122341

Accounting Series

Standards For Internal Controls In The Federal Government

GAO

United States General Accounting Office

1983

CONTENTS

Foreword

Introduction 1

Internal Control Standards 2

Explanation of General Standards 4

Explanation of Specific Standards 8

Explanation of the Audit Resolution Standard 12

FOREWORD

In 1950, the Accounting and Auditing Act was passed requiring, among other things, that agency heads establish and maintain effective systems of internal control. Since then, the General Accounting Office (GAO) has issued numerous publications to guide agencies in establishing and maintaining effective internal control systems. While the need for improved internal controls has continued, development of effective systems has been slow.

In the past decade, numerous situations came to light that dramatically demonstrated the need for controls as the Government experienced a rash of illegal, unauthorized, and questionable acts which were characterized as fraud, waste, and abuse. It is generally recognized that good internal controls would have made the commission of such wrongful acts more difficult. Consequently, increased attention is being directed toward strengthening internal controls to help restore confidence in Government and to improve its operations.

The Federal Managers' Financial Integrity Act of 1982 requires renewed focus on the need to strengthen internal controls. The act requires that agency internal control systems be periodically evaluated and that the heads of executive agencies report annually on their systems' status. These evaluations are to be made pursuant to the "Guidelines for the Evaluation and Improvement of and Reporting on Internal Control Systems in the Federal Government," issued by the Office of Management and Budget in December 1982, and the reports are to state whether systems meet the objectives of internal control and conform to standards established by GAO.

This document presents the internal control standards to be followed, and covers both the program management as well as the traditional financial management areas. From time to time, as may become necessary, GAO will issue interpretations and revisions to these standards.

We are grateful to the Government officials, professional organizations, public accounting officials, and other members of the academic and financial communities who provided us valuable assistance through their comments on our draft proposals.

Charles A. Bowsher

Comptroller General
of the United States

INTRODUCTION

This document contains the Comptroller General's internal control standards to be followed by executive agencies in establishing and maintaining systems of internal control as required by the Federal Managers' Financial Integrity Act of 1982 (31 U.S.C. 3512(b)). Internal control systems are to reasonably ensure that the following objectives are achieved:

- Obligations and costs comply with applicable law.
- All assets are safeguarded against waste, loss, unauthorized use, and misappropriation.
- Revenues and expenditures applicable to agency operations are recorded and accounted for properly so that accounts and reliable financial and statistical reports may be prepared and accountability of the assets may be maintained.

The act directs the heads of executive agencies to:

- Make an annual evaluation of their internal controls using guidelines established by the Office of Management and Budget (OMB).
- Provide annual reports to the President and Congress that state whether agency systems of internal control comply with the objectives of internal controls set forth in the act and with the standards prescribed by the Comptroller General. Where systems do not comply, agency reports must identify the weaknesses involved and describe the plans for corrective action.

The following concept of internal controls is useful in understanding and applying the internal control standards set forth and discussed on succeeding pages.

The plan of organization and methods and procedures adopted by management to ensure that resource use is consistent with laws, regulations, and policies; that resources are safeguarded against waste, loss, and misuse; and that reliable data are obtained, maintained, and fairly disclosed in reports.

The ultimate responsibility for good internal controls rests with management. Internal controls should not be looked upon as separate, specialized systems within an agency. Rather, they should be recognized as an integral part of each system that management uses to regulate and guide its operations. In this sense, internal controls are management controls. Good internal controls are essential to achieving the proper conduct of Government business with full accountability for the resources made available. They also facilitate the achievement of management objectives by serving as checks and balances against undesired actions. In preventing negative consequences from occurring, internal controls help achieve the positive aims of program managers.

INTERNAL CONTROL STANDARDS

The internal control standards define the minimum level of quality acceptable for internal control systems in operation and constitute the criteria against which systems are to be evaluated. These internal control standards apply to all operations and administrative functions but are not intended to limit or interfere with duly granted authority related to development of legislation, rulemaking, or other discretionary policymaking in an agency.

General Standards

1. Reasonable Assurance. Internal control systems are to provide reasonable assurance that the objectives of the systems will be accomplished.

2. Supportive Attitude. Managers and employees are to maintain and demonstrate a positive and supportive attitude toward internal controls at all times.

3. Competent Personnel. Managers and employees are to have personal and professional integrity and are to maintain a level of competence that allows them to accomplish their assigned duties, as well as understand the importance of developing and implementing good internal controls.

4. Control Objectives. Internal control objectives are to be identified or developed for each agency activity and are to be logical, applicable, and reasonably complete.

5. Control Techniques. Internal control techniques are to be effective and efficient in accomplishing their internal control objectives.

Specific Standards

1. Documentation. Internal control systems and all transactions and other significant events are to be clearly documented, and the documentation is to be readily available for examination.

2. Recording of Transactions and Events. Transactions and other significant events are to be promptly recorded and properly classified.

3. Execution of Transactions and Events. Transactions and other significant events are to be authorized and executed only by persons acting within the scope of their authority.

4. Separation of Duties. Key duties and responsibilities in authorizing, processing, recording, and reviewing transactions should be separated among individuals.

5. Supervision. Qualified and continuous supervision is to be provided to ensure that internal control objectives are achieved.

6. Access to and Accountability for Resources. Access to resources and records is to be limited to authorized individuals, and accountability for the custody and use of resources is to be assigned and maintained. Periodic comparison shall be made of the resources with the recorded accountability to determine whether the two agree. The frequency of the comparison shall be a function of the vulnerability of the asset.

Audit Resolution Standard

Prompt Resolution of Audit Findings. Managers are to (1) promptly evaluate findings and recommendations reported by auditors, (2) determine proper actions in response to audit findings and recommendations, and (3) complete, within established time frames, all actions that correct or otherwise resolve the matters brought to management's attention.

EXPLANATION OF GENERAL STANDARDS

General internal control standards apply to all aspects of internal controls.

Reasonable Assurance

Internal control systems are to provide reasonable assurance that the objectives of the systems will be accomplished.

The standard of reasonable assurance recognizes that the cost of internal control should not exceed the benefit derived. Reasonable assurance equates to a satisfactory level of confidence under given considerations of costs, benefits, and risks. The required determinations call for judgment to be exercised.

In exercising that judgment, agencies should:

- Identify (1) risks inherent in agency operations, (2) criteria for determining low, medium, and high risks, and (3) acceptable levels of risk under varying circumstances.
- Assess risks both quantitatively and qualitatively.

Cost refers to the financial measure of resources consumed in accomplishing a specified purpose. Cost can also represent a lost opportunity, such as a delay in operations, a decline in service levels or productivity, or low employee morale. A benefit is measured by the degree to which the risk of failing to achieve a stated objective is reduced. Examples include increasing the probability of detecting fraud, waste, abuse, or error; preventing an improper activity; or enhancing regulatory compliance.

Supportive Attitude

Managers and employees are to maintain and demonstrate a positive and supportive attitude toward internal controls at all times.

This standard requires agency managers and employees to be attentive to internal control matters and to take steps to promote the effectiveness of the controls. Attitude affects the quality of performance and, as a result, the quality of internal controls. A positive and supportive attitude is initiated and fostered by management and is ensured when internal controls are a consistently high management priority.

Attitude is not reflected in any one particular aspect of managers' actions but rather is fostered by managers' commitment to achieving strong controls through actions concerning agency organization, personnel practices, communication, protection and use of resources through systematic accountability, monitoring and systems of reporting, and general leadership. However, one important way for management to demonstrate its support for good internal controls is its emphasis on the value of internal auditing and its responsiveness to information developed through internal audits.

The organization of an agency provides its management with the overall framework for planning, directing, and controlling its operations. Good internal control requires clear lines of authority and responsibility; appropriate reporting relationships; and appropriate separation of authority.

In the final analysis, general leadership is critical to maintaining a positive and supportive attitude toward internal controls. Adequate supervision, training, and motivation of employees in the area of internal controls is important.

Competent Personnel

Managers and employees are to have personal and professional integrity and are to maintain a level of competence that allows them to accomplish their assigned duties, as well as understand the importance of developing and implementing good internal controls.

This standard requires managers and their staffs to maintain and demonstrate (1) personal and professional integrity, (2) a level of skill necessary to help ensure effective performance, and (3) an understanding of internal controls sufficient to effectively discharge their responsibilities.

Many elements influence the integrity of managers and their staffs. For example, personnel should periodically be reminded of their obligations under an operative code of conduct.

In addition, hiring and staffing decisions should include pertinent verification of education and experience and, once on the job, the individual should be given the necessary formal and on-the-job training. Managers who possess a good understanding of internal controls are vital to effective control systems.

Counseling and performance appraisals are also important. Overall performance appraisals should be based on an assessment of many critical factors, one of which should be the implementation and maintenance of effective internal controls.

Control Objectives

Internal control objectives are to be identified or developed for each agency activity and are to be logical, applicable, and reasonably complete.

This standard requires that objectives be tailored to an agency's operations. All operations of an agency can generally be grouped into one or more categories called cycles. Cycles comprise all specific activities (such as identifying, classifying, recording, and reporting information) required to process a particular transaction or event. Cycles should be compatible with an agency's organization and division of responsibilities.

Cycles can be categorized in various ways. For example:

- Agency management.
- Financial.
- Program (operational).
- Administrative.

Agency management cycles cover the overall policy and planning, organization, data processing, and audit functions. Financial cycles cover the traditional control areas concerned with the flow of funds (revenues and expenditures), related assets, and financial information. Program (operational) cycles are those agency activities that relate to the mission(s) of the agency and which are peculiar to a specific agency. Administrative cycles are those agency activities providing support to the agency's primary mission, such as library services, mail processing and delivery, and printing. The four types of cycles obviously interact, and controls over this interaction must be established. For example, a typical grant cycle would be concerned with eligibility and, if awarded, administration of the grant. At the time of award, the grant (program) and disbursement (financial) cycles would interface to control and record the payment authorization.

Complying with this standard calls for identifying the cycles of agency operations and analyzing each in detail to develop the cycle control objectives. These are the internal control goals or targets to be achieved in each cycle. The objectives should be tailored to fit the specific operations in each agency and be consistent with the overall objectives of internal controls as set forth in the Federal Managers' Financial Integrity Act.

In appendix B of its "Guidelines for the Evaluation and Improvement of and Reporting on Internal Control Systems in the Federal Government," OMB has provided a list of suggested agency cycles and cycle control objectives. Agencies should consider this and other sources when identifying their cycles and cycle control objectives.

Control Techniques

Internal control techniques are to be effective and efficient in accomplishing their internal control objectives.

Internal control techniques are the mechanisms by which control objectives are achieved. Techniques include, but are not limited to, such things as specific policies, procedures, plans of organization (including separation of duties), and physical arrangements (such as locks and fire alarms). This standard requires that internal control techniques continually provide a high degree of assurance that the internal control objectives are being achieved. To do so they must be effective and efficient.

To be effective, techniques should fulfill their intended purpose in actual application. They should provide the coverage they are supposed to and operate when intended. As for efficiency, techniques should be designed to derive maximum benefit with minimum effort. Techniques tested for effectiveness and efficiency should be those in actual operation and should be evaluated over a period of time.

EXPLANATION OF SPECIFIC STANDARDS

A number of techniques are essential to providing the greatest assurance that the internal control objectives will be achieved. These critical techniques are the specific standards discussed below.

Documentation

Internal control systems and all transactions and other significant events are to be clearly documented, and the documentation is to be readily available for examination.

This standard requires written evidence of (1) an agency's internal control objectives and techniques and accountability systems and (2) all pertinent aspects of transactions and other significant events of an agency. Also, the documentation must be available as well as easily accessible for examination.

Documentation of internal control systems should include identification of the cycles and related objectives and techniques, and should appear in management directives, administrative policy, and accounting manuals. Documentation of transactions or other significant events should be complete and accurate and should facilitate tracing the transaction or event and related information from before it occurs, while it is in process, to after it is completed.

Complying with this standard requires that the documentation of internal control systems and transactions and other significant events be purposeful and useful to managers in controlling their operations, and to auditors or others involved in analyzing operations.

Recording of Transactions and Events

Transactions and other significant events are to be promptly recorded and properly classified.

Transactions must be promptly recorded if pertinent information is to maintain its relevance and value to management in controlling operations and making decisions. This standard applies to (1) the entire process or life cycle of a transaction or event and includes the initiation and authorization, (2) all aspects of the transaction while in process, and (3) its final classification in summary records. Proper classification of transactions and events is the organization and format of information on summary records from which reports and statements are prepared.

Execution of Transactions and Events

Transactions and other significant events are to be authorized and executed only by persons acting within the scope of their authority.

This standard deals with management's decisions to exchange, transfer, use, or commit resources for specified purposes under specific conditions. It is the principal means of assuring that only valid transactions and other events are entered into. Authorization should be clearly communicated to managers and employees and should include the specific conditions and terms under which authorizations are to be made. Conforming to the terms of an authorization means that employees are carrying out their assigned duties in accordance with directives and within the limitations established by management.

Separation of Duties

Key duties and responsibilities in authorizing, processing, recording, and reviewing transactions should be separated among individuals.

To reduce the risk of error, waste, or wrongful acts or to reduce the risk of their going undetected, no one individual should control all key aspects of a transaction or event. Rather, duties and responsibilities should be assigned systematically to a number of individuals to ensure that effective checks and balances exist. Key duties include authorizing, approving, and recording transactions; issuing and receiving assets; making payments; and reviewing or auditing transactions. Collusion, however, can reduce or destroy the effectiveness of this internal control standard.

Supervision

Qualified and continuous supervision is to be provided to ensure that internal control objectives are achieved.

This standard requires supervisors to continuously review and approve the assigned work of their staffs. It also requires that they provide their staffs with the necessary guidance and training to help ensure that errors, waste, and wrongful acts are minimized and that specific management directives are achieved.

Assignment, review, and approval of a staff's work requires:

- Clearly communicating the duties, responsibilities, and accountabilities assigned each staff member.
- Systematically reviewing each member's work to the extent necessary.
- Approving work at critical points to ensure that work flows as intended.

Assignment, review, and approval of a staff's work should result in the proper processing of transactions and events including (1) following approved procedures and requirements, (2) detecting and eliminating errors, misunderstandings, and improper practices, and (3) discouraging wrongful acts from occurring or from recurring.

Access to and Accountability for Resources

Access to resources and records is to be limited to authorized individuals, and accountability for the custody and use of resources is to be assigned and maintained. Periodic comparison shall be made of the resources with the recorded accountability to determine whether the two agree. The frequency of the comparison shall be a function of the vulnerability of the asset.

The basic concept behind restricting access to resources is to help reduce the risk of unauthorized use or loss to the Government, and to help achieve the directives of management. However, restricting access to resources depends upon the vulnerability of the resource and the perceived risk of loss, both of which should be periodically assessed. For example, access to and accountability for highly vulnerable documents, such as check stocks, can be achieved by:

- Keeping them locked in a safe.
- Assigning or having each document assigned a sequential number.
- Assigning custodial accountability to responsible individuals.

Other factors affecting access include the cost, portability, exchangeability, and the perceived risk of loss or improper use of the resource. In addition, assigning and maintaining accountability for resources involves directing and communicating responsibility to specific individuals within an agency for the custody and use of resources in achieving the specifically identified management directives.

EXPLANATION OF THE AUDIT RESOLUTION STANDARD

Prompt Resolution of Audit Findings

Managers are to (1) promptly evaluate findings and recommendations reported by auditors, (2) determine proper actions in response to audit findings and recommendations, and (3) complete, within established time frames, all actions that correct or otherwise resolve the matters brought to management's attention.

The audit resolution standard requires managers to take prompt, responsive action on all findings and recommendations made by auditors. Responsive action is that which corrects identified deficiencies. Where audit findings identify opportunities for improvement rather than cite deficiencies, responsive action is that which produces improvements.

The audit resolution process begins when the results of an audit are reported to management, and is completed only after action has been taken that (1) corrects identified deficiencies, (2) produces improvements, or (3) demonstrates the audit findings and recommendations are either invalid or do not warrant management action.

Auditors are responsible for following up on audit findings and recommendations to ascertain that resolution has been achieved. Auditors' findings and recommendations should be monitored through the resolution and followup processes. Top management should be kept informed through periodic reports so it can assure the quality and timeliness of individual resolution decisions.