Establishing Internal Controls For Organizational Effectiveness



All businesses have or at least should have procedures, plans, and policies in place to ensure that the organization operates as efficiently and effectively as possible. These plans or operational measures are designed to monitor the firm's assets, prevent fraud, minimize errors, authenticate the accuracy and reliability of accounting data, and promote the efficient operation of the firm while ensuring that established management practices are followed. Such measures, known as internal controls, are used by accountants and auditors to test the effectiveness of the firm's ongoing compliance with established financial and managerial practices implemented by the firm.

At one time internal controls were generally used to test, evaluate, and validate accounting and financial transactions, information and data, and to assure accuracy in financial reporting. With the advent of the Internet, rapid advances in technology, flexible manufacturing processes, and concepts, such as total quality management and quality control; the business environment has become a more complex, competitive arena that has required the need to re-engineer business processes and establish new business models. From such restructuring, internal control systems are also used to test, evaluate, and validate all aspects of a firm's operations and administration to ensure that management objectives/decisions are being fulfilled and established administrative, operational, and financial policies and procedures are being followed. The internal controls a business establishes should be inclusive and all encompassing and should extend to administrative and operational systems as well. Keep in mind that the objectives of internal control systems are to achieve:

- organizational goals;
- operational efficiency;
- compliance with germane laws and regulations;
- safeguard assets against waste, fraud, misuse, and unauthorized use of resources; • accurate and proper reporting and recording of revenue and data.

A firm's internal controls should include finance, operations, and administration. Quality control is a

type of internal control mechanism generally used by manufacturing and engineering firms to assure that products and services meet or exceed customer requirements and expectations. However, quality control should not be a tool used only by manufacturers or engineering firms but rather a tool used by any firm that sells products or provides services to customers or clients. Quality control could be as simple as purchasing superior products from wholesalers for resale to customers, having good customer service associates operate a call center, receipt/delivery of just-intime inventory for timely shipments of purchases by a distributor, or listening to customer complaints and taking the necessary actions to resolve problem areas within the firm. Clearly, implementation of comprehensive internal control systems goes far beyond excellence in production, development, service, delivery, or accuracy in reporting/recording revenue to encompass all systems that result in business efficiencies, effectiveness, compliance with regulatory requirements/laws, and economy of scales. The various types of internal controls are accounting, administrative, operational, preventive, and detective. All are designed to achieve specific organizational objectives and compliance with management decisions. Accounting controls, for example, ensure that:

- financial transactions are properly authorized and reported;
- access to assets is properly authorized;
- financial statements are prepared correctly;
- recorded assets are periodically compared and reconciled with existing assets.

Regardless of the level of sophistication, any accounting systems should accomplish the following objectives for a small business or for any business:

- yield an accurate, thorough picture of operating results;
- permit an immediate comparison of current data with prior year’s operating results and budget goals; provide financial statements that management, lenders, and potential creditors may use;
- facilitate prompt filing or reports and tax returns to regulatory and tax-collecting government agencies;
- expose employee fraud, waste, and record-keeping errors.

Characteristically, administrative and operational controls advance efficiency in daily operations of the firm and ensure that management’s objectives and decisions are being followed. Preventive controls keep errors or irregularities from occurring in the first place while detective controls identify errors and irregularities that have occurred to assure prompt corrective action.

The types and complexity of internal controls firms implement depend often on the business type, size, location and industry in which it operates. For example, large businesses and multi-national corporations may have more complex, extensive internal controls than many medium-sized or small businesses. A company that hauls hazardous waste must concern itself with not only the transport of toxic materials, but also, its proper disposal and compliance with federal/state environmental protection laws and reporting requirements. Regardless of the business size, type, location, or industry; there are regulatory laws and policies to which all business must adhere. Such regulatory requirements or laws may range from local commercial zoning laws, proper disposal of hazardous waste, business recycling requirements, reporting and payment of quarterly taxes, compliance with the America for Disabilities Act to

requesting a TIN (tax identification number) versus an EIN (employee identification number), OSHA regulations, wage and hour laws, Equal Employment Opportunity laws, or interstate commerce regulations.

Establishing and implementing internal control systems for a small business isn't necessarily a complex extensive process initially, but it requires careful examination of the firm's assets and managerial objectives. It may simply require looking at the organizational structure and identifying what checks and balances must be put in place and where, who will report to whom, what reports and payments are due and when, and who is responsible for what. For example, a computer report listing employees assigned a lower tax rate is an operational/detective type of internal control. Its purpose is to verify that lower tax rates are assigned to qualified employees only. This kind of report prevents employees who don't qualify for a lower tax rate from being assigned to this particular category. However, the detective nature of the control mechanism aids in identifying employees who have mistakenly been placed in this tax rate category and allows for the necessary corrective action to be taken immediately to rectify the error.

An administrative/preventive internal control may be the approval by the supervisor of employee's attendance entries. The purpose of this control mechanism is to ensure adherence to time and attendance procedures. The corrective aspect of this type of internal control procedure is for the supervisor to ensure that the time entries employees submit are in fact accurate. If this is not the case, it's the responsibility of the supervisor to correct discrepancies and to address this problem with employees. Such actions ensure that accurate time, attendance, and payroll records are maintained.

A financial/detective control may be to link to an electronic check monitoring system to identify customers who continuously write or have written bad checks. The financial aspect of this control prevents receipt of bad checks, the attendant loss of inventory, and the time it takes to recover money from bad purchases if at all; the detective aspect of the control allows for immediate identification of bad-check writers and prevents sales from occurring whereby payment is via a check. Finally, an operational/detective internal control may consist of a computer cross matching of unemployment insurance benefits and employment files. The intent of this type of operational internal control system is to identify fraud in receipt of benefits. The detective aspect of such a

system identifies employees or former employees who are fraudulently receiving unemployment insurance benefits and allows for immediate rectification of such errors.

Inadequate internal controls routinely result in loss of revenue, loss of market share, loss of critical business information and data, inaccurate/untimely reporting, or failure on outside audits or reviews. Potentially serious consequences are faced by any business, organization, or agency that lacks control systems, has weak control systems or has controls that are not followed. A failure in control systems jeopardizes a firm's ability to provide goods or critical services in a timely, efficient manner and may result in such negative consequences as:

- loss of assets and resources;
- intentional errors, illegal acts, or unauthorized use of resources;

- unintentional errors, inefficiency, or waste;
- mismanagement;
- loss of consumer confidence and market share;
- erroneous reporting of information;
- failure of the business to meet and certainly exceed management objectives;
- failure to follow management decisions and policies;
- failure to meet regulatory requirements; and
- failure on outside audits and reviews.

It is important for organizations to identify, establish, and implement effective internal controls because such measures ensure compliance with regulatory requirements, timely accurate reporting, elimination of fraud, waste, unauthorized access to and use of assets, misuse of resources, and fulfillment of management objectives.