and records.
- *Cut off.* Transactions and events have been recorded in the correct accounting period.
- *Classification and understandability.* Items in the statements have been properly described, sorted, and classified. Financial information is appropriately presented and described, and information in disclosures is expressed clearly.

How does a small business owner know that all of the assets and liabilities presented in the financial statements actually exist? What can management and small business owners do to ensure that financial statements are complete? How does management know that certain complex accounting transactions are recorded properly? How can proper allocation among accounts and between periods be assured? How does management know what disclosures are necessary in accordance with various accounting frameworks? Only well designed, properly implemented,

and adequately maintained control-related policies and procedures can provide management with a reasonable basis for making the implicit assertions that underlie any financial statement.

However, many small businesses<sup>7</sup> and nonprofit and governmental organizations do not have the internal accounting expertise necessary to prepare reliable financial statements. Accordingly, practitioners in public practice have played an important role, through the performance of a variety of services, in helping those clients with their accounting systems and in the preparation of appropriate financial statements. Because of the complexity of many accounting standards, the practitioner's involvement in the client's system of internal control over financial reporting improves the quality and reliability of the financial information and results in more informed decision making by financial statement users. Those users, including third party users, as well as management, those charged with governance, and owners of small businesses, count on the practitioner to help management "get it right." In other words, the practitioner assists the client in preventing or detecting and correcting misstatements in the financial statements or management's financial information.

### **Components of Internal Control**

Internal control consists of five interrelated components. These are derived from the way management runs an organization and are integrated with the management process. Although the components apply to all entities, smaller organizations may implement them differently than larger ones. Their controls may be less formal and less structured, yet a small organization can still have effective internal control. The five components of internal control are described in the following sections.

#### **Control Environment**

The control environment component is the foundation upon which all other components of internal control are based, and it sets the tone of an organization. A small business can have unique advantages in establishing a strong control environment. Employees in many smaller businesses interact more closely with top management and are directly influenced by management actions. Through day-to-day practices and actions, management can effectively reinforce the company's fundamental values and directives. The close working relationship also enables senior management to quickly recognize when employees' actions need modification.

#### **Risk Assessment**

Risk assessment, as it relates to the objective of reliable financial reporting, involves identification and analysis of the risks of material misstatement. Establishment of financial reporting objectives articulated by a set of financial statement assertions for significant accounts is a precondition to the risk assessment process. Risk assessment in small businesses can be relatively efficient, often because in-depth knowledge of the company's operations enables the owner and management to have first-hand information of where risks exist. In carrying out their

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<sup>7</sup> In some cases, this includes smaller public companies.

normal responsibilities, including obtaining information gained from employees, customers, suppliers, and others, these managers identify risks inherent in business processes. In addition to focusing on operations and compliance risks, they are positioned to consider the following risks to reliable financial reporting:

- Failing to capture and record all transactions
- Recording assets that do not exist or transactions that did not occur
- Recording transactions in the wrong period or wrong amount or misclassifying transactions
- Losing or altering transactions once recorded
- Failing to gather pertinent information to make reliable estimates
- Recording inappropriate journal entries
- Improperly accounting for transactions or estimates
- Inappropriately applying formulas or calculations

### **Control Activities**

Control activities are the policies and procedures that help ensure management directives are carried out. They help ensure that necessary actions are taken to address risks to achievement of the entity's objectives. Control activities occur throughout the organization at all levels and in all functions. They include a range of activities as diverse as approvals, authorizations, verifications, reconciliations, reviews of operating performance, security of assets, and segregation of duties. When resource constraints compromise the ability to segregate duties, many smaller companies use certain compensating controls to achieve the objectives.

### **Information and Communication**

Information systems identify, capture, process, and distribute information supporting the achievement of financial reporting objectives. Information systems in small businesses are likely to be less formal than in large ones, but their role is just as significant. Many small businesses rely more on manual or stand-alone IT applications than complex integrated applications. Effective internal communication between top management and employees may be facilitated in smaller companies due to fewer levels and numbers of personnel and greater visibility and availability of the owner. Internal communication can take place through frequent meetings and day-to-day activities in which the owner and other managers participate.

### **Monitoring**

Internal control systems need to be monitored, which is a process that assesses the quality of the system's performance over time. This is accomplished through ongoing monitoring activities, separate evaluations, or a combination of the two. Managers of many smaller businesses have high-level first-hand knowledge of company activities, and their close involvement in operations positions them to identify variances from expectations and potential inaccuracies in reported financial information.

COSO has depicted how these elements work together from a process perspective as follows:



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### **What Are Nonattest Services?**

According to the AICPA Code of Professional Conduct (the code), the term *nonattest services* includes accounting, tax, and consulting services that are not part of an attest engagement. Attest engagements include financial statement audits, reviews, and compilations, as well as any engagement performed under the Statements on Standards for Attestation Engagements (for example, agreed-upon procedures engagements). Therefore, nonattest services include all services that are not attest services. Pursuant to the code, the performance of certain general activities would impair independence. One general activity is establishing or maintaining internal controls, including performing ongoing monitoring activities for a client.<sup>8</sup>

### **What Are Internal Control Services?**

Simply speaking, internal control services are any services that impair a practitioner's independence under the general activity previously set forth.<sup>9</sup> Procedures performed as part of an internal control service have a different intent from procedures performed as part of an attest service. When performing internal control services, such procedures are performed for the

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<sup>8</sup> Interpretation No. 101-3.

<sup>9</sup> In a proposed Statement on Standards for Accounting and Review Services, the Accounting and Review Services Committee has defined the term consistent with this notion as "a nonattest service, separate from [a] compilation [or review] engagement, performed by the accountant on behalf of management to design or operate any aspect of internal control over financial reporting."

benefit of management, and the results of those procedures are used by management. On the other hand, attestation procedures are performed for the benefit of the practitioner in helping him or her form the basis for his or her report.<sup>10</sup>

Internal control services may include establishing the control (designing a control to prevent or detect and correct a misstatement) or maintaining the control (performing or operating the control to prevent or detect and correct a misstatement), or both. Internal control services may be performed for public companies [performing monitoring procedures for the benefit of management to provide an assertion under Rule 404(a) of the Sarbanes-Oxley Act of 2002], or they may be performed for private entities. Internal control services that prevent or detect and correct misstatements in the financial statements traditionally are categorized as described in the following sections.

## **POINT OF EMPHASIS**

The examples of internal control services in the following sections are not intended to be all-inclusive. The key point is that if the nonattest service establishes or maintains internal control, then that service is an internal control service, and establishing or maintaining internal controls for a client will impair independence.

### **Approval, Authorization, and Verification**

The first step toward controlling financial reporting is to ensure that all transactions are properly authorized in accordance with management's policies. Management authorizes employees to perform certain activities and execute certain transactions within limited parameters. In addition, management specifies those activities or transactions that need supervisory approval before they are performed or executed by employees. A supervisor's approval (manual or electronic) implies that he or she has verified and validated that the activity or transaction conforms to established policies and procedures.

*Authorization* is the delegation of authority, and it may be general or specific. Giving a department permission to expend funds from an approved budget is an example of general authorization. Specific authorization relates to individual transactions; it requires the signature or electronic approval of a transaction by a person with approval authority. Approval of a transaction means that the approver has reviewed the supporting documentation and is satisfied that the transaction is appropriate; accurate; and complies with applicable laws, regulations, policies, and procedures. Generally, approvers review supporting documentation, question unusual items, and make sure that necessary information is present to justify the transaction before they sign off on the transaction.

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<sup>10</sup> Attestation services may indirectly benefit management. For example, if a practitioner identifies a misstatement in the financial statements while performing a review engagement and proposes an adjustment to correct a material misstatement, management is benefited. However, the direct purpose of the review procedure was performed for the benefit of the practitioner in obtaining review evidence.

As a general rule, authorization controls do both of the following:

- Require advance approval
- Require written documentation of approval

**Example of Internal Control Service**

The practitioner may perform procedures that entail approval, authorization, or verification. These procedures are performed for the benefit of management to prevent misstatements in the financial statements. The following examples illustrate how this internal control service may be performed for a client:

Establish authorization control	The practitioner designs a control that establishes approval limits and states that approvers should review supporting documentation, question unusual items, and make sure that necessary information is present to justify the transaction before signing a check.
Maintain authorization control	The practitioner maintains the control of reviewing and approving transaction classifications prior to posting the transaction in the general ledger.

**Security of Assets and Records**

Security must be maintained over an entity’s assets to minimize the danger of loss or misuse. What is frequently overlooked, however, is that security over an entity’s accounting records is equally important. It does little good, for instance, to maintain tight control over assets if easy access to the underlying accounting records subjects those assets to substantial potential loss. Adequate security over assets and records generally encompasses all of the following:

- Controlled access
- Physical security
- Backup for computer records
- Disaster recovery

**Example of Internal Control Service**

The practitioner may perform procedures that relate to the security of assets and records. These procedures are performed for the benefit of management, primarily to prevent and detect misstatements in the financial statements. The following examples illustrate how this internal control service may be performed for a client:

Establish security control	The practitioner designs controls that require that access to equipment, inventories, securities, cash, and other assets is restricted through the use of locks, passwords, and data encryption.
Maintain security control	The practitioner performs a control that requires periodically counting inventory items and comparing those counts to balances per the perpetual records.

### **Segregation of Duties**

Segregation of duties is critical to effective internal control because it reduces the risks of both erroneous and inappropriate actions. An incompatible duty is one that would put a single individual in the position of being able to commit an irregularity and then conceal it. For instance, receiving reports are used to ensure that ordered goods have actually been received before payment is made. If a single individual was able to place orders and prepare receiving reports, that person could then fabricate fictitious orders, resulting in improper payments. Accordingly, such incompatible duties should be segregated.

In practice, three types of functions are considered to be mutually incompatible: authorization, record keeping, and custody. Thus, no single individual should be able to (1) authorize a transaction, (2) record the transaction in the accounting records, and (3) maintain custody of the assets resulting from the transaction. When these functions cannot be separated, due to limited personnel, a detailed supervisory review of related activities may be used as a compensating control activity.

### **Example of Internal Control Service**

The practitioner may perform procedures that relate to segregation of duties. These procedures are performed for the benefit of management, primarily to prevent misstatements in the financial statements. The following examples illustrate how this internal control service may be performed for a client:

Establish segregation of duties control	While performing monitoring procedures, the practitioner determines that the person who opens the mail and prepares a listing of the checks received is the same person who makes the deposit. The practitioner then establishes a new control for implementation.
Maintain segregation of duties control	The practitioner performs cash reconciliations in order to segregate that duty from the person

	who has custody of the checks.
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**Periodic Reconciliations**

Broadly defined, *reconciliation* is a comparison of different sets of data to one another, identifying and investigating differences and taking corrective action, when necessary, to resolve differences. Reconciling balances reported in general ledger control accounts to related amounts reported in subsidiary ledger accounts is an example of reconciling one set of data to another. This control activity helps ensure the accuracy and completeness of transactions. To ensure proper segregation of duties, the person who approves transactions or handles cash receipts should not be the person who performs the reconciliation. A critical element of the reconciliation process is to resolve differences. It does no good to note differences and do nothing about them. Differences should be identified, investigated, and explained—corrective action must be taken. Reconciliations should be documented and approved by management.

**Example of Internal Control Service**

The practitioner may perform procedures that relate to periodic reconciliations. These procedures are performed for the benefit of management, primarily to detect misstatements in the financial statements. The following examples illustrate how this internal control service may be performed for a client:

Establish reconciliation control	The practitioner establishes the control policy that requires comparison of vacation and sick leave balances per departmental records to vacation and sick leave balances per the payroll system.
Maintain reconciliation control	The practitioner maintains a control that reconciles the detail of fixed assets per the fixed asset ledger to the general ledger accounts. Any differences noted by the practitioner are investigated and adjusted as necessary.

**Analytical Review**

Reviewing reports, statements, reconciliations, and other information by management is an important control activity; management should review such information for consistency and reasonableness. Reviews of performance provide a basis for detecting problems. Management should compare information about current performance to budgets, forecasts, prior periods, or other benchmarks to measure the extent to which goals and objectives are being achieved and to identify unexpected results or unusual conditions that require follow up. Management’s review of reports, statements, reconciliations, and other information should be documented, as well as

the resolution of items noted for follow up. Analytical review also is often the most efficient means to ensure adequate control in situations when it is not practical to segregate incompatible duties.

## **POINT OF EMPHASIS**

Analytical procedures performed as part of a review or audit engagement are not considered internal control services. Analytical review procedures performed as part of an internal control service have a different intent from analytical procedures performed as part of a review or audit. When performing internal control services, the analytical procedures are performed for the direct benefit of management, and the results of those procedures are used by management. Analytical procedures performed as part of a review or audit engagement are for the direct purpose of gathering evidence for the benefit of the practitioner in helping him or her form the basis for his or her report.

### **Example of Internal Control Service**

The practitioner may perform procedures that relate to analytical review. These procedures are performed for the benefit of management, primarily to detect misstatements in the financial statements. The following examples illustrate how this internal control service may be performed for a client:

Establish analytical review control	The practitioner designs a control that compares information about current performance to budgets, forecasts, prior periods, or other benchmarks on a monthly basis to measure the extent to which goals and objectives are being achieved and to identify unexpected results or unusual conditions that require follow up.
Maintain analytical review control	The practitioner performs a monthly analytical review by comparing internal financial information with other financial or nonfinancial data to identify unexpected results and follows up to determine the cause of the unexpected results.

### **Controls Over Information Systems**

Controls over information systems are grouped into two broad categories: general and application controls. General controls commonly include controls over software acquisition and maintenance, access security, and application system development and maintenance. Application controls, such as computer matching and edit checks, are programmed steps within application

software. They are designed to help ensure the completeness and accuracy of transaction processing, authorization, and validity. General controls are needed to support the functioning of application controls; both are needed to ensure complete and accurate information processing.

### Example of Internal Control Service

The practitioner may perform procedures that relate to controls over information systems. These procedures are performed for the benefit of management, primarily to prevent and detect misstatements in the financial statements. The following examples illustrate how this internal control service may be performed for a client:

Establish information system control	The practitioner designs a disaster recovery plan that includes specific file backup policies and procedures.
Maintain information system control	The practitioner performs a periodic backup of accounting system and data files.

### Summary

Nonattest services consist of all services performed for a client, other than attest services. Therefore, any service performed for a client outside of an audit, review, compilation, or other attest service is a nonattest service. Any service that establishes or maintains internal controls, including monitoring for the client, is a nonattest service, and it impairs independence. These services are referred to as *internal control services*. Internal control services are performed for the benefit of management, and the results of those procedures are used by management to help prevent or detect and correct misstatements in the financial statements. The subsequent figure illustrates the relationship of internal control services to nonattest services.

The practitioner may perform a variety of internal control services for a client, including the following:

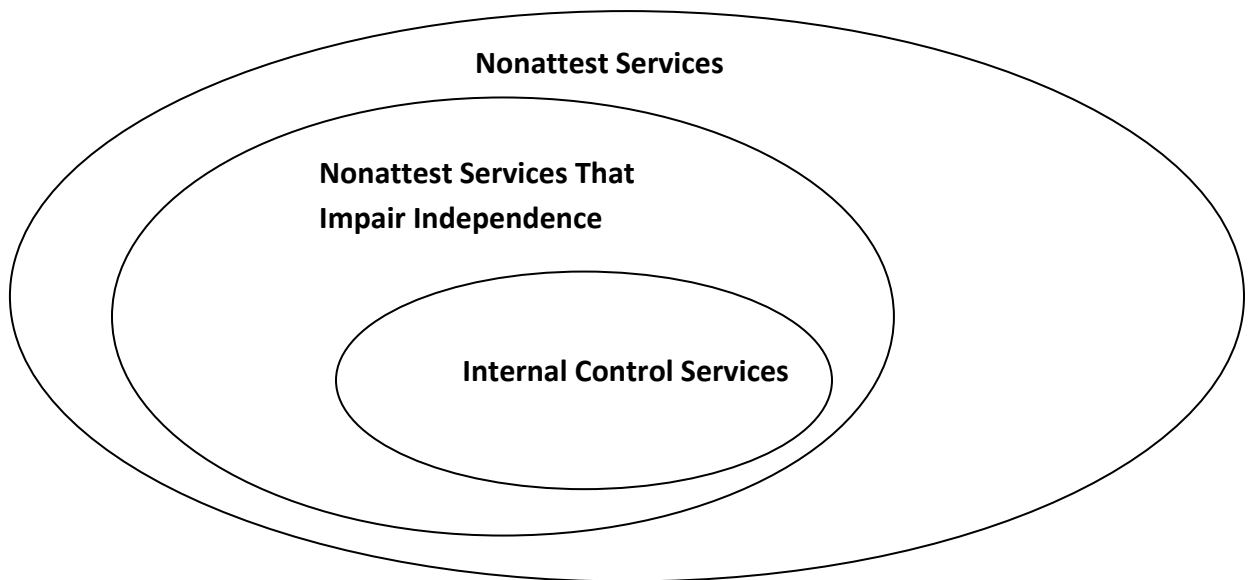
- *Related to the control environment.* These services may include establishing job descriptions and responsibilities, implementing complex accounting standards, and evaluating the competency of personnel.
- *Related to risk assessment.* These services may include indentifying financial statement assertions, reviewing financial accounting policies, and evaluating financial reporting processes.
- *Related to control activities.* These services may include selecting and developing specific policies and procedures, such as segregation of incompatible duties and compensating controls.
- *Related to information and communication.* These services may include communicating information regarding financial reporting objectives to those charged with governance,

such as the board of directors, and consulting with outside advisors on behalf of management.

- *Related to monitoring.* These services may include identifying and correcting internal control deficiencies on behalf of the owner and management.

## **POINT OF EMPHASIS**

Monitoring can be accomplished through ongoing activities, separate evaluations, or a combination of both. Ongoing monitoring activities are the procedures designed to assess the quality of internal control performance over time and are built into the normal recurring activities of an entity (for example, regular management and supervisory activities). Separate evaluations focus on the continued effectiveness of a client's internal control.



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