

# Government's Internal Control Environment: Why Managers Have to Care (A Lot)

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## The Urgency of Management's Responsibility for Internal Control – Name Dropping

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- Enron
- WorldCom
- San Diego
- Your Organization's Name Here?



## And the Pitfalls...

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“It isn’t my enemies who are getting me in trouble, it’s my # @ & \$ % friends!”

- President Warren G. Harding



## Topics – A Framework of Internal Control

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- The Big Issues for Managers
  - What are Internal Controls?
  - What is management’s responsibility for internal controls? (“Isn’t that why I have accountants and auditors?”)
  - How can we know if internal controls are adequate?
  - “Winning Compliance” – a Tool for Maintaining a favorable control environment



## Management's Mission

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- To achieve the purpose of the organization....
- And, to accomplish this task
  - Effectively and efficiently
  - Openly (financial and results reporting)
  - In compliance with law, regulations, organizational policies, SOPs



## What is the purpose of internal controls?

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- Safeguarding of assets from the danger of loss or misuse
- Ensuring the effective and efficient use of assets
- Providing accountability for stewardship over assets through periodic reporting



## What are the essential elements of an internal control structure?

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- Sound *control environment*
- Properly designed and maintained *accounting system*
- Properly designed and implemented *control policies and procedures*



## What are the essential features of an effective control environment?

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- Management awareness of the importance of controls and communication to employees
- Rational and well-defined organizational structure
- Sound personnel policies and practices
- Active monitoring of operations and investigation of discrepancies
- Governing body oversight of management



## Why is management involvement essential to good control?

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- Controls require time, effort and money
- Natural tendency if for controls to break down over time (“red tape” syndrome)
- Management involvement needed to
  - Set the right tone
  - Educate employees
  - Provide the resources needed to design, implement and maintain good controls



## Why is a well-defined organizational structure needed?

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- Clear communication of authority and responsibility needed
- *Everyone* responsible = *no one* responsible
  - Difficult or impossible to monitor accountability or to ensure proper authorization
  - Invites and facilitates the circumvention of controls



## How can sound personnel policies help?

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- Goal = *honest* and *qualified* individuals
- Tools to achieve goal
  - Well designed job descriptions
  - Appropriate job qualifications
  - Background and reference checks
  - Periodic employee evaluations
  - Ongoing training
- Helpful in avoiding disaffection-induced fraud



## Why are monitoring and follow-up essential to good control?

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- Impractical to review all transactions
- Discrepancies between actual and anticipated outcomes are “red flags” for potential problems
- Investigation of discrepancies
  - Helps to *detect* irregularities
  - Also helps to *prevent* irregularities



## Why is governing board oversight needed?

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- Management is *primarily* responsible for controls
- Governing board is *ultimately* responsible for controls
  - Must make sure that management is meeting its control responsibilities
  - Especially important because management is in a position to override its own controls
  - Practical tool = audit committee



## What is the role of the audit committee?

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- Maintain management accountability to the board for its control responsibilities
- Role of the audit committee
  - Select the independent auditor
  - Monitor the progress of the audit
  - Evaluate the results of the audit
  - Follow up on weaknesses disclosed by the audit
  - Serve as a direct link between the governing board and the auditor
  - Monitor internal control structure



## The Details of Good Internal Control

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- A solid accounting system
- Control policies and procedures
- Proper authorization (before the fact)
- Segregation of duties
- A policies and procedures manual
- Evaluating internal controls themselves
  - Control cycles
- Assessing your risk - Vulnerability assessment



## What are the key features of a good accounting system?

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- Assemble data
- Analyze data
- Classify data
- Record data
- Report data
- Maintain accountability for assets



## How can the effectiveness of an accounting system be judged?

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- Existence or occurrence (everything that is reported is true)
- Completeness (nothing is missing)
- Rights and obligations (things are what they appear to be)
- Allocation (right period/right accounts)
- Presentation and disclosure (all the information needed for GAAP reporting)



## What are control policies and procedures?

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- Assurance needed that an accounting system is doing what it is supposed to do
- Control policies and procedures = practical tools to ensure the effectiveness of an accounting system



## What types of policies and procedures are needed?

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- Effective policies and procedures must ensure that:
  - All transactions are properly *authorized*
  - Incompatible duties are segregated
  - Accounting records and documentation are properly designed and maintained
  - Access to assets and records is controlled
  - Accounting data are periodically compared with the underlying items they represent



## What's needed for proper authorization?

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- Written policies and procedures governing who may authorize transactions
- “Authorization” obtained after the fact is *not* authorization
  - Document authorization
  - Document when authorization given



## What is the segregation of incompatible duties?

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- One person in the ordinary course of duty should not be able to both *commit* and *conceal* an irregularity
- Collusion still remains a risk



## How can the segregation of duties be accomplished?

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- Incompatible duties are:
  - Authorization of transactions
  - Recording of transactions
  - Custody of assets
- How to divide
  - Between departments (large governments)
  - Between individuals (smaller governments)
  - Substitutes when impractical (very small governments)
    - Mandatory vacation policy
    - Mandatory rotation of duties policy
    - Analytical review



## When do controls become excessive?

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- Controls are a means to an end, not an end in themselves
- Costs of controls should not outweigh benefits
- “More” is *not* “better” when it comes to controls



## Why is a policies and procedures manual important?

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- Documentation needed if controls are to function effectively
  - Assigns authority and responsibility to specific employees
  - Reference tool for handling less frequent transactions
  - Maintains continuity in the face of turnover



## What is needed for such a manual to be effective?

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- Complete
  - *Which* employees
  - are to perform *which* functions
  - in *which* manner (not just “how,” but “why”)
- Up-to-date
- Available
- USED!!!



## Why is it important to evaluate internal controls?

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- Internal controls, of their nature, tend to break down unless actively maintained
- Monitoring is key to proper maintenance



## Who is responsible for evaluating controls?

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- **Management is primarily responsible**
  - Often assisted by internal auditors
- Independent auditor of financial statements
  - Only indirectly responsible
  - No substitute for management involvement



## How are controls evaluated?

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- **Five-step process**
  - Identify control cycles
  - Perform vulnerability assessment
  - Document controls
  - Identify key controls
  - Test key controls



## What are control cycles?

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- A grouping of related control procedures
  - Enhances efficiency of evaluation process
  - Enhances effectiveness of evaluation process by highlighting how controls interact with each other
- Identification of specific control cycles a matter of professional judgment



## What is a vulnerability assessment?

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- Not possible to evaluate all controls at once
- Logical method of establishing priorities for control evaluations based upon relative risk (“vulnerability”)



## What types of risk are considered in such an assessment?

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- Likelihood
  - Quality of the control environment
- Potential Impact
  - Inherent Risk



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- *Inherent risk*
    - High volume of cash transactions
    - Transactions with individuals outside the government (e.g., benefit payments)
    - Implementation of new programs
    - Recent computer conversions
    - Complex program requirements
    - Financial stress
    - Rapid downsizing of operations



## How should identified control weaknesses be handled?

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- Factors for consideration:
  - Is there a compensating control in place that makes the weak control redundant?
  - Do the costs of the control outweigh the benefits?
- Otherwise: immediate remedial action needed



## “Winning Compliance” – A Tool for Establishing a Favorable Control Environment

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- A Manager’s Plight: “In Charge,” but not “In Control”
- How do you get other people to (willingly) do what’s necessary?
- How do you control the costs of control?



## Nine Steps to Winning Compliance

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1. Build support for standards, norms, or expectations.
2. Make regulations performance- rather than process-based.
3. Educate those who need to comply on how to do so.
4. Make the process simple and easy
5. Make the compliance organization accountable for **its** part of the compliance process.



## Nine steps, continued

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6. Report information on compliance performance.
7. Treat people and organizations differently based on their performance.
8. Use a range of consequences from rewards to punishments.
9. Create market incentives to reinforce compliance.



Thanks to Peter Hutchinson and David Osborne for this concept, from their essay, "Winning Compliance."

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# Discussion



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# Thank you!

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