Evaluating Internal Controls: A Local Government Manager's Guide

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Foreword

Now more than ever, citizens are demanding the very highest level of accountability from government officials for their stewardship of public resources. To be truly accountable, public-sector managers must use the resources committed to their care as effectively and efficiently as possible, in full accordance with all applicable legal requirements and restrictions. At the same time, managers in the public sector must ensure that reliable financial information is provided on a timely basis to decision makers both inside and outside the government. These objectives can only be achieved within the framework of a sound and comprehensive system of internal controls.

Until recently, managers in both the public and private sectors have often been all too willing to consign the whole issue of internal controls to their internal and external auditors. Long experience has clearly demonstrated, however, that it is managers who must take the lead if internal controls are to function effectively. Accordingly, the GFOA is offering this publication as a practical tool for managers at the local government level who wish to take a more active role in the design, implementation and maintenance of their governments' internal controls.

The Government Finance officers Association (GFOA) wishes to thank Stephen J. Gauthier, the Director of the GFOA's Technical Services Center, for writing this publication. He is the author of numerous GFOA publications and editor of the GFOA's monthly accounting, auditing and financial reporting periodical *GAAFR Review*.

The GFOA remains committed to the concept of professional accountability for public finance professionals. It is our hope that this publication will provide practical assistance to local government officials across the country as they continue to strive to meet this objective.

Jeffrey L. Esser
Executive Director
Government Finance Officers Association

Preface

The Government Finance Officers Association (GFOA) first provided extensive guidance on how to evaluate internal controls in its 1981 publication, *How to Evaluate and Improve Internal Controls in Governmental Units*. That publication proved to be of great assistance to local governments for a number of years. The late 1980s and early 1990s, however, gave rise to a number of very important developments that changed significantly how managers, auditors and other finance professionals have come to view internal controls. Nowhere are these changes more in evidence than in the report of the Committee of Sponsoring Organizations of the Treadway Commission, entitled *Internal Control—Integrated Framework* (*COSO Report*). Consequently, the GFOA decided the time had come to produce a new publication on internal controls for local governments that would reflect and incorporate these significant recent developments. This new publication, *Evaluating Internal Controls: A Local Government Manager's Guide*, is specifically designed to provide managers at the local level with the information they need to take a leadership role in the design, implementation and maintenance of a sound and comprehensive framework of internal controls.

The text of this publication is entirely new and follows the conceptual framework for internal controls outlined in the *COSO Report*. The appendix draws heavily upon specific examples of weaknesses and compensating controls provided in the previous publication, although these examples have been updated to reflect more recent developments, including changes in accounting and financial reporting standards (e.g., wire transfers, custodial credit risk for investments, securities lending arrangements).

I am pleased to acknowledge my debt to the four members of the special committee assigned to review this publication. They are Mr. Lee Carter, Institute of Government, University of North Carolina; Mr. Frederick Clarke, Accounting and Budget Manager, MUNI, San Francisco, California; Mr. Patrick Hardiman, Partner, Deloitte & Touche; and Mr. Glen McKay, Assistant Director, Tennessee Division of State Audit. Their reviews of the manuscript were thorough, timely and much appreciated. I also wish to thank Mr. Christopher Freeze, Investigative Auditor IV, of the Tennessee Division of State Audit, who offered helpful suggestions on the outline.

I also wish to thank all of the members of the GFOA staff who assisted in the preparation and production of this manuscript. In particular, it is my pleasure to acknowledge my colleague and friend, Gregory Allison, Assistant Director in the Technical Services Center, who reviewed the entire manuscript and offered timely and helpful suggestions for improvement. Likewise, I am pleased to acknowledge the contribution of Rebecca Russum, Director of the Publications Center.

Finally, I am pleased to thank my wife Barbara and my sons Marc, Paul and Gregory for their patience and support throughout this project.

Stephen J. Gauthier

Introduction

The key role in internal controls has always properly belonged to management. Important recent developments, such as the release of the report *Internal Control—Integrated Framework* by the Committee of Sponsoring Organizations of the Treadway Commission (*COSO Report*), have only served to underscore this crucial fact. In other words, no system of internal controls, no matter how well designed, can function properly without the knowledge and support of management at all levels.

In recent years, managers have become increasingly aware of their responsibility for internal controls. Even the most conscientious managers, however, often complain that they find it difficult to meet this important responsibility because they lack adequate grounding in the design and operation of internal controls. The current publication is specifically designed to fill this gap for managers at the local government level. That is to say, this publication aims at providing managers in local governments with the practical guidance they need to assume a leadership role in the design, implementation and maintenance of a comprehensive framework of internal controls for their government.

Chapter 1 of this publication provides an overview of the internal control framework and how it relates to the achievement of basic management objectives. Chapter 2 offers a more detailed examination of management's basic objectives (i.e., effectiveness, efficiency, compliance and financial reporting) and related responsibilities in a specifically governmental context. Chapters 3 through 7 are each dedicated to one of the five components of a comprehensive framework of internal controls outlined in the *COSO Report* (i.e., the control environment, risk monitoring and assessment, control-related policies and procedures, information and communication, and monitoring).

Internal controls must necessarily address each of management's objectives. However, it is the intent of this publication to place special emphasis on internal controls specifically related to accounting and financial reporting. Accordingly, chapter 8 focuses on practical steps management can take to evaluate these particular controls. Likewise, this publication incorporates an appendix that illustrates how to identify potential risks involving accounting and financial reporting in each of five separate control cycles, along with examples of compensating controls.

Finally, no discussion of internal controls would be complete without an examination of fraud prevention and detection. Thus, chapter 9 examines the causes of fraud in the public sector, the cost of fraud, some of the more common types of public-sector fraud, fraud prevention, fraud detection and fraud investigation.

It is a common mistake for managers to wish to "cut to the chase" and go directly to a description of specific internal control procedures. However, attempting to understand specific control procedures without first understanding the overall framework of internal controls is much like attempting to learn how to read before mastering the alphabet. In both cases, the result is likely to be short-term frustration combined with a long-term lack of progress. Viewed another way, the alphabet, though a simple tool, has almost unlimited powers—allowing writers to use whatever words are needed in a given set of circumstances. So too, the comprehensive framework of internal controls described in this publication is a *practical tool* that gives managers the *flexibility* they need to design, implement, maintain and *alter* controls to meet the ever-changing circumstances of a rapidly evolving environment.

Chapter 1
Internal Controls: An Overview

There is always the risk in discussing internal controls that the discussion will turn into a piece-meal examination of specific control-related policies and procedures. When this occurs, it is easy to become lost or confused, because individual controls may appear isolated and unrelated to one other. However, internal controls are actually a coordinated set of policies and procedures that reflect a comprehensive strategy for achieving management objectives. When internal controls are approached from this perspective, it is much easier to understand how individual controls function and work together. This chapter is designed to provide just such a conceptual overview of internal controls—what they are and who is responsible for them. This overview will serve, in turn, as the framework for the more detailed discussion to be found in the chapters that follow.

Management's responsibilities and the internal control framework

Any entity, be it a government, a business or a nonprofit organization, exists to achieve some purpose. It is the role of management to provide the leadership needed for an entity to realize that purpose. Furthermore, management is not free simply to act in any way it might choose to achieve the entity's goals. Rather, management's options and actions are circumscribed by constraints and expectations, both implicit and explicit. Therefore, any analysis of management's fundamental responsibilities would need to address all of the following:

- *Effectiveness*. Ultimately, success must be judged on the basis of whether an entity is achieving its objectives. That is to say, effort is no substitute for results. Yet, it is very easy for management to focus so intensely on the handling of day-to-day activities that it loses sight of whether those activities are actually achieving their intended purpose.
- *Efficiency*. The modern study of economics is based upon the axiom of the scarcity of resources. Given that there are legitimate and conflicting demands for scarce resources, management has a responsibility to make optimal use of the scarce resources placed under its control.[1] It should be noted also in this regard that there is a clear link between efficiency and effectiveness. On the one hand, it is possible for a program to meet its objectives but be too expensive (i.e., a program can be effective, but inefficient). On the other hand, it is *not* possible for a program to be both economical and ineffective (i.e., a program, no matter how inexpensive, cannot be economical if it does not accomplish what it is supposed to accomplish). Therefore, any attempt to assess efficiency must also take into account ef-

[1] Ensuring the optimal use of assets requires, among other things, that assets be adequately safeguarded against loss or misuse.

fectiveness. That is to say, an ineffective program is no bargain at any price.

- *Compliance*. It was noted earlier that management does not have unlimited authority over the resources under its control. Rather, management's control over resources typically is limited to some degree by policy, law or regulation, particularly in the public sector. It is a condition of management's stewardship of resources that it strictly comply with such restrictions.
- *Financial reporting*. Managers are also *financial decision makers*. The best decision, however, is only as good as the data upon which it is based. Thus, it is critical that managers have in place a system of accounting and financial reporting that provides *the types of information managers need* to make financial decisions *when they need it*. Likewise, managers also must be accountable to individuals and groups outside the entity for their management of the entity's resources. Managers meet this responsibility by preparing financial statements for the benefit of those without direct access to the entity's accounting system.

If effectiveness, efficiency, compliance and financial reporting are all responsibilities of management, then *internal controls* should be seen as the framework that management establishes to ensure that it meets those responsibilities. The comprehensiveness of an entity's internal control framework can be assessed on the basis of whether it does all of the following:

- *Provides a favorable control environment*. Modern sociology has demonstrated that interactions among individuals are profoundly affected by the social structure within which those interactions take place, as well as by a variety of spoken and unspoken expectations (e.g., beliefs, assumptions, values). In the private sector, this complex mix of factors is sometimes referred to as a business's "corporate culture," although the same phenomenon can be found equally in public-sector entities. Thus, internal controls do not function in a vacuum. Instead, internal controls are necessarily and profoundly influenced by the environment in which they operate. Consequently, the first and most important step in establishing an effective framework of internal controls is for senior management to create a favorable control environment. A favorable control environment is one in which 1) management is knowledgeable about internal controls, 2) management is committed to establishing and maintaining controls, and 3) management communicates its support for internal controls to staff at all levels. Attempting to make internal controls function effectively in a hostile or indifferent environment is likely to be a frustrating and futile endeavor.
- *Continually assesses risk*. A variety of risks may hamper or prevent management from fulfilling its responsibilities and achieving its goals. Some of these risks can arise from within the entity itself (e.g., a change in personnel), while others may originate outside the entity (e.g., a change in the population being served by a program). When management is able to anticipate such risks, it is better prepared to "manage" them. Accordingly, a sound internal control framework must provide for the ongoing identification and assessment of potential risks.
- *Establishes and maintains effective control-related policies and procedures*. Once management has identified and assessed potential risks, it needs to take action to compensate for them. In practice, a variety of specific policies and procedures have been developed as tools for achieving

this goal (i.e., prior authorization and approval of transactions, properly designed records, appropriate security over assets and records, segregation of incompatible duties, periodic reconciliations, periodic verifications, analytical review and the timely preparation of financial statements). In some cases, these policies and procedures may themselves be adequate to prevent undesired actions and events (e.g., appropriate physical security over assets may prevent some thefts). In other cases, the goal of such policies and procedures is to alert management of undesired actions and events in time to take effective corrective action (e.g., a periodic bank reconciliation may alert management to a "kiting" scheme).[2]

- *Effectively communicates information*. Information must be reliable if it is to be of use to decision makers. Likewise, the selection, format, timeliness and accessibility of information are also crucial factors. Accordingly, a sound framework of internal controls will ensure that the *right information* is provided to the *right individuals* at the *right time* and in the *right format*. Furthermore, there must be adequate means of ongoing communication both within and between various levels and activities of the entity, as well as with those outside the government (e.g., citizens, suppliers).
- *Monitors the effectiveness of control policies and procedures as well as the resolution of potential problems identified by controls*. Once appropriate controls are in place, care must be taken to ensure that those controls continue to function properly. Most often, this monitoring takes place on an ongoing basis. Sometimes, however, special reviews also will be undertaken of all or a portion of an entity's control-related policies and procedures. Moreover, management must monitor not only the effectiveness of internal controls themselves, but also the effectiveness of its own response to potential problems identified by those controls (e.g., Does management follow up on discrepancies disclosed by periodic reconciliations?).

In brief then, internal controls are the varied means used by *management* to achieve *management* objectives and to meet *management* responsibilities. Unfortunately, those unfamiliar with internal controls are sometimes unaware of this necessary and integral connection between internal controls and management. As a result, such individuals may mistakenly come to view internal controls as little more than accounting "bells and whistles," and may even come to see internal controls as hindering management rather than helping it to achieve its goals. Alternatively, such individuals may appreciate the importance of internal controls, but may believe erroneously that internal controls are principally the concern of accountants and auditors rather than of managers. In fact, however, internal controls are essentially *management* techniques that are an integral and inextricable part of how management "does business."

Limitations of internal controls

Any technique, of its very nature, is a means to an end, rather than an end in itself. Consequently, internal controls must be modified at the point where they start to hinder rather than to help (i.e., the costs of internal controls never should exceed the benefits they provide). Accordingly, one limitation of internal controls is that considerations of cost will prevent management from ever installing a "perfect" system. Instead, management will properly choose to run certain risks because the cost of preventing such risks cannot be justified, just as

[2] Kiting schemes are described in chapter 9, which is devoted to fraud.

an automobile owner will not insure against all possible losses, but will instead arrange for a "deductible" in the insurance contract.

A second important limitation of internal controls is that they are potentially subject to "management override." That is to say, if management has the power to establish a given control policy or procedure, management probably also has the ability to "override" that same policy or procedure. For example, management generally may require adequate documentation and review of travel claims, but could wrongfully direct that its own travel claims be processed without such documentation or review.

A third limitation of internal controls is the risk of collusion. Often internal controls are designed so that one employee functions as a "check" on another employee's work (e.g., segregation of incompatible duties). In such cases, there is always the risk that employees who are supposed to serve as a check on one another may instead choose to work together to circumvent controls.

Finally, it should be noted, as a basic rule, that "more" is not "better" in the case of internal controls. Not only does the cost of excessive or redundant controls not exceed the benefits, but the perception of excessiveness or redundancy may have a serious negative effect on how employees view controls in general (e.g., "red tape"), thus adversely affecting the overall control environment.[3]

Responsibility for internal controls

As noted earlier, internal controls are essentially *management* techniques, an inextricable part of how management conducts its business. Accordingly, management (*not* the internal or external auditors) is primarily responsible for the effectiveness of internal controls, just as management is accountable for all other aspects of its performance. Furthermore, it is a basic principle of good management that authority and responsibility should not be separated. Therefore, since management alone is in a position to both establish and maintain internal controls, it is management that must be held primarily accountable for their proper functioning.

Management's performance is subject to oversight by the entity's governing board. Therefore, although management is *primarily* responsible for internal controls, the governing board is *ultimately* responsible for ensuring that management fulfills this duty. The governing board's role in this regard is particularly important because of management's ability to override controls.

Audit professionals, both the independent auditors of the entity's financial statements and members of the entity's internal audit staff, can play a valuable role in *helping* management and the board to fulfill their respective responsibilities for internal controls. Nevertheless, auditors cannot themselves assume primary or ultimate responsibility for internal controls.

Management's responsibilities for internal controls can be categorized as follows:

- *Design*. Management should use the conceptual framework of internal controls described earlier to design control-related policies and procedures tailored to the entity's individual circumstances.
- *Implementation*. Management should ensure that control-related policies and procedures are actually installed as designed and placed in service.

[3] Another potential limitation on internal controls is that management may be unable to anticipate certain risks (e.g., situations involving rare transactions or remote consequences), and thus fail to design and implement appropriate controls.

- *Monitoring*. Management should ensure that controls continue to function as designed after installation, and that controls are modified or enhanced, as needed, to conform to changes in the entity's operating environment.
- *Reporting*. Management should keep the governing board apprised of how internal controls are functioning.

In many cases, management makes use of the services of internal auditors to monitor the continued effectiveness of control-related policies and procedures on an ongoing basis. Management itself also may directly evaluate the effectiveness of internal controls from time to time. Such direct periodic management evaluations are required, for example, in jurisdictions that have enacted "financial integrity" legislation patterned on the Federal Financial Managers' Integrity Act of 1984.[4]

Typically, governments engage the services of an independent audit firm to render an opinion on the fair presentation of the government's financial statements. Independent auditors must gain an understanding of the entity's internal control framework as part of the process of assessing "audit risk." Accordingly, management has sometimes reached the understandable but mistaken conclusion that the independent audit of the financial statements is sufficient to ensure that internal controls are adequately designed and functioning properly. In fact, however, the purpose and scope of the independent auditor's assessment of internal controls are limited.

The objective of the independent audit is to provide assurance to potential users of financial statements that they can reasonably rely upon those statements to be free from errors that could change their overall assessment of the entity's finances. Accordingly, a properly conducted financial statement audit should uncover all internal control weaknesses that could have such a major impact on financial reporting (referred to by auditors as "material weaknesses"). However, most internal control weaknesses, although important to management, are not of such magnitude as to potentially affect a user's overall assessment of the entity's finances. Consequently, there is no assurance that all such "immaterial" weaknesses will be uncovered, even in the course of a thorough and well conducted financial statement audit. Thus, the independent auditor's assessment of internal controls should *not* be viewed as a substitute for management's own ongoing monitoring of the effectiveness of control-related policies and procedures.

Summary

Internal controls are the practical techniques employed by management to accomplish its objectives and meet its responsibilities. A comprehensive framework of internal controls should 1) create and maintain an environment conducive to control, 2) ensure that risks from both inside and outside the entity are assessed and managed on an ongoing basis, 3) result in the design and implementation of appropriate control-related policies and procedures, 4) provide for the appropriate communication of information both inside and outside the entity, and 5) monitor the effectiveness of control-related policies and procedures as well as the resolution of potential problems identified by controls.

Internal controls are essential, but not foolproof. Some controls cannot be implemented because the cost of the controls would exceed their potential ben-

[4] Financial integrity legislation is examined in chapter 3, which is devoted to the control environment.

efit. Also, employees may collude to circumvent certain controls. Likewise, there is always the risk that management may override any controls it establishes.

Management (*not* the internal or external auditor) is *primarily* responsible for designing, implementing, monitoring and reporting on controls. An entity's governing board, however, is *ultimately* responsible for ensuring that management fulfills its internal control responsibilities. Audit professionals can assist management and the governing board in meeting their internal control responsibilities, but auditors cannot assume those responsibilities on their behalf.

The independent auditor must gain an understanding of the internal control framework to assess audit risk. However, the independent auditor focuses primarily on control weaknesses that could have a significant impact on financial reporting. Accordingly, many weaknesses of potential importance to management would not necessarily be uncovered in a financial statement audit. Therefore, the independent audit should not be viewed as a substitute for management's own ongoing monitoring of the effectiveness of control-related policies and procedures.

Chapter 2
Management Objectives and Responsibilities

Internal controls are techniques used by management to achieve its objectives and to meet its responsibilities. Because of this fundamental connection, it is essential to gain an understanding of basic management objectives and responsibilities before proceeding to a discussion of the internal control framework within which they are met.

Effectiveness

The key criterion in assessing management performance is the degree to which management is meeting its objectives. It is hard to take aim without a visible target. Likewise, it is hard for management to meet unstated, unclear or inconsistent objectives. Therefore, the identification of management objectives is an important first step toward assuring that those objectives are attained.

An entity's objectives should arise naturally and logically from its basic purpose. Often this purpose is set forth in the government's charter. Alternatively, some governments, like many private-sector enterprises, have elected to develop a formal "mission statement" to provide a clear declaration of their purpose. In either case, a government's "purpose" or "mission" provides management with a general target toward which it can direct its efforts.

This general target must, in turn, be subdivided into a series of more specific targets, commonly referred to as "goals" and "objectives." Governments typically establish goals and objectives for themselves as part of the budgetary process. In some cases, this budgetary process is itself incorporated into a comprehensive strategic planning effort or business plan.

Once identified, goals and objectives serve to provide management with clear direction. A second and equally important function of goals and objectives is to provide the criteria needed for assessing management's performance, thus helping to ensure management accountability.

Well designed goals and objectives should focus primarily on *results* rather than on *efforts*. What is important, for example, is not so much the number of employee hours to be devoted to a given purpose, as whether and to what extent that purpose will be achieved. Thus, governments may wish to incorporate the following types of measures into their goals and objectives:

- *Output. Measures of "output" focus on how much* of a good or service is to be provided. For example, how many tons of refuse are to be removed? How many miles of road are to be repaved?
- *Outcome.* Measures of "outcome" focus on the *quality* of the goods or services to be provided. For example, test scores are sometimes used as a measure of *how well* students are being educated.

In practice, output and outcome measures often are combined. For example, a city may set for itself the goal of restoring a certain number of miles of road (output) to a given level of quality (outcome). Specific performance measures often are selected based upon the government's past experience, or based upon the experience of other similar and comparable governments. Likewise, selected national, regional and state "benchmarks" and averages (e.g., average test scores for high school students) also are sometimes used.[1]

Of course, the ultimate effectiveness of management will depend upon the extent to which management at all levels is able to communicate its directives to employees and to ensure that those directives are being carried out. A useful comparison might be made in this regard between management's directives and the steering function of a motor vehicle. A driver needs to know that a change in the position of the steering wheel will result in a corresponding change in the direction of the vehicle. Likewise, management needs to know that its directives will result in a corresponding change in direction on the part of those to whom the directives are addressed. Thus, management's inability to achieve its stated goals and objectives may be symptomatic of a deeper underlying problem, i.e., management's inability to communicate its directives clearly and to exercise adequate control over one or more aspects of the entity's operations.

EXAMPLES OF WAYS TO ACHIEVE ECONOMY: FIXED ASSETS AND INVENTORIES

Significant opportunities for economy exist in connection with the acquisition, maintenance and disposal of inventories and fixed assets:[a]

- *Economies can be realized by obtaining inventories and fixed assets in appropriate quantities.* Governments often are able to achieve economies of scale by purchasing certain items in bulk. Accordingly, governments often combine purchases, centralize their purchasing process or join together with other governments to place themselves in a better position to take advantage of bulk purchasing. Conversely, excessive purchases tie up resources that could more profitably be invested until they are needed. Excessive purchases also can increase the danger that inventories or fixed assets will become obsolete. Therefore, governments frequently strive to maintain their stocks of inventory and fixed assets at the lowest level consistent with their needs (e.g., utilization of "just-in-time" purchasing methods for inventories). It also is important to avoid duplicative purchasing. Thus one department should not be purchasing inventories or equipment if these same items are currently unused or underutilized in another department.
- *Economy is best achieved by obtaining inventories and fixed assets of appropriate* ▶

[a] In the public sector, the term "fixed assets" is commonly used to describe land, buildings, equipment and improvements other than buildings (e.g., parking lots). In the private sector, the terminology "property, plant and equipment" is more commonly used.

Efficiency

Management can be said to be "efficient" if it makes optimal use of the resources entrusted to its care. Of course, anything that does not achieve its intended purpose cannot be said to be "efficient." Thus, there is a natural and unavoidable link between efficiency and effectiveness.

One practical way of understanding "efficiency" is to view it as the process of obtaining desired results (i.e., effectiveness) with the least expenditure of scarce resources. It was noted earlier that goals and objectives for effectiveness can be stated in terms of "outputs" (i.e., "how many or how much?") and "outcomes" (i.e., "how well?"). Measures of efforts are often compared to measures of outputs and outcomes to arrive at measures of efficiency, as follows:

- *Effort/output.* Such measures attempt to arrive at a cost per unit of output. For this purpose "cost" can be expressed as either a monetary or a nonmonetary measure. Thus, employee hours/mile

[1] Information on potential measures of output and outcome for several of the most common types of government services can be found in a series of publications of the Governmental Accounting Standards Board (GASB) entitled *Service Efforts and Accomplishments Reporting: Its Time Has Come.*

of road resurfaced (nonmonetary measure) and instructional costs/student educated (monetary measure) are both examples of effort/output measures.

- *Effort/outcome*. In addition to "pure" measures that compare effort to outcome alone (e.g., overall cost to maintain a city's bridges at an acceptable level of serviceability), it also is possible to use hybrid measures that compare effort to both output and outcome simultaneously (e.g., the monetary cost [i.e., effort] of restoring a mile of roadway [i.e., output] to a predetermined condition level [i.e., outcome]).

Once again, specific performance measures for efficiency often are selected based upon a government's previous experience, or based upon the experience of similar and comparable governments. Selected national, regional and state "benchmarks" and averages also may be used for this purpose.[2]

In short then, efficiency measures compare costs (i.e., effort) to results (i.e., effectiveness). To the extent that desired levels of effectiveness have been predetermined, efficiency can only be improved by reducing costs, a process commonly known as "economy." (See sidebar on pages 8, 9 and 10 for some specific examples of how economy can be achieved in connection with the acquisition, maintenance and disposal of inventories and fixed assets.)

Thus efficiency is essentially concerned with reducing costs without sacrificing value. Because the resulting savings increase the resources available for other purposes, efficiency can also fairly be described as the art of achieving more for less.

Compliance

Management's stewardship of assets is subject to numerous restrictions established by policy, regulation, law or contract. It is not enough for management to demonstrate compliance with such restrictions after the fact. Rather, management is responsible for establishing controls to *ensure* compliance with such requirements.

Annual appropriated budget. Governing bodies exercise their power over management, both elected and appointed, through their legislative "power of the purse." That is to say, a government's resources may be expended only with the approval of the governing body. For most of a government's activities, this approval is embodied in the appropriated budget, which possesses the force of law. Management needs to es-

[2] Information on potential measures of efficiency for several of the most common types of government services can be found in the GASB's series *Service Efforts and Accomplishments Reporting: Its Time Has Come*.

▶ *quality*. Purchases are no "bargain" if the items obtained are of poor quality and thus ill suited for their intended use. Conversely, there often is a "point of diminishing returns" in matters of quality, so that beyond a certain point the added benefits of higher quality do not always justify the additional cost.

- *Inventories and fixed assets should be obtained at the least possible cost consistent with quality*. Governments often require competitive bidding for large purchases to ensure that they obtain a fair price. Likewise, governments can reduce costs by taking advantage of discounts offered for prompt payment. Furthermore, care should be taken to ensure that reimbursable costs are recovered from grantors.
- *Economy demands that fixed assets be maintained properly.* The life of a fixed asset can vary greatly depending upon whether it is properly maintained. Moreover, it is almost always less expensive in the long run to maintain an asset properly than to repair it. Accordingly, governments should establish and faithfully follow a regular maintenance schedule for their fixed assets. Above all, governments should resist short-sighted pressures to "defer" maintenance on their fixed assets, especially their infrastructure assets.[b] Governments can no more afford the "savings" of deferred maintenance than a car owner can afford to "save" money by foregoing regular oil changes. Also, in the case of certain highly sensitive assets (e.g., computer hardware), it is essential to maintain a carefully controlled physical environ- ▶

[b] "Infrastructure assets" are defined as assets that are immovable and of value only to the government. Common examples include roads, bridges, gutters and streetlights.

tablish adequate systems to ensure that this appropriated budget is not over expended. (See sidebar on pages 11 and 12 for examples of some of the techniques used in practice to achieve this goal.)

Grantor requirements. Almost all local governments receive financial assistance from their state government and from the federal government. As a condition of receiving federal funds, a government submits itself to a variety of legal requirements. State grants too often are subject to various compliance requirements.[3] Management is responsible for ensuring compliance with all such mandates imposed by grantors.

State oversight requirements. Local governments often are subject to state laws governing how they conduct their affairs. For example, special permission frequently is needed before a local government can issue debt, or before it can enter into a capital lease agreement. In the same way, local governments frequently are required to follow state guidelines when adopting their annual budget (e.g., balanced budget requirements). Once again, it is management's responsibility to ensure that the government complies with these legal requirements.

Internal Revenue Service (IRS) requirements. As an employer, a government is required to comply with various withholding and reporting requirements set by the IRS. Management must ensure that its payroll system is designed and operating in such a way as to meet these requirements. Similarly, management must ensure compliance with applicable federal regulations governing the reinvestment of the proceeds of tax-exempt debt.[4]

Bond covenants. Governments often undertake legal commitments in connection with the issuance of debt. For example, governments frequently commit themselves to establishing special "reserve" accounts in connection with the issuance of revenue bonds. In addition, the U.S. Securities and Exchange Commission requires that state and local governments issuing debt undertake to provide certain financial information to investors on an ongoing basis. Management must ensure that the government complies with all such bond covenants and undertakings.

Local laws and regulations. Governments are both "citizens" and "lawmakers." As a corporate "citizen" a local government may be subject to many of the same legal burdens it imposes on other citizens (e.g., building code requirements). Management must ensure that the government fulfills its obligations in this regard. Also, management must ensure that any "earmarked" revenues

▶ ment (e.g., appropriate temperature and humidity levels) to ensure that those assets attain their maximum useful life.

- *Inventories and fixed assets should be protected against the risk of loss or misuse.* Inventories of supplies should be kept in locked storerooms. Larger assets (e.g., trucks, cars, tractors and boats) should be kept in locked compounds. Moveable assets should be assigned to specific individuals and physically secured to reduce the danger of theft (e.g., locked offices, tagging). Assets also should be insured at an appropriate value.
- *Economies can be realized if assets are properly redeployed or disposed of when no longer needed.* When assets are no longer needed for a given purpose, they should either be reassigned to some other use (e.g., another department) or promptly disposed of to ensure that their full salvage value is recovered. In particular, policies should be in place to ensure that employees cannot benefit personally from the disposal of assets. □

[3] State grants are often funded in part with federal monies, in which case they are also subject to federal compliance requirements.

[4] In many cases, state and local governments are legally prohibited from reinvesting the proceeds of tax-exempt securities in higher yielding taxable securities (i.e., arbitrage). In other cases, state and local governments are free to make such investments, but are required to remit to the federal government any earnings in excess of the yield on the underlyng tax-exempt debt.

(e.g., gas taxes dedicated to road construction and repair) are only used for their intended purpose.

It is important, therefore, that management 1) carefully identifies all applicable legal requirements, 2) establishes appropriate controls to ensure that it complies with such requirements and 3) properly documents compliance.

Financial reporting

Financial reporting serves as the informational infrastructure of public finance. That is to say, financial reporting provides decision makers, both inside and outside the government, with the reliable financial data they need to make informed decisions. It is customary to divide financial reporting into separate *internal* and *external* components.

Internal financial reporting. As financial decision makers, a government's managers need to have timely financial information on which to base their decisions. Internal financial reports are designed to meet this need. Because internal reports are designed primarily to serve management needs, management normally is free to determine the appropriate contents, format and timing of such reports. Owing to the primacy of the budget in the public sector, internal financial reports normally are prepared using the budgetary basis of accounting, which may differ from generally accepted accounting principles (GAAP). The timing of internal management reports can vary from one government to the next, depending upon how often management believes it is necessary or practical to gather the information needed for such reports. As a general rule, smaller governments are likely to prepare internal financial reports less frequently than their larger counterparts. It is management's responsibility to determine the scope and frequency of internal reports.

External financial reporting. External financial reports are of two types: *special-purpose* external financial reports and *general-purpose* external financial reports.

- *Special-purpose external financial reports*. Local governments sometimes are required to file specialized financial reports for the benefit of specific parties outside the government. For example, grantors often require periodic reports on grant activity. Likewise, local governments sometimes must file financial reports with regulatory agencies (e.g., in connection with the operation of municipal utilities). Oversight agencies also may require specialized financial reporting as part of national or state-wide statistics-gathering efforts. The contents and format of such reports are determined by the entity mandating the report.
- *General-purpose external financial reports*. Management is in a position to determine the content and format of the financial information it receives, as are the recipients of special-purpose external financial reports.

TECHNIQUES COMMONLY USED TO ENSURE BUDGETARY COMPLIANCE

The following techniques are frequently incorporated into the budgetary system to ensure compliance:

- *Preaudit for available funds.* Typically, a disbursement is authorized only after it has been verified that funds remain available in the appropriation.
- *Encumbrance accounting.* In most budgetary systems, management may not *over commit* an appropriation. That is to say, the combined total of expenditures, outstanding purchase orders and executory (i.e., open) contracts cannot exceed the appropriation. Under an encumbrance system, outstanding purchase orders and executory contracts are "encumbered" and these "encumbrances" are treated as expenditures for purposes of determining the balance of available resources in an appropriation. For example, if a government expended $5,000 and encumbered $2,000 under a $10,000 appropriation, only the balance of $3,000 (i.e., $10,000 appropriation - $5,000 expenditures - $2,000 encumbrances = $3,000 balance) would be available for further spending.

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Many of those with an interest in a government's finances, however, are *not* necessarily in such an enviable position (e.g., citizens, the media, investors, creditors). Accountability requires that governments also meet the information needs of such groups and individuals. Consequently, every government should prepare a comprehensive annual financial report (CAFR) in conformity with GAAP.[5] As noted earlier, most governments prepare their internal financial reports using the budgetary basis of accounting. Therefore, it is imperative that management have systems in place to collect whatever additional information may be needed to bring budgetary data into conformity with GAAP for purposes of general-purpose external financial reporting.

- *Allotments.* An appropriation is an authorization to spend public funds. Normally, such an appropriation is made on an annual basis. Thus, governments face the risk that an appropriation designed to meet the needs of an entire fiscal year potentially could be spent within just a few months, leaving no resources to cover the remainder of the period. Therefore, just as parents of a college student often choose to send money in installments rather than in one lump sum, so too governments often divide an annual appropriation into smaller semiannual, quarterly or monthly installments known as "allotments." For example, if a government allotted a $10,000 appropriation evenly on a quarterly basis, management would be unable to spend more than $5,000 during the first six months of the fiscal year, even though $10,000 had been appropriated.

Summary

The first step toward understanding internal controls is to gain an understanding of the management objectives and responsibilities to which they relate. *Effectiveness* is concerned with the extent to which management is achieving its goals and objectives. Ultimately, the effectiveness of management depends upon its ability to communicate its directives to employees and to ensure that those directives are carried out. *Efficiency* involves attaining goals and objectives with the least expenditure of scarce resources. *Economy* promotes efficiency by reducing costs. Management also must ensure and demonstrate *compliance* with restrictions imposed by policy, regulation, law or contract. Such restrictions include the annual appropriated budget, grantor requirements, state oversight requirements, IRS requirements, bond covenants, and local laws and regulations. Finally, management must use *financial reporting* effectively to ensure that decision makers, both inside and outside the government, have the financial data they need to make informed decisions. It is to achieve these objectives and meet these responsibilities that management establishes a framework of internal controls, as discussed in the chapters that follow.

[5] A CAFR is specially designed to meet the information needs of a broad range of potential users.

Chapter 3
The Framework of Internal Controls: The Control Environment

A comprehensive framework of internal controls is one that allows management to attain its objectives and meet its responsibilities. In recent years, a consensus has developed that any truly comprehensive internal control framework will possess the following five elements: 1) a favorable control environment, 2) ongoing risk assessments, 3) control-related policies and procedures, 4) effective communication of information and 5) monitoring the effectiveness of internal controls and the resolution of potential problems identified by those controls. This chapter will focus on the first of these five components, the control environment.

Relationship to other elements of the internal control framework

Internal controls do not operate in a vacuum. The term "control environment" is used to describe what is commonly referred to in the private sector as an entity's "corporate culture." It is impossible to exaggerate the importance of this environment to the effectiveness of internal controls. When management believes that internal controls are important to achieving its goals and communicates that view to employees at all levels, internal controls are likely to function well. Conversely, if management views internal controls as unrelated to achieving its objectives, or even as an obstacle, it is all but certain that this attitude will be communicated to staff at all levels, despite official statements or policies to the contrary. In such an environment, employees readily come to see internal controls as "red tape" that they can "cut through," as needed, to "get the job done."

Management's attitude and example

The key element in a favorable control environment is management's attitude, as demonstrated through its actions and example. It has been said that an individual's checkbook and calendar are probably the best evidence of that person's true priorities. Similarly, if management is truly committed to internal controls, it will assign the resources needed (i.e., time and money) to implement and maintain an effective framework of internal controls. Moreover, management must lead by example, creating a "tone at the top" that sets the standard for the entire organization. Does management consistently exhibit high ethical and professional standards in its conduct? Does management consistently resist the temptation to "cut corners"? Just as parents who say one thing and do another are likely to find that their actions carry more weight than their words, so too, managers soon discover that even the best policies and procedures cannot overcome the force of a bad example.

Communication

A favorable control environment also requires that management throughout the organization communicate the importance of internal controls to staff at all levels. One way to accomplish this aim is to establish an official code of conduct or an official set of policies governing employee conduct. To be truly effective, such guidance must be communicated in a practical way to all staff and reviewed with them periodically.[1] Moreover, managers at the highest levels must regularly communicate the importance of controls to managers at lower levels, because the latter are in the best position to ensure that control-related policies and procedures are actually followed on a day-to-day basis. Finally, there must be swift and appropriate disciplinary action for employees who violate standards of conduct. Failure to take appropriate disciplinary action inevitably "sends a message" that management is not really committed to controls.

The role of the internal audit function

Management also can improve the quality of the control environment by establishing an internal audit function. Unlike the independent auditors of the government's financial statements, a government's internal auditors work directly for management.[2] Typically, internal auditors play an active role in monitoring the effectiveness of control-related policies and procedures for management. In this role, internal auditors themselves function as a "super control" that enhances the effectiveness of the entity's other controls. Thus, an effective internal audit function can contribute significantly to improving the quality of the overall control environment.

The role of the audit committee

Management is accountable to the entity's governing body for its performance. While management is *primarily* responsible for internal controls, the governing body is *ultimately* responsible for ensuring that management fulfills that responsibility. The governing board's role in this regard is crucial, because management is in a unique position to override control-related policies and procedures.

The best way for the governing board to oversee management's performance in regard to internal controls as they relate to accounting and financial reporting is to establish an audit committee. Ideally, an audit committee should include a majority of members from outside the entity (e.g., business people). Also, if possible, an audit committee should avoid the inclusion of any members of the governing board who may also exercise management responsibilities. As a rule, members of the audit committee should possess specialized knowledge of matters relating to accounting, auditing and financial reporting.

The audit committee's purpose is threefold: 1) to ensure that the auditor of the financial statements is truly independent of management, 2) to provide an objective perspective on matters related to internal controls and the audit of the financial statements and 3) to provide a communications link between manage-

[1] The all too common practice of simply "posting" a code of ethics or management policies governing employee conduct is clearly ineffective, and sometimes even counterproductive.

[2] Although internal auditors are not independent in the same way as the auditors of the government's financial statements, they still must retain a significant degree of independence to be effective. One step toward achieving such independence is to maintain the internal audit function outside the regular line management function and to have the internal auditors report directly to top managment. Nonetheless, internal auditors normally should not report directly to the governing board except in highly unusual circumstances (e.g., evidence of fraud by top management.).

ment, the independent auditor and the governing board. To fulfill this role, the audit committee is often involved in all of the following:

- *Selecting the independent auditor*. Often the primary responsibility of the audit committee is the selection of the firm that will conduct the independent audit of the government's financial statements. The audit committee will solicit proposals from qualified firms and analyze the proposals it receives based upon the government's specific needs and the experience and expertise of the proposing audit firms. The fact that members of the audit committee are knowledgeable in matters relating to accounting, auditing and financial reporting should help to ensure that auditors are selected primarily on the basis of their technical qualifications rather than on the basis of price alone. Typically, the audit committee does not itself select the independent auditors, but instead makes a formal recommendation to the governing body, which is responsible for the final selection.
- *Communicating with the independent auditor*. To some degree, the independent auditor functions as a "check" on management. If management is not meeting its internal control responsibilities satisfactorily, there must be some way to ensure that the governing board is made aware of the independent auditor's findings. An audit committee provides a natural vehicle for such communications between the independent auditor and the governing board. Indeed, generally accepted auditing standards specifically require that the independent auditor ensure that the audit committee (or its equivalent) is aware of certain matters connected with the audit of the financial statements.[3] For example, the audit committee must be aware of any significant differences between the independent auditor and management regarding the proper application of generally accepted accounting principles.
- *Reviewing the financial statements and the results of the financial statement audit*. The audit committee is responsible for reviewing the entity's financial statements, which are the representations of management, and for reviewing the results of the financial statement audit. In particular, the audit committee will be concerned with internal control weaknesses identified during the audit.[4] The audit committee also may be responsible for 1) ensuring that management commits itself to taking appropriate action to correct deficiencies disclosed by the financial statement audit and 2) monitoring the status of such corrective action.
- *Monitoring the performance of the independent auditor*. The audit committee also communicates with management to assess the performance of the independent auditor. The audit committee is concerned with determining that the audit was conducted in accordance with the audit contract, and that the independent auditor's work was thorough, timely and professional.
- *Monitoring the work of the internal audit function*. As noted earlier, an internal audit function can play an important role in a favorable control environment. The audit committee can help to ensure the effectiveness of the internal audit function by reviewing the work of internal auditors, as well as their annual work plan.

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[3] Statement on Auditing Standards No. 61, *Communication with Audit Committees*.

[4] These are referred to by auditors as "reportable conditions." Reportable conditions that are so significant that they could result in misleading financial statements are known as "material weaknesses."

Qualified staff

A favorable internal control environment also requires competent and honest staff. The following personnel policies and practices can play an important role in meeting this need:

- *Establish and maintain up-to-date job descriptions.* Management should maintain job descriptions for all employees. These descriptions should detail the responsibilities of each position as well as the qualifications needed to fill the position. It is important that job descriptions be kept up-to-date to reflect changes in responsibilities.
- *Follow appropriate hiring policies.* It is essential that job qualifications and references be thoroughly checked before hiring new employees. In addition, a government may wish (or may even be legally obligated) to require bonding for employees in sensitive positions.[5] Moreover, the process of hiring should be open, thorough and well documented to ensure that conscious and unconscious bias are avoided.
- *Assign authority and responsibility in an appropriate manner.* Employees should possess *all* the authority and *only* the authority needed to fulfill their assigned responsibilities as outlined in their job description.
- *Ensure that employees are properly trained.* A combination of formal and on-the-job training is essential to ensure that employees are properly prepared to perform their duties. Moreover, training should be offered on a continuing basis to reinforce existing skills and to help employees adjust to changes in their job responsibilities or work environment.[6]
- *Periodically review and document performance.* It is not enough to hire honest and qualified individuals; management must also periodically review their performance and *document that review.*[7] When corrective action is needed, that action should be taken promptly and should be thoroughly documented. It is especially important that management pay particular attention to the performance of employees during their initial probationary period of employment, when corrective action can be taken most effectively and efficiently. Also, top management needs to review lower-level performance reviews to ensure that managers at all levels are giving frank and objective evaluations of performance.[8]
- *Set appropriate performance goals and criteria for promotion.* It is important that management not send "mixed signals" to its employees. While high standards are important, unrealistic performance goals or criteria for promotion can be an invitation for employees to "cut corners."

The Foreign Corrupt Practices Act

A number of years ago, federal law-enforcement officials discovered that a number of large American corporations were illegally paying bribes to foreign officials to facilitate their conduct of business abroad. Further investigation disclosed that management's failure to understand or take responsibility for cor-

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[5] Bonding is a form of insurance against losses from theft. Bonding has at least two indirect benefits. First, bonding companies typically perform thorough background checks of candidates for bonding. Second, bonding may discourage theft because of bonding companies' reputation for aggressively pursuing the prosecution of offenders.

[6] It is a common mistake for management to attempt to deal with budgetary difficulties by first cutting its training budget.

[7] In a litigious age, it is impossible to exaggerate the importance of carefully documenting all personnel actions.

[8] It may be difficult for management to take later corrective action in the case of unsatisfactory employees if prior evaluations do not document substandard performance.

porate internal controls created the environment within which such illegal activities could flourish. To prevent a recurrence of such illegal activities, the federal government passed the Foreign Corrupt Practices Act. This legislation assigned to corporate management direct legal responsibility for the maintenance of adequate internal controls. While the Foreign Corrupt Practices Act does not apply to state and local governments, it does provide evidence of the importance of management's taking an active role in establishing and maintaining good internal controls.

Financial integrity legislation

As noted earlier, management must take an active role to ensure that internal controls are properly implemented and maintained. Unfortunately, management has sometimes viewed itself as "too busy" to be concerned with control-related matters. Yet, internal controls have little chance of functioning properly in the face of management's indifference or even hostility. Therefore, the federal government passed the Federal Managers' Financial Integrity Act in 1982. This legislation requires federal financial managers periodically to review and assess the adequacy of their internal controls and to report on the results of their review and assessment. The goal is to educate federal financial managers about the importance of internal controls and to keep them actively involved in monitoring those controls. Since 1982, a number of state governments have adopted similar legislation. Model legislation also is available for adoption by local governments. Once again, the relevance of financial integrity legislation to this discussion of the control environment is the evidence it provides of the need for management to take an active role in establishing and maintaining good internal controls.

Summary

The control environment is one of the five elements of a comprehensive internal control framework. The control environment also can be viewed as the most important of the five elements, because the effectiveness of the other four elements ultimately will depend upon it. Management's attitude and example are essential to a favorable control environment. In addition, management must communicate its support for internal controls to staff at all levels if controls are to function effectively.

An internal audit function can serve as a "super control" that enhances the effectiveness of other controls, thus contributing significantly to the overall control environment. Likewise, an active audit committee can help the governing body to ensure that management is meeting its responsibilities for internal controls over accounting and financial reporting. Even the best control-related policies and procedures are only as good as the staff that implement them. Accordingly, a favorable control environment requires appropriate controls to ensure that staff are honest and competent to perform their assigned roles.

Finally, the importance of management's role in establishing a sound control environment is evidenced by the Foreign Corrupt Practices Act, which assigns direct legal responsibility to corporate management for the effectiveness of the internal control framework. In the same manner, financial integrity legislation at the federal, state and local levels reaffirms the need for management to play an active role in internal controls.

Chapter 4
The Framework of Internal Controls: Risk Monitoring and Assessment

As a general rule, risks become increasingly more difficult to manage the longer they remain undetected. Thus, physicians insist on routine checkups for their patients so that problems can be identified as soon as possible to ensure the most effective and efficient treatment. Likewise, a competent attorney will insist upon reviewing contracts and agreements before they are signed to minimize the potential for future lawsuits. In either case, strong emphasis is placed on the need for prevention and prompt corrective action. This sense of urgency is understandable, because the options available for effective and efficient corrective action almost invariably decrease with the passage of time.

It is not enough, therefore, for public-sector managers to strive to attain their objectives and meet their responsibilities. They also must continually monitor and assess potential risks that could hinder or prevent them from achieving their goals. This ongoing monitoring and assessment of risk constitutes the second element of a government's internal control framework.

Focus of risk monitoring

As noted earlier, management's principal objectives are to ensure 1) effectiveness, 2) efficiency, 3) compliance with laws and regulations, and 4) proper financial reporting. A comprehensive internal control framework requires that management attempt on an ongoing basis to identify potential risks that could hinder it from fully realizing any of these four objectives. Such risks can arise from both inside and outside the government. For example, unexpected staff turnover in key positions could have a negative effect on efficiency. In the same way, significant changes might be needed to comply with new regulations resulting from federal or state legislative action. Management's goal should be to identify all such potential internal and external risks as soon as possible so that it will have adequate opportunity to craft an effective and efficient response.

Assignment of responsibility

If top management alone is involved in monitoring and assessing risk, there is a good possibility that many of the specific risks facing individual programs and activities will be missed. Conversely, if a government's risk monitoring and assessment is confined to lower-level managers operating on an activity-by-activity basis, it is quite possible that more generalized risks may be completely overlooked. Accordingly, effective risk monitoring and assessment must include both "macro" and "micro" components, and will necessarily involve managers at all levels.

The effect of change on risk assessment

Change, by its very nature, creates a certain degree of risk. Therefore, every significant change a government undergoes or anticipates needs to be monitored and assessed by management for its potential risk. In particular, common experience has identified certain types of changes as requiring particular attention from management.

Changes in the operating environment. As stated previously, governments do not operate in a vacuum. Thus, changes in a government's circumstances can produce unanticipated risks. For example, intense media scrutiny or political debate surrounding a particular program could place extra pressure on staff to "cut corners" to achieve results. In the same way, a change in regulations can have a serious effect on how an activity is conducted (e.g., disposal of municipal solid waste).

Changes in personnel. Even the best systems and equipment are no better than the people who operate them. As a result, changes in personnel always carry with them a certain element of risk. New employees, for example, are likely to need some time before they become proficient in their new position. Likewise, there may be an interval between the departure of an employee and the hiring of that employee's replacement, during which time the departing employee's duties may be performed on a temporary basis by one or more individuals. The risks accompanying personnel changes especially increase when changes 1) are numerous, 2) involve high-level staff or 3) involve employees in highly sensitive positions.

Changes in information systems and technology. The revolution in data processing has profoundly affected how most state and local governments operate on a day-to-day basis. Moreover, the computer revolution is an ongoing one, requiring governments periodically to alter or replace their information systems to take advantage of technological advances. Such changes often entail considerable disruption and attendant risks. Likewise, there is often the risk that a government may not adjust its control procedures sufficiently to keep pace with technological advances. Furthermore, in an era of rapid technological advances, obsolescence rather than age can become the critical factor in an asset's useful life. Consequently, there is a risk that technological changes will require that assets be replaced much sooner than anticipated.

Rapid growth. Quick growth can place acute pressure on internal controls as staff attempt to respond to a rapid increase in the demand for services. In particular, there is the risk that staff will be tempted to "cut corners" in an attempt to avoid complaints and speed up operations.

New programs and services. Some adjustments are needed when a government undertakes a new program or activity (e.g., a new grant program). Risk may result from staff's inexperience with the new program or from staff's unfamiliarity with applicable laws and regulations.

Changes in structure. Governments sometimes reduce or eliminate programs. In such situations, public-sector management can face many of the same problems encountered in the private sector when businesses are "restructured." Some risk may occur, for example, as the result of the morale problems that frequently accompany such transitions. Likewise, there is the danger that staff will concentrate on their future assignments rather than on bringing the existing program to a successful close.

Inherent risk

Change is not the only factor that can be used to identify risks that need to be specially monitored and assessed by management. There also are various other factors, sometimes known as "inherent risk," that indicate that special management attention may be warranted. The following are some examples of situations that commonly are considered to involve "inherent risk":

- *Complexity*. There is a saying that "the more that can go wrong, the more that is likely to go wrong." So too, complexity increases the dangers that a program or activity will not operate properly or comply fully with applicable laws and regulations.
- *Cash receipts*. The more easily an asset can be converted to personal use, the more likely it is to be stolen. Accordingly, the presence of cash receipts poses special risks, because cash is a government's most liquid asset.
- *Direct third-party beneficiaries*. The rule just stated for cash receipts holds equally true for benefits provided to third parties. The closer a benefit is to a cash payment (e.g., public assistance, food stamps), the more likely individuals will fraudulently attempt to obtain that benefit.
- *Degree of centralization*. In most cases, decentralization makes it more likely that problems will occur. On the other hand, the problems that occur in centralized systems may be more significant than those encountered in decentralized systems (i.e., because they affect the entire system).
- *Prior problems*. Bad situations tend to repeat themselves. So, too, a past record of control weaknesses is often a good predictor of future problems. A pattern of past findings of control weaknesses by internal and external auditors typically indicates a heightened level of risk.
- *Prior unresponsiveness to identified control weaknesses*. In the previous discussion of the control environment, much emphasis was placed on management's attitude toward controls. If management has a history of failing to respond promptly and effectively to control weaknesses identified by the internal and external auditors, this failure may be a good indicator that future weaknesses are likely to occur.

Assessment criteria

Once various risks have been identified, their potential importance must be assessed. A balanced assessment should take into consideration both of the following factors:

- *Significance*. The significance of a given risk depends upon the degree of harm that could result if that risk is not successfully avoided.
- *Likelihood of occurrence*. What is the probability that a given risk will actually materialize?

These two factors are closely linked. That is to say, a moderate risk with a high likelihood of occurrence may pose as great a danger as a potentially more serious risk that is less likely to occur. Assume, for example, that a \$100 loss could result from Risk A and a \$50 loss from Risk B. Further assume that there is a 20 percent chance that Risk A will be realized, but a 40 percent chance that Risk B will materialize. In such a situation, the potential loss in both cases would be equal (i.e., $\$100 \times .2 = \$20$; $\$50 \times .4 = \$20$). Therefore, both factors need to be considered.

The goal of risk monitoring and assessment is to enable management to prevent or minimize harm. To achieve this goal, management must follow up on the results of risk monitoring and assessment with appropriate corrective action.[1] The priority accorded to specific corrective actions should be based upon the significance and likelihood of occurrence of each type of risk identified. Thus, management would assign highest priority to controlling risks of great potential significance with a high likelihood of occurrence. Conversely, much less attention would be paid to risks of relatively small significance that are unlikely to occur.

Summary

Public-sector managers need to monitor and assess potential risks that could hinder or prevent them from achieving their objectives of effectiveness, efficiency, compliance with laws and regulations, and proper financial reporting. Such risks arise from both inside and outside the government. Effective risk monitoring and assessment must involve management at all levels. Monitoring risk is particularly important when a government undergoes changes. Likewise, special risk monitoring is in order in situations involving high levels of inherent risk. Once identified, risks should be prioritized for purposes of corrective action based upon an assessment of their significance and likelihood of occurrence.

[1] The relative costs and benefits of corrective action are an important factor in assessing its appropriateness.

Chapter 5
The Framework of Internal Controls: Control-related Policies and Procedures

The third essential component of any truly comprehensive framework of internal controls will be the design, implementation and maintenance of control-related policies and procedures. Such policies and procedures are needed to control the various risks identified by management that could impede or prevent management from accomplishing any of its basic objectives (i.e., effectiveness, efficiency, compliance with laws and regulations, and proper financial reporting). The discussion in this chapter will focus uniquely on policies and procedures designed to control risks related to financial reporting. Although not discussed here, similar controls are equally necessary for risks related to management's other basic objectives (i.e., effectiveness, efficiency and compliance with laws and regulations).[1]

Essential tasks of an accounting system

Financial reporting is the process of presenting reliable financial information in a format that is useful for management (i.e., internal financial reporting) and for other interested parties (i.e., external financial reporting). The data presented in financial reports are a product of the government's accounting system. Therefore, the first step management needs to take toward achieving its financial reporting objectives is to establish a suitable accounting system. The adequacy of an accounting system should be judged based upon its ability to accomplish all of the following tasks:

- *Assemble all relevant information.* The accounting system should collect information on all transactions and events that are relevant to a government's finances (i.e., that result in a change in a government's assets or liabilities).
- *Analyze assembled data.* Once relevant transactions and events have been identified, their specific impact on the government's assets and liabilities must be determined. For example, a government that leased equipment would need to report both the leased asset and the related liability if the lease agreement had the effect of transferring the benefits and risks of ownership to the government.[2]

[1] In chapter 2 on management objectives and responsibilities, for instance, examples are given of control-related policies and procedures related to efficiency and compliance with laws and regulations.

[2] Accountants refer to such arrangements as "capital leases." Conversely, leases that do *not* transfer the risks and benefits of ownership are known as "operating leases."

- *Classify assembled data.* Governments enter into thousands of transactions in any given period. It is neither practical nor desirable to include all of this detailed information in financial reports. Instead, similar items are grouped together into a limited number of preestablished categories known as "accounts," which are defined in a "chart of accounts." Thus machinery, tools, trucks and furnishings might all be classified simply as "machinery and equipment." Likewise, expenditures made by detectives in investigating criminal activities, detecting and arresting criminal offenders, obtaining evidence for prosecution of criminal cases, filing cases, returning fugitive felons from other jurisdictions, testifying in court cases, locating missing persons and recovering lost or stolen property might be reported in a single "criminal investigation" expenditure account.
- *Record assembled data.* Once data have been analyzed and classified, they need to be recorded in the government's accounting records. The various records used to account for individual transactions traditionally are referred to as "journals."[3] Records used to account for the balances in individual accounts are known as "ledgers."[4] The process used to modify ledger accounts to reflect transactions and events as they are recorded in the journals is known as "posting."
- *Furnish data needed for internal and external financial reporting on a timely basis.* It is the goal of financial reporting to provide information that is useful for decision making. Naturally, the value of information for this purpose decreases with the passage of time. Therefore, it is critical that accounting systems allow for *timely* financial reporting.[5]
- *Maintain accountability over the government's assets.* An accounting system not only must maintain records of all events and transactions that result in a change in a government's assets, it also must adequately account for assets during the period between their acquisition and disposal.

Management's implicit assertions

Financial reports contain management's representations concerning the government's finances. Naturally, it is assumed that management's representations will be truthful; therefore, management really is making the following *implicit assertions* whenever it issues financial reports:

- *Existence or occurrence.* At the most basic level, management is asserting that all of the information contained in the financial report is true. That is to say, all of the assets and liabilities that are reported really exist, and that all the transactions and events that are reported really occurred.
- *Completeness.* When a witness takes an oath in a court of law, the witness swears to tell not just "the truth," but "the *whole* truth." Indeed, a series of truthful statements can create a very false impression if relevant facts

[3] For example, the cash receipts journal, the cash disbursements journal and the general journal.

[4] Thus, the "general ledger" will report the current balance in each account of the chart of accounts. A single general ledger account (e.g., "accounts receivable") sometimes will be supported by detailed records (e.g., amounts receivable from each individual customer). In such cases, the general ledger account is known as a "control account," and the detailed supporting records are known collectively as a "subsidiary ledger."

[5] For purposes of general-purpose external financial reporting, the Government Finance Officers Association's Certificate of Achievement for Excellence in Financial Reporting Program requires that financial reports be issued within six months of the close of the fiscal year. Earlier reporting is strongly encouraged. Likewise, regulations of the U.S. Securities and Exchange Commission require governments issuing debt securities to enter into undertakings to provide ongoing financial information on a timely basis to investors.

are omitted. Therefore, whenever management issues a financial report, it is asserting not only that all of the data presented are true, but that nothing important has been omitted.

- *Rights and obligations*. It is not enough that all of the assets and liabilities presented in a financial report really exist; they also must truly be what they purport to be. For example, a building that is reported may exist, but may not actually belong to the entity (e.g., rental property). Similarly a liability that is reported may exist, but may not actually be a liability of the entity (e.g., a vendor may erroneously have billed the government for goods or services provided to another customer). Accordingly, management is making an implicit assertion when it prepares a financial report that all of the assets and liabilities reported are truly assets and liabilities *of the entity*. Viewed another way, management, like a witness in a court of law, is making the assertion, that it is telling "the truth" (i.e., existence or occurrence), "the whole truth" (i.e., completeness), and "*nothing but* the truth" (i.e., rights and obligations).
- *Allocation*. As noted earlier, individual assets, liabilities and transactions are combined into various prespecified accounts. These accounts, in turn, are combined into various "funds."[6] Whenever management issues financial statements, it is asserting that all of the items reported have been properly classified. For example, if a separate fund is used to account for road repairs, then resources set aside for that purpose should be reported in that fund rather than in some other fund. Likewise, management is asserting that all transactions and events reported took place *within the accounting period*, and that all assets and liabilities were present *as of the last day of the fiscal year*.
- *Presentation and disclosure*. Internal reports typically are prepared on the same basis as the budget. General-purpose external financial reports, however, should be prepared in conformity with certain widely recognized national standards known collectively as "generally accepted accounting principles" (GAAP),[7] which may differ from the government's budgetary basis of accounting. GAAP establish specific rules governing how assets, liabilities, transactions and events should be valued and reported in the financial statements. In addition, GAAP often require that additional information on such matters be disclosed as notes to the financial statements. Whenever management issues a general-purpose external financial report in conformity with GAAP, it is asserting that all of these display and disclosure requirements have been met.

As will be discussed in a later chapter, these "implicit assertions" can serve as an excellent "checklist" to help identify potential risks that could hamper or prevent management from meeting its financial reporting objectives.

Control-related policies and procedures

How is management to know that all of the assets and liabilities presented in financial reports actually exist? What can management do to ensure that financial statements are complete? How can proper allocation among accounts and

[6] Governments use separate "funds" to account for resources that are segregated for the purpose of carrying on specific activities or attaining certain objectives. Funds are such a salient and characteristic feature of accounting by state and local governments that sometimes governmental accounting as a whole is referred to simply as "fund accounting."

[7] GAAP for state and local governments are set by the Governmental Accounting Standards Board.

between periods be assured? Only well designed, properly implemented and adequately maintained control-related policies and procedures can provide management with a reasonable basis for making the implicit assertions that underlie any financial report. Control-related policies and procedures involving financial reporting traditionally are categorized as described in the paragraphs that follow.

Authorization. The first step toward controlling financial reporting is to ensure that all transactions are properly authorized in accordance with management's policies. That is to say, only specified individuals should be able to initiate a transaction (e.g., purchase requisition, check request). As a rule, authorization controls should do both of the following:

- *Require advance approval.* It is all too easy for managers to find themselves in the position of being asked to approve something that has already happened. In such cases, management essentially loses much of its ability to control transactions and prevent problems before they happen. For example, support staff may ask managers to approve overtime *after the time has already been worked* (e.g., "Will you please fill out the overtime approval form for the work I did last night?"). Good authorization controls require that authorizations always be obtained in advance.
- *Require written documentation of approval.* Too often, approvals are obtained orally and then documented after the fact. The problem with such an approach is that it often leads to the situation described earlier (i.e., employees delay seeking approval until after something has already happened). Consequently, management should require that authorizations be obtained in writing, and that the authorization be dated to ensure that approval was obtained *in advance*. Written documentation also has the advantage of providing an "audit trail" to test whether authorization controls are continuing to function properly.

Properly designed records. A second step toward achieving management's financial reporting objectives is to ensure that accounting records are properly designed. Characteristics of well designed accounting records include the following:

- *Sequential numbering of documents.* As noted earlier, one of management's implicit assertions in financial reporting is that *all* relevant items are presented (i.e., "completeness"). The sequential numbering of documents helps to provide such assurance. For example, if all purchase orders are made using sequentially numbered forms, management can easily determine that it has not "overlooked" a purchase order by accounting for each of the prenumbered forms.[8] To obtain the full benefit of using sequentially numbered documents, it is important that management prohibit the destruction of unusable forms (e.g., spoiled or voided forms). Instead, such forms should be maintained on file so that each and every prenumbered form can be accounted for.[9]
- *Automatic duplicates.* Some documents (e.g., purchase orders, receipts) are provided to individuals outside the government. Accounting records should be designed to provide automatic duplicates of such documents.

[8] This is the same process used by individuals to reconcile their checkbook and bank statement.

[9] Otherwise, for example, an employee could use a purchase order form to improperly obtain goods, while concealing the improper conduct by claiming that the missing form had been destroyed because it was "spoiled."

- *Gathering information for multiple purposes.* A single transaction may need to be included in several different reports (e.g., budgetary report, general-purpose external financial report, special-purpose grantor report). The specific information required for each of these reports, however, may differ. For example, the basic system may use the budgetary basis of accounting, whereas additional information may be needed to make some of the adjustments necessary to prepare financial statements in conformity with GAAP. Likewise, highly detailed employee time records are sometimes necessary to comply with grantor reporting requirements. Therefore, it is important that accounting records be designed to gather information for multiple purposes, as needed.
- *Avoiding unnecessary information.* The computer revolution has now made it technologically feasible to maintain highly detailed records. While it is important to maintain a variety of information for different reporting purposes, management should bear in mind that "more" is not necessarily "better." Excessive detail can needlessly increase record-keeping costs and can unnecessarily burden the system. For example, the maintenance of highly specific information on the location of small assets that are moved frequently (e.g., desks in a school building) may require constant updating of the accounting records and is unlikely to be cost beneficial. Likewise, governments should strive to avoid unnecessary complexity in their financial reporting by using the smallest number of funds possible consistent with management needs and legal requirements.[10]

Security of assets and records. Of course, security must be maintained over a government's assets (e.g., cash, inventories, equipment) to minimize the danger of loss or misuse. What is frequently overlooked, however, is that security over a government's accounting records is equally important. It does little good, for instance, to maintain tight control over a personal phone credit card if the number on the card is posted on a bulletin board. Likewise, there is little advantage to maintaining tight control over assets if easy access to the underlying accounting records subjects those assets to substantial potential loss (e.g., unauthorized payroll adjustments, unauthorized write-offs of receivables). Adequate security over assets and records will encompass all of the following:

- *Controlled access.* It is important that individuals only have access to assets or records based on the specific needs of their job. For example, a payables clerk does not need to have access to receivables records. Likewise, an office worker would not need access to motor pool supplies. The more individuals that have access to assets or records, the greater the risk. Also, it is best if particularly confidential or sensitive material (e.g., sales tax and payroll records) are maintained separately from regular records. Because of the pervasiveness of computers, it is important that access controls involving data processing be adequate. For example, employees should be required to use meaningful passwords (e.g., *not* "password"or the name or the employee or the employee's spouse) that are changed regularly and kept secret.
- *Physical security.* Physical security involves two factors. First, assets and records must be protected against the danger of loss or theft. For example, supplies should be kept in locked storerooms and cash and checks should be deposited promptly. "Walk-away" assets (e.g., tools) should be as-

[10] The concept that a government should use as few funds as possible (consistent with its needs) is referred to by accountants as the "number of funds principle."

signed to specific employees or checked out by employees as needed. Checkout cards should be required if accounting records are to be removed temporarily. In addition, specific individuals should be assigned responsibility for the custody of specific records. Second, assets and records should be protected against environmental dangers. For instance, computer equipment should be kept in rooms maintained at appropriate temperature and humidity levels.

- *Backup for computer records.* Almost all local governments now rely heavily on electronic data processing for their accounting records. Therefore, it is important, that data maintained on electronic media be "backed up" daily to protect against the danger of information loss should the information system malfunction. Moreover, no record used to input data into the system should be disposed of prior to backup.
- *Disaster recovery.* Local governments provide many services that are essential to the public welfare. Management must have plans in place to allow the government to continue to provide services even in the event of a disaster. For example, management should have a standing agreement that would provide it with access to needed computer processing services should its own information systems become temporarily inoperative in the event of a disaster. For this same reason, the backup files discussed earlier should be maintained *off site* to ensure that the backup files are not destroyed by the same disaster that destroyed the original data.

Segregation of incompatible duties. An "incompatible" duty is one that would put a single individual in the position of being able both to commit an irregularity and then to conceal it. For instance, receiving reports are used to ensure that goods ordered have actually been received before payment is made. If a single individual were able both to place orders and prepare receiving reports, that person could then fabricate fictitious orders resulting in improper payments. Accordingly, such incompatible duties should be *segregated*. In larger governments, incompatible duties may be segregated among different departments. In smaller governments, incompatible duties may be segregated among individuals within the same department.

In practice, three types of functions are commonly considered to be mutually incompatible: authorization, record-keeping and custody. Thus, ideally, no single individual should be able to 1) *authorize* a transaction, 2) *record* the transaction in the accounting records and 3) maintain *custody* of the assets resulting from the transaction. For example, the various duties involved in the purchase of supplies could be segregated as follows:

- The purchasing department is responsible for issuing a purchase order to the vendor based upon a properly completed requisition form (i.e., authorization function);
- the receiving department is responsible for verifying that the ordered goods have been received and issuing a receiving report (i.e., custody); and
- the accounting department is responsible for preparing a check request and recording the transaction in the accounting records after reviewing and matching the requisition, the purchase order, the receiving report and the invoice (i.e., record keeping).

Of course, there is always the risk that the segregation of incompatible duties could be circumvented if individuals who are supposed to function as a check upon each other decide instead to work together to bypass controls (i.e., collusion). In practice, however, it is often difficult for dishonest employees to gain the cooperation of their colleagues for fraudulent activities (e.g., honesty, fear of punishment). Therefore, the segregation of incompatible duties is still useful, despite the risk of collusion, because it places a significant hurdle in the path of those who might otherwise be tempted to commit an irregularity.

The cost of internal controls should never exceed their expected benefit. Accordingly, it may not be practical in some instances to segregate incompatible duties (e.g., a single employee at a branch office). In that case, management may wish to institute a mandatory vacation policy (e.g., two consecutive weeks) or a policy requiring the periodic rotation of duties among employees. The idea behind such policies is to have other individuals perform an employee's duties for a while to see if there is any noticeable change (e.g., a marked increase in cash receipts). Such a change could be an indication of prior irregularities. It also may be useful in situations where it is not practical to segregate incompatible duties to compare financial and nonfinancial factors to assess the reasonableness of data (e.g., Are the amounts of supplies purchased consistent with the government's needs?).

Periodic reconciliations. It is important that related accounting records be compared periodically. For example, the amount of cash reported in the accounting records should be reconciled to the cash balances reported on the bank statement. Likewise, the balances reported in general ledger control accounts (e.g., accounts payable-control) should be reconciled to related amounts reported in subsidiary ledgers (e.g., total balances in individual payable accounts). Moreover, data entry in computer systems should incorporate built-in "edit checks" to ensure that all items are entered properly (e.g., reasonableness checks).

Periodic verifications. Management should never lose sight of the fact that accounting records are only good to the extent that they faithfully reflect the underlying facts. Thus, management should periodically compare data contained in the accounting records to what those data purport represent. For example, management should periodically undertake a physical inventory of its fixed assets, compare the results of that inventory to the accounting records, and then make appropriate adjustments to the latter. Likewise, balances in receivables and payables accounts should be confirmed directly with taxpayers, customers and suppliers from time to time.

Analytical review. Analytical review is the process of attempting to determine the reasonableness of financial data by comparing their behavior with other financial and nonfinancial data. Viewed another way, analytical review attempts to compare what is reported to what might reasonably be expected. For example, if a public utility generated a certain amount of power last year, how much revenue should it reasonably have been expected to earn? Why have motor pool repair costs remained stable even though a third of the vehicles recently were replaced with new models? Why have actual results differed from what was anticipated in the budget? Why are revenues at Concession Stand X so much lower than for similarly situated concession stands?[11] Analytical review is particularly important because it is often the only practical means of determining if data in the financial statements are complete.[12] Analytical review also is often the most

[11] In one actual case, management discovered fraud when it questioned the reasonableness of invoices billing the city for gravel at the rate of 800,000 pounds per boxcar load. Further investigation revealed that the boxcars in question actually could hold only 200,000 pounds of gravel.

efficient means to ensure adequate control in situations where it is not practical to segregate incompatible duties (e.g., very small governments).

Timely preparation of financial reports in conformity with GAAP. Management should have in place systems that ensure the collection and compilation of the data needed for the timely preparation of financial statements in conformity with GAAP. As noted previously, this often involves providing for the collection of *additional* data to supplement the budgetary-basis data routinely maintained by the accounting system.

Summary

A comprehensive system of internal controls will necessarily involve the design, implementation and maintenance of control-related policies and procedures. Such policies and procedures are needed to ensure that the various risks identified by management do not impede or prevent it from meeting its various objectives, including those related to financial reporting.

The first step toward effective controls over financial reporting is to establish a suitable accounting system. An adequate accounting system will 1) assemble all relevant data, 2) analyze assembled data, 3) classify assembled data, 4) record assembled data, 5) furnish data needed for financial reporting on a timely basis and 6) maintain accountability over the government's assets.

Financial statements are management's representations concerning the government's finances. Whenever management issues a financial report, it is making several implicit assertions: 1) all of the assets and liabilities reported really exist and all of the transactions and events reported actually occurred, 2) all relevant items have been included, 3) all the assets and liabilities reported are truly those of the government, 4) assets, liabilities and transactions have been properly classified and allocated among funds, accounts and accounting periods and 5) the displays and disclosures included in general-purpose external financial reports meet the requirements of GAAP. These implicit assertions can be useful in identifying risks specific to financial reporting.

Management must design, implement and maintain control-related policies and procedures to ensure the reliability of its financial reporting. Traditionally, such controls are categorized as follows: 1) authorization, 2) properly designed records, 3) security over assets and records, 4) segregation of incompatible duties, 5) periodic reconciliations, 6) periodic verifications, 7) analytical review and 8) the timely preparation of financial statements in conformity with GAAP.

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[12] It is easier to determine that something ought not to be in the financial statements than to determine if something is missing.

Chapter 6
The Framework of Internal Controls: Information and Communication

There is much overlap among the different components of a comprehensive framework of internal controls. For example, risk assessment is a necessary precondition for designing and establishing effective control-related policies and procedures. Likewise, it is unlikely that control-related policies and procedures will function effectively in the absence of a favorable control environment. However, nowhere else is overlap so much in evidence as in the case of the fourth component of the internal control framework: information and communication. Indeed, information and communication are really *pervasive* characteristics that affect all aspects of the internal control framework.

Meeting information needs

As noted previously, the essential function of internal controls is to permit management to achieve its objectives (i.e., effectiveness, efficiency, compliance with laws and regulations, and proper financial reporting). Accordingly, staff at all levels should obtain whatever information they need to accomplish this purpose. To be truly useful, the information provided to staff should meet the following criteria:

- *Appropriate content.* It is essential that the right information be provided to the right individuals throughout the organization. Before the computer revolution, the principal difficulty was providing all of the information needed. In the information age, however, the main challenge often is how to ensure that crucial information is not obscured by the sheer mass of data provided. The competing demands of completeness and conciseness must be balanced.
- *Timeliness.* Information must be received soon enough to allow individuals receiving the information to take effective action. The criteria for timeliness vary depending upon the type of information involved. Some kinds of information need to be communicated immediately (e.g., evidence of fraud or noncompliance). Regular periodic reports (e.g., weekly, monthly, quarterly) may be sufficient for other types of information.
- *Currency.* It is not enough that information be communicated in a timely manner. It also is important that whatever information is communicated be current. Effective decisions cannot be based upon "yesterday's news."
- *Accuracy.* Information is only valuable to the extent that it faithfully reflects what it purports to represent. The cost of providing information, however, should never exceed the benefits to be derived from that information. Therefore, the ultimate goal is *reliability* rather than *preciseness.* That is to say, the degree of accuracy required will vary depending upon the type of information in question and how that information will be used.

- *Accessibility*. Information must be accessible to the individuals who need it if it is to be useful. In practice, there often is a problem communicating information to management and staff at lower levels, where the information often is needed most.

In brief, the information component of the internal control framework may be considered to be functioning properly when current, accurate and appropriate information is made available on a timely basis to those who need it.

Communication

It is essential if internal controls are to function properly that there be clear lines of communication throughout the organization. In the first instance, top-level management must be able to communicate its directives to management and staff at all levels.[1] Conversely, it is equally important that staff at all levels have the ability to communicate "upward" to management. Indeed, nonmanagement employees at all levels are often in a unique position to identify many of the potential risks that need to be addressed by management. Moreover, some means must be provided for staff at lower levels to communicate "around" management that may be involved in improper conduct.

The environment within which governments and businesses operate has grown increasingly complex. As a result, many problems and potential risks cannot effectively be "pigeon holed" into any one traditional functional category, but instead require that management take an "interdisciplinary" approach to their resolution. For example, the public safety department, the department of parks and recreation, and the department of human services may all need to work together to deal with the problem of juvenile crime in city parks. Therefore, it is important that there be lateral communication among management officials in various functions and departments throughout the government. Such lateral communication is particularly important in the case of the finance function, because its work has a direct effect on all of the government's functions and departments.

It is very important that governments maintain open lines of communication with appropriate outside parties. A government needs to have open communication with its citizens, for example, to determine if services are being provided effectively and efficiently.[2] Similarly, good communications with suppliers and contractors can help to deter or detect inappropriate purchasing and bidding practices.

Of course, management also should have open lines of communication with the governing board. Such open communications are necessary if the governing board is to be able to meet its oversight responsibilities.

Because internal controls are concerned with management's ability to achieve *all* of its objectives, the scope of communications must necessarily be broad, involving both financial and nonfinancial matters (e.g., effectiveness, compliance with laws and regulations). Communication also will take a variety of forms, from the highly formal (e.g., a policies and procedures manual, policy memoranda) to the highly informal (e.g., oral updates). Finally, good communications will combine regularly scheduled exchanges of information (e.g., monthly staff meetings) with special efforts (e.g., task force projects).

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[1] The importance of such "top-down" communication was already explored in chapter 3, which was devoted to the control environment.

[2] In recent years, many local governments have begun to undertake surveys of their citizens to determine their level of satisfaction with key government services.

Accounting policies and procedures manual

One form of communication that is particularly important to the proper functioning of controls over financial reporting is the accounting policies and procedures manual. A well designed accounting policies and procedures manual will clearly outline the specific authority and responsibility of individual employees, thus providing the essential foundation needed for establishing employee accountability. It also serves as a reference tool for employees seeking guidance on the proper handling of less frequently encountered transactions and situations. In addition, an accounting policies and procedures manual lessens the threat to continuity posed by employee turnover.

To be effective, an accounting policies and procedures manual should possess all of the characteristics of useful information discussed earlier:

- *Appropriate content.* A properly designed accounting policies and procedures manual will indicate *which employees* are responsible for performing *which functions* in *which manner*. Employees are more likely to perform control procedures faithfully if they are aware of the purpose and importance of the procedures; therefore, a sound policies and procedures manual will go beyond a simple description of the appropriate handling of transactions and events to communicate clearly the design and objectives of control policies and procedures.
- *Timeliness.* The accounting policies and procedures manual should be expanded promptly to provide guidance on new programs and activities.
- *Currency.* The accounting policies and procedures manual should be updated regularly to reflect changes in the government's operating environment (e.g., discontinued programs, new compliance requirements).
- *Accuracy.* The procedures described in the accounting policies and procedures manual should reflect controls as management actually intends for them to function. That is to say, the accounting policies and procedures manual should describe the specific controls that management intends to implement and maintain, rather than some "ideal" set of controls.[3]
- *Accessibility.* The accounting policies and procedures manual should be disseminated widely enough to be easily available to all of the employees who will need it.

Because of the critical need for management involvement in all aspects of internal controls, it is recommended that the accounting policies and procedures manual be approved and promulgated by top management. Top management's clear association with the accounting policies and procedures manual can greatly enhance its credibility, and hence its effectiveness, with management and staff at all levels.[4]

Summary

Information and communication are really pervasive characteristics that affect all aspects of the internal control framework. Communication is no better than the information communicated. It is essential, therefore, that current, accurate and appropriate information be made available on a timely basis to those who need it. These criteria apply, for example, to the accounting policies and proce-

[3] For example, considerations of relative costs and benefits may persuade management to make practical adaptations to certain "textbook" controls. In such cases, the policies and procedures manual should reflect these adaptations. As noted previously, the cost of controls should never exceed their expected benefits.

[4] Top-level management also may wish to include an explicit reference to internal control responsibilities in its performance evaluations of key staff.

dures manual, which is an important form of communication that assists management in meeting its financial reporting objectives.

To be truly effective communication must be multidirectional. Not only should top-level management be able to communicate its directives to management and staff at all levels, but staff and management at all levels must be able to communicate with higher management. Moreover, special procedures should be in place to allow lower level management and staff to bypass their immediate supervisors if the latter are implicated in inappropriate conduct. In addition, there must be lateral communication within the government, especially for employees in the finance function. Finally, management should have open lines of communication with the governing board, as well as with appropriate outside parties (e.g., service recipients, vendors, contractors).

Chapter 7
The Framework of Internal Controls: Monitoring

The purpose of control-related policies and procedures is to counteract the various risks that could hinder or prevent management from achieving its objectives (i.e., effectiveness, efficiency, compliance with laws and regulations, and proper financial reporting). It is essential that management monitor control-related policies and procedures on an ongoing basis to ensure that they are continuing to function properly, as designed. Likewise, management must monitor potential problems disclosed by internal controls to ensure that such situations are corrected or otherwise resolved on a timely basis. The process of monitoring the continued operation of control-related policies and procedures, as well as the resolution of potential weaknesses disclosed by controls, forms the fifth component of a comprehensive framework of internal controls.

To understand the importance of monitoring, it may be useful to compare internal controls to a smoke alarm. The purpose of a smoke alarm is not to extinguish a fire, but rather to alert those who can. Likewise, a smoke alarm has to be checked regularly to ensure that its battery is still properly charged. In the same way, it is of little value that internal controls identify potential problems unless management "follows through" with prompt and appropriate corrective action. Similarly, internal controls cannot be "installed" once and for all, but must regularly be tested to ensure that they are still functioning properly as designed.

Ongoing monitoring of controls

Management uses a variety of control-related policies and procedures in its attempt to prevent or contain risks that could hinder or prevent it from achieving its goals. Such controls include periodic reconciliations, periodic verifications and analytical review procedures. All of these controls are designed to identify or "flag" potential problems. A bank reconciliation, for example, may reveal an unexplained discrepancy between the amount of cash reported on the bank statement and the amount of cash reported in the government's accounting records. A physical inventory of equipment may disclose that some of the items reported in the accounting records are no longer in the possession of the government. A comparison of budget estimates and actual expenditures for supplies may reveal a significant unexplained increase in purchases of supplies.

If internal controls are to be effective, it is critical that management investigate and resolve such discrepancies. For example, did the problem with the bank reconciliation result from an innocent failure to record a deposit in the accounting records, or is the discrepancy evidence of a possible "kiting" scheme?[1] Did staff

[1] "Kiting" is a fraudulent scheme in which an employee diverts cash from the government and attempts to cover the missing funds by attributing the resulting disparity between the bank statement and accounting records to a "timing difference." Kiting schemes are discussed in chapter 9, which is devoted to fraud-related issues.

inadvertently fail to fill out the appropriate paperwork when the missing equipment was disposed of, or was that equipment diverted to personal use? Does the unanticipated increase in supplies expenditures reflect an unexpected increase in vendor prices, or are supplies being pilfered? Management needs to ask and answer these and similar questions arising as a result of control-related procedures.

Unfortunately, it is all too easy to place internal controls on "automatic pilot." In such cases, staff may diligently follow control-related policies and procedures, but no action follows as a result. Instead, this month's report of discrepancies disclosed by computer edit checks is simply placed in a cabinet on top of last month's report, or inventory records are simply "adjusted" for discrepancies without investigation. To avoid such situations, management should require that the resolution of all discrepancies be adequately documented. Ideally, this documentation should be prepared by one employee and reviewed and approved by another.

Furthermore, it is important that management not satisfy itself with unsubstantiated oral explanations. Rather, management should require that any explanation be supported by some type of evidence. Assume, for example, that failure to fill out a disposal form is blamed for the "appearance" that equipment is missing. In that case, there should be some evidence that the asset was, in fact, properly disposed of (e.g., salvage receipt) rather than converted to personal use. Indeed, it is so easy to be misled by facile "explanations" that generally accepted auditing standards require independent auditors to seek supporting evidence before accepting explanations as fact in connection with the application of analytical review procedures.[2]

It also is important that management carefully monitor audit findings resulting from both internal audits and from the independent audit of the government's financial statements. Management is primarily responsible for ensuring that weaknesses, once identified, are promptly and effectively corrected. In this regard, it is advisable to prepare written "corrective action plans" with an appropriate timetable for implementation. Top management should then monitor lower level management's progress toward meeting this timetable.[3]

Separate evaluations of internal controls

The regular ongoing monitoring of internal controls often is supplemented by separate evaluations of the effectiveness of control-related policies and procedures. Internal auditors, for instance, often target controls in specific areas for special attention as part of their annual work plan. Likewise, some governments have passed "financial integrity legislation" that requires management itself to undertake periodic reviews of internal controls and to report on the results of these self-assessments to the governing body.

The independent auditor also will study the internal control framework and test certain control-related policies and procedures as part of the audit of the government's financial statements. As a rule, the independent auditor's work will be focused on identifying "material weaknesses," i.e., weaknesses in the internal control framework that are so serious that they could cause the government's financial statements to be misleading. If the auditor happens to discover less serious weaknesses in the course of the audit, those weaknesses will be com-

[2] See Statement on Auditing Standards No. 56, *Analytical Procedures*, paragraph 21.

[3] It should be noted that management's prompt and effective response to internal control weaknesses, once identified, may help to mitigate adverse publicity in connection with the publication of the auditor's findings.

municated to management as "reportable conditions." However, the scope of the auditor's work is *not* specifically designed to find control weaknesses that are not "material" in relation to the financial statements.

Independent auditors also sometimes are requested to extend the scope of their audit work to focus attention on a specific program or activity of special interest to management or the governing body. For example, a fraud involving travel claims may prompt a government to contract with the independent auditor to perform special tests of controls over the processing of travel claims in conjunction with the annual audit of the financial statements. Similarly, a local government may elect to contract with its independent auditors to focus on internal controls in a different department each year, on a rotating basis.

Regardless of the particular controls being studied, all such separate evaluations of internal controls are concerned with two primary issues. First, are controls properly designed so that they will accomplish their intended purpose if functioning properly? Second, are controls actually functioning as designed?

Summary

It is essential that management monitor control-related policies and procedures on an ongoing basis to ensure that they are continuing to function properly. Furthermore, management must monitor any potential problems disclosed by internal controls to ensure that they are being promptly and effectively resolved. The resolution of potential problems identified by internal controls should be documented and supported by appropriate evidence. Likewise, corrective action plans and timetables should be required for the resolution of internal and external audit findings.

The regular ongoing monitoring of internal controls often is supplemented by separate evaluations. These separate evaluations may be performed by internal auditors, by external auditors or by management subject to the provisions of "financial integrity" legislation. Such evaluations are aimed at determining that controls are both well designed and properly functioning.

Chapter 8
Evaluating Controls Over Accounting and Financial Reporting

Change is a characteristic of all aspects of life, and internal controls are no exception to this general rule. For example, changes in a government's circumstances (e.g., introduction of a new program or information system) can render once satisfactory control-related policies and procedures inadequate or obsolete. Moreover, internal controls have a natural tendency to deteriorate over time unless they are properly "maintained" by management. Therefore, as discussed in the preceding chapter, it is essential that management monitor its internal controls on an ongoing basis. This chapter will describe how the concept of monitoring can be applied specifically to the evaluation of controls over accounting and financial reporting.

Identifying control cycles

It is easy for management to be daunted by the sheer volume and complexity of controls over accounting and financial reporting. Accordingly, the first step in evaluating these controls is to know where to start. The best place to begin is by "breaking down" what a government does into manageable groupings of similar or related activities, commonly known as "control cycles."

At the most basic level, governments are in the business of obtaining resources and then applying those resources to provide goods and services to citizens. Thus, the process of obtaining resources and the process of applying resources may be viewed as the two most basic control cycles.

Obtaining resources, of course, involves several steps. First, a government must obtain a legal claim to resources by using its taxing power (e.g., property tax), by providing goods or services on a user-fee or user-charge basis (e.g., utilities, transit fees) or by meeting grant requirements. Second, a government must demand payment from taxpayers, customers and grantors based upon its legal claim. Finally, a government must convert the amounts owed by taxpayers, customers and grantors into cash. When all of these various steps are combined together, the result is the "resource inflows" control cycle (see exhibit 1).

Likewise, the application of resources is also a multi-step process. First, a government must determine specifically how resources are to be applied (e.g., issuance of purchase orders, approval of contracts, hiring of employees, awarding of grants). Second, a government needs to determine that all conditions for the application of resources have been met (e.g., receipt of goods or services, compliance with grant requirements). Finally, a government must discharge itself of its obligations by making a cash payment. When all of these steps are combined together, the result is the "resource outflows" control cycle (see exhibit 2).

Of course, governments are not able to apply immediately all of the resources they obtain. Rather, there will be a greater or lesser interval between when re-

Exhibit 1

The Resource Inflows Control Cycle

Obtaining legal claim	Demanding payment	Converting to cash
Assessing taxes Providing goods or services Meeting grant requirements	Levying taxes Billing customers Applying for payment from grantors	Managing receivables Collecting cash

Exhibit 2

The Resource Outflows Control Cycle

Applying resources	Ensuring conditions met	Making cash payment
Issuance of purchase orders Approval of contracts Hiring of employees, consultants and contractors Awarding of grants	Receipt of goods or services Compliance with grant requirements	Managing payables Making cash payments

sources are first obtained and when those resources are finally converted into goods and services. During this interval, a government must carefully manage the resources entrusted to its care. This interim management typically takes two forms. First, liquid resources (e.g., cash) must be properly protected and used to best advantage until needed (i.e., invested or placed on deposit). Second, nonliquid assets used in the provision of services (e.g., equipment, inventories of supplies) must be properly protected and maintained. When both of these processes are combined together, the result is a third control cycle for "resource management."

Thus far we have identified a core of three separate control cycles based upon the natural "flow" of resources through the government (see exhibit 3). It also is possible to add additional control cycles at either end of this basic chain. For example, it is the budget process that gives rise to the resource inflows and outflows discussed previously. Therefore, it is possible to treat the budgeting process itself as a separate control cycle of its own. Likewise, management is required after the fact to give an accounting for its stewardship in each of the control cycles already discussed. The process used to meet this obligation may be treated as yet a fifth control cycle (i.e., the books, records and reports control cycle). Consequently, an average local government could divide its activities into at least five control cycles (see exhibit 4).

There are two important reasons for classifying a government's internal controls over accounting and financial reporting into control cycles. First, as noted earlier, the division into control cycles provides management with "workable" units for designing and evaluating controls. Second, it helps to underscore the logical relationships that necessarily exist among the multitude of control-related policies and procedures. Thus, for example, management should be aware of the close relationship that naturally exists among controls over billings, re-

Exhibit 3

Core Control Cycles

Resource inflows control cycle (i.e., "coming in") ➜ Resource management control cycle (i.e., "in between") ➜ Resource outflows control cycle (i.e., "going out")

Exhibit 4

Summary of Coordinate System of Control Cycles

Budgeting ➜ Resource inflows ➜ Resource management ➜ Resource outflows ➜ Books, records and reports

ceivables and cash collections, which all form part of a single "resource inflows" control cycle.

The control cycles described here are those used in the illustrative material contained in the appendix to this publication. They are by no means the only control cycles that can be used. It is possible, for example, to divide the cycles differently, just as it is possible to create additional cycles. Thus, the specific control cycles described here are offered only by way of example. What is important is not how the control cycles happen to be defined here, but rather the fact that the identification of these (or other) control cycles should be the first step in the process of evaluating internal controls.

Vulnerability assessment

As a practical matter, management cannot evaluate all of its controls at the same time. Consequently, management must find some way to prioritize its evaluations.

The process of logically determining where to begin (e.g., Which department? Which activity? Which control cycle?)[1] is often referred to as a "vulnerability assessment." Just as priority in a hospital emergency room is given to patients with potentially life-threatening conditions, so too, evaluations of internal controls should begin with a government's most critical control-related policies and procedures.

As noted in the chapter devoted to risk assessment[2], management evaluates the seriousness of possible risks on the basis of their significance (i.e., potential harm) and the likelihood of their occurrence. These are the same criteria used in a vulnerability assessment. That is to say, management should ask itself both "where does our government face the greatest possible losses?" and "which types of losses are most likely to occur?"

The answer to the first of these questions is often determined on the basis of management's assessment of the "inherent risk" of a given department, activity or control cycle. Any number of factors may make one situation "inherently" riskier than another. These factors include the complexity of a given activity, the volume of cash receipts involved, the presence of direct third-party benefi-

[1] Sometimes a given control cycle will be examined for the government as a whole (especially centralized accounting functions). In other cases (e.g., resource management, budgeting), the focus may be on a control cycle within a given department (e.g., public safety) or activity (e.g., police).

[2] See chapter 4.

ciaries, the degree of centralization,[3] a history of prior problems and prior unresponsiveness to identified control weaknesses.[4]

The answer to the question of how likely it is that losses will occur typically is based upon management's assessment of the quality of the control environment. As noted previously, the quality of the control environment will depend upon management's attitude and example, the quality of communication within the government, the presence of an active internal audit function, the presence of an effective audit committee (or its equivalent) and the qualifications of staff.[5]

Once management has assessed both inherent risk and the quality of the control environment, it is in a position to prioritize its efforts logically. For example, management clearly would wish to begin its evaluation of controls with departments or activities or control cycles that had both great inherent risk and an unfavorable control environment. Conversely, internal controls in situations involving little inherent risk and a favorable control environment would be a much lower priority. Other situations would fall in between these two extremes.

Documentation of how transactions and events are processed

Once management has completed its vulnerability assessment to determine where to begin the task of evaluating internal controls, the next step is to document how transactions and events are supposed to be handled in the particular department, activity or control cycle selected for evaluation. Typically, this documentation takes the form of a narrative memorandum describing how various transactions and events are processed. In some cases, this memorandum is further developed into a "flow chart," which provides a visual representation of how transactions and events are processed.

The purpose of documenting the flow of transactions and events is to provide management with a practical tool for identifying potential risks and weaknesses, as well as controls intended to compensate for those risks and weaknesses. To be effective for this purpose, the documentation must clearly disclose 1) *who* is performing each step of each process, 2) *what* is involved in each step of each process being performed and 3) any *resulting documentation*. For example, the documentation for the resource outflows control cycle might show that staff from the receiving department (i.e., "who") count all purchases received (i.e., "what") and send a report of their findings (i.e., "resulting documentation") to the accounting department.

Ideally, most of the information needed should already be available in the government's accounting policies and procedures manual. Likewise, useful information also may be available from the internal auditor or from the independent auditor of the financial statements. Before proceeding further, however, management should supplement such written sources by means of conversations with appropriate staff[6] and direct observation. Continuing with the example cited earlier, for instance, management may wish to directly ask staff in the receiving department what they do when a purchase is received. If staff respond that they routinely fill out receiving reports, management may wish to follow up on this assertion by directly observing employees receiving

[3] Also, a small staff may create a degree of inherent risk if the size of the staff makes it impractical to effectively segregate incompatible duties.

[4] The concept of inherent risk is discussed in more detail in chapter 4.

[5] Chapter 3 is devoted specifically to the control environment.

[6] "Inquiries" is the term of art used by auditors to refer to such conversations.

purchases to see whether they are, in fact, regularly completing receiving reports. Finally, as a practical matter, management will wish to "walk through" a sample transaction of each type to ensure that all aspects of the process have been properly considered. Only then is management ready to commit to writing its understanding of how transactions and events are processed.

Identifying potential risks

Management's next step in evaluating its controls over accounting and financial reporting is to identify the specific risks it faces in the department, activity or control cycle under consideration. It will be recalled from a previous discussion[7] that management actually is making a number of "implicit assertions" any time it issues a financial report, namely that:

- All the assets and liabilities presented in the report actually exist and all of the transactions and events presented in the report really occurred (i.e., "existence or occurrence");
- The report contains all relevant facts (i.e., "completeness");
- All of the assets and liabilities included in the report are truly assets and liabilities of the government (i.e., "rights and obligations");
- All items have been properly classified, all transactions and events reported took place within the accounting period, and all assets and liabilities were present as of the last day of the fiscal year (i.e., "allocation"); and
- Display and disclosure in general-purpose external financial reports conform to the requirements of generally accepted accounting principles (i.e., "presentation and disclosure").

Management can employ these same five implicit assertions as a practical tool for drawing up a list of potential risks to be avoided for the department, activity or control cycle under consideration. Assume, for example, that management plans to evaluate the purchases portion of the resource outflows control cycle. In that case, management could use the five implicit assertions to ensure that all significant risks are identified, as follows:[8]

- *Existence or occurrence*. Has a purchase been recorded for goods or services that have not yet been received? Has a vendor been paid twice for the same goods or services?
- *Completeness*. Have any purchases been made, but not recorded?
- *Rights and obligations*. Have all purchases been properly authorized? Have all purchases been made within approved budgetary limits? Have all grant-related purchases been made in conformity with the terms of the grant (e.g., reasonable, allowable, approved and documented)?
- *Allocation*. Have all purchases been recorded in the proper accounting period? Have all purchases been classified in the proper funds and accounts?
- *Presentation and disclosure*. Has the government refrained from reporting encumbrances related to outstanding purchase orders as expenditures in the operating statement presented in conformity with generally accepted accounting principles (GAAP)?

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[7] See chapter 5 on control-related policies and procedures.

[8] A reporter uses the famous "five Ws" (i.e., who?, what?, when?, where?, why?) in much the same way.

Identifying compensating controls

Once management has drawn up a list of the potential risks connected with the department, activity or control cycle under consideration, management should next turn its attention to identifying any control-related policies and procedures that have been designed to compensate for such risks. It will be recalled from a previous discussion[9] that control-related policies and procedures can be classified into one of the following eight categories: authorization, properly designed records, security of assets and records, segregation of incompatible duties, periodic reconciliations, periodic verifications, analytical review, and the timely preparation of financial reports in conformity with GAAP. Management should carefully examine its documentation of how transactions and events are processed to see which of these controls are in place. For example, an examination of the documentation relative to the purchases portion of the resource outflows control cycle might disclose the following compensating controls:

- *Prior authorization and approval.* Requisitions are required from the appropriate department head for all purchases. Purchase orders must be approved by the government's purchasing agent.
- *Properly designed records.* Requisition forms and purchase order forms are prenumbered. Payments are only made based on original invoices that are then stamped or perforated to prevent reuse. Proper cutoff procedures are in place to ensure that purchases are reported in the appropriate period.
- *Security of assets and records.* Access to blank requisition forms, purchase orders and receiving reports is strictly controlled.
- *Segregation of incompatible duties.* The receipt of ordered goods must be confirmed by a receiving report issued by a separate department before payment is authorized. The receipt of services must be confirmed in writing by an individual other that the one who requisitioned the services before payment is authorized.
- *Periodic reconciliations.* Encumbrances are regularly compared with outstanding purchase orders. Used and unused requisition forms and purchase orders are regularly reconciled to ensure that all such forms are properly accounted for. Payment is not authorized until management has examined and matched the requisition form, purchase order, receiving report and invoice.
- *Periodic verifications.* The uncommitted balance of appropriations is checked and documented before purchase orders are issued. Purchase orders involving grants are checked for compliance with grant conditions prior to approval. The proper classification by fund and account is verified before purchases are recorded in the accounting records.
- *Timely preparation of financial reports in conformity with GAAP.* The accounts are reviewed prior to the preparation of the GAAP operating statement to ensure that all encumbrances have been removed from expenditure accounts.

Matching potential risks and compensating controls

Once control-related policies and procedures have been identified, the next step is to determine whether there are appropriate compensating controls in place to counteract or contain each identified risk. Pursuing the purchasing example, it would appear that there is indeed a compensating control for each of the risks

[9] This discussion can be found in chapter 5.

identified using management's implicit financial reporting assertions, as follows:

Identified risk	**Compensating controls**
Has a purchase been recorded for goods or services that have not yet been received?	The receipt of ordered goods must be confirmed by a receiving report issued by a separate department before payment is authorized. The receipt of services must be confirmed in writing by an individual other than the one who requisitioned the services before payment is authorized.
	Payment is not authorized until management has examined and matched the requisition form, purchase order, receiving report and invoice.
Has a vendor been paid twice for the same goods or services?	Payments are only made based on original invoices that are then stamped or perforated to prevent reuse.
Have any purchases been made, but not recorded?	Requisition forms and purchase order forms are prenumbered.
	Used and unused requisition forms and purchase orders are regularly reconciled to ensure that all such forms are properly accounted for.
Have all purchases been properly authorized?	Requisitions are required from the appropriate department head for all purchases.
	Purchase orders must be approved by the government's purchasing agent.
	Access to blank requisition forms, purchase orders and receiving reports is strictly controlled.
Have all purchases been made within approved budgetary limits?	The uncommitted balance of appropriations is checked and documented before purchase orders are issued.
	Encumbrances are regularly compared with outstanding purchase orders.
Have all grant-related purchases been made in conformity with the terms of the grant (e.g., are they reasonable, allowable, approved and documented)?	Purchase orders involving grants are checked for compliance with grant conditions prior to approval.

Identified risk	Compensating controls
Have all purchases been recorded in the proper accounting period?	Proper cutoff procedures are in place to ensure that purchases are reported in the appropriate period.
Have all purchases been classified in the proper funds and accounts?	The proper classification by fund and account is verified before purchases are recorded in the accounting records.
Has the government refrained from reporting encumbrances related to outstanding purchase orders as expenditures in the GAAP operating statement?	The accounts are reviewed prior to the preparation of the GAAP operating statement to ensure that all encumbrances have been removed from expenditure accounts.

If, however, management is unable to identify an appropriate compensating control, then immediate corrective action is needed to remedy the deficiency.[10]

Evaluating the design of compensating controls

There is little use plugging in a broken appliance. So too, there is little use testing controls that are improperly designed. Therefore, the next step after identifying compensating controls is to evaluate their design. That is to say, is each compensating control designed in such a way that it could reasonably be expected to accomplish its intended purpose if properly implemented and maintained?

Assume, for example, that a government requires written documentation of the receipt of goods or services prior to recording a purchase, but does *not* require that this documentation come from someone other than the individual who originally requisitioned the goods or services. In that case, what would prevent an employee from placing bogus orders with a dishonest vendor (perhaps in exchange for a kickback) that resulted in payments for goods or services that were never actually provided to the government? In other words, such a control procedure would be of only limited value even if followed faithfully. Therefore, management would *not* need to proceed to testing the control, because it is already clear that its design is inadequate.

Normally, when the design of a control is found to be inadequate, management will wish to change the design so that the control can function effectively. There are exceptions to this general rule, however. In some situations, for instance, there may already be other controls in place that provide the needed assurance. In other cases, management may determine that the benefits of a redesigned control do not justify the costs. In such instances, elimination rather than redesign of the control may be in order.

Testing compensating controls

Even a well functioning appliance is not of much use if it is not plugged in. So too, even the best designed control-related policies and procedures are of little value if not actually followed in practice. Therefore, once management has determined that a control-related policy or procedure is well designed, it should

[10] Assuming, of course, that the benefits of such a control could reasonably be expected to outweigh the cost.

then perform tests to determine whether that policy or procedure has been properly implemented and remains operational.

The first step in the testing process is to determine the total number of relevant transactions. For example, if management wishes to test controls over purchases, how many purchases were there during the period under study? Management's goal in testing should be to verify that the particular control under study was functioning properly for all of these transactions.

Ideally, management would wish to test each and every relevant transaction. Because of the sheer volume of transactions, however, such an approach normally is impractical. Therefore, just as political pollsters will survey a relatively small number of voters to determine the views of voters generally, so too, management will carefully examine a small number of individual transactions to determine whether a given control is being followed generally for all relevant transactions. The term "sampling" is used to describe the process of drawing conclusions for a larger group based upon a careful study of a smaller representative group.

The results of sampling will only be valid if the smaller group under study is truly representative of the larger group for which conclusions are to be drawn. A survey of voters made in only one state, for example, would not necessarily produce results that would be valid for the entire country. The key to ensuring that a sample is really representative is to select all of the items in the smaller "sample" group on a random basis. To be a truly random sample, each relevant transaction must have an equal chance of being selected.[11] Furthermore, the transactions selected should be *representative of the entire period under study*. Thus, an examination of all payroll transactions for one or two randomly selected payroll periods (a procedure commonly referred to as "block sampling") would *not* necessarily reflect how payroll transactions were handled at other times during the year.[12]

The next step in the testing process is for management to determine the rate of control failure that it can tolerate for a given control. In the case of controls judged to be critical (e.g., prior approval of purchases), for example, management may be willing to accept few if any control failures. For less critical controls (e.g., rechecking the math of vendor invoices), on the other hand, management may be ready to accept occasional control failures provided they do not exceed a predetermined level.

Once management has determined the rate of control failure that it is willing to accept for a given control, it must decide the number of transactions it wishes to test to verify that the control is functioning properly. Although the selection of a specific sample size is ultimately a matter of professional judgment, the following factors should be taken into consideration:

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[11] For example, a random number generator could be used to ensure that the selection of all sample items is truly random. Another approach would be to divide the total number of transactions to be tested (e.g., 500) by the number of items that are desired for the sample (e.g., 25) and then use the result (i.e., 20) as a sampling interval (i.e., select every twentieth item starting from a randomly selected starting point, such as the last four digits of a serial number on a dollar bill). There are two weaknesses with this latter approach. First, testing at regular intervals could fail to disclose problems that also may occur at regular intervals (e.g., a computer error that occurs every tenth transaction). Also, such an approach could fail to disclose potential problems involving sequential transactions (e.g., "splitting" a single purchase into two smaller purchase orders to avoid special procedures applicable to larger purchases).

[12] For example, there may have been a change in personnel toward the end of the period under examination that was not reflected in either of the payroll periods selected.

- Management's predetermined rate of tolerable control failure will affect the size of the sample needed for testing. If management can tolerate little or no control failure, a relatively small sample of transactions may be sufficient for testing purposes. Conversely, a higher rate of tolerable control failure may require a larger sample of transactions.[13]
- Sampling, by its very nature, will never provide the *absolute* assurance that would result from testing each and every item. A larger sample size, however, can provide a higher level of confidence in the results of testing and can reduce the margin of error inherent in sampling.[14]
- Management may elect to use formal statistical sampling methodologies if it wishes to be able to quantify the results of its test work.[15] If this election is made, management may be able to obtain technical assistance from its internal or external auditors. Even if management elects *not* to use formal statistical sampling methodologies, management still may find it useful to compare anticipated sample sizes to those calculated for statistical sampling purposes.[16]
- Management may wish to *supplement* its random samples with special tests of highly sensitive items (e.g., large dollar-value transactions) or transactions with a past history of problems (e.g., travel claims).[17]

Once management has determined the number of transactions it wishes to test and has randomly selected transactions for inclusion in the sample, it is ready to proceed with testing. Management should examine each transaction in the sample to determine that the control-related policies or procedures under study were, in fact, followed in each case (e.g., Is a receiving report on file for each purchase in the sample? Was that report filled out by someone in the receiving department?[18]).

It will be recalled that the purpose of testing control-related policies and procedures is to determine whether they are actually operational. If a control is not operational, this fact may become clear early in the testing process (e.g., failures may be discovered in three of the first five items tested). In such cases, the goal

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[13] Assume, for example, that the very first item tested revealed a control failure. If the goal in testing was to prove that there were *no* control failures, that goal would already have been met by the disclosure of a single control failure. Conversely, if the goal was to establish that a given control did not fail more than 3 percent of the time, further testing would still be needed, because a single instance of control failure would *not* necessarily prove that control failures exceeded 3 percent.

[14] In matters of sampling, however, one rapidly reaches a point of diminishing returns. That is to say, the value of increasing a sample size can decrease rapidly beyond a certain point. For instance, a sample of 125 items normally would provide significantly more confidence than a sample of 25 items, but a sample of 1,000 items would *not* provide significantly more confidence than a sample of 125 items. Therefore, given the added costs entailed in increasing sample sizes, "more" is *not* necessarily "better."

[15] For example, using formal statistical methodologies, management might be able to state with a "90 perent level of confidence and a 2 percent margin of error that errors occurred at a rate of X percent."

[16] By definition, the size of a statistical sample is the *smallest* possible that can mathematically justify a given level of confidence and a given margin of error. Logically then, a nonstatistical sample must be at least as large to provide the same level of confidence and the same margin of error.

[17] Such supplemental testing does *not* violate the rule of random sampling described earlier, because the items selected for testing will not form part of a "sample" (i.e., the results of testing these specially selected items will not be used to reach conclusions regarding a larger body of untested items).

of testing has already been achieved (i.e., it has been determined that the control cannot be relied upon) and further testing should be discontinued as being unnecessary and uneconomical.

It is important that management carefully document its testing. Sound documentation of testing will include all of the following information:

- A description of the group of relevant transactions under study and the total number of transactions in that group,
- The method used to select transactions for inclusion in the sample (including the specific procedures used to ensure randomness),
- Identification of each tested item (e.g., purchase order number),
- Identification of the specific tests performed on each item and the identity of the individual performing the test,
- The results of testing for each item. The documentation of the results of testing should specifically indicate 1) each item for which a control procedure failed and the objective of the procedure, 2) the specific facts of each control failure, 3) the cause of each control failure, and 4) the potential impact of each control failure and of all identified control failures in the aggregate.

At a minimum, documentation of testing should provide all of the information that would be needed by an unaided third party to reperform the same tests on the same items.

Assessing the results of testing

If properly performed, management's tests of control-related policies and procedures should have revealed whether those controls were, in fact, operating as designed. If the tests demonstrated that the internal controls examined were indeed functioning properly, management may still wish to ask itself the following questions before going on to the examination of other controls:

- Is the control possibly redundant (i.e., are there already other controls in place and operational that achieve the same purpose)? In that case, considerations of relevant costs and benefits may require management to reevaluate the need for both controls.
- Do the benefits of the control really justify its cost?[19]

If management determines that control-related policies and procedures are *not* functioning properly, these same two considerations still need to be taken into account. That is to say, is the control not functioning properly because staff are relying on some other control that achieves the same purpose? Or is the control not functioning because the benefits of the control do not outweigh the related costs?

Regardless of the reason controls may not be functioning as designed, it is *never* acceptable to keep nonoperative control-related policies and procedures in place. Just as unrepaired vandalism encourages further vandalism, the presence of inoperative controls is an open invitation to ignore other control-related policies and procedures. Consequently, it is essential that management take prompt corrective action. If a control-related policy or procedure is inoperative

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[18] Each separate aspect of a control being tested is often referred to as an "attribute." Likewise, control failures are commonly known as "exceptions."

[19] Ideally, management should consider both of these possibilities as part of its evaluation of the design of controls. As a practical matter, however, it may be beneficial to reconsider this possibility after testing as well.

because it is redundant or uneconomical, then that control needs to be modified or eliminated. Otherwise, management should take immediate corrective action to ensure that the policy or procedure will be regularly followed in the future. Furthermore, management should schedule similar tests of that same control for the future to ensure that the corrective action taken will, in fact, have been effective.

Summary

Changes in a government's circumstances can render internal controls inadequate or even obsolete. Likewise, there is a natural tendency for internal controls to deteriorate over time unless they are properly maintained. Therefore, it is important for management to monitor on an ongoing basis the continued functioning of internal controls over accounting and financial reporting.

The first step in this process is to group naturally interrelated control policies and procedures into "control cycles." After that, management should prioritize the examination of controls by department, activity or control cycle based upon the perceived degree of "vulnerability." The two key factors to be considered in assessing vulnerability are "inherent risk" and the quality of the control environment.

Once priorities have been established, management should initiate the process of testing controls by documenting how transactions and events are supposed to be handled in the particular department, activity or control cycle selected for evaluation. This documentation, which may take the form of a narrative memorandum or a flow chart, should clearly show *who* is responsible for doing *what*, as well as any *resulting documentation*. Written sources of information on how transactions and events are processed should be supplemented by inquiry, observation and, finally, by an actual "walk through" the process.

Management's next step is to use the assertions implicit in financial reporting to identify potential risks. Management then identifies all of the related control policies and procedures designed to compensate for those potential risks. The two lists (i.e., potential risks and related compensating controls) are then matched to ensure that there is an appropriate compensating control for each type of risk identified.

Management then proceeds to study the design of each compensating control to evaluate whether the control would be effective if operating as designed. If not, no point is served by testing whether the control is operational. If, however, management determines that a compensating control is properly designed, the next step would be to test to see if the control has actually been implemented and remains operational.

Testing begins with an identification of the total number of relevant transactions affected by a given control procedure. Because of the sheer volume of transactions, management typically will test only a random sample of transactions. The size of the sample needed will depend upon the rate of control failure that management is willing to tolerate for a given type of control, as well as upon the degree of confidence desired and the margin of error that is acceptable to management. Furthermore, management may wish to supplement its random sampling of transactions with special testing of highly sensitive items, or transactions with a past history of problems. Management should create at least enough documentation of its testing procedures so that those procedures could be duplicated by an unassisted third party.

Management needs to evaluate and act promptly upon the results of its testing. If management discovers that controls are not working properly, they should be amended or eliminated, or steps should be taken to improve compliance. Even if controls are found to be working properly, management may still wish to consider the possibility that the controls may be redundant, or that the costs of the controls may exceed their benefit. Finally, management needs to "follow through" on any corrective action undertaken as a result of its testing to ensure that all needed changes have, in fact, been implemented.

Chapter 9
Public-sector Fraud: Prevention and Detection

Like managers in the private sector, public-sector managers have a duty of stewardship for the resources entrusted to their care. Indeed, many would argue that public-sector managers have an even higher degree of responsibility for stewardship than do their private-sector counterparts because the resources they administer are obtained involuntarily (i.e., through taxation) rather than voluntarily (i.e., through individual investment decisions). Whatever the case might be, citizens clearly expect managers of public-sector resources to take every reasonable precaution to prevent the misuse or diversion of public funds. Indeed, the press and the public typically are unforgiving toward management when fraud does occur, even when the amounts actually lost by the government are relatively minor.

Causes of fraud

Fraud does not just "happen." Typically, various circumstances combine together to create a situation favorable to fraudulent activity. One factor to be considered is the character and personality of those working for the government. Any of the following situations may predispose a given individual to consider committing a fraud:

- *Financial stress.* Desperate problems can lead some individuals to desperate "solutions." People facing financial crises (e.g., unpaid medical bills, bankruptcy) may be prime candidates for fraud.
- *Addiction.* Individuals attempting to support gambling, alcohol or drug "habits" may turn to fraud to help finance their addiction.
- *Disaffection.* Employees who believe that they have somehow been mistreated (e.g., denied promotions or raises) may be tempted to use fraud to "strike back" against the government or to "get what's due" them.
- *Pathologies.* There are some rare individuals who are pathologically disposed to fraud, or who may engage in frauds as a type of intellectual challenge.[1]

A second, more important factor is *opportunity*. Even the most troubled individual cannot commit fraud without the right opportunity. So too, otherwise honest people often have been led to commit fraud simply because the opportunity to do so became "irresistible." Opportunity then, not only *permits* fraud to occur, but actually *promotes* it. The "opportunity" needed for fraud is created

[1] Intellectual challenge, for example, has been cited as the prime motivating force that has driven a number of well publicized "hackers" to attempt to gain illegal access to various sensitive com-

when management fails to meet its responsibility to establish and maintain a sound and comprehensive framework of internal controls.

Cost of fraud

The most visible "cost" of fraud is the diversion of public resources from their intended purpose. There also are other significant costs involved with fraud that are at least as important:

- *Loss of confidence in the government*. Governments depend upon their taxpayers to obtain the resources they need to provide services. The publicity surrounding public-sector frauds can have a serious negative impact on taxpayers' confidence in their government, and consequently on their willingness to provide additional resources.
- *Loss to the reputation of innocent third parties*. When a fraud occurs in a given department, a "cloud" often forms over innocent people working in that same department. Thus, people often will falsely assume that others in the department were involved in the fraud, or at least were aware of it. The result is "guilt by association" that can taint the careers of many individuals with no connection to the fraud.
- *Cost to the perpetrator*. It is only fitting that people who commit frauds be punished for betraying the public trust. Nonetheless, there is an element of tragedy in the punishment that sometimes awaits perpetrators of fraud in the public sector, where relatively small thefts may be widely publicized and result in the loss of reputation, career, family and sometimes even life.

Types of public-sector fraud

The public sector is challenged by many of the same types of fraud as private-sector enterprises. Some of the more common of these frauds are briefly described in the paragraphs that follow.

Kiting. Kiting is a classic scheme for "borrowing" funds from a government and then concealing their absence. In ordinary circumstances, the cash balance reported in the accounting records will be different from the cash balance reported in the monthly bank statement. For example, a government's cash balance per the bank's records will include uncashed checks, but not amounts "in transit" from the government to the bank. In a kiting scheme, a dishonest employee will attempt to hide the fact that funds are missing by claiming that the amounts are actually in transit between the government and the bank.

Lapping. Lapping schemes operate on the principle of "robbing Peter to pay Paul." A dishonest employee with access to both the accounts receivable records and cash collections will "borrow" funds by failing to credit a payment made to an account. This account is then later "reimbursed" when a subsequent payment destined for a second account is, in fact, diverted to "pay off" the first account. This process can then be continued indefinitely. One advantage of lapping is that no single account remains "out of balance" for a long period, thus reducing the chance of detection. Indeed, even if an affected individual happens to notice that an account has not been credited for a payment already made, the individual is more likely to blame "bureaucratic delays" or "computer glitches" than to suspect fraud.

Bid rigging. Governments often use competitive bidding to obtain the lowest possible price for needed goods and services. Because of the often considerable sums of money involved, it is not uncommon for unscrupulous individuals to attempt to circumvent the competitive bidding process, a practice commonly referred to as "bid rigging." For example, competing firms may illegally reach an understanding to "take turns" placing the low bid on government contracts, or may agree to divide up a service area so that each colluding firm will always be the low bidder in "its" area. Firms also may improperly agree to "share" a contract by taking on unsuccessful "competitors" as subcontractors.

Still other types of bid rigging require the participation of corrupt government officials. For example, an individual bidder may be informed by someone inside the government that a certain specification will be eliminated from a contract after it is awarded. In that case, the bidder can use this knowledge to "lowball" competitors by including in the bid an unrealistically low price for the specification that will be eliminated. A similar corrupt use can be made of change orders (i.e., contract amendments made subsequent to the award of the contract) if these are known in advance. In the same vein, dishonest government employees can slant specifications to favor a specific firm. In all of these cases, kickbacks from contractors to dishonest government employees may provide the incentive needed for collusion.[2]

Payroll fraud. Governments may be fraudulently induced into paying salaries or wages that have not been earned. For example, "phantom" employees may be placed on the payroll, or supervisors may delay processing termination papers on employees and then keep the checks for one or two pay periods after the employees have been terminated. Another, more subtle form of payroll fraud is to increase artificially the hours worked by retiring employees as a means of inflating their pension benefits (which are often calculated using final salary levels). Other types of payroll fraud involve unnecessary overtime, falsified overtime and unreported leave.

Healthcare beneficiary fraud. Healthcare benefits are among the most costly that a government provides to its employees. Sometimes individuals will attempt to cheat on health insurance coverage by listing as beneficiaries individuals who do not qualify (or no longer qualify) as family members.

False claims. Governments are sometimes billed for goods or services they did not receive. One particular form of this fraud is to substitute inferior goods for those actually ordered by the government and then bill the government for the higher quality goods.

Double payments. Dishonest individuals sometimes try to defraud a government by billing it twice for the same goods or services. One method used for this purpose is to bill for the same item under two separate contracts. Another approach is to seek payment from both petty cash and the regular reimbursement process for one and the same item.

Charge-off fraud. A government will "write off" its delinquent receivables after all reasonable attempts have been made at collection. If a single individual has access both to cash collections and to the receivables records, that individual may make an unexpected collection on a delinquent account and then write it off as "uncollectible," thereby removing all evidence of the theft.

Disposal fraud. The government alone is entitled to profit from the disposal of its surplus equipment and supplies. Nonetheless, sometimes an employee responsible for disposing of surplus items may become aware of a way to profit

[2] Kickbacks also can take the less direct form of gifts or favors (e.g., free travel or meals).

from the disposal of which the government itself is unaware. Rather than allowing the government to benefit from this knowledge, the employee may be tempted to make a personal profit. Such an action, however, is fraudulent, because an employee entrusted with the disposal of surplus assets has the fiduciary responsibility to obtain the highest available price for those assets.

Travel-claim fraud. Some government employees are required to travel as a part of their job. In such situations, the employee is properly reimbursed for reasonable and necessary travel costs. Employees sometimes are tempted to cheat on travel claims by claiming expenses that they did not, in fact, incur (e.g., meals already provided free as part of a conference program) or by inflating expenses (e.g., claiming excessive mileage). They also may attempt to "reimburse" themselves for unallowable items (e.g., alcoholic beverages) by "running them through" other accounts that may require little or no documentation (e.g., tips and miscellaneous).

Pilfering. Pilfering is the petty theft of supplies and similar items of small monetary value. Because the cost of controls should not exceed their benefits, a certain amount of pilfering is unavoidable. However, pilfering can easily "get out of hand," especially in larger governments. What may begin as the occasional chance removal of a few pens or a tablet can easily escalate, if left unchecked, into a large-scale diversion of supplies.

Misuse of assets and services. Like pilfering, the small-scale misuse of assets and services by employees can quickly escalate. Common examples of such misuse of government assets and services include nonbusiness-related telephone calls, copying, faxing and use of computers and electronic mail.

Petty cash fraud. Custodians of petty cash funds sometimes illicitly "borrow" from the resources of those funds. One method used to conceal such thefts is to include an adding machine tape along with the receipts in the petty cash box. This adding machine tape will show an amount for each receipt. Moreover, the total shown on the tape, when added to the cash still in the box, will equal the amount that is supposed to be in the petty cash fund. However, the total on the adding machine tape only produces the "correct" amount because there originally was another number at the top of the tape (i.e., an amount equal to the "borrowing") that was subsequently removed. If the individual reimbursing the petty cash fund relies on the total printed on the adding machine tape rather than readding the amounts, the theft may go undetected.

Fraud prevention

The only effective response to fraud is prevention, and prevention requires a sound and comprehensive internal control framework. Indeed, as noted earlier, poor internal controls do not just permit fraud to occur, they actually *encourage* it.

A few examples taken from the frauds discussed above may be useful in showing the important role internal controls can play in stopping fraud before it happens.

- *Properly designed records.* Duplicate payments for the same goods or services are unlikely to occur if payment is only made based upon *original documentation* that is subsequently stamped or perforated to prevent reuse.
- *Segregation of incompatible duties.* Charge-off fraud cannot occur (absent collusion[3]) if cash collections are kept separate from the accounts receiv-

able function. Similarly, lapping is dependent upon access to both cash collections and receivables records.

- *Periodic reconciliations*. Regular, timely and independently performed bank reconciliations are sufficient to prevent kiting.
- *Periodic verifications*. Unauthorized "borrowings" from petty cash funds and "phantom employees" can be kept in check or prevented by surprise inspections.
- *Analytical review*. The reasonableness of travel claims can be established by making appropriate comparisons with similar past trips. Likewise, an independent analysis of supply needs can disclose unacceptably high levels of pilferage.

It should be noted from some of the examples just given that even controls that are designed to detect fraud after it occurs (e.g., periodic verifications and analytical review) can also be highly effective in preventing its occurrence. That is to say, the knowledge that detection and exposure will be swift and certain is a powerful disincentive to fraud. Thus, educating employees at all levels about the purpose and operation of internal controls can itself help to discourage fraudulent behavior, just as a highly visible "cop on the beat" can deter crime.

Fraud detection

Fraud detection is no substitute for fraud prevention. Nonetheless, because no system of internal controls is fool proof, management must be prepared to detect fraud when it does occur.[4] Unfortunately, there is no systematic way to ensure that all instances of fraud will be detected. Nonetheless, the following guidelines can significantly increase the likelihood of detecting fraud when it does occur:

- *Remember that anyone can commit fraud*. It is true that some individuals are more predisposed to commit fraud than others. Nonetheless, with sufficient opportunity almost anyone may be tempted to steal. Indeed, many individuals get trapped in easily detected frauds precisely because they are convinced that they are just "borrowing" funds temporarily and will be able to return the money in time to avoid detection. There is no bigger error than to think that "only thieves" steal.
- *Do not dismiss tips, even when obtained from hostile sources*. In practice, tips are the single most important means of detecting fraud.[5] Sometimes, tips are provided by honest individuals who believe it is their ethical duty to report a fraud, or who fear they may be implicated in the fraud if they fail to report it. Often, however, the motive for providing a tip may be considerably less praiseworthy. For example, a jealous employee who was "passed over" for a promotion may offer incriminating information on a co-worker who was promoted. Likewise, a former husband or wife may volunteer information on fraudulent activities involving their ex-spouse.

[3] It will be recalled that collusion occurs when two or more employees who are to act as a control on each other cooperate instead to circumvent controls.

[4] It will be recalled from an earlier discussion (chapter 1) that there are a number of inherent limitations on any system of internal controls. Thus, it is not practical to implement every possible control because the cost of controls should not exceed their benefits. Likewise, dishonest employees can collude to circumvent controls. Also, there is the chance that management may be tempted to "override" the very controls that it has set in place.

[5] Because of the importance of tips in fraud detection, a number of governments have established "hot lines" where citizens wishing to report fraudulent or suspicious activities may do so anonymously.

Just because a person's motives are questionable, however, does not mean that the person is not telling the truth. Accordingly, all tips should be investigated if it appears they could have a reasonable basis in fact.[6]

- *Use analytical review to identify potential problems.* One of the best ways to find fraud is to look for situations where actual results differ from what might reasonably have been expected in the circumstances. For example, management should rigorously investigate significant budget variances.
- *Carefully examine unusual transactions.* The demands of bookkeeping sometimes force individuals committing frauds to record sham "transactions" to conceal the diversion of resources. Management should be on the lookout for "unusual" transactions and demand a thorough explanation and supporting evidence. In particular, management should demand a thorough justification for all adjusting journal entries.
- *Carefully examine supporting documentation.* When examining transactions as part of its testing of control-related policies and procedures over accounting and financial reporting, management should carefully examine all supporting documentation. In the case of checks, for instance, the following occurrences may indicate a potential problem:
  —Checks made payable to "cash,"
  —Checks made out in even amounts for sums over $100,
  —Checks made out to vendors that were cashed rather than deposited,[7]
  —Nonpayroll checks endorsed by hand.[8]

  Likewise, invoices possessing any of the following characteristics may indicate a potential problem:

  —Invoices with only a post office box number,
  —Invoice numbers that are typed rather than printed,
  —Invoices with a heading that is rubber-stamped rather than printed,
  —Invoices that do not provide a telephone number,
  —Invoices for goods or services of a type not normally provided by the vendor (e.g., an invoice for hardware from an office supply firm).

  The goal in examining documentation should be to target factors that are unusual or unexpected and then to pursue explanations. Indeed, the very *absence* of normal flaws (e.g., typos, erasures, wear and tear) in documents can itself be an indication of potential problems.[9]

It is important to note that the presence of a potential fraud indicator[10] does *not* necessarily mean that a fraud has actually occurred. Rather, fraud indicators serve simply as "red flags" to alert management to situations where there is a

[6] Tips should be distinguished from mere speculation or conjecture. Thus, the first question to be asked of someone offering a tip is "how do you *know* that what you are saying is true?" Does the informant have direct personal knowledge of the fraud (e.g., "I saw him do it"; "I saw crates of city supplies in his garage")? Has the person obtained information from someone with direct personal knowledge (e.g., "one of his coworkers told me that she saw him do it")? Or is the informant simply passing on vague rumors (e.g., "everyone in the department knows he's a thief"). While a mere rumor should put management on its guard that there may be a problem, it does not, of itself, necessarily justify a full investigation.

[7] It is ordinary business practice to deposit all checks intact and then to make withdrawals separately.

[8] It is ordinary business practice to use a stamp to endorse all checks as received.

[9] For example, the document may not have been subjected to normal wear and tear because it did not actually go through the regular approval process.

higher than average chance that fraud may have occurred. Only a thorough investigation can resolve whether a fraud actually did occur.

Investigating fraud

It is management's responsibility to investigate thoroughly any indications that a fraud may have occurred. However, because every investigation of a possible fraud could potentially result in a prosecution, it is extremely important that management conduct its investigation in such a way as to avoid any chance of hampering an eventual prosecution. ***The first step is to obtain professional legal help.***[11] With the benefit of legal advice, management should then keep within the following guidelines in conducting any portion of the investigation:

- *Maintain objectivity.* The goal of any investigation should be to uncover *all* of the relevant facts. If investigators focus their efforts solely on gathering incriminating material, the information they collect may be deemed inadmissable in court, where the standard is not just "the truth," but "the *whole* truth."
- *Seek out the "best evidence."* Management should obtain original documents whenever possible.[12] If not, the official custodian of the document should make a copy for management and write "true copy" on its face. It is important to explain in writing why it was impossible to obtain the original document if that is the case.
- *Obtain documents only from official custodians.* It is important that records not be obtained improperly. Accordingly, care should be taken to address any requests for documents to the official custodian of the documents.
- *Maintain a "chain of custody" over potential evidence.* If a fraud is eventually prosecuted, the court will insist that management prove that any incriminating evidence was not tampered with subsequent to its collection. That is to say, management will have to be able to indicate precisely who had responsibility for the evidence at any given moment from the time of its collection until the trial. Management also will need to be able to indicate the safeguards that were in place to ensure that unauthorized individuals could not gain access to the evidence during that time.
- *Exercise care in conducting interviews.* Always conduct interviews with at least one other individual present. A consistent note-taking policy should be followed for all interviews (i.e., do not take notes of some conversations, but not of others).[13] Notes should be made either during the interview or immediately thereafter (i.e., *not* three days from now or next week). Management should resist the temptation to "fill in" silences, and instead should allow the person being interviewed to do most of the talking. The interviewer also should be careful to assume nothing, but rather to ask the person being interviewed to clarify any potential ambiguities (e.g., "What do you mean exactly when you say that X was `in on it'"?). One good technique to avoid potential misunderstandings is for the inter-

[10] A "fraud indicator" is any circumstance or set of circumstances that signal a greater than ordinary chance that an irregularity may have occurred.

[11] Indeed, most or all of a typical fraud investigation will be conducted by someone other than management.

[12] If an original document is to be removed from the records, the custodian of that document should make a copy to replace the original and write "true copy" on its face.

[13] This rule applies equally to telephone conversations.

viewer to restate or summarize periodically what the person being interviewed has just said.[14]

- *Retain all written records.* All written records of the investigation, including original notes of conversations and drafts, should be retained.
- *Discuss the investigation only with competent authorities.* It is extremely important that the good reputation of employees be protected. Accordingly, progress on an investigation should only be discussed with those who have a professional "need to know," and only upon the advice of legal counsel.[15]

When an investigation discloses that an irregularity has, indeed, taken place, management must then attempt to determine the full extent of the fraud. Who was responsible? What was stolen? When did the fraud begin and how long did it last?

One useful way to identify potential participants in a fraudulent scheme is to ask the additional question "who else *should have known* about the fraud?" Likewise, when determining what was taken, it is a good idea to ask "what else could that same individual have stolen?" Individuals have been known to confess willingly to small frauds (once they have been uncovered) to deflect attention away from larger fraudulent schemes that still remained undetected. Finally, discovering the motivation for the fraud may be useful in helping to "pin down" dates. If the fraud is blamed on medical bills, for example, then the fraud should not have preceded those bills. Once again, dishonest individuals may volunteer information on a starting date for the fraud to conceal even larger thefts that may have occurred *before* that date. Accordingly, management should examine at least a brief period prior to the alleged starting date of the fraud to verify that the fraud had not, in fact, begun at some earlier date.

Prosecution

Those who abuse the public trust by stealing or otherwise misusing public resources deserve to be punished. Unfortunately, management sometimes does not elect to pursue the prosecution of "white collar" criminals, but instead will satisfy itself with restitution and the dismissal of the offending employee in an effort to avoid adverse publicity. This approach is unsatisfactory for several reasons. First, it is the role of the district attorney and of the courts (*not* management) to decide on the appropriate punishment for those who have broken the *public* trust. Second, management may expose itself to severe public criticism if the details of such an arrangement become public (which is counterproductive if management desires to avoid "negative" publicity). Third and most important, the public punishment of those who commit fraud can serve as a strong disincentive to those who might otherwise be tempted to pursue the same path, thus reinforcing the government's control environment.

Summary

Citizens expect managers of public-sector resources to take every reasonable precaution to prevent the misuse or diversion of public funds. A variety of conditions can come together to predispose individuals to commit fraud (e.g., financial stress, addiction, disaffection, pathologies). However, even otherwise honest employees can be tempted to commit fraud if provided with sufficient

[14] It is particularly important to seek legal advice before interviewing someone who is suspected of fraud.

[15] Discussing a fraud investigation inappropriately can result in significant potential legal liability for the government.

opportunity. Therefore, it may fairly be said that opportunity not only *permits* fraud to occur, it actually *promotes* it.

There is a high cost to public-sector fraud, even beyond the diversion of funds. Publicity surrounding fraud may reduce taxpayers' confidence in their government, as well as their willingness to support it financially. Also, innocent third parties often are victimized by the "cloud" that frequently hovers indiscriminately over all those who work in an office or department where fraud has occurred. Finally, the publicity surrounding even relatively minor public-sector frauds can create disproportional personal tragedies for the perpetrators.

The types of fraud found in the public sector are often similar to fraudulent schemes found in the private sector. These include kiting, lapping, bid rigging, payroll fraud, healthcare beneficiary fraud, false claims, double payments, charge-off fraud, disposal fraud, travel-claim fraud, pilfering, misuse of assets and services, and petty cash fraud. The only effective response to these and other types of fraud is prevention, and prevention requires a sound and comprehensive framework of internal controls. It is noteworthy that even controls designed to detect fraud can actually help to prevent it from occurring, just as the visible presence of a "cop on the beat" can deter crime.

Because of inherent limitations in any system of internal controls, management must be on the alert for situations that could indicate the presence of fraud. Management can improve its chances of detecting fraud by remembering that anyone can commit fraud, by following up on tips, by performing analytical review procedures, by carefully examining unusual transactions and by carefully examining supporting documentation.

It is important that management obtain legal assistance before investigating potential fraud. Also, throughout the course of any fraud investigation, management should strive to maintain its objectivity, to seek out the "best evidence," to obtain documents only from official custodians, to maintain a "chain of custody" over potential evidence, to exercise care in conducting interviews, to retain all written records and to discuss the investigation only with competent authorities.

Finally, once it has been discovered that fraud has occurred, management must seek to determine the full extent of the fraud. Questions that should be asked include "Who else should have known about the fraud?," "What else could the same individual have stolen?," and "Was there any external motivation for the fraud (e.g., financial difficulties) that might help to pinpoint the starting date?" Likewise, management should pursue the prosecution of those who commit fraud to strengthen the government's control environment.

Appendix
Illustrations of Potential Internal Control Weaknesses and Compensating Controls: Accounting and Financial Reporting

Chapter 8 of this publication describes how management can conduct an effective evaluation of internal controls over accounting and financial reporting. As part of that process, management is advised

- to use the assertions implicit in financial reporting (i.e., existence or occurrence, completeness, rights and obligations, allocation, and presentation and disclosure) as a practical means of identifying potential risks and
- to review control-related policies and procedures (i.e., prior authorization and approval, properly designed records, security of assets and records, segregation of incompatible duties, periodic reconciliations, periodic verifications, and timely preparation of financial reports in conformity with generally accepted accounting principles—GAAP) to identify specific controls that may compensate for those risks.

The purpose of this appendix is to provide some practical illustrations of how these two tasks can be accomplished. Specifically, the five implicit assertions of financial reporting are used to identify potential weaknesses in each of the control cycles identified in chapter 8. Likewise, potential compensating controls are also identified for each of these control cycles.[1]

The goal of this appendix is *not* to provide an exhaustive list of potential weaknesses and compensating controls. Rather, this appendix aims at demonstrating *how management can apply the techniques outlined in this publication* to identify weaknesses and compensating controls *in a variety of different circumstances.*

A number of checklists are available for those desiring more detailed information on specific internal control policies and procedures. For example, an internal control checklist specifically designed for state and local governments can be found in Appendix B to the American Institute of Certified Public Accountants' *Audits of State and Local Governmental Units* (1995).

Management is cautioned, however, that such checklists must be tailored to each government's individual circumstances. That is to say, no checklist, no matter how well prepared, can serve as a substitute for the careful exercise of professional judgment.

[1]The control cycles used in chapter 8 and in this appendix are solely illustrative. Other logical groupings of related transactions could serve equally well for this purpose.

I. The Budgeting Cycle

Summary of Coordinate System of Control Cycles								
BUDGETING	➜	Resource inflows	➜	Resource management	➜	Resource outflows	➜	Books, records and reports

I. Overall objective: the authorized budget should reflect anticipated revenues and appropriations

II. Potential weaknesses
- A. Existence or occurrence
  1. Budget based on erroneous assumptions
  2. Budget erroneously recorded
- B. Completeness
  1. Budget not prepared based on all sources of revenues or appropriations
  2. Budget changes not recorded
- C. Rights and obligations
  1. Budget includes erroneous sources of revenue or appropriations in error
  2. Unauthorized budget changes
- D. Allocation
  1. Budget items misclassified
- E. Presentation and disclosure
  1. Budget to actual comparisons in financial statements not based on final amended budget
  2. Budgetary compliance not demonstrated at legal level of control in the comprehensive annual financial report (CAFR)
  3. Legal level of control not properly defined in CAFR
  4. Budget and actual data not presented on the budgetary basis of accounting
  5. Non-GAAP budget presentation not reconciled to GAAP operating statement
  6. Failure to state whether encumbrances lapse at the end of the fiscal year
  7. Failure to disclose in notes that the original budget was amended
  8. Failure to reserve fund balance in governmental funds for nonlapsing encumbrances (reserves for lapsing encumbrances are permitted, but not required)

III. Compensating controls
- A. Authorization and approval
  1. Budget prepared based on ordinance and in accordance with state laws (as appropriate)
  2. Budget changes approved prior to recording
- B. Segregation of incompatible duties
  1. Budget recorded by someone independent of approval and preparation
  2. Budget components reviewed in detail by someone independent of preparation
- C. Periodic verification
  1. Budget compared to tax roll, grant/entitlement awards or other support
  2. Recorded budget reviewed and compared to authorized budget

3. Verification that budget changes have been recorded

D. Timely preparation of financial reports in conformity with GAAP

1. Budgetary presentation and disclosure checked against the Government Finance Officer's Association's (GFOA) checklist for the Certificate of Achievement for Excellence in Financial Reporting Program (Certificate Program)

II. The Resource Inflows Cycle

Summary of Coordinate System of Control Cycles								
Budgeting	➜	**RESOURCE INFLOWS**	➜	Resource management	➜	Resource outflows	➜	Books, records and reports

I. Assessing, levying and collecting taxes

A. Overall objectives

1. The authorization to levy taxes, including the determination of assessed property values, the recognition of special exemptions and the proper calculation and recording of the levy should be reflected in the accounting records
2. All receipts should be recorded accurately and deposited
3. All receipts should be allocated to the correct fund and account in the correct period and properly applied

B. Potential weaknesses

1. Existence or occurrence
   a. Incorrect assessed values used
   b. Incorrect tax rates used
   c. Levy calculated incorrectly
   d. Levy recorded incorrectly
   e. Cash receipts recorded, but not deposited
   f. Cash receipts amount recorded incorrectly
2. Completeness
   a. Incorrect special exemptions
   b. Incomplete tax rolls
   c. Taxes levied, but not billed
   d. Appropriate penalties not assessed
   e. Appropriate collection techniques not followed for delinquencies
   f. Cash receipts not recorded or deposited
   g. Cash receipts deposited, but not recorded
3. Rights and obligations
   a. Taxes levied on wrong party
4. Allocation
   a. Levy misclassified
   b. Cash receipts credited to wrong account
   c. Cash receipts credited to wrong period
   d. Billings delayed
5. Presentation and disclosure
   a. Property taxes recognized as revenue in financial statements before date due
   b. Property taxes recognized as revenue in governmental funds before they are available to finance liabilities of the current period (not to exceed 60 days)

c. Property taxes levied to finance subsequent year's budget recognized as revenue in financial statements of current year
d. Receivable for property taxes not recognized as of levy date
e. Property tax receivable not reported net of allowance for doubtful accounts
f. Levy date, due date and collection date not disclosed in the notes to the financial statements

C. Compensating controls
1. Prior authorization and approval
    a. Changes in assessed values approved
    b. Tax rolls approved prior to issuance of tax bills
    c. Changes to tax rolls require approval
    d. Exemptions approved
    e. Tax calculations approved
    f. Tax levy approved
2. Properly designed records
    a. Tax rolls changed upon disposition of property
    b. Tax bills numerically controlled
    c. Tax bills issued on a timely basis in conformity with approved calendar
3. Security of assets and records
    a. Lockbox for tax payments
    b. Use of cash registers and similar machines containing controlled-access cash register tapes
    c. Appropriate collection techniques followed for delinquent accounts
4. Segregation of incompatible duties
    a. Segregation of 1) the handling and listing of cash receipts, 2) the posting to the taxes receivable and general ledgers, 3) the maintenance of the cash receipts book and 4) the making of deposits
    b. Incoming cash items listed for subsequent reconciliations to deposits by someone independent of recording cash receipts
    c. The independent investigation and follow-up on overdue accounts receivable balances
    d. Use of an individual independent of the billings and taxes receivable functions for investigating complaints from taxpayers
    e. Independent review of bank reconciliations
5. Periodic reconciliations
    a. Bank reconciliations prepared at regular intervals
    b. Comparison of control account in general ledger with balances in subsidiary ledger
6. Periodic verification
    a. Assessed values verified for accuracy
    b. Tax rolls reviewed prior to issuance of tax bills
    c. Tax levy reviewed (including classification)
    d. Special exemptions verified
    e. Tax rates used for tax rolls compared to authorized rates
    f. Tax calculations verified
    g. Assessment of penalties verified for delinquencies
7. Timely preparation of financial reports in conformity with GAAP

a. Property tax presentation and disclosure checked against the GFOA's checklist for the Certificate Program

II. Billing and collecting user charges
   A. Overall objectives
      1. The authorization to provide services or facilities should be reflected in the accounting records
      2. All receipts should be recorded accurately and deposited
      3. All receipts should be allocated to the correct account in the correct period, and properly applied
   B. Potential weaknesses
      1. Existence or occurrence
         a. Billings to wrong party
         b. Billings for incorrect amount
         c. Billings recorded incorrectly
         d. Services or facilities provided to bad credit risk
         e. Cash receipts recorded, but not deposited
         f. Cash receipts amounts recorded incorrectly
      2. Completeness
         a. Services or facilities provided, but not billed
         b. Cash receipts not recorded or deposited
         c. Cash receipts deposited, but not recorded
      3. Rights and obligations
         a. Billings for services or facilities not provided
      4. Allocation
         a. Cash receipts credited to wrong fund or account
         b. Cash receipts credited to wrong period
      5. Presentation and disclosure
         a. Receivable not presented net of allowance for doubtful accounts
   C. Compensating controls
      1. Prior authorization and approval
         a. Documents, lease agreements, etc., require approval
      2. Properly designed records
         a. Documents, lease agreements, etc., required before providing services or facilities
         b. Documents prenumbered and accounted for
         c. Pre-numbered receipt slips used and accounted for
      3. Security of assets and records
         a. Credit references checked before providing services or leasing facilities
         b. Security deposits required for new utility customers
         c. Cutoff procedures in place for delinquent utility customers
         d. Lockbox for payments
         e. Use of cash registers and similar machines containing controlled-access cash register tapes
      4. Segregation of incompatible duties
         a. Billings recorded by someone independent of preparation
         b. Segregate duties of 1) handling and listing cash receipts, 2) posting to the receivables subsidiary ledger and the general ledger, 3) maintaining the cash receipts book and 4) making deposits

c. Incoming cash items listed for subsequent reconciliations to deposits by someone independent of recording cash receipts
d. Bank reconciliations independently reviewed
e. Independent investigation and follow-up of overdue receivable balances
f. Use of an individual independent of the billings and receivables functions for investigating complaints

5. Periodic reconciliations
   a. Bank reconciliations prepared at regular intervals
   b. Periodic reconciliation of the control account in the general ledger with the related account balances in the subsidiary ledger
6. Periodic verification
   a. Billing rates and leasing terms verified for accuracy
   b. Billings based on appropriate use/service documentation
7. Analytical review
   a. The reasonableness of billings is assessed by investigating variances from estimated amounts
   b. The amount billed to customers is compared to the amount of services provided
8. Timely preparation of financial reports in conformity with GAAP
   a. Presentation and disclosure of billings and receipts within the CAFR checked against the GFOA's checklist for the Certificate Program

III. Billing and collecting intergovernmental revenues
   A. Overall objectives
      1. The authorization for grants/entitlements billings should result in the preparation of accounting record that recognize only allowable amounts
      2. All receipts should be recorded accurately and deposited
      3. All receipts should be allocated to the correct account, in the correct period and properly applied
   B. Potential weaknesses
      1. Existence or occurrence
         a. Unallowable amounts incurred
         b. Amounts billed at incorrect amounts
         c. Billings recorded incorrectly
         d. Billings prepared incorrectly
         e. Cash receipts recorded, but not deposited
         f. Cash receipts amount recorded incorrectly
      2. Completeness
         a. Amounts incurred, but not billed
         b. Cash receipts not recorded or deposited
         c. Cash receipts deposited, but not recorded
      3. Allocation
         a. Cash receipts credited to wrong fund or account
         b. Cash receipts credited to wrong period
      4. Presentation and disclosure
         a. Receivables reported in governmental funds for entitlements that are not yet available
         b. Revenue recognized for expenditure-driven grants before all grant requirements have been met

C. Compensating controls
   1. Prior authorization and approval
      a. Letters of credit or payment vouchers approved
   2. Security of assets and records
      a. Lockbox for proceeds
      b. Use of electronic funds transfer technology
   3. Segregation of incompatible duties
      a. Billings compared to award or entitlement by individual independent of billings
      b. Billings recorded by individual independent of preparation
      c. Segregation of duties for 1) handling and listing cash receipts, 2) posting to the receivables subsidiary ledger and the general ledger, 3) maintaining the cash receipts book and 4) making deposits
      d. Incoming cash items listed for subsequent reconciliations to deposits by someone independent of recording cash receipts
      e. Bank reconciliations independently reviewed
      f. The independent investigation and follow-up of overdue receivables balances
      g. Use of an individual independent of the billings and receivable functions for investigating disallowed amounts
   4. Periodic reconciliations
      a. Bank reconciliations prepared at regular intervals
   5. Periodic verifications
      a. Amounts billed only after comparison with grant/entitlement award
      b. Allowability of amounts billed verified prior to billing
      c. Letters of credit or payment vouchers reviewed for accuracy
      d. Open grants reviewed periodically to ensure timeliness of billings
   6. Timely preparation of financial reports in conformity with GAAP
      a. Presentation and disclosure of intergovernmental revenues checked against the GFOA's checklist for the Certificate Program

IV. Billing and collecting other revenues
   A. Overall objectives
      1. The authorization for other revenues should be reflected accurately in the accounting records
      2. All receipts should be recorded accurately and deposited
      3. All receipts should be allocated to the correct account, in the correct period and properly applied
   B. Potential weaknesses
      1. Existence or occurrence
         a. Billings incorrectly calculated
         b. Billings recorded incorrectly
         c. Cash receipts recorded, but not deposited
         d. Cash receipts amount recorded incorrectly
      2. Completeness
         a. Amount not assessed
         b. Amount assessed, but not billed
         c. Amount improperly released
         d. Cash receipts not recorded or deposited

    e. Cash receipts deposited, but not recorded
  3. Rights and obligations
    a. Billed to wrong party
  4. Allocation
    a. Billing misclassified
    b. Cash receipts credited to wrong fund or account
    c. Cash receipts credited to wrong period
  5. Presentation and disclosure
    a. Receivable for billings not reported net of allowance for doubtful accounts

C. Compensating controls
  1. Prior authorization and approval
    a. Releases require approval of responsible individual
    b. Fees and fines approved prior to billing and/or recording
  2. Properly designed records
    a. Prenumbered documents used and accounted for
    b. Prenumbered cash receipt slips used and accounted for
  3. Security of assets and records
    a. Lockbox used for mail receipts
    b. Use of cash registers and similar machines containing controlled-access cash register tapes
    c. Centralized collections
  4. Segregation of incompatible duties
    a. Segregation of duties for 1) handling and listing cash receipts, 2) posting to the fines and fees subsidiary ledger and the general ledger, 3) maintaining the cash receipts book and 4) making deposits
    b. Incoming cash items listed for subsequent reconciliations to deposits by someone independent of recording cash receipts
    c. Bank reconciliations independently reviewed
    d. The independent investigation and follow-up of overdue receivable balances
    e. Use of an individual independent of the billings and receivable functions for investigating complaints
  5. Periodic reconciliations
    a. Bank reconciliations prepared at regular intervals
  6. Periodic verifications
    a. Inspections to determine if licenses and permits have been obtained
    b. Fees and fines verified for accuracy
    c. Fees and fines reviewed prior to billing and/or recording
    d. Fees and fines billed based on dockets, prior year licenses or new permits
  7. Timely preparation of financial reports in conformity with GAAP
    a. Presentation and disclosure of billings and collections for other revenues checked against the GFOA's checklist for the Certificate Program

III. The Resource Management Cycle

Summary of Coordinate System of Control Cycles								
Budgeting	➜	Resource inflows	➜	**RESOURCE MANAGEMENT**	➜	Resource outflows	➜	Books, records and reports

I. Investment purchases and sales
   A. Overall objectives
      1. Purchases of investments should be properly authorized and accurately recorded
      2. Investments should be properly safeguarded
      3. Sales of investments should be properly authorized and accurately recorded
   B. Potential weaknesses
      1. Existence or occurence
         a. Investments recorded, but not acquired
         b. Failure to deliver security to custodian
         c. Investment disposals recorded, but investments not sold
         d. Sold investments recorded at wrong amount
      2. Completeness
         a. Investment acquired but not recorded
         b. Investments sold, but not recorded
      3. Rights and obligations
         a. Investments unauthorized
         b. Unauthorized sales
         c. Inadequate insurance or collateralization of deposits
         d. Government's claim to investments evidenced by securities not properly secured
      4. Allocation
         a. Investments or earnings misclassified between funds or accounts
      5. Presentation and disclosure
         a. Investment income not properly allocated among funds
         b. Investment policy not disclosed
         c. Violations of investment policy not disclosed
         d. Deposits not reported at both bank and book value
         e. Bank value of deposits not classified by degree of custodial credit risk
         f. Investments not reported at both book value and market value
         g. Investments evidenced by securities not reported by degree of custodial credit risk
         h. Disclosure not made of fact that significantly larger amounts of deposits or investments were in highest category of custodial credit risk at some time during the year than at year end
         i. Disclosure not made of type of investments held during the year, but not at year end
         j. Reverse repurchase agreements not reported as an asset and liability
         k. Securities lending agreements with cash collateral (or collateral securities that can be pledged or sold without a default) not reported as an asset and liability

- l. Disclosure of "matching" not provided for reverse repurchase agreements and for securities lending agreements reported as an asset and liability
- m. Direct and indirect risks related to derivatives not disclosed
- n. Reported value of investments not reduced for decreases in value that are "other than temporary"

C. Compensating controls

1. Prior authorization and approval
   - a. All investment transactions approved after verifying conformity with written investment policy
   - b. All investment transactions certified as conforming to written investment policy
2. Properly designed records
   - a. Appropriate evidence obtained for all purchases prior to recording
   - b. Remittance advice received from trustee prior to recording investments sold
3. Security of assets and records
   - a. Use of a delivery vs payment system
   - b. Investments accounted for and maintained by trustee
   - c. Deposits collateralized for amounts in excess of depository insurance
   - d. Government's claim to investment securities properly protected against custodial credit risk (e.g., registered, insured, held by the government's agent in the government's name)
   - e. Wire transfers only to predesignated accounts
4. Segregation of incompatible duties
   - a. Investment purchases posted to investment ledger by individual independent of other investment functions
   - b. Investment sales recorded by individual independent of other investment sales functions
5. Periodic reconciliations
   - a. Investment purchases agreed to investment ledger
   - b. Trustee statements reconciled to investment ledger
   - c. Remittance advices for investments sold agreed to amounts recorded
6. Periodic verifications
   - a. Investment certificates periodically inspected
   - b. Sold investments reviewed prior to recording
   - c. Investment transactions amount and account classification reviewed prior to recording
   - d. Proper bidding procedures followed when acquiring investments
7. Timely preparation of financial reports in conformity with GAAP
   - a. Accounting and disclosure for investment transactions and balances checked against the GFOA's checklist for the Certificate Program

II. Equipment and facilities and inventory records cycle

A. Overall objectives

1. The cost of equipment and inventory should be reflected in the accounting records

2. The cost of equipment and inventory should be allocated to the correct time period and to the appropriate cost center

B. Potential weaknesses

1. Existence or occurrence
   a. Requisition of equipment and/or supplies recorded, but equipment and/or supplies not issued
   b. Equipment disposals not properly recorded
   c. Equipment or supplies lost (e.g., casualty loss, theft)
2. Completeness
   a. Equipment or inventory obtained and/or used but not charged to fund or departments
3. Presentation and disclosure
   a. Material balances of inventory related to governmental funds and expendable trust funds using the "purchases method" not reported on the balance sheet
   b. Equipment reported in proprietary funds not depreciated

C. Compensating controls

1. Security of assets and records
   a. Appropriate control over the movement of equipment and supplies (e.g., by use of prenumbered receipts or other similar devices or by direct charge to the receiving department or program)
   b. Central stock room with limited access
   c. Appropriate insurance coverage
2. Periodic verifications
   a. Periodic examinations to compare actual equipment and supplies inventories to subsidiary records and general ledger figures, with investigation of any differences
3. Analytical review
   a. Periodic investigations of variances between budget and actual usage
4. Timely preparation of financial reports in conformity with GAAP
   a. Transactions and balances involving inventory checked against the GFOA's checklist for the Certificate Program

IV. The Resource Outflows Cycle

Summary of Coordinate System of Control Cycles

Budgeting → Resource inflows → Resource management → **RESOURCE OUTFLOWS** → Books, records and reports

I. Purchases, encumbrances, payables and payments

A. Overall objectives

1. The authorization to purchase supplies and services should be reflected in the accounting records, which should include the following:
   a. Compliance with requirement for formal or informal bids
   b. Purchase order approval based on available budget
   c. Recording and elimination of encumbrances
   d. Establishment of purchase prices, terms and commitments
   e. Requisitioning of supplies and services

  f. Recording of purchases in the correct time period and amount with sufficient documentation
  g. Proper expenditure of financial assistance
2. All expenditures made should be reflected in the accounting records, including the 1) payment amount and 2) allocation, in the correct time period, to the appropriate fund or account with sufficient information to identify the payee

B. Potential weaknesses
1. Existence or occurrence
  a. Purchase recorded, but goods or services not received
  b. Double payments
  c. Encumbrance and/or purchase recorded incorrectly
  d. Payment amount recorded incorrectly
2. Completeness
  a. Payment made, but not recorded
  b. Purchases made, but not recorded
3. Rights and obligations
  a. Unauthorized purchases
  b. Ineligible expenditure of grant funds
  c. Budget overexpended
4. Allocation
  a. Encumbrance and/or purchase misclassified
  b. Payment recorded in wrong fund or account
  c. Payment recorded in wrong period
5. Presentation and disclosure
  a. Encumbrances reported as expenditures in the GAAP financial statements
  b. Failure to reserve fund balance in governmental funds for nonlapsing encumbrances (reservation of fund balance for lapsing encumbrances is optional)

C. Compensating controls
1. Prior authorization and approval
  a. Requisitions approved by appropriate department head for all purchases
  b. Purchase order approved by the purchasing agent
2. Properly designed records
  a. Prenumbered requisition forms used and accounted for for all purchases
  b. Prenumbered purchase orders used and accounted for
  c. Encumbrances recorded
  d. Encumbrances canceled when expenditures recorded
  e. Use of prenumbered checks or warrants
  f. Vouchers canceled when paid (with all supporting documentation stamped or perforated to prevent reuse)
  g. Proper cutoff procedures ensure that purchases are reported in the appropriate period
3. Security of assets and records
  a. Access to blank requisition forms, purchase orders and receiving reports is strictly controlled
4. Segregation of incompatible duties
  a. Independent checks of expense analysis and account codings on invoices

   b. Independent follow-up of the serial continuity of checks or warrants
   c. Independent reconciliation and review of vendor/supplier statements
   d. Receipt of ordered goods must be confirmed by a receiving report issued by a separate department before payment is authorized
   e. The receipt of services must be confirmed in writing by an individual other than the one who requisitioned the services before payment is authorized
  5. Periodic reconciliations
   a. Bank reconciliations performed regularly
   b. Encumbrance record agreed to open purchase orders
   c. Invoice, receiving report, purchase order and requisition quantities compared
   d. Used and unused requisition forms and purchase orders are regularly reconciled to ensure that all such forms are properly accounted for
   e. Numerical sequence of unused checks or warrants accounted for
   f. No payment authorized until management has examined and matched the requisition form, the purchase order, the receiving report and the invoice
  6. Periodic verifications
   a. Competitive bids required
   b. Purchase orders compared to budget ordinance prior to recording encumbrance
   c. Grant/entitlement expenditures compared to grant/entitlement award conditions or restrictions
   d. Proper classification by fund and account is verified before purchases are recorded in the accounting records
  7. Timely presentation of financial reports in conformity with GAAP
   a. Encumbrance accounting compared against the GFOA's checklist for the Certificate Program

II. Wages and salaries
 A. Overall objectives
  1. All payroll liabilities should be reflected in the accounting records, including 1) the amount of the liability and 2) allocation to the appropriate fund, program or expenditure account and time period
  2. All recorded payroll liabilities should be supported by appropriate evidence showing that the liability is for authorized work actually performed by authorized employees, temporaries or consultants
 B. Potential weaknesses
  1. Existence or occurrence
   a. Errors in payroll calculation and summary
   b. Employee overpaid/payroll inflated
   c. Employee paid for work not done
  2. Completeness
   a. Employee underpaid/payroll understated

3. Allocation
    a. Wages/salaries charged to wrong fund or account
4. Presentation and disclosure
    a. Liability for compensated absences does not include direct incremental charges related to payroll
    b. Liability for compensated absences not calculated on the basis of pay rates in effect as of the end of the fiscal year
    c. Liability for compensated absences does not include sick leave that is payable to employees upon termination
    d. Liability for compensated absences includes sick leave not payable to employees upon termination
    e. Portion of liability for compensated absences not normally expected to be liquidated with available expendable financial resources of governmental funds and expendable trust funds not reported in general long-term debt account group

C. Compensating controls
1. Prior authorization and approval
    a. Time cards and overtime approved by department head prior to payroll preparation
    b. Requirement for written preapproval of overtime
2. Properly designed records
    a. Receipt obtained from employees when payroll paid in cash
    b. Changes in salaries and wages properly documented in personnel file
3. Segregation of incompatible duties
    a. Allocation of wages and salaries independently reviewed
4. Security of assets and records
    a. Use of an imprest payroll account
    b. Direct deposit of payroll checks
    c. Challenging employees for identification when payroll is distributed
5. Periodic reconciliations
    a. Current payroll reconciled to previous payroll
    b. Payrolls compared to time records (e.g., time cards or time sheets)
    c. Current payroll reconciled to standard payroll
    d. Periodic surprise payroll payouts
6. Periodic verifications
    a. Payroll calculations checked by second employee
    b. Eligibility for fringe benefits verified
    c. Calculation of fringe benefits verified
7. Analytical review
    a. Use of exception reports to highlight items in excess of stated amounts or limits
    b. Periodic investigation of variances between anticipated costs and actual costs
    c. Consideration of reasonableness of overtime
8. Timely preparation of financial reports in conformity with GAAP
    a. Wages and salaries display and disclosure checked against the GFOA's checklist for the Certificate Program

V. The Books, Records and Reports Cycle

Summary of Coordinate System of Control Cycles								
Budgeting	➜	Resource inflows	➜	Resource management	➜	Resource outflows	➜	**BOOKS, RECORDS AND REPORTS**

I. Overall objectives

A. All posting of transactions from the books of original entry to the general or subsidiary ledgers or between funds and accounts within these ledgers and all adjustments, deductions or write-offs should be in accordance with the governing board's and management's general and/or specific authorizations

B. All transactions recorded within the books of original entry should be analyzed and summarized (where appropriate), and accurately posted to the correct general or subsidiary ledger accounts, in the correct time period

C. All adjustments, deductions or write-offs of account balances should be calculated, summarized and recorded in the correct period

D. All postings to the general ledger or subsidiary ledgers or transfers between ledger accounts or adjustments to general ledger balances should be supported by and referenced to adequate, authorized documentation or by entries in the books of original entry

II. Potential weaknesses

A. Existence or occurrence

1. Inaccurate summarization or posting to the general or subsidiary ledgers, or incorrect transfer between accounts
2. Inaccurate calculation, summarization of account adjustment, deduction or write-off
3. Ledger postings or transfers or adjustment unsupported by journal voucher or books of original entry
4. Inadequate records for fixed assets

B. Rights and obligations

1. Unauthorized posting or transfer between accounts or adjustment to account balances

C. Allocation

1. Posting or transfer to the wrong fund, program unit or ledger account
2. Posting or transfer made in the wrong time period
3. Account adjustment, deduction or write-off posted to the wrong account or fund
4. Account adjustment, deduction or write-off recorded in the wrong period

III. Compensating controls

A. Prior authorization and approval

1. Assigned authorization levels for standard and nonstandard journal entries and adjustments of accounts
2. Policy statements and procedure manuals that specify how, when and by whom posting, adjustments to accounts and transfers are to be made

B. Properly designed records

1. A formal requirement for all nonstandard journal entries to be supported by adequate documentation

2. Use of the chart of accounts as applicable for each fund
3. Maintenance of control accounts within the general ledger
4. Maintenance of sufficiently detailed records for fixed assets

C. Security of assets and records
1. Restriction of access to books of original entry, journals, the general ledger and subsidiary ledgers

D. Segregation of incompatible duties
1. Regular independent review of journal entries and supporting documentation

E. Periodic reconciliations
1. Regular reconciliation of control accounts to the related subsidiary records

F. Analytical review
1. Regular extraction of fund trial balances and prompt investigation of any unusual items