

## Chapter 5: Principles of internal control

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### INTRODUCTION

1. This chapter describes the components and objectives of internal control to assist management in establishing other necessary controls that could not be incorporated in the accounting procedures contained in this manual and should be read in conjunction with the [Non-Public Property \(NPP\) Fraud Prevention Handbook and Questionnaire](#).
2. Internal controls promote effectiveness and efficiency, reduce risks of asset loss, and help ensure the reliability of financial statements and compliance with laws and regulations. Internal control concepts apply equally to manual and computerized systems.
3. Management at all levels must also be aware that the effectiveness of internal control systems depends upon the competency and dependability of the people using them. In the face of the many challenges faced in the diverse NPP environment (such as a high staff turnover rates) management must continually monitor internal controls to ensure they are adhered to and remain in place.

### INTERNAL CONTROL

4. The Institute of Internal Auditors (IIA) Standards define control as “any action taken by management, the board, and other parties to manage risk and increase the likelihood that established objectives and goals will be achieved. Management plans, organizes, and directs the performance of sufficient actions to provide reasonable assurance that objectives and goals will be achieved.”
5. The primary objectives of internal control are to ensure the following:
  - a. reliability and integrity of financial and operational information;
  - b. effectiveness and efficiency of operations and programs;
  - c. safeguarding of assets; and
  - d. compliance with laws, regulations, policies, procedures, and contracts.
6. The Nature of Control:
  - a. control is effected by people at all levels of the organization;
  - b. managers who are accountable for their operations must also have control of those operations;
  - c. control must be flexible enough to adapt to changing conditions, both internally and externally (as risks change, controls must also change);
  - d. organizations must balance autonomy, integration, consistency, and change to effect controls; and
  - e. controls can never provide absolute assurance, only reasonable assurance as controls must be cost-effective and have inherent limitations (such as faulty decision making,

human errors, management overriding controls, and collusion).

## **ELEMENTS OF INTERNAL CONTROL**

7. Every organization functions under conditions unique to its field of endeavour and with particular requirements. Thus, there is no universal, "ready-made", or packaged internal control system that meets the needs of all organizations. Management must select the internal controls necessary by comparing the costs to the organization relative to the expected benefits.
8. There are however, certain basic components that are essential to satisfactory internal control in organizations. These are:
  - a. a logical organizational plan which clearly identifies lines of authority and delegation of responsibility, and, which segregates incompatible functions and/or duties (see paragraphs 9 to 14 below);
  - b. an adequate accounting structure (including budgetary techniques, a chart of accounts, procedural manuals and instructions, which reflect the flow of transactions);
  - c. a complete information reporting structure (entity managers must be responsible for the continuous examination and assessment of all internal controls);
  - d. transactions should be promptly recorded;
  - e. competent personnel with integrity should be hired and properly trained;
  - f. actions are only taken by individuals acting within their authority;
  - g. adequate physical security and safeguards over cash and fixed assets;
  - h. adequate physical security and safeguards for paper documentation and electronic data, including back-ups;
  - i. access to all assets should be limited to authorized individuals on an as required/need-to-know basis;
  - j. accounting records should be compared to assets on a regular basis. This comparison should be done at times by individuals other than those having custody; and
  - k. senior and entity management should review the organization's financial operations and position and internal controls at regular and frequent intervals.

## **SEGREGATION OF DUTIES/INCOMPATIBLE FUNCTIONS**

9. Segregation of duties is a basic, key internal control and one of the most difficult to achieve. It is used to ensure that errors or irregularities are prevented or detected on a timely basis by employees in the normal course of business. Segregation of duties provides two benefits; first, a deliberate fraud is more difficult because it requires collusion of two or more persons, and second, it is much more likely that innocent errors will be found. At the most basic level, it means that no single individual should have control over two or more phases of a transaction or operation.
10. The underlying premise of segregation of duties is to prevent one person from having both access to assets and responsibility for maintaining the accountability of those assets. If internal control is to be effective, there must be an adequate division of responsibilities among those who perform accounting procedures or control activities and those who handle assets. In general, the flow of transaction processing and related activities should be designed so that the work of one individual is either independent of, or serves to check on, the work of another.

11. The principal incompatible duties or responsibilities to be segregated are:
  - a. custody of assets;
  - b. authorization or approval of related transactions affecting those assets;
  - c. recording or reporting of related transactions; and
  - d. reconciliation
  
12. In an ideal system, different employees would perform each of these four major functions. In other words, no one person should have control of two or more of these responsibilities. The more negotiable the asset, the greater the need for proper segregation of duties - especially when dealing with cash, negotiable cheques and inventories. If a single person can carry out and conceal errors and/or irregularities in the course of performing their day-to-day activities, they have generally been assigned or allowed access to incompatible duties or responsibilities (incompatible functions). Some examples of incompatible functions are:
  - a. authorizing a transaction, receiving and maintaining custody of the asset that resulted from the transaction;
  - b. receiving cheques (payment on account) and approving write-offs;
  - c. depositing cash and reconciling bank statements;
  - d. approving payroll and having custody of payroll cheques; and
  - e. having unlimited access to assets, accounting records and computer terminals and programs.
  
13. In those instances where duties cannot be fully segregated, mitigating or compensating controls must be established to reduce the risk of errors or irregularities. For instance, if the record keeper also performs a reconciliation process, a detailed review of the reconciliation should be performed and documented by a supervisor to provide additional control over the assignment of incompatible functions. Segregation of duties is more difficult to achieve in a centralized, computerized environment. Compensating controls in that arena include passwords, inquiry only access, logs, dual authorization requirements, and documented reviews of input/output.
  
14. Some special aspects of segregation of duties apply to different environments such ABACIS Database and IT functions. There should be segregation between systems development and operations, operations and data control, and data base administration and system development.

## **PREVENTION OF ERRORS IN JOURNALS AND RECORDS**

15. There are seven detailed objectives that an internal control system must meet to prevent errors in journals and records. The organization must ensure that:
  - a. recorded transactions are valid;
  - b. transactions are properly authorized;
  - c. all existing transactions are recorded (no omissions);
  - d. transactions are properly valued;
  - e. transactions are properly classified;
  - f. transactions are recorded at the proper time; and
  - g. transactions are properly included in subsidiary records and correctly summarized.

16. [Chapter 6 \(Control of Accountable Documents\)](#) provides direction on the necessary controls and procedures for serially numbered documents such as cheques, tickets, purchase orders and Non-Public Funds official receipts along with other business documents.
17. [Chapter 7 \(Security of Non-Public Funds\)](#) provides direction on the necessary controls and security procedures for Non-Public Funds.
18. [Chapter 18 \(Cash and Other Receipts\)](#) provides direction on the necessary controls and procedures required over cash and other receipts.
19. [Chapter 28 \(Fixed Assets\)](#) provides direction on the necessary controls over fixed assets.

## **NPP ACCOUNTABILITY FRAMEWORK**

20. [Chapter 30 \(Write-Off, Reporting, and Loss/Damage of NPP\)](#) provides direction on write-off, reporting, investigation and loss/damage of NPP.
21. The NPP Accountability Framework is composed of a number of elements that have inherent internal controls built in. Below is a non-exhaustive list:
  - a. National and local governance;
  - b. [CDS Delegation of Authorities for Financial Administration of NPP](#) supported by a requirement to pass a NPP Certification Course;
  - c. NPP Letter of Financial Management Attestation;
  - d. [NPP Contracting Policy](#);
  - e. [NPP Travel Policy](#);
  - f. HR Policy, Accounting Policy, Sponsorship and Donation Policy, etc;
  - g. National entities externally audited;
  - h. CRS is responsible for the audit of NPP with the Canadian Forces;
  - i. Compliance and Assurance Team;
  - j. Consolidated Insurance Program; and
  - k. [NPP Fraud Prevention Handbook and Questionnaire](#).