Characteristics of an effective system of internal control

Business, Accounting

1.) In accounting systems, certain controls are needed to ensure that employees are doing their jobs properly and ensure that the system runs properly. These checks are in the best interest of the organization. These controls come in the form of internal controls for the system. The internal controls are the checks that are placed in the system by the company's own management to prevent the intentional misrepresentation of financial data for one party's gain at the expense of the organization. Fraud is the primary reason that internal controls are essential in safeguarding assets.

To have an effective system of internal control, five objectives must be met. The first, and most important, is the safeguard of assets. If the organization fails to secure assets such as cash or inventory, those assets will silently slip away over time. Second, the employees must be encouraged to follow company policy and work towards the company'sgoals. This involves setting in place a set of clear policies that provide fair treatment for all. This leads to the third objective, which is promoting operational efficiency. When employees follow company policy, resources are utilized at maximum capacity, which minimizes waste, lowers cost, and raises profits.

Fourth, the company must ensure accurate and reliable accounting records, which are essential in measuring thehealthof the organization. Without doing so, the company is operating in the dark. Lastly, to maintain legitimacy, the organization must comply with legal requirements. Otherwise, it would not be permitted to conduct business and would cease to exist as an entity. There are also five different aspects involved with the implementation of internal control. It begins with creating a controlenvironment, which starts at the owner and top management level. They should set the example for their employees on how to act ethically within the business and that controls are necessary.

Secondly, there should be an accurate system of risk assessment set in place. A company must be able to identify its business risks, as well as to establish procedures for dealing with those risks to minimize their impacts on the company. Third, an accurate and reliable accounting information system should be present within operations. Accurate information is required in order to keep track of assets and to measure profits and losses. This system should be able to record transactions as they occur, journalize them in a timely manner, post them to the company books, and then report them in financial statements. Monitoring the system of controls is the fourth aspect of internal control, and is a very important component. Day-to-day activity must be scrutinized by internal auditors to prevent anomalies.

In turn, the control system, along with its overseers, should also be analyzed by external auditors outside of the organization. The final aspect of internal control is the actual control procedures themselves. A primary example of control procedures is the separation of duties, which is considered the cornerstone for safeguarding assets. ? Under the separation of duties procedure, different duties are assigned to different individuals within the organization. This is done in such a way that no one person can have full control over any single transaction. This ensures that an individual cannot have full control over the creation and operating of the system. One reason for this division is having one person controlling the system can result in fraud if that person is not completely trustworthy.

Division of duties sets into place a system of comparison. Any individual's involvement in a particular transaction is checked and compared against another individual's involvement in the same transaction. For this reason, it is considered the cornerstone for safeguarding assets; because no single individual has complete control over acquisition and reporting of assets. Another reason for the division of duties is to prevent the organization from becoming totally dependent on the person controlling the system. If this person were to leave, then the organization would have no one to run the system. Therefore, the division of duties also ensures that employees can leave without having any major effect on the system. If the separation of duties control has not been set in place, then a very dangerous possibility is left open to the organization.

This would allow a single individual to gain custody of an asset, while at the same time, have control over accounting for it. Say, for example, that Matt is the manager of a firm that performs service on credit. Matt collects and processes customer payments on account, and at the same time, Matt is also in charge of the company's books. Here is what can happen in this situation. Matt writes-in an account-receivable for service performed on credit within the company's books. A few weeks later, the cust sends a cash payment to cover the entire account-receivable, which Matt has control of handling. Matt decides that his wife deserves a new, and very expensive jewel necklace, which he would normally never be able to afford.

Matt sees an opportunity here, so he pockets the rather sizable payment on account made by the customer, and since he controls the books, he writes off the customer account as uncollectible. Matt has just committed fraud for personal gain, at a significant loss to the company. This is case-in-point as to why internal controls like separation of duties are essential in operating a business. In the case of Gretchen Rourke, the accountant for Dublin Limited, Rourke should take immediate action upon discovery of a major accounting error made by her supervisor; be it deliberate or not. First, Rourke should make the error known to the company's internal auditor(s) as well as her supervisor and his or her authority. The key to the problem is to make multiple people aware of the accounting problem, so that no one individual may have the power to coerce the situation to their advantage. There should be as much transparency as possible in order to correctly resolve the overstatement of net income.

Finally, Rourke should go about making the corrected entries into the company's books, so that the financial statements reflect an accurate portrayal of the company's financial status. In the case of Flynn's embezzlement from Downtown Kalamazoo, there are four ways this could have been prevented. First, Flynn should never have had access to subscriber cash receipts. There should have been one person appointed to receive these payments, and another person appointed to account for them. Second, auditing should have performed regular bank reconciliations, and then they would have seen an inordinate amount of checks being written to Flynn from the company. Third, Flynn should have been required to submit regular budgets and exception reports, so that the board of directors would be made aware of business operation and cash flow within the company. And fourth, regular external audits should have been performed, so that an unbiased view could have questioned where the company'smoneywas going.

Mr Smith: Since you are the store manager, I feel that it is myresponsibilityto make you aware of an internal control weakness in the operation of the point-of-sale terminals. The main weakness involved is that the terminals do not record the transaction, only sale amounts. Since this is the case, it would be only too easy for a register clerk to collect the stated amount for a transaction, but take part of the payment for himself and record a lesser amount in the register. Each transaction should therefore be itemized so that amounts match items sold. This would prevent any possible theft. Sincerely, Matthew Garrett The missing internal control characteristic for situation (a) is the separation of duties. Since the purchasing agent is responsible for purchasing as well as approving invoices for payment, along with signing the checks, he could write the invoices for any amount he desires and keep the excess for himself.

This would never be discovered since there is no supervisor that reviews this purchasing agent's work. The solution to this problem is to assign a separate person to approve invoices for payment, yet another person to sign the actual checks, and also a supervisor to monitor the agent's work. Again, the internal control characteristic missing in situation (b) is the separation of duties. The two senior architects are not doing their job while Joyce, the owner, is away on business trips. Yes, they may be performing managerial duties, but are obviously not maximizing efficiency since only one employee is capable of managing the office. The solution is that Joyce needs to hire an interim office manager to run operations while she is away on business. This would ensure that everyone held liable and is performing the functions in which their job title affords them.

Once more, separation of duties is the missing component of internal control for situation (c) as well. Durfee should not be performing all accounting duties, plus opening the mail, preparing bank deposits and reconciliations. This allows J. T. too much control over assets and accounting for them. Durfee could possibly steal money, while cooking the books and reconciliations. A separate person should be brought in to open the mail and prepare the bank deposits, and they should be monitored by a superior while performing these duties.

Durfee should only be in charge of accounting for these transactions and performing bank reconciliations. ??