Internal Controls: A Practical Matter

CUNA
Credit Union National Association

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Introduction

Welcome to the course on *Internal Controls: a Practical Matter.*

Internal controls are an integral part of a credit union's risk management program, and a key responsibility of the board of directors and the supervisory and audit committees. The primary objective of internal controls is to prevent employee dishonesty and protect the credit union from loss. The more complete the controls, the less tempted employees will be to commit dishonest acts. Internal controls should employ a system of checks and balances that holds individuals accountable for their actions, and minimizes the risk of loss to the credit union.

Objectives

The objectives for this course are to:

- Define Internal Controls and describe why they are needed;
- Explain the roles and responsibility for internal controls;
- Identify the components of internal controls; and
- Describe specific implementation steps at the credit union.

What is Internal Control?

Webster's online defines it as "an accounting procedure or system designed to promote efficiency or assure the implementation of a policy or safeguard assets or avoid fraud and error, etc."

Internal controls are a shared responsibility. The primary objectives of internal controls are to prevent employee dishonesty, and protect the credit union from loss.

History and Background

Internal controls used to be limited to financial statements and reporting processes, such as entering journal entries into the general ledger, reviewing the general ledger account reconciliations, and compiling and reviewing financial statements.

In the 1980s, however, there were a large number of savings and loan failures, as well as audit failures. In response to those failures, in 1985 the National Commission of Fraudulent Financial Reporting, known as the Treadway Commission, formed The Committee of Sponsoring Organizations, also known as "COSO".

COSO is a national consortium, and was jointly sponsored by five major financial professional associations in the United States in 1985, including the American Accounting Association, the National Association of Accountants, the American Institute of CPAs, Financial Executives Institute and the Institute of Internal Auditors.

COSO is a voluntary private sector organization dedicated to improving the quality of financial reporting through business ethics, effective internal control and corporate governance.

In 1992, COSO issued a report called the *Internal Control – Integrated Framework*. This document changed the way we look at internal control, and now internal control is viewed on a much wider, integrated basis. Prior to the formation of COSO, internal controls were deemed to be limited to financial statements and reporting processes. COSO introduced a much wider perspective of internal controls to include:

- Hard controls such as separation of duties; for example making sure that the individuals responsible for entering journal entries aren't the same individuals who are reviewing journal entries.
- Soft controls, such as employee competence and professionalism, active oversight by audit (supervisory) committees, and an objective internal audit function.

COSO Definition of Internal Control

COSO defines internal control as a process, adopted by the credit union's board of directors, management and other personnel, designed to provide reasonable achievement of objectives in three categories:

1. Effectiveness and efficiency of operations: the credit union's basic business objectives, including performance and profitability goals and safeguarding resources.
2. Reliability of financial reporting: the preparation of published financial statements, including interim and condensed financial statements and selected financial data derived from such statements, such as earnings reports.
3. Compliance with applicable laws and regulations.