

Exposure Draft

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Standards for Internal Control in the Federal Government



G A O

Accountability * Integrity * Reliability

Foreword

Federal policymakers and program managers are continually seeking ways to better achieve agencies' missions and program results, in other words, they are seeking ways to improve accountability. A key factor in helping achieve such outcomes and minimize operational problems is to implement appropriate internal control. Effective internal control also helps in managing change to cope with shifting environments and evolving demands and priorities.

The Federal Managers' Financial Integrity Act of 1982 (FMFIA) requires the General Accounting Office (GAO) to issue standards for internal control in government. The standards provide the overall framework for internal control and Office of Management and Budget (OMB) Circular A-123, Management Accountability and Control, revised June 21, 1995, provides the specific requirements for assessing and reporting on controls. The term internal control in this document is synonymous with the term management control (as used in OMB Circular A-123) that covers all aspects of an agency's operations (programmatic, financial, and compliance).

Recently, other laws have prompted renewed focus on internal control. The Government Performance and Results Act of 1993 (commonly known as the Results Act) requires agencies to clarify their missions, set strategic and annual performance goals, and measure and report on performance toward those goals. Internal control plays a significant role in helping managers achieve those goals. Also, the Federal Financial Management Improvement Act of 1996 identifies internal control as an integral part of improving financial management systems.

In 1983, GAO drew on its previously issued guidance and experts throughout government, private sector,

and academic communities to develop and issue “Standards for Internal Controls in the Federal Government” to help agencies establish and maintain effective internal control systems. Although those standards remain conceptually sound, this update gives greater recognition to the increasing use of information technology to carry out critical government operations and incorporates, as appropriate, relevant updated internal control guidance developed by the private sector.

Introduction

The following definition, objectives, and fundamental concepts provide the foundation for the internal control standards.

Definition and Objectives

Internal Control

An integral component of an organization’s management that provides reasonable assurance that the following objectives are being achieved:

- effectiveness and efficiency of operations,
- reliability of financial reporting, and
- compliance with applicable laws and regulations.

Internal control is a major part of managing an organization. It comprises the plans, methods, and procedures used to meet missions, goals, and objectives and, in doing so, supports performance-based management. Internal control also serves as the first line of defense in safeguarding assets. In short, internal control, which is synonymous with management control, helps government program managers achieve desired results through effective stewardship of public resources.

Internal control should provide reasonable assurance that the objectives of the agency are being achieved in the following categories:

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- Effectiveness and efficiency of operations including the use of the entity's resources.
 - Reliability of financial reporting, including reports on budget execution, financial statements, and other reports for internal and external use.
 - Compliance with applicable laws and regulations.

A subset of these objectives is the safeguarding of assets. Internal control should be designed to provide reasonable assurance regarding prevention of or prompt detection of unauthorized acquisition, use, or disposition of an agency's assets.

Fundamental Concepts

Internal Control

- A continuous built-in component of operations.
- Effected by people.
- Provides reasonable assurance, not absolute assurance.

The fundamental concepts provide the underlying framework for designing and applying the standards.

Internal Control Is a Continuous Built-in Component of Operations

Internal control is not one event, but a series of actions and activities that occur throughout an entity's operations and on an ongoing basis. Internal control should be recognized as an integral part of each system that management uses to regulate and guide its operations rather than as a separate system within an agency. In this sense, internal control is management control that is built into the entity as a

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part of its infrastructure to help managers run the entity and achieve their aims on an ongoing basis.

Internal Control Is Effected by People

People are what make internal control work. The responsibility for good internal control rests with all managers. Management sets the objectives, puts the control mechanisms and activities in place, and monitors and evaluates the control. However, all employees in the organization play important roles in making it happen.

Internal Control Provides Reasonable Assurance, Not Absolute Assurance

Management should design and implement internal control based on the related cost and benefits. No matter how well designed and operated, internal control cannot provide absolute assurance that all agency objectives will be met. Factors outside the control or influence of management can affect the entity's ability to achieve all of its goals. For example, human mistakes, judgment errors, and acts of collusion to circumvent control can affect meeting agency objectives. Therefore, once in place, internal control provides reasonable, not absolute, assurance of meeting agency objectives.

Internal Control Standards

Presentation of the Standards

The Five Standards for Internal Control

- Control Environment
- Risk Assessment
- Control Activities
- Information and Communications
- Monitoring

These standards define the minimum level of quality acceptable for internal control in government and provide the basis against which internal control is to be evaluated. These standards apply to all aspects of an agency's operations: programmatic, financial, and compliance. However, they are not intended to limit or interfere with duly granted authority related to developing legislation, rule-making, or other discretionary policy-making in an agency. These standards provide a general framework. In implementing these standards, management is responsible for developing the detailed policies, procedures, and practices to fit their agency's operations and to ensure that they are built into and an integral part of operations.

In the following material, each of these standards is presented in a short, concise statement. Additional information is provided to help managers incorporate the standards into their daily operations.

Control Environment

Management and employees should establish and maintain an environment throughout the organization that sets a positive and supportive attitude toward internal control and conscientious management.

A positive control environment is the foundation for all other standards. It provides discipline and structure as well as the climate which influences the quality of internal control. Several key factors affect the control environment.

One factor is the integrity and ethical values maintained and demonstrated by management and staff. Agency management plays a key role in providing leadership in this area, especially in setting and maintaining the organization's ethical tone, providing guidance for proper behavior, removing temptations for unethical behavior, and providing discipline when appropriate.

Another factor is management's commitment to competence. Managers and employees need to possess and 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 control. Management needs to identify appropriate knowledge and skills needed for various jobs and provide needed training, as well as candid and constructive counseling, and performance appraisals.

Management's philosophy and operating style also affect the environment. This factor determines the degree of risk the agency is willing to take and management's philosophy towards performance-based management. Further, the attitude and philosophy of management toward data processing, accounting, personnel functions, monitoring, and audits and evaluations can have a profound effect on internal control.

Another factor affecting the environment is the agency's organizational structure. It provides management's framework for planning, directing, and controlling operations to achieve agency objectives. A good internal control environment requires that the agency's organizational structure clearly define key areas of authority and responsibility and establish appropriate lines of reporting.

The environment is also affected by the manner in which the agency delegates authority and responsibility throughout the organization. This delegation covers authority and responsibility for operating activities, reporting relationships, and authorization protocols.

Good human capital policies and practices are another critical environmental factor. This includes establishing appropriate practices for hiring, orienting, training, supervising, evaluating, counseling, promoting, compensating, and disciplining personnel. It also includes providing a proper amount of supervision.

A final factor affecting the environment is the agency's relationship with the Congress and central oversight agencies such as OMB. Congress mandates the programs that agencies undertake and monitors their progress and central agencies provide policy and

guidance on many different matters. In addition, Inspectors General and internal senior management councils can contribute to a good overall control environment.

Risk Assessment

Internal control should provide for an assessment of the risks the agency faces from both external and internal sources.

A precondition to risk assessment is the establishment of clear, consistent agency objectives. Risk assessment is the identification and analysis of relevant risks associated with achieving such objectives and forming a basis for determining how risks should be managed.

Management needs to comprehensively identify risks and should consider all significant interactions between the entity and other parties as well as internal factors at both the entity-wide and activity level. Risk identification methods may include qualitative and quantitative ranking activities, management conferences, forecasting and strategic planning, and consideration of findings from audits and other assessments.

Once risks have been identified, they should be analyzed for their possible effect. Risk analysis generally includes estimating the risk's significance, assessing the likelihood of its occurrence, and deciding how to manage the risk and what actions should be taken.

Because governmental, economic, industry, regulatory, and operating conditions continually change, mechanisms should be provided to identify and deal with any special risks prompted by such changes.

Control Activities

Internal control activities help ensure that management's directives are carried out. The control activities should be effective and efficient in accomplishing the agency's control objectives.

Control activities are the policies, procedures, techniques, and mechanisms that enforce management's directives, such as the process of adhering to requirements for budget development and execution. They help ensure that actions are taken to address risks. Control activities are an integral part of an entity's planning, implementing, reviewing, and accountability for stewardship of government resources and achieving effective results.

Control activities occur at all levels and functions of the entity. They include a wide range of diverse activities such as approvals, authorizations, verifications, reconciliations, performance reviews, maintenance of security, and the creation and maintenance of related records which provide evidence of execution of these activities as well as appropriate documentation.

Activities may be classified by specific control objectives, such as ensuring completeness and accuracy of information processing.

Examples of Control Activities

- Top level reviews of actual performance,
- Reviews by management at the functional or activity level,
- Management of human capital,
- Controls over information processing,
- Physical control over vulnerable assets,
- Establishment and review of performance measures and indicators,
- Segregation of duties,
- Proper execution of transactions and events,
- Accurate and timely recording of transactions and events,
- Access restrictions to and accountability for resources and records, and
- Appropriate documentation of transactions and the internal control structure.

There are certain categories of control activities that are common to all agencies. Examples include the following:

Top Level Reviews of Actual Performance

Management should track major agency achievements and compare these to the plans, goals, and objectives established under GPRA.

Internal Control Standards

Reviews by Management at the Functional or Activity Level	Managers also need to compare actual performance to planned or expected results throughout the organization.
Management of Human Capital	Effective management of an organization's employees—its human capital—is essential to achieving results and an important part of internal control. Management should view human capital as an asset rather than a cost. Only when the right employees for the job are on board and are provided the right training, tools, structure, incentives, and responsibilities is operational success possible. Management should ensure that skill needs are continually assessed and that the organization is able to obtain employees that have the required skills that match those necessary to achieve organizational goals. Training should be aimed at developing and retaining employee skill levels to meet changing organizational needs. Performance evaluation and feedback, supplemented by an effective reward system, should be designed to help employees understand the connection between their performance and the organization's success. As a part of its human capital planning, management should also consider how best to retain valuable employees, plan for their eventual succession, and ensure continuity of needed skills and abilities.
Controls Over Information Processing	A variety of controls are used. Examples include edit checks of data entered, accounting for transactions in numerical sequences, comparing file totals with control accounts, and controlling access to data, files, and programs.
Physical Control Over Vulnerable Assets	Examples include security for and limited access to assets such as cash, securities, inventories, and some equipment which might be vulnerable to risk of loss or unauthorized use. Such assets should be

	periodically counted and compared to control records.
Establishment and Review of Performance Measures and Indicators	Activities need to be established to monitor performance measures and indicators. These controls could call for comparisons and assessments relating different sets of data to one another so that analyses of the relationships can be made and appropriate actions taken. Controls should also be aimed at validating the propriety and integrity of both organizational and individual performance measures and indicators.
Segregation of Duties	Key duties and responsibilities need to be divided or segregated among different people to reduce the risk of error or fraud. This should include separating the responsibilities for authorizing transactions, processing and recording them, reviewing the transactions, and handling any related assets. No one individual should control all key aspects of a transaction or event.
Proper Execution of Transactions and Events	Transactions and other significant events should be authorized and executed only by persons acting within the scope of their authority. This is the principal means of assuring that only valid transactions to exchange, transfer, use, or commit resources and other events are initiated or entered into. Authorizations should be clearly communicated to managers and employees.
Accurate and Timely Recording of Transactions and Events	Transactions should be promptly recorded to maintain their relevance and value to management in controlling operations and making decisions. This applies to the entire process or life cycle of a transaction or event from the initiation and authorization through its final classification in summary records. In addition, control activities help

	to ensure that all transactions are completely and accurately recorded.
Access Restrictions to and Accountability for Resources and Records	Access to resources and records should be limited to authorized individuals, and accountability for their custody and use should be assigned and maintained. Periodic comparison of resources with the recorded accountability should be made to help reduce the risk of errors, fraud, misuse, or unauthorized alteration.
Appropriate Documentation of Transactions and the Internal Control Structure	Internal control and all transactions and other significant events need to be clearly documented, and the documentation should be readily available for examination. The documentation should appear in management directives, administrative policies, or operating manuals and may be in paper or electronic form. These examples are meant only to illustrate the range and variety of control activities that may be useful to agency managers. They are not all-inclusive and may not include particular control activities that an agency may need. Furthermore, an agency's entire control structure should be flexible to allow agencies to tailor control activities to fit their special needs. The specific control activities used by a given agency may be different from those used by others due to a number of factors. These could include specific threats they face and risks they incur; differences in objectives; managerial judgment; size and complexity of the organization; operational environment; sensitivity and value of data; and requirements for system reliability, availability, and performance.

Special Control
Activities for
Information Systems

- General Control
- Application Control

There are two broad groupings of information systems control - general control and application control. General control applies to all information systems—mainframe, minicomputer, network, and end-user environments. Application control is designed to cover the processing of transactions within the application software.

General Control

This category includes control over data center operations, system software acquisition and maintenance, access security, and application system development and maintenance. More specifically:

- Data center operations control includes job set-up and scheduling, operations activities, backup and recovery procedures, and contingency and disaster planning.
- System software control includes control over the acquisition, implementation, and maintenance of all system software including the operating system, data-based management systems, telecommunications, security software, and utility programs.
- Access security control protects the systems and network from inappropriate access and unauthorized use by hackers and other trespassers or inappropriate use by agency personnel. Specific control activities include frequent changes of dial-up numbers; use of dial-back access; restrictions on users to allow access only to system functions that they need; software and

hardware “firewalls” to restrict access to assets, computers, and networks by external persons; and frequent changes of passwords and deactivation of former employees passwords.

- Application system development and maintenance control provides the structure for safely developing new systems and modifying existing systems. Included are documentation requirements; authorizations for undertaking projects; and reviews, testing, and approvals of development and modification activities before placing systems into operation. An alternative to in-house development is the procurement of commercial software, but control is necessary to ensure that selected software meets the user's needs, and that it is properly placed into operation.

Application Control

This category of control is designed to help ensure completeness, accuracy, authorization, and validity of all transactions during application processing. Control should be installed at an application's interfaces with other systems to ensure that all inputs are received and are valid and outputs are correct and properly distributed. An example is computerized edit checks built into the system to review the format, existence, and reasonableness of data.

General and application control over computer systems are interrelated. Both are needed to ensure complete and accurate information processing. If the general control is inadequate, the application control is unlikely to function properly and could be overridden. The application control assumes effective general control provides immediate feedback on errors, mismatches, incorrect format of data, and inappropriate data access.

Because information technology changes rapidly, controls must evolve to remain effective. Changes in

technology will change the specific control activities that may be employed and how they are implemented, but the basic requirements of control will not have changed. As more powerful computers place more responsibility for data processing in the hands of the end users, the needed controls should be identified and selected.

Information and Communications

Information should be recorded and communicated to management and others within the entity who need it and in a form and within a time frame that enables them to carry out their internal control and other responsibilities.

For an entity to run and control its operations, it must have relevant, reliable, and timely communications relating to internal as well as external events.

Information is needed throughout the agency to achieve all of its objectives. Pertinent information should be identified, captured, and distributed in a form and time frame that permits people to perform their duties efficiently.

Effective communications should occur in a broad sense with data flowing down, across, and up the organization. In addition to internal communications, management should ensure there are adequate means of communicating with, and obtaining information from, external stakeholders that may have a significant impact on the agency achieving its goals.

Monitoring

Internal control monitoring should assess the quality of performance over time and ensure that the findings of audits and other reviews are promptly resolved.

Internal control should generally be designed to assure that ongoing monitoring occurs in the course of normal operations. It is performed continually and is ingrained in the agency's operations. It includes regular management and supervisory activities, comparisons, reconciliations, and other actions people take in performing their duties.

Separate evaluations of control can also be useful by focusing directly on the controls' effectiveness at a specific time. The scope and frequency of separate evaluations should depend primarily on the assessment of risks and the effectiveness of ongoing monitoring procedures. Separate evaluations may take the form of self-assessments as well as review of control design and direct testing of internal control. Separate evaluations also may be performed by the agency Inspector General or an external auditor. Deficiencies found during ongoing monitoring or through separate evaluations should be communicated to the individual responsible for the function and also to at least one level of management above that individual. Serious matters should be reported to top management.

Monitoring of internal control should include policies and procedures for ensuring that audit findings are promptly resolved. Managers are to (1) promptly evaluate audit findings, including those showing

deficiencies 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 resolution process begins when audit results 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 do not warrant management action.

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