OVERVIEW OF INTERNAL CONTROLS AND RISK

Internal Controls are EVERYONE'S Responsibility!

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WHAT IS INTERNAL CONTROL?

INTERNAL CONTROL is a process that provides reasonable assurance of the achievement of the entity's objectives. It is enacted by the board of trustees, management, and other personnel to promote:

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

Internal Controls, if designed and implemented properly, will assist in mitigating identified risks.

WHAT CHARACTERIZES INTERNAL CONTROL?

- Internal control is a **PROCESS**. It is a means to an end, not an end in itself.
- Internal control relies on commitment and actions of **PEOPLE**. It is not merely policy manuals and forms but people acting 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 Controls are **EVERYONE'S** responsibility because they help us to:

- Manage identified risks
- Comply with laws and regulations
- Safeguard assets
- Ensure all transactions are properly recorded and for valid business expenses
- Protect the University from litigation or loss of grants, gifts, or donations
- Communicate the vision, mission, and objectives
- Provide operational and behavioral boundaries
- Use resources efficiently and effectively
- Promote reliability and integrity of financial information
- Monitor results and provide subsequent feedback

TYPES OF CONTROLS

Preventive (Ideal):

- Control mechanisms that ***prevent*** problems from occurring, for example:
- Authorization/approval for expenses
- Management oversight of ongoing performance
- Segregation of duties
- System access controls (passwords)
- Physical access controls
- Safes to store cash and prevent theft

Detective:

- Control mechanisms that ***uncover*** a problem, for example:
- Account reconciliation and review
- Budget vs. actual analyses
- Effective monitoring
- Exception reporting
- Complaints/tips/hot-line calls
- Job rotations
- Effective monitoring

Controls are also either Automated (Ideal) or Manual:

Automated (Ideal):

- Three-way match of invoices for payment
- Background checks
- Electronic signatures
- Card swipe for time keeping
- Batch control totals

Manual:

- Manual reconciliations
- Information verification
- Authorized signatures
- Employee appraisals
- Credit checks and approvals
- Standardized hard copy forms

WHAT ARE RISKS?

A RISK IS ANYTHING that could jeopardize the achievement of an organization's objectives.

HOW ARE RISKS MANAGED?

Risks are effectively managed by:

- Avoidance/Transfer
- Acceptance
- Sharing (e.g., Insurance)
- Mitigation with INTERNAL CONTROL

WHAT CHARACTERIZES A STRONG SYSTEM OF INTERNAL CONTROL?

A strong system of Internal Controls includes the following three components:

THE INTERNAL ENVIRONMENT

Management sets the tone of an organization, influencing the control awareness of its people by:

- Walking the talk
- Leading by example
- Complying with policies
- Promoting ethical values and conduct

CONTROL ACTIVITIES

These are the ***policies and procedures*** that help ensure the necessary actions are taken to address risks. Examples include:

- Documented policies and procedures
- Established lines of authority
- Two-level signature authorizations
- Systems backup practices

MONITORING

This is the ***oversight process*** to assure the quality of the internal control system's performance over time, including regular management and supervisory activities. These include:

- Monthly ledger reviews
- Annual employee performance reviews
- Routine spot check of transactions and reconciliations

HOW ARE RISKS IDENTIFIED AND ASSESSED?

A RISK ASSESSMENT is a three-step process to:

1. *Identify* significant risks to the organization/department.
A Risk Assessment should be conducted periodically by each organization/department by identifying the:

- Organization's objectives
- Risks (events/situations) that could hinder achieving those objectives
- Work-related events that keep you awake at night
- Events that would be devastating to the organization

Typical high-risk areas to consider include:

- Compliance with federal and state regulations
- Security of financial data, patient information
- Disaster planning (operational and information systems)
- Cash management
- Sponsored research activities

2. *Categorize* each identified risk into one or more of these five areas:

- **Strategic:** risks that affect the strategic objectives of the organization
- **Financial:** risks that affect the accuracy and reliability of reported financial information
- **Operational:** risks that affect the effectiveness and efficiency of daily operations
- **Regulatory:** risks that affect compliance with federal, state, and local regulations
- **Reputational:** risks that affect the reputation of the University

3. *Assess* each risk on a two-dimensional scale:

- What is the likelihood of occurrence?
- What are the potential impacts if the risk were to occur?

For example:

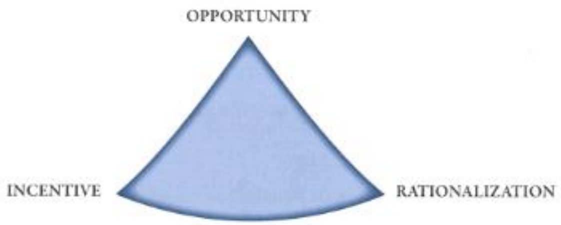
- Misstated financial records
- Loss of revenues
- Decrease in public trust
- Violation of policies, laws, regulations
- Decreased patient safety
- Failure to meet professional organization standards (e.g., JCAHO)

RISKS AND INTERNAL CONTROL
A BALANCED RELATIONSHIP

There is a conscious trade-off by management between the costs to establish and sustain a controlled environment and the level of risk being mitigated. A level of control required to provide absolute assurance generally comes at a prohibitive cost to the organization.

HOW IS FRAUD RELATED TO INTERNAL CONTROL?

The FRAUD TRIANGLE depicts the three conditions that can contribute to a fraud occurring:



The key to mitigating the risk of fraud is to significantly reduce the opportunity through effective INTERNAL CONTROLS.

Office of University Audit

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Published: Dec 2004 Revised: Sept 2013
PRINTED ON RECYCLED PAPER · UNIVERSITY COMMUNICATIONS
1055-5M-1213SV