



# Financial Adviser

Shawn Emerson, CPA, is a manager with the certified public accounting firm McGill, Power, Bell & Associates. He has extensive experience in affordable housing, government and nonprofit auditing areas. Emerson is a member of the firm's Nonprofit and Government Service Group. Emerson, who works from the firm's Erie office, graduated from Canisius College in Buffalo, New York.

## Internal Control — A Piece in the Business Puzzle

In recent years, there has been an increased level of interest in internal control associated with the accounting system of a business. This heightened interest is contributed to a number of factors, including:

- Increasing concern about fraud.
- Increasing concern by investors, lenders and regulatory agencies about corporate governance and the role of management in internal control over financial reporting.
- Confusion about the role of auditors, management and other parties in preventing and detecting fraud.
- Increasing dependence of organizations on technology for initiating, recording, processing and reporting transactions.

Legislation such as the Sarbanes Oxley Act of 2002 and issuance of the Public Company Accounting Oversight Board (PCAOB) auditing standard 2, "An Audit of Internal Control Over Financial Reporting Performed in Conjunction With an Audit of Financial Statement," have created considerable interest in management's responsibility for internal control and the auditor's responsibility for bringing certain internal control-related matters to management's attention in an audit of financial statements.

### What is Internal Control?

Internal control is defined as a process, effected by an entity's board of directors, management and other personnel, designed to provide reasonable assurance regarding the achievement of objectives in the following categories:

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

The first category addresses an entity's basic business objectives, including performance and profitability goals and safeguarding of resources. The second relates to the preparation of reliable published financial statements, including interim and condensed financial statements and selected financial data derived from such statements. The third deals with complying with those laws and regulations to which the entity is subject. These distinct but overlapping categories address different needs and allow a direct focus to meet the separate needs.

Internal control consists of five interrelated components. These are derived from the way management runs a business and are integrated with the management process. Although the components apply to all entities, small and mid-size companies may implement them differently than large ones. Its controls may be less formal and less structured, yet a small company can still have effective internal control. The components are:

- Control Environment
- Risk Assessment

- Control Activities
- Information and Communication
- Monitoring

These components are combined into an integrated system that reacts dynamically to changing conditions. The internal control system is part of the entity's operating activities and exists for fundamental business reasons.

### What Can Internal Control Do?

Internal control can help an entity achieve its performance and profitability targets, and prevent loss of resources. In short, it can help an entity get to where it wants to go and avoid pitfalls and surprises along the way.

### What Can't Internal Control Do?

Internal control cannot provide an absolute guarantee of the achievement of an entity's objectives. The likelihood of achievement is affected by limitations inherent in all internal control systems. These include faulty judgments in decision-making, circumventing of controls by the collusion of two or more people, and management's ability to override the system. Plus, the design must reflect that there are resource constraints, and the benefits of controls must be considered relative to their costs.

The characteristics of smaller companies can make it challenging for cost-effective internal control; however, here are six basic controls that will help lower the threat of fraud at your company:

- Require dual signatures on all checks above a specified amount.
- Have the owner receive all bank statements unopened and then review the account(s) for suspicious activity.
- Have someone outside the company reconcile your bank statements on a monthly basis.
- For QuickBooks customers, set up users and passwords carefully to prevent users from changing or deleting transactions.
- Prepare regular financial statements and then conduct simple "inquiry and analytical review" process to spot any inconsistencies.
- Maintain a skeptical mind-set.

As a business grows and technology advances it will become more important than ever to establish an effective internal control system to assist in managing your organization. Effective internal control does not necessarily mean that every component must be the best possible. In truth, deficiencies in one component might be mitigated by other controls in that component or by controls of another component such that overall control is sufficient to reduce risk to an acceptable level. ★

For more information about internal controls, contact Shawn Emerson at McGill, Power, Bell & Associates, LLP at 814/453-6594 or shawne@mpbcpa.com.

