CRITICAL INTERNAL CONTROLS

Importance & Salient Features

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RTI Chennai – Seminar on Internal Audit

TOPICS FOR DISCUSSION

- **Benefits of Internal Control**

- **Meaning of Internal Control**

- **Types & List of ICs**

- **Most Important IC**

- **Mitigating Risks through ICs**

- **Critical Controls in Procurement Cycle**

- **Critical Controls in Stores & Inventory**

- **Critical Controls in Accounts Receivables**

- **Evolution of Computers & ERP Systems**

- **Critical Controls in ERP Environment**

- **Four Most Essential ICs – Recommendation**

- **Limitations of Internal Control Systems**

BENEFITS / OBJECTIVES / USES OF INTERNAL CONTROL

- Conduct Business in an orderly & efficient manner

- Safeguard Assets & Resources

- Prevent, Detect & Correct Errors, Fraud, Theft etc

- Ensure Accuracy & Completeness of Accounting Data

- Produce Reliable & Timely Financial & Management Information

- Ensure Adherence to Policies & Procedures

Meaning of ICS

- **SYSTEMATIC MEASURES**
- **SUCH AS**
  - **REVIEWS, CHECKS & BALANCES**
  - **METHODS & PROCEDURES**
- **IMPLEMENTED BY AN ENTITY**
- **TO**
- **ACHIEVE ENTITY'S OBJECTIVES**
- **FOR SUCCESSFUL CONDUCT OF THE ENTITY.**

Types of Controls

- **Preventive Controls**

- **Detective Controls**

- **Corrective Controls**

List of Controls

- **Segregation of Duties** – Preventive

- **Physical Verification** – Detective

- **Reconciliation** – Detective

- **Internal Audit** – Detective & Corrective

- **Pre-Audit –** Preventive

- **Approval –** Preventive

- **Delegation of Authority -** Preventive

- **Audit Trail –** Detective

- Dual Signature – **Preventive**

- Back Up – **Preventive**

- Input Edit Controls **Preventive**

- Confirmation of Balances **Detective**

Most Important Control

- Segregation of Duties

- It is a Preventive Control

- What it means:-
  - ❖ **No one single person should be doing all of the following:-**
    - ✓ **Initiate the transaction**
    - ✓ **Approve the transaction**
    - ✓ **Record the transaction**
    - ✓ **Reconcile the account**
    - ✓ **Handle assets connected with the transaction**
    - ✓ **Review Reports of MIS**

It can help mitigate following Risks:-

- Cash Mis-appropriation
- Financial reporting Mis-statement
- Personal purchases / gain
- Theft
- Falsification of Records
- Committing Fraud
- Funds diversion

Job Rotation / Training / Compulsory Leave, vacation

Help mitigate following Risks:-

- Low Employee Morale
- Being stressed
- Doing things inefficiently
- Violating Policies & Precedures
- Unearth Errors & Frauds
- Hiding Red Flags

CRITICAL CONTROLS IN PROCUREMENT CYCLE

- SPECIFIC FUNCTIONS INVOLVED IN THIS CYCLE:-

  - Supplier selection

  - Purchasing

  - Receiving

  - Accounts payable

  - Disbursement

- **Critical Controls to be in place:-**
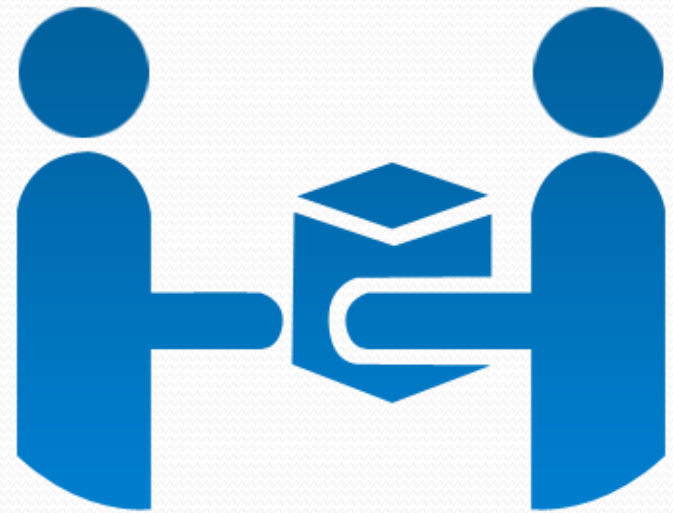
  - Some one to Monitor & Supervise the entire process

MURPHY'S LAW:
"IF ANY THING IS LEFT ON ITS OWN, IT WILL DETERIORATE"

- **Choose Suppliers wisely**

  - Vendors selection process to be comprehensive & elaborate

  - Suppliers Empanelment

- **Supplier Registration Form to be reviewed by a Committee**

  ➢ **Purchase**

  ➢ **Quality Assurance**

  ➢ **Finance**

  ➢ **Plant**

SUPPLIER ASSESSMENT AUDIT AT THEIR PREMISES

Info to be collected

- Name, Address, Contact details
- Associate, Subsidiary, Group details
- Nature of Business
- Turnover for 3 years
- Annual Report / Financials for 3 years

HR details (No of emp, Tech, Non tech, Quality

Registration particulars – CIN, GSTIN, PAN

Details of top 10 customers

Certifications acquired – ISO etc

Do you have an approved Quality Manual

Organization Chart

List of Machineries / Equipments

List of Testing & Measuring Instruments

Do you follow In-coming Inspection

Do you follow Pre-despatch Inspection

Do you provide regular Training to upgrade skills

Can our QA Team visit your premises for Assessment Test

For effective communication, nominate your QA person

Declaration

Signature

Justification Report for selecting other than L-1

Documents to be in place:-

- Purchase Requisition
- Suppliers Quotations
- Quotations Analysis Statement
- Justification Reports
- Purchase Orders
- Inspection Reports
- Goods Received Note
- Suppliers Invoices
- Suppliers Regn Forms
- Suppliers Assessment Reports

Approved Suppliers List reviewed & updated continually

- Percent of On -Time - Delivery
- Accuracy of shipments
- Stock out situations
- Product Quality – Rejection Reports

- Justification Reports for having single supplier
- (Documented, Approved & Retained)

- Rotation of Buyers

- Receiving Bay physically separated from Purchase Department

- Serial Numbering for PR, PO, IR, GRN (approved & retained)

Critical Controls in Inventory & Stores

Objectives of Inventory Cycle

- **Right Material**
- **At Right Price**
- **At Right time**
- **At Right quantity**

Documents to be in place

- Materials Requisition
- GRN
- MIN
- FG Production Report
- Pre dispatch Inspection Report
- FG Dispatch Report (DC)
- Sales Invoice

Control Points

1. **Physical Verification of Stock by independent staff (IA / Consultant)**

2. **Physical Verification Report – Variance Analysis – SAN (Stock Adj-approval)**

3. Perpetual Inventory Verification System

4. Inventory Variance Analysis Report

Balances between two dates analyses

Program developed by IA / IT

Inputs: Quantity, Rate, Value

Report output gives Qty Variance, Price Variance, Zero Variance

Excess Stock reasons analyzed

Non Moving / Dead Stock identified, Disposal action taken
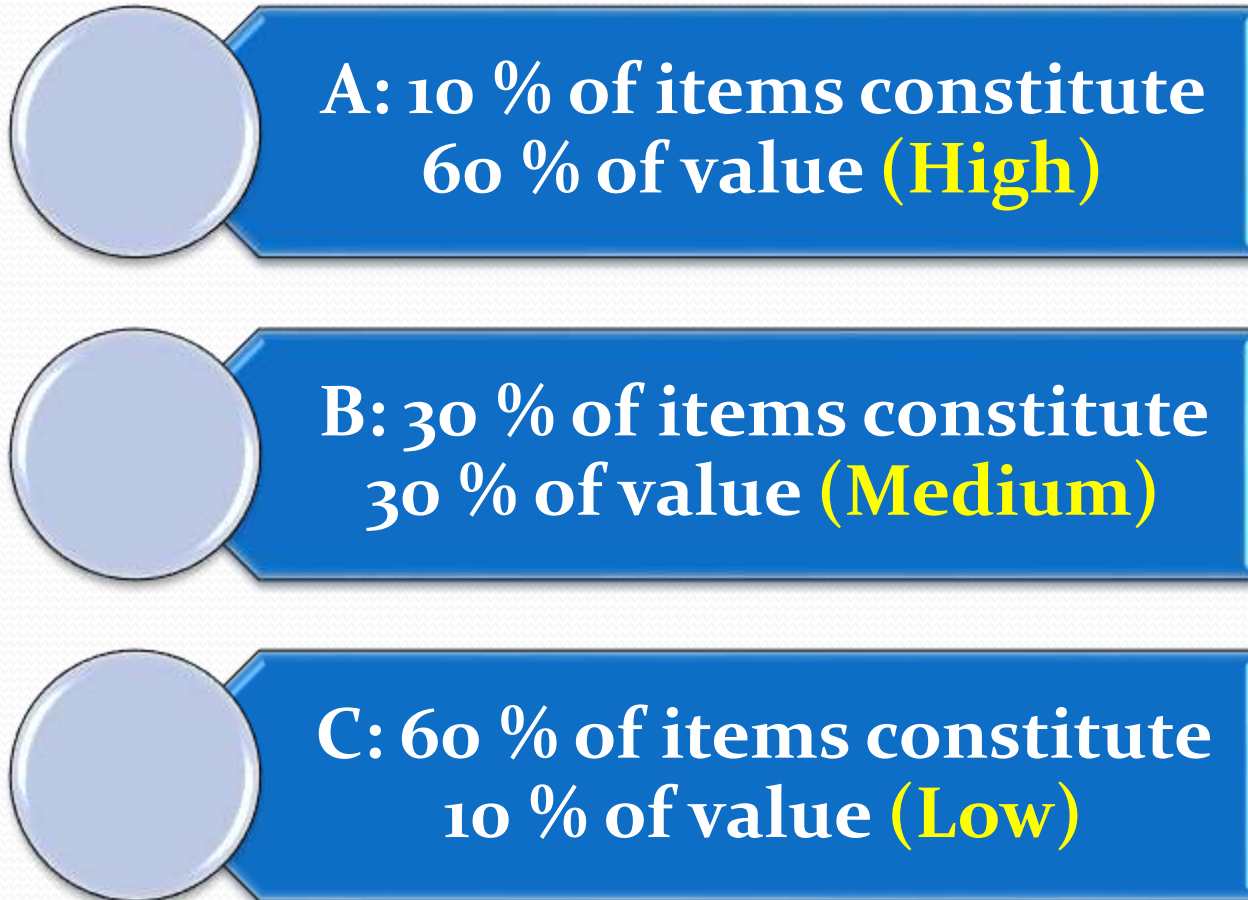
Why Inventory Value gone up ? Analyzed

5. Damaged stock disposal

6. Obsolete Stock Disposal/Alternate use

7. FSN Analysis (Fast, Slow, Non Moving)

8. ABC Analysis

A: 10 % of items constitute 60 % of value (High)

B: 30 % of items constitute 30 % of value (Medium)

C: 60 % of items constitute 10 % of value (Low)

9. Do not exceed EOQ quantity while ordering

10. Do not exceed Reorder Level
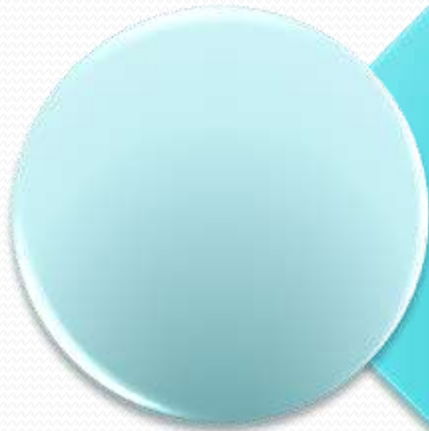
(Lead time in days X Average Daily Consumption)

Control Points Contd..
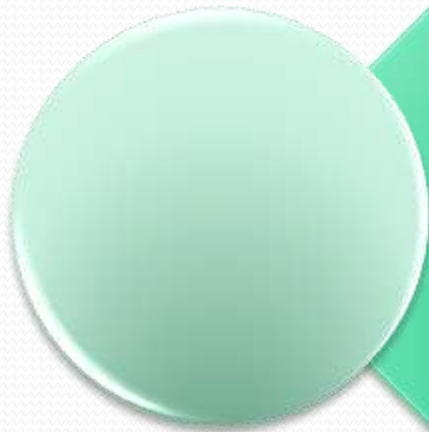
11. Stock Movements accounting to be up to date

12. FG Stock moved vis-à-vis Sales Invoicing

13. JIT Inventory (Just In Time) Japanese Technique

Materials bought Just In Time to meet Assembly Line requirements

JIT Essentials:
(Dependable Suppliers/ Located proximately/ Reliable Transport System)

Critical Controls in Accounts Receivable

1. **AR Records to be maintained by a person not having access to Billing / Cash**

2. **Written Credit Policy in place**

3. **Goods dispatched to be reconciled with Invoices generated**

4. **Do Aging Analysis & review Overdue balances**

5. **Give convenient payment options (Online Payment / NEFT / RTGS)**

6. **Consider Outsourcing Collection job**

7. **Periodic payment reminders (phone/Email/Letter/Convey constraints)**

8. **Legal Course to be last resort**

9. **Genuine difficulty of**

   Customer – No legal action
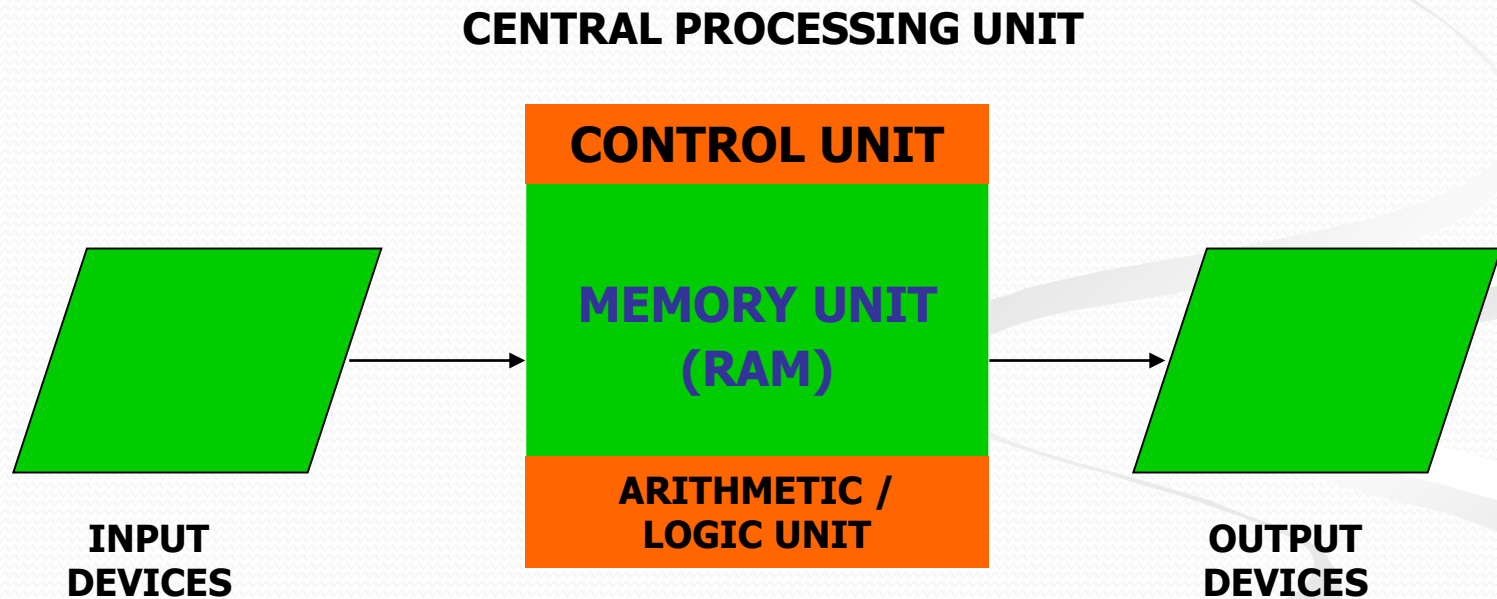
   because of waste of efforts

   & Money

Evolution of Computers & ERP Systems

- **Stage – 1 : PC**

- **Stage – 2 : LAN**

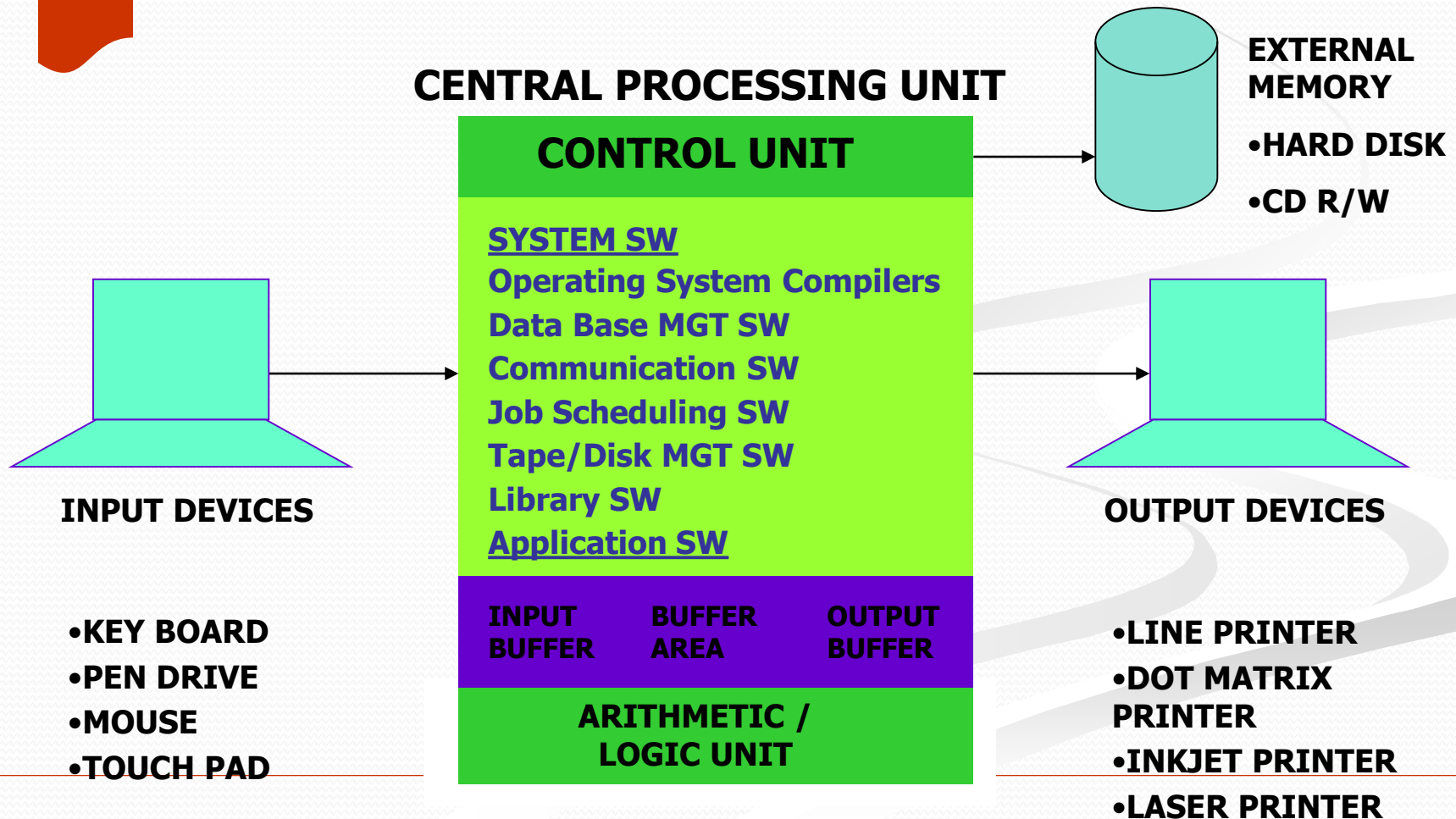- **Stage – 3 : WAN**

EVOLUTION

STAND ALONE PC / DESK TOP

CENTRAL PROCESSING UNIT

CONTROL UNIT	
MEMORY UNIT (RAM)	
ARITHMETIC / LOGIC UNIT	

INPUT DEVICES → → **OUTPUT DEVICES**

Desk Top System

EVOLUTION

CENTRAL PROCESSING UNIT

EXTERNAL MEMORY

- **HARD DISK**
- **CD R/W**

CONTROL UNIT

SYSTEM SW
Operating System Compilers
Data Base MGT SW
Communication SW
Job Scheduling SW
Tape/Disk MGT SW
Library SW
Application SW

INPUT BUFFER	BUFFER AREA	OUTPUT BUFFER

ARITHMETIC / LOGIC UNIT

INPUT DEVICES

- **KEY BOARD**
- **PEN DRIVE**
- **MOUSE**
- **TOUCH PAD**

OUTPUT DEVICES

- **LINE PRINTER**
- **DOT MATRIX PRINTER**
- **INKJET PRINTER**
- **LASER PRINTER**

EVOLUTION

LAN ARCHITECTURE

CLIENT SEVER – ARCHITECTURE

C-1

Data Base Sever

Appln SW Server

C-2

C-3

C-4

**Client
I/O function
(Accounts)**

**Client
I/O function
(Sales)**

**Client
I/O function
(Inventory)**
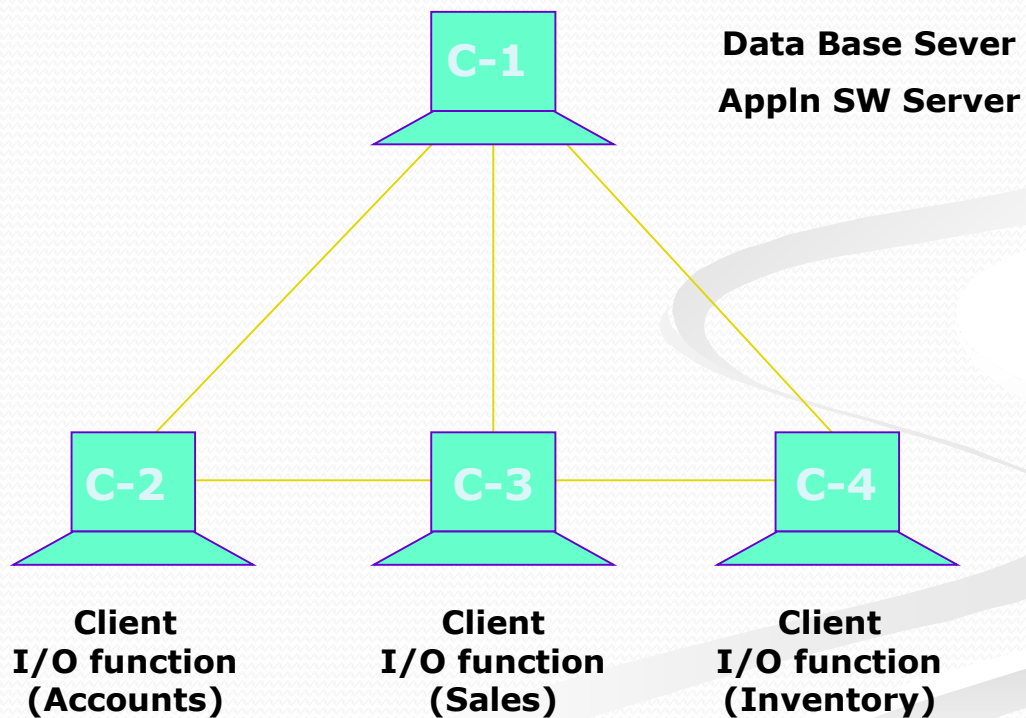
STAGE – 3: WAN

Information Systems - Hardware

WIDE AREA NETWORK - INTRANET

H O

LAN-1

Factory 1

LAN-6

Factory 2

LAN-5

Branch 1

Branch 2

Branch 3

LAN-2

LAN-3

LAN-4

EVOLUTION

WIDE AREA NETWORK - EXTRANET

H O

LAN-1

Factory 1

LAN-6

Customer

Factory 2

LAN-5

Supplier

Branch 1
LAN-2

Branch 2
LAN-3
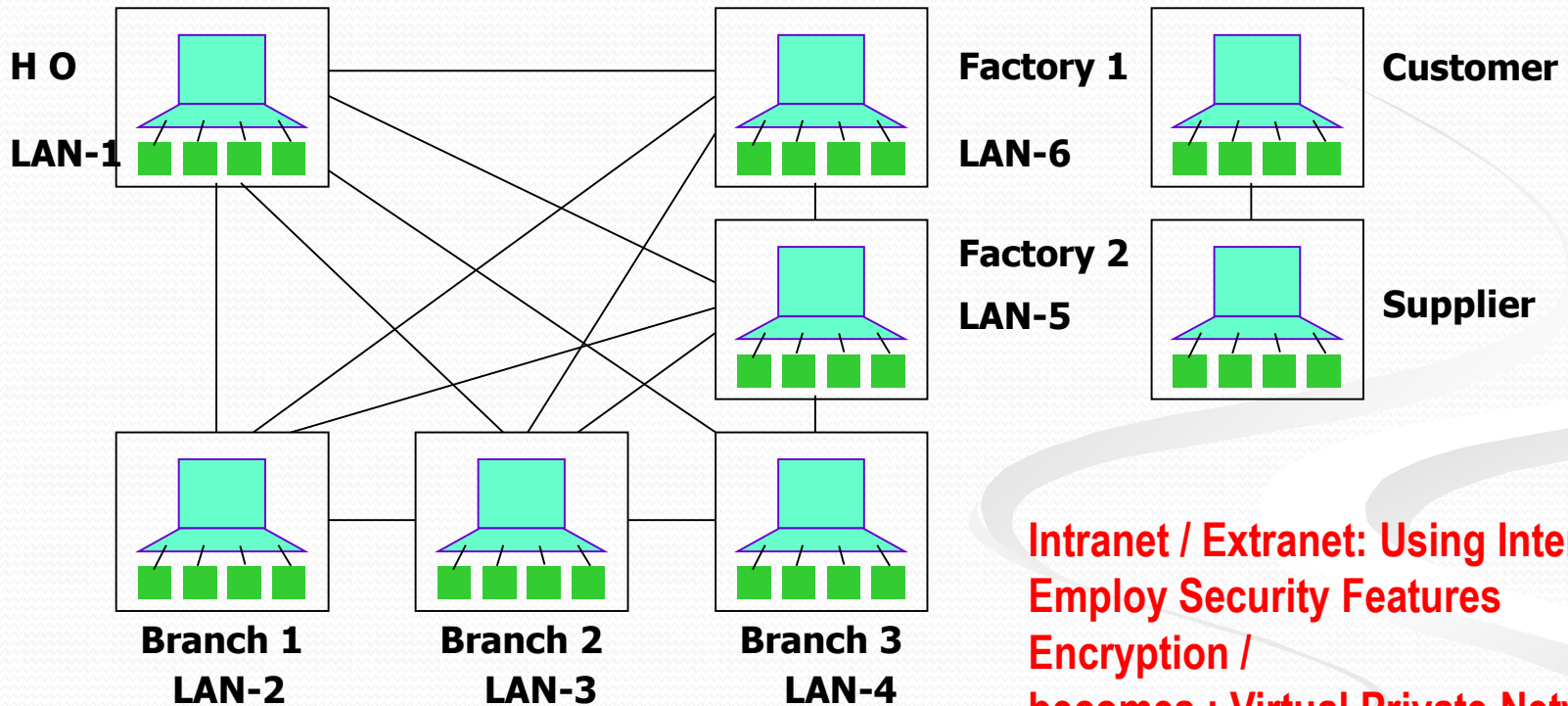
Branch 3
LAN-4

**Intranet / Extranet: Using Internet
Employ Security Features
Encryption /
becomes : Virtual Private Network**

LAN : Departmental Systems connected

WAN: Branches connected in the Network

WAN: Customers & Suppliers Systems connected

ERP Evolution

MRP System: Materials Resources Planning

MRP – 2 System: Manufacturing Resources Planning (Materials/Production Planning/Labour/Maitenance)

ERP System: Enterprise-wide Resources Planning (Plant/Marketing/Finance/Payroll/Distribution/Inventory/HR/Customers/Suppliers)

ERP Packages:-

SAP – SME Version

MS Dynamics

In-House Developed

Consultant Developed

POPULAR ERP PACKAGES

1. **JD Edwards – USA – 1996**
   - * Mainly for Manufacturing sector
   - * Brand Name: One World for SMEs
   - * Merged with PeopleSoft in 2003

2. **PeopleSoft – USA – 1987**
   - *Mainly for HR & CRM
   - *Later included Fin, Logistics, Distribution etc
   - *Merged with Oracle in 2004

3. Oracle

- RDBMS Package

- Components: Fin, Projects, HR, CRM etc

4. Microsoft Dynamics – USA – 2001

5. SAP Business One – 2002 for SMEs

- * Modules: 16 (Fin, Sales, Inv, MRP, HR etc)

Uniqueness of ERP Systems

- Audit Trail online within ERP
- Lack of Physical Audit Trail
- All internal Docs are within ERP
- External docs of Vendors & Customers in Phy form
- Concentration of large Database in one place
- IT Gen. Controls a must (Backup, Remote Backup, DRP, etc)

Categories of Controls maintained in ERP

Security Controls

Access Controls

Fin Module Controls

Inventory Cycle Controls

Exp Cycle Controls

Revenue Cycle Controls

Asset Controls

HR Controls

Each Control described as under

❖ **Control Serial Number**

❖ **Description of Control**

❖ **Category of Control**

❖ **Objective of Control**

❖ **Risks Mitigation**

Control – 1
Description: Critical Vendor Master Data

Category: Finance Module Control

Objective: Critical Master Data fields are configured as compulsory fields in Data Entry

Risks Mitigated: Critical Master data fields should not be left blank (fields like terms of payment)

Control – 2
Description: Customer Master Data Records

Category: Finance Module Control

Objective: Critical master data fields must be made mandatory fields

Risk: If left blank, impact is huge on financials. Hence, configured as compulsory fields. (Critical fields are: Payment terms, method of payment, Bank details)

Control – 3
Posting to GL A/cs marked for deletion

Category: Finance module

Objective: Block posting

Risk: Unwanted GL A/c will be marked for deletion at the time of setting up or configuration of ERP. If posted to such a/cs data gets deleted. So, such postings should be blocked.

Control – 4
Manual posting to GL A/cs.

❖ **Category:** Finance

❖ **Objective:** Manual posting or Direct posting to GL A/cs should be prevented. Automatic posting by the system alone should be allowed.

❖ **Risk:** Posting happen from various sub modules in an automatic mode. Direct or Manual postings may lead to fraudulent postings and hence to be blocked or prevented.

Control – 5
Des: Processing of bank transactions

- **Category:** Finance

- **Objective:** Only authorised persons should have access to maintain bank statements in ERP

- **Risk:** ERP provides for automatic bank reconciliation process. Transactions must be accessed only by authorised persons.

Control – 6
Des: Security of high profile access

➤ **Category:** Access Control

➤ **Objective:** High level access must be given only to super user

➤ **Risk:** Under high level access profile, it is possible to execute almost all transactions in ERP. This poses substantial surety risk. Super user must be created with PW during installation phase itself.

Control – 7
Des: Access to execute external OS commands

- **Category:** Access Control

- **Objective:** Access to execute external OS commands must be restricted

- **Risk:** For various maintenance purposes, ERP allows execution of OS commands. These commands are powerful and can be used for critical functions including creation and deletion of records, fields or files. Hence access to execute external OS commands should be restricted.

Control – 8
Documentation for user admin

- **Category:** Access Control
- **Objective:** User administration must be documented properly and Policies and Procedures must be in place and implemented fully.
- **Risk:** Most of the ERP auditing rests on or involves checking of Access Controls (Segregation of Duties) granted to users. This is part of online segregation of duties. So, user access Policies and Procedures must be adequately documented. Auditor must verify whether the documented policies and procedures are put into practice and fully followed by checking actual sample data. This is part of Internal Control review

Control – 9
Authorisation of Custom Program Development

❖ **Category:** Basic System Control

❖ **Objective** : Custom program development must be entrusted only to authorized group.

❖ **Risk :** Custom Program Development is a powerful tool. Any type of Program can be developed to extract any data including confidential and critical data. Proper access controls must be in place for such programs development facility. Otherwise, confidentiality will be given a go by. Only authorised group must be allowed to do custom programs development.

Control Reports in ERP

1. Changes to PW Access Controls
2. Multiple failed log on attempts
3. Roles assigned to users
4. Users with incomplete identification data
5. Duplicate Supplier Invoices Listing
6. Blocking Supplier payment if GSTR-1 not filed
7. Inventory Phy verification Report
8. Inventory Variance Analysis Report
9. FSN Analysis
10. ABC Analysis
11. FG Deliveries Vs Sales Invoices generation.

STRONG INTERNAL CONTROL SYSTEMS

1. Segregation of Duties thru Multi-level PW Access Controls
2. Change Management Controls
   A. PR / CR Forms (Problem Reports / Change Request)
   B. Master Records Access Controls
   C. Master Records Amendment Controls
   D. Approvals
   E. Documentation & Retention
3. System Log Files Review

4. Control Reports:-

A. Budget Vs Actual – Variance Analysis

B. Inventory Values in 2 different dates – Variance Analysis

C. Sales Returns / Rejections Analysis – Leading to finding Inspection dept anomalies

D. Insurance Claims Analysis – Leading to seeing Drivers ineffective Performance

E. Inventory Physical Verification Report – Variance Analysis

F. FSN Analysis Report

5. Application Controls (Input Validation/Processing/Output/Documentation)

6. IT General Controls / Cyber Security Controls (Separate Session)

Recommending 4 Essential Controls:-

1. **Segregation of Duties**

2. **Documentation**

3. **Internal Audit**

4. **Financial Delegation of Authority**

(These 4 Controls encompass all functionalities)

IA's Role in Internal Controls

- Primary activity of IA is Evaluating IC

- Management is responsible for IC

- Control Owners are Managers

- IA is Control Expert who evaluates Controls

LIMITATIONS OF ICS

- Collusion will defeat the objectives

- Cost Benefit is the key

- Excessive Controls will affect smooth flow of business

- Top Management indifference will not be conducive

- Educating Managers & Top Mgt is the job of IA

If IC Violations not addressed timely, it can result in

- Controls Break Down and

- Significant Losses to business

- Importance of ICS should be realized by every

  Manager & Auditor

- # Thank You

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THANK YOU.