INTERNAL CONTROL

Internal control is broadly defined as 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:

1. Effectiveness and efficiency of operations.
2. Reliability of financial reporting.
3. 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, including interim and condensed financial statements and selected financial data derived from such statements, such as earnings releases, reported publicly. 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 systems operate at different levels of effectiveness. Internal control can be judged effective in each of the three categories, respectively, if the board of directors and management have reasonable assurance that:

- They understand the extent to which the entity's operations objectives are being achieved.
  1. Published financial statements are being prepared reliably.
  2. Applicable laws and regulations are being complied with.
  3. While internal control is a process, its effectiveness is a state or condition of the process at one or more points in time.

Internal control consists of five interrelated components. These are derived from the way management runs a business, and are integrated with the management process. Although the components apply to all entities, small and mid-size companies may implement them differently than large ones. Its controls may be less formal and less structured, yet a small company can still have effective internal control. The components are:

**Control Environment**

The control environment sets the tone of an organization, influencing the control consciousness of its people. It is the foundation for all other components of internal control, providing discipline and structure. Control environment factors include the integrity, ethical values and competence of the entity's people; management's philosophy and operating style; the way management assigns authority and responsibility, and organizes and develops its people; and the attention and direction provided by the board of directors.

**Risk Assessment**

Every entity faces a variety of risks from external and internal sources that must be assessed. A precondition to risk assessment is establishment of objectives, linked at different levels and internally consistent. Risk assessment is the identification and analysis of relevant risks to achievement of the objectives, forming a basis for determining how the risks should be managed. Because economic, industry, regulatory and operating conditions will continue to change, mechanisms are needed to identify and deal with the special risks associated with change.

**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.

Information and Communication
Pertinent information must be identified, captured and communicated in a form and timeframe that
enable people to carry out their responsibilities. Information systems produce reports, containing
operational, financial and compliance-related information, that make it possible to run and control
the business. They deal not only with internally generated data, but also information about external
events, activities and conditions necessary to informed business decision-making and external
reporting. Effective communication also must occur in a broader sense, flowing down, across and up
the organization. All personnel must receive a clear message from top management that control
responsibilities must be taken seriously. They must understand their own role in the internal control
system, as well as how individual activities relate to the work of others. They must have a means of
communicating significant information upstream. There also needs to be effective communication
with external parties, such as customers, suppliers, regulators and shareholders.

Monitoring
Internal control systems need to be monitored—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. Ongoing monitoring occurs in the course of operations. It
includes regular management and supervisory activities, and other actions personnel take in
performing their duties. The scope and frequency of separate evaluations will depend primarily on
an assessment of risks and the effectiveness of ongoing monitoring procedures. Internal control
deficiencies should be reported upstream, with serious matters reported to top management and
the board.

There is synergy and linkage among these components, forming an integrated system that reacts
dynamically to changing conditions. The internal control system is intertwined with the entity's
operating activities and exists for fundamental business reasons. Internal control is most effective
when controls are built into the entity's infrastructure and are a part of the essence of the
enterprise. "Built in" controls support quality and empowerment initiatives, avoid unnecessary costs
and enable quick response to changing conditions.

There is a direct relationship between the three categories of objectives, which are what an entity
strives to achieve, and components, which represent what is needed to achieve the objectives. All
components are relevant to each objectives category. When looking at any one category—the
effectiveness and efficiency of operations, for instance—all five components must be present and
functioning effectively to conclude that internal control over operations is effective.

The internal control definition—with its underlying fundamental concepts of a process, effected by
people, providing reasonable assurance—together with the categorization of objectives and the
components and criteria for effectiveness, and the associated discussions, constitute this internal
control framework.

What Internal Control Can Do
Internal control can help an entity achieve its performance and profitability targets, and prevent
loss of resources. It can help ensure reliable financial reporting. And it can help ensure that the
enterprise complies with laws and regulations, avoiding damage to its reputation and other
consequences. In sum, it can help an entity get to where it wants to go, and avoid pitfalls and
surprises along the way.

What Internal Control Cannot Do
Unfortunately, some people have greater, and unrealistic, expectations. They look for absolutes, believing that:

Internal control can ensure an entity’s success--that is, it will ensure achievement of basic business objectives or will, at the least, ensure survival. Even effective internal control can only help an entity achieve these objectives. It can provide management information about the entity’s progress, or lack of it, toward their achievement. But internal control cannot change an inherently poor manager into a good one. And, shifts in government policy or programs, competitors’ actions or economic conditions can be beyond management’s control. Internal control cannot ensure success, or even survival.

Internal control can ensure the reliability of financial reporting and compliance with laws and regulations.

This belief is also unwarranted. An internal control system, no matter how well conceived and operated, can provide only reasonable--not absolute--assurance to management and the board regarding achievement of an entity's objectives. The likelihood of achievement is affected by limitations inherent in all internal control systems. These include the realities that judgments in decision-making can be faulty, and that breakdowns can occur because of simple error or mistake. Additionally, controls can be circumvented by the collusion of two or more people, and management has the ability to override the system. Another limiting factor is that the design of an internal control system must reflect the fact that there are resource constraints, and the benefits of controls must be considered relative to their costs.

Thus, while internal control can help an entity achieve its objectives, it is not a panacea.

**Roles and Responsibilities**

Everyone in an organization has responsibility for internal control.

**Management**

The chief executive officer is ultimately responsible and should assume “ownership” of the system. More than any other individual, the chief executive sets the "tone at the top" that affects integrity and ethics and other factors of a positive control environment. In a large company, the chief executive fulfills this duty by providing leadership and direction to senior managers and reviewing the way they’re controlling the business. Senior managers, in turn, assign responsibility for establishment of more specific internal control policies and procedures to personnel responsible for the unit’s functions. In a smaller entity, the influence of the chief executive, often an owner-manager, is usually more direct. In any event, in a cascading responsibility, a manager is effectively a chief executive of his or her sphere of responsibility. Of particular significance are financial officers and their staffs, whose control activities cut across, as well as up and down, the operating and other units of an enterprise.

**Board of Directors**

Management is accountable to the board of directors, which provides governance, guidance and oversight. Effective board members are objective, capable and inquisitive. They also have a knowledge of the entity’s activities and environment, and commit the time necessary to fulfill their board responsibilities. Management may be in a position to override controls and ignore or stifle communications from subordinates, enabling a dishonest management which intentionally misrepresents results to cover its tracks. A strong, active board, particularly when coupled with effective upward communications channels and capable financial, legal and internal audit functions, is often best able to identify and correct such a problem.

**Internal Auditors**

Internal auditors play an important role in evaluating the effectiveness of control systems, and contribute to ongoing effectiveness. Because of organizational position and authority in an entity, an internal audit function often plays a significant monitoring role.
**Other Personnel**

Internal control is, to some degree, the responsibility of everyone in an organization and therefore should be an explicit or implicit part of everyone's job description. Virtually all employees produce information used in the internal control system or take other actions needed to effect control. Also, all personnel should be responsible for communicating upward problems in operations, noncompliance with the code of conduct, or other policy violations or illegal actions.

A number of external parties often contribute to achievement of an entity's objectives. External auditors, bringing an independent and objective view, contribute directly through the financial statement audit and indirectly by providing information useful to management and the board in carrying out their responsibilities. Others providing information to the entity useful in effecting internal control are legislators and regulators, customers and others transacting business with the enterprise, financial analysts, bond raters and the news media. External parties, however, are not responsible for, nor are they a part of, the entity's internal control system.
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