



## Limits of an internal control system

- **The reasonable assurance internal controls provide helps agencies achieve their objectives while minimizing undesirable events.**
- **Internal controls are only as effective as the people responsible for their functioning.**

Nothing in this world is ever perfect. Unfortunately, internal control systems are no different. Internal controls, no matter how well designed and implemented, can only provide reasonable assurance regarding the achievement of intended objectives. However, despite these inherent limitations, the reasonable assurance that internal controls provide enables an agency to focus on reaching its objectives while minimizing undesirable events. Management awareness and mitigation of these inherent limitations is important to the overall success of the internal control system and to the success of the agency's objectives.

Common inherent limitations that hinder the effectiveness of an internal control system are:

*Cost vs. Benefit:* The concept of reasonable assurance recognizes that the cost of internal controls should not exceed the benefits derived and also recognizes evaluation of these factors requires estimates and judgments. Prohibitive costs prevent management from implementing the perfect internal control system.

Management accepts certain risks because the cost of preventing such risks cannot be justified. When considering the cost versus benefit of implementing a specific control, management must weigh both tangible and intangible risks to the agency.

*Inadequate Segregation of Duties:* Division or segregation of duties among different employees is critical to reduce the risk of errors or inappropriate actions. Staff size limitations can make maintaining the necessary checks and balances of the duties relating to record keeping, custody, and authorization difficult. If ideal separation of duties is not possible, the use of compensating controls, such as independent reviews and oversight, can provide the necessary control.

*Control Override:* An internal control system is

only as effective as the people who are responsible for its functioning. Consistent management override sends the message that standard procedures are not important. While exceptions to established policies are sometimes necessary to accomplish a specific task, they pose a significant risk if not monitored and limited.

*Human Error:* The effectiveness of an internal control system is limited by the reality that human beings are not perfect. Errors may occur due to employee carelessness, distraction, or fatigue. Decisions are often made under time pressures, based on limited information, and rely heavily on human judgment. Additionally, management may fail to anticipate certain risks and ultimately fail to design and implement appropriate controls to mitigate those risks.

*Collusion:* Two or more employees acting together to perpetrate and conceal an action from detection can often circumvent the most effective system of internal control. One of the best deterrents and methods of curtailing collusion is a control environment that enforces written policies and procedures, appropriately monitors internal controls, provides reporting of suspicious activity, and educates employees about the consequences of fraud.

*Suggested action steps:* Are written policies and procedures enforced? Do employees receive information about the consequences of fraud? Has a commitment been made to periodically re-evaluate existing control activities for effectiveness?

If you have any questions, please contact [Heidi Henry at Heidi.Henry@state.mn.us](mailto:Heidi.Henry@state.mn.us) or 651-201-8078.