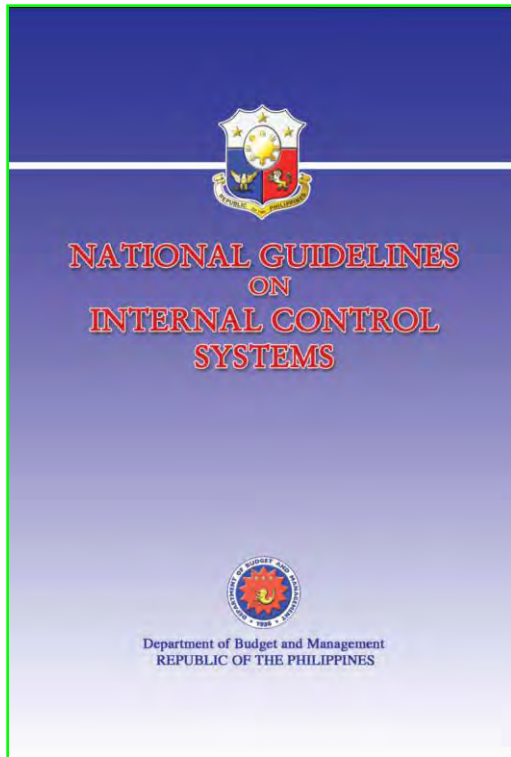


# **INTERNAL CONTROL SYSTEM IN THE GOVERNMENT**

**65<sup>th</sup> Annual National Convention  
Philippine Institute of Certified Public Accountants  
November 23-26, 2010  
Iloilo City, Philippines**

**RUFO R. MENDOZA, Ph.D., CPA**

# The NGICS



**DBM Circular Letter No. 2008-8  
October 23, 2008**

**Heads of Departments, Bureaus, Offices  
and Agencies of the National Government,  
including State Universities and Colleges;  
Government-Owned and/or –Controlled  
Corporations; Local Government Units; and  
All Others Concerned**

# Responsibility of the Head of Agency

- The direct responsibility for installing, implementing, and monitoring a sound system of internal control rests with the **chief or head** of each government agency or instrumentality

(Section 124, Presidential Decree No. 1445, dated June 11, 1978; and EO No. 292, The Administrative Code of 1987)

# INTERNATIONAL STANDARD-SETTING BODIES

- **INTOSAI** - International Organization of Supreme Audit Institutions
- **IFAC** - International Federation of Accountants
- **IIA** - Institute of Internal Auditors
- **IASB** - International Accounting Standards Board
- **IOSCO** - International Organization of Securities Commissions
- **COSO** – Committee of Sponsoring Organizations

## INTOSAI

INTOSAI



- an umbrella organization for the external government audit community
- founded in 1953 as an autonomous, independent and non-political organization

## IFAC



- the global organization for the accountancy profession
- works with its 157 members and associates in 123 countries and jurisdictions

# IIA



- an international professional association of more than 150,000 members
- Throughout the world, recognized as the internal audit profession's leader in certification, education, research, and technical guidance

# IASB



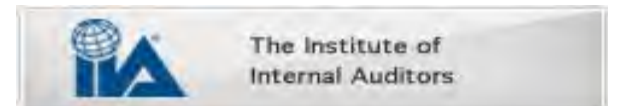
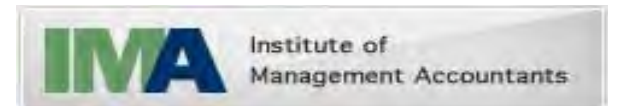
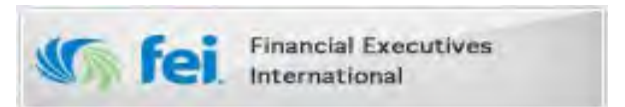
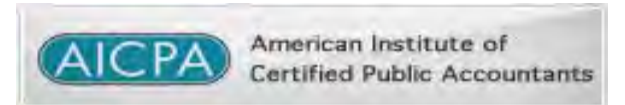
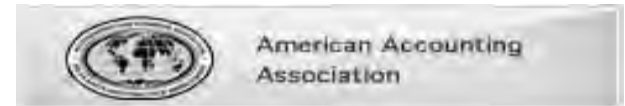
- an independent standard-setting body, appointed and overseen by a geographically and professionally diverse group of trustees under the International Accounting Standards Committee Foundation

# IOSCO



- an international organization of regulators of the world's securities and futures markets

## COSO Committee of Sponsoring Organizations



# COSO

- Representatives:
  - industry
  - public accounting
  - investment firms
  - stock exchange

**1992**

**Issued the Internal Control-Integrated Framework**

**1994**

**Amended the framework to expand the scope to address additional controls pertaining to safeguarding of assets**

**2006**

**Issued the Internal Control over Financial Reporting-Guidance for Smaller Public Companies**

What are internal controls  
and why are they important?

“an organization’s whole  
system or network of  
methods, procedures and  
plans which govern its  
activities to accomplish  
its goals and objectives”

## What are internal controls and why are they important?

“the plan of organization and all the coordinate methods and measures adopted within a business to safeguard its assets, check the accuracy and reliability of its accounting data, promote operational efficiency, and encourage adherence to prescribed managerial policies”

(AICPA; PD 1445)

# Government Accounting and Auditing Manual

Internal Control comprises the plan of organization and all the methods and measures adopted within an agency to ensure that:

- resources are used consistent with laws, regulations and policies;
- resources are safeguarded against loss, wastage and misuse;
- Financial and non-financial information are reliable, accurate and timely;
- operations are economical, efficient and effective

# International Organization of Supreme Audit Institutions

- Internal control is an integral process that is effected by an entity's management and personnel and is designed to address risks and to provide reasonable assurance that in pursuit of the entity's mission, the following general objectives are being achieved:
  - executing orderly, ethical, economical, efficient and effective operations;
  - fulfilling accountability obligations;
  - complying with applicable laws and regulations; and
  - safeguarding resources against loss, misuse and damage.

# United States Government Accountability Office

- Internal control is “an integral component of an organization’s management that provides reasonable assurance that the following objectives are being achieved:
  - effectiveness and efficiency of operations,
  - reliability of financial reporting, and
  - compliance with applicable laws and regulations.”

# Internal Control as a Process

- a series of actions that occur throughout an entity's operations on an ongoing basis; best intertwined with an entity's activities and built into its infrastructure as an integral part of the essence of an organization.
- built in rather than built on; it is embedded with the management processes of planning, organizing, budgeting, staffing, implementing and monitoring.

# Internal Control is Management Control

- helps government program managers achieve desired results through effective stewardship of public resources
- requires the participation and involvement of the agency head, officials and personnel at all levels, including the various organizational units therein, in order to obtain reasonable assurance that an agency's mandate and sectoral goals are achieved efficiently, effectively and economically

# *Reasonable Assurance*

Internal control, no matter how well designed and operated, can provide only **reasonable assurance** regarding achievement of an entity's objectives. The likelihood of achievement is affected by limitations inherent in all internal control systems.



# Changing View on Internal Controls

INTERNAL  
ACCOUNTING  
CONTROL



**AGENCY/  
BUSINESS  
CONTROLS**



# Virtually all employees play some role in effecting control.



# **Roles and Responsibilities**

- 1. Management**
- 2. Board of directors and audit committee**
- 3. Internal auditors**
- 4. Other entity personnel**
- 5. Independent auditors**
- 6. Other external parties**

# How Much Do Internal Controls Cost?

**The cost of implementing a specific control should not exceed the expected benefit of the control.**



The potential loss of a computer printer may justify the cost of a door lock but not an alarm system.

# LIMITATIONS OF INTERNAL CONTROL

- Internal control must be attained at reasonable cost.
- Good internal control methods and measures are not foolproof.
- Strong internal control are still subject to human fallibility → negligence, errors of judgment, lack of complete understanding

# LIMITATIONS OF INTERNAL CONTROL

- Organizational changes may render internal control systems and manuals obsolete.
- The degree of compliance (implementation) with the system strongly influences the effectiveness.

# Factors that Reduce or Eliminate Effectiveness of Controls

- Errors in human judgments
- Breakdowns
- Management override
- Collusion
- Excessive controls



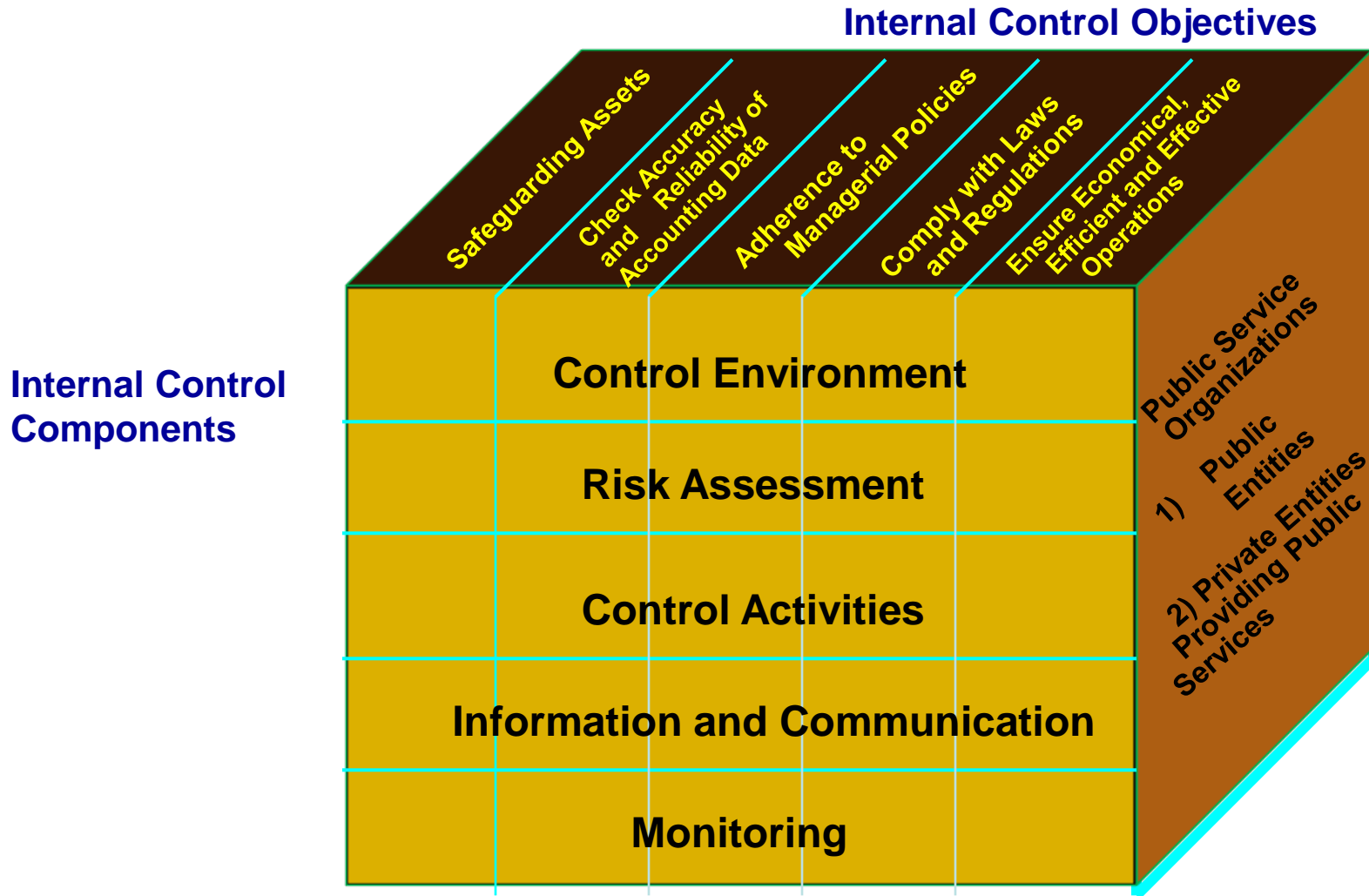
# Possible Hazards Arising from Weak Internal Control System

- Wasteful and inefficient use of resources
- Poor management decisions
- Unintentional errors in recording/ processing data
- Accidental loss or destruction of data
- Loss of assets or resources through carelessness or pilferage

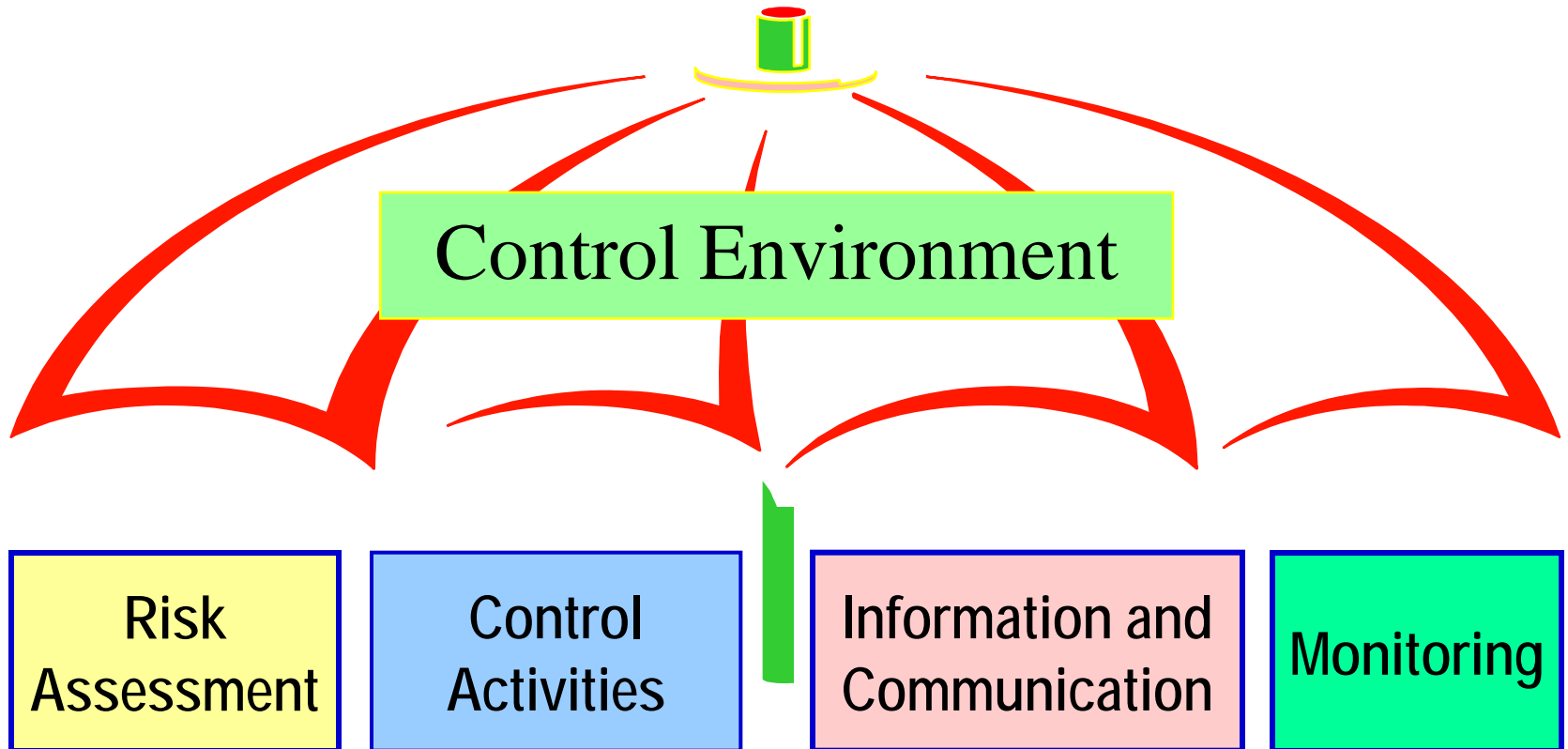
# Possible Hazards Arising from Weak Internal Control System

- Lack of compliance with laws, rules and regulations and other management policies
- Embezzlement (theft or misappropriation of agency resources accompanied by falsification of records or documents to conceal theft)
- Other illegal acts of members of organization

# Internal Control Components Relationship in a Three-Dimensional Matrix



# Five Components of Internal Control



## COMPONENT

### 1

# The 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.
- It represents an organization's first line of defense to mitigate the risks.

# The Control Environment

Integrity and ethical values

Commitment to competence

Management's philosophy  
and operating style

Organizational structure

Assignment of authority  
and responsibility

Human resources  
policies and practices

Board of directors or audit  
committee participation

## COMPONENT 2

# 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 objectives, forming a basis for determining how the risks should be managed.

COMPONENT  
3

## CONTROL ACTIVITIES

**Control activities** are those policies and procedures that help ensure that 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 have various objectives and are applied at various organizational and functional levels.

# CONTROL ACTIVITIES

- a. Segregation of Duties
- b. Information Processing Controls
- c. Physical Controls
- d. Authorization Procedures
- e. Adequate Documents and Records
- f. Verification
- g. Reconciliation
- h. Performance Reviews
- i. Supervision

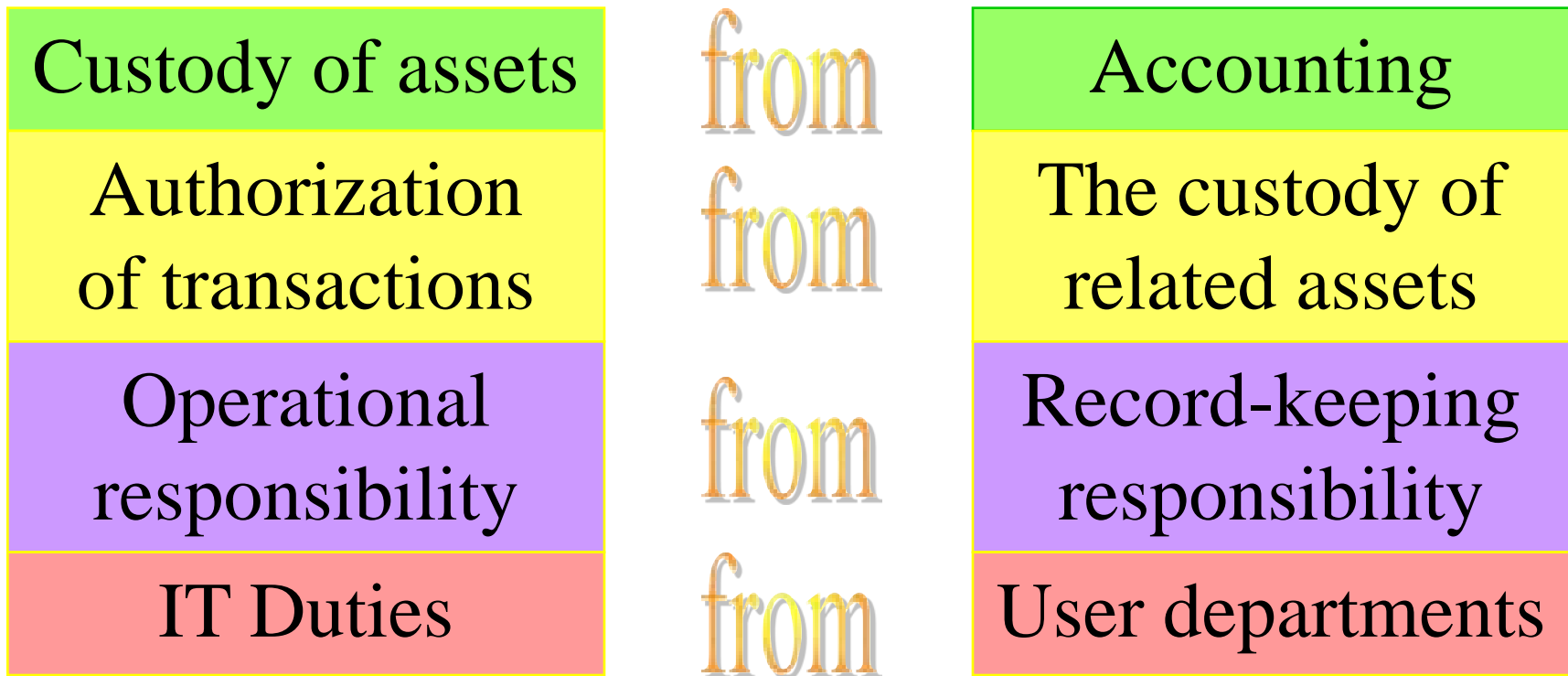
## a. SEGREGATION OF DUTIES

- The fundamental premise of segregated duties is that an individual or small group of individuals should not be in a position to initiate, approve, undertake and review the same action. These are called incompatible duties when performed by the same individual.
  - Duties are incompatible when it is possible for a person to commit an error or irregularity and be in a position to conceal it in the normal course of his or her duties.

Four kinds of functional responsibilities that should be performed by different work units, or at a minimum, by different persons within the same unit:

- 1. Authorization to execute transactions**
- 2. Recording transactions**
- 3. Custody of assets involved in the transactions**
- 4. Periodic reviews and reconciliation of existing assets to recorded amounts**

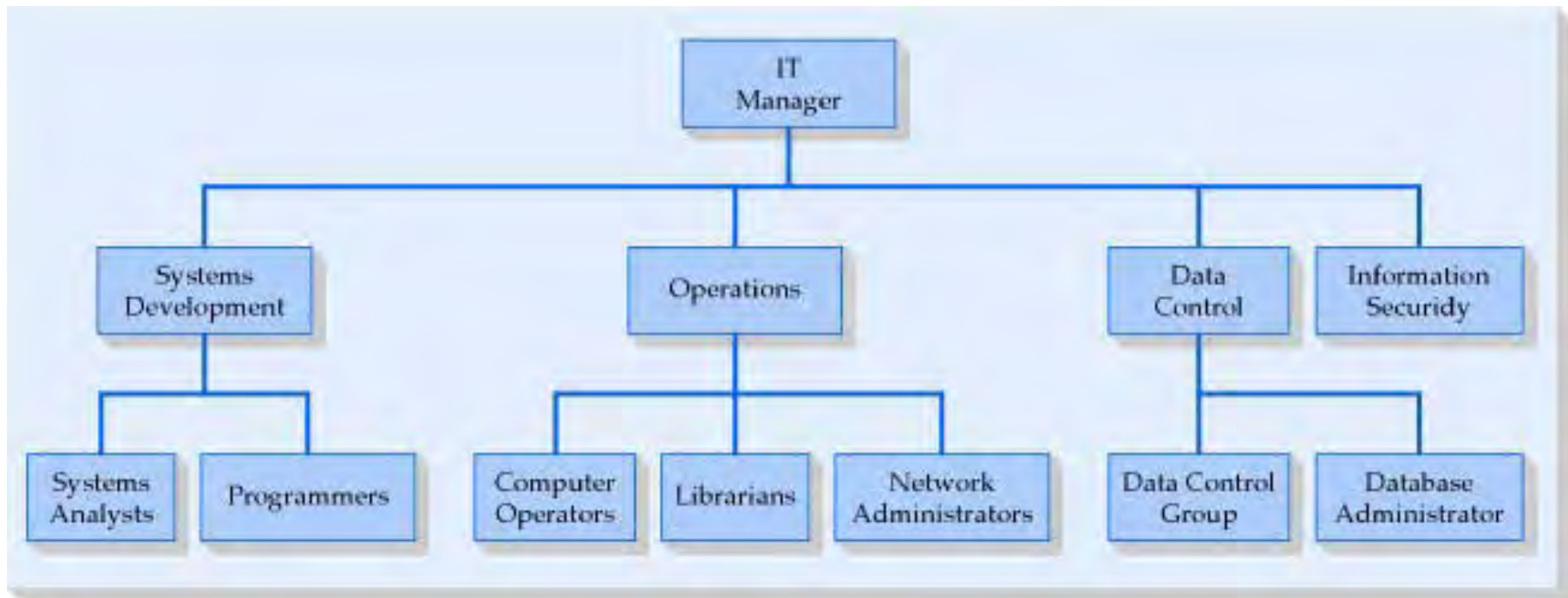
# Adequate Separation of Duties



## Traditional Segregation of Duties



## IT Functions Requiring Segregation



## **b. Information Processing Control**

- **General controls**—those that apply to computer information systems as a whole and include controls related matters such as data centre organization, hardware and systems software acquisition and maintenance, and back up and recovery procedures.
- **Application controls**—those that apply to processing of specific types of transactions such as invoicing, paying suppliers, and preparing payroll.

## **C. Physical Control Over Assets And Records**

**Physical precautions**

**Controls related to IT equipment,  
programs, and data files**

**Physical  
controls**

**Access  
controls**

**Backup and  
recovery  
procedures**

## d. Proper Authorization Procedures

- Ensure that transactions are authorized by personnel acting within the scope of their authority.
- These are important for limiting access to assets; documents and records; and computer equipment, programs and files.
- Types of Authorization
  - General authorization
  - Specific authorization

## e. Adequate Documents and Records

- All transactions and other significant events should be clearly documented, and the documentation should be readily available for examination at each agency.
  - Detailed written evidence of the internal control system, its objectives and activities, is essential.
  - Internal control reviews and risk analyses should be documented.
  - Documentation of transactions and other significant events should be timely, complete and accurate and should allow tracing the transaction or event from the source documents, while it is in process, through to the financial reports.

# Document/Form Design

Prenumbered consecutively

Prepared at the time of transaction

Simple enough to ensure understanding

Designed for multiple uses

Constructed to encourage correct preparation

## f. Independent Checks or Verification

These involve the verification of work performed by other people or departments, or the proper measurement of recorded amounts.

The need for independent checks arises because the operation of internal controls tends to change over time unless there is a mechanism for frequent review.

## g. Periodic Reconciliations

Managers should provide for periodic comparison of recorded amounts with independent evidence of existence and valuation. The individuals to do this, however, should not also have responsibility for authorization of the related transactions, accounting or recordkeeping, or custodial responsibility for the assets.

Periodic comparisons may include reconciliation of bank statements, inventory counting, confirmation of accounts receivable and accounts payable. The more frequent the comparisons, the greater the opportunity to detect errors. For other records, the frequency of periodic comparisons must be balanced against the costs and benefits.

## h. Performance Reviews

These involve managers' participation in the supervision of operation. Frequent performance reviews give managers a great chance of detecting errors, and can include management review and analysis of:

- Reports that summarize the detail of account balances such as aged trial balance of accounts receivable or report of sales activity by division, product, or salesperson
- Actual performance compared with budgets, forecasts or previous period amounts.

## i. Supervision

- The effectiveness of any system of internal control depends on continuous, qualified supervision of all staff. In fulfilling their responsibilities, managers and supervisors should:
  - Assign tasks and establish written procedures for completing assignments.
  - Systematically review each staff member's work.
  - Approve work at critical points to ensure quality and accuracy.
  - Provide guidance and training when necessary.
  - Provide documentation of supervision and review (e.g., initialing examined work).
- Adequate and timely supervision is especially important in small departments, where limited personnel make it difficult to establish a complete segregation of duties.

# TYPES OF INTERNAL CONTROL ACTIVITIES

```
graph TD; A[TYPES OF INTERNAL CONTROL ACTIVITIES] --> B[PREVENTIVE CONTROLS]; A --> C[DETECTIVE CONTROLS]; A --> D[CORRECTIVE CONTROLS]; B --- B_desc[Designed to discourage errors or irregularities]; C --- C_desc[Designed to identify an error or irregularity after it has occurred]; D --- D_desc[Designed to remedy the effects caused by adverse events];
```

## PREVENTIVE CONTROLS

Designed to discourage errors or irregularities

## DETECTIVE CONTROLS

Designed to identify an error or irregularity after it has occurred

## CORRECTIVE CONTROLS

Designed to remedy the effects caused by adverse events

# Examples of Preventive Controls

- Use of password in computers
- Orientation program for new employees
- Manager's review of purchases for a proper business purpose prior to approval



# Examples of Detective Controls

- Use of fire alarm
- Use of CCTV
- Manager's review of long distance telephone charges



# Examples of Corrective Controls

- Changing recruitment policies to attract qualified personnel
- Disciplining an employee for violating a “No Smoking” safety regulations in hazardous areas
- Revising a report you have written because you are dissatisfied with it



## COMPONENT

### 4

# 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.

**COMPONENT  
5**

# MONITORING

Process of assessing the quality of internal control performance over time. It involves assessing the design and operation of controls on a timely basis and taking the necessary corrective actions. It is done to ensure that controls continue to operate effectively.

Management's ongoing and periodic assessment of the quality of internal control performance ...

to determine whether controls are operating as intended and modified when needed.

# Monitoring Component

## *Ongoing Monitoring*

Management, supervisory, and other monitoring activities in the ordinary course of operations that assess the quality of internal controls

## *Separate Monitoring*

Evaluation focusing directly on system effectiveness with a scope and frequency dependent on the assessment of risks, and ongoing monitoring

## *Reporting Deficiencies*

Upstream reporting of internal control deficiencies, with certain matters reported to top management and the board

# Four Systems Covered in the NGICS

- Human Resource Management
- Financial Management
- Quality Management
- Performance Management

# Internal Audit

- Organizational Arrangements
- Legal Basis
- Functional Descriptions
- Internal Audit Approach