INTERNAL CONTROL

Essential for Safeguarding Assets, Compliance With Laws and Regulations, and Reliable Financial Reporting

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Summary

Internal Control: Essential for Safeguarding Assets, Compliance With Laws and Regulations, and Reliable Financial Reporting

The importance of internal controls cannot be understated, especially in a large, complex organization like the federal government. Internal control is the first line of defense against fraud, waste, and abuse and helps agencies achieve their missions effectively and efficiently. My testimony discusses three questions: (1) What is internal control? (2) Why is it important? and (3) What happens when it breaks down?

What Is Internal Control? Internal control is concerned with stewardship and accountability of resources consumed while striving to accomplish an agency’s mission with effective results. Specifically, GAO’s Standards for Internal Controls in the Federal Government defines internal control as “the plan of organization and methods and procedures adopted by management to ensure resource use is consistent with laws, regulations, and policies; that resources are safeguarded against waste, loss, and misuse; and that reliable information is obtained, maintained, and fairly disclosed in reports.” Internal control is synonymous with management control in that the broad objectives of internal control cover all aspects of agency operations. Although ultimate responsibility for internal controls rests with management, all employees have a role in the effective operation of internal controls established by management. Effective internal control provides reasonable, not absolute, assurance that an agency’s activities are being accomplished in accordance with its control objectives.

Why Is Internal Control Important? Internal control helps management achieve the mission of the agency and prevent or detect improper activities. The cost of fraud cannot always be measured in dollars. Improper activities erode public confidence in the government. In 1982, the Congress passed the Federal Managers’ Financial Integrity Act requiring (1) agencies to annually evaluate their internal controls, (2) GAO to issue internal controls standards, and (3) OMB to issue guidelines for agencies to follow in assessing their internal controls. Agencies were required to report annually to the President and the Congress whether their internal controls complied with GAO’s standards. The Integrity Act was beneficial in focusing management and employee attention on the importance of internal control. Although progress was made, internal control problems continued. More recently, the Congress has enacted a number of statutes to provide a framework for performance-based management and accountability. These statutes include the Chief Financial Officers Act of 1990, as expanded by the Government Management Reform Act of 1994 (to ensure more reliable financial reporting); the Government Performance and Results Act of 1993.
(requiring agency strategic and annual performance planning); and the Federal Financial Management Improvement Act of 1996 (to improve federal financial management systems).

What Happens When Internal Controls Are Not Effective? Weak internal controls pose a significant risk to the government—losses in the millions, or even billions, of dollars can and do occur. For example, weak internal controls contributed significantly to the failure of over 700 savings and loans in the 1980s, costing the taxpayers hundreds of billions of dollars. In the health care area, the Health and Human Services Inspector General estimated that $23 billion of $163 billion in processed fee-for-service payments during fiscal year 1996 were improper. GAO and others have reported that weak internal controls over safeguarding and accounting for government property are a serious continuing problem. GAO’s 1997 high-risk series identifies major areas of government operations where the risks of losses to the government is high and where achieving program goals is jeopardized.

Effective internal controls are essential to achieving agency missions. Management and employees should focus not necessarily on more controls, but on more effective controls.
Mr. Chairman and Members of the Subcommittee:

We are pleased to be here today to discuss the subject of internal control. Its importance cannot be understated, especially in the large, complex operating environment of the federal government. Internal control is the first line of defense against fraud, waste, and abuse and helps to ensure that an entity’s mission is achieved in the most effective and efficient manner. Although the subject of internal control usually surfaces for discussion after improprieties or inefficiencies are found, good managers are always aware of and seek ways to help improve operations through effective internal control. As you requested, my testimony today will discuss the following questions: (1) What is internal control? (2) Why is it important? and (3) What happens when it breaks down?

What Is Internal Control?

Internal control can be simply defined as the methods by which an organization governs its activities to effectively and efficiently accomplish its mission. More specifically, internal control is concerned with stewardship and accountability of resources consumed in the process of striving to accomplish an entity’s mission with effective results. In that respect, we have defined internal control in our Standards for Internal Controls in the Federal Government as follows:

“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.”

Internal control should not be looked upon as separate, specialized systems within an agency. Rather, internal control should be recognized as an integral part of each system that management uses to regulate and guide its operations. Internal control is synonymous with management control in that the broad objectives of internal control cover all aspects of agency operations. Although ultimate responsibility for good internal control rests with management, all employees have a role in the effective operation of internal control that has been set by management.

Understanding of internal control can be enhanced by focusing on two basic aspects of internal control: objectives and techniques. Objectives are the goals or purposes to be achieved, while techniques are the mechanisms (the procedures, processes, physical arrangements, organizational structures, and assignments of responsibility and authority,
to name a few) that achieve the goal. All internal controls have objectives and techniques. In practice, internal control starts with defining entitywide objectives and then more specific objectives throughout the various levels in the entity. Techniques are then implemented to achieve the objectives.

In its simplest form, internal control is practiced by citizens in the daily routine of everyday life. For example, when you leave your home and lock the door or when you lock your car at the mall or on a street, you are practicing a form of internal control. The objective is to protect your assets against undesired access, and your technique is to physically secure your assets by locks. In another routine, when you write a check, you record the check in the ledger or on your personal computer. The objective is to control the money in your checking account by knowing the balance. The technique is to document the check amount and the balance. Periodically, you compare the checking account transactions and balances you have recorded with the bank statement. Your objective is to ensure the accuracy of your records to avoid costly mistakes. Your technique is to perform the reconciliation.

These same types of concepts form the basis for internal control in business operations and the operation of government. The nature of their operations is, of course, significantly larger and more complex, as is the inherent risk of ensuring that assets are safeguarded, laws and regulations are complied with, and data used for decision-making and reporting are reliable. Focusing a discussion on objectives and techniques, the acquisition, receipt, use, and disposal of property, such as computer equipment, can illustrate the practice of internal control in the operation of government activities.

Internal control at the activity level such as procuring equipment should be preceded, at a higher organizational level, by policy and planning control objectives and control techniques that govern overall agency operations in achieving mission objectives. Examples of high-level control objectives that logically follow a pattern include the following:

- The mission of the agency should be set in accordance with laws, regulations, and administration and management policy.
- Agency components should be defined in accordance with the overall mission of the agency.
- Missions of the agency and components should be documented and communicated to agency personnel.
• Plans and budgets should be developed in accordance with the missions of the agency and its components.
• Policies and procedures should be defined and communicated to achieve the objectives defined in plans and budgets.
• Authorizations should be in accordance with policies and procedures.
• Systems of monitoring and reporting the results of agency activities should be defined.
• Transactions should be classified or coded to permit the preparation of reports to meet management’s needs and other reporting requirements.
• Access to assets should be permitted only in accordance with laws, regulations, and management’s policy.

Examples of control techniques to help achieve the objectives include the following:

• agency and component mission statements approved by management and its legal counsel;
• training of personnel in mission and objectives;
• long and short-range plans developed related to budgets;
• monitoring of results against plans and budgets;
• policies and procedures defined and communicated to all levels of the organization and periodically reviewed and revised based on internal reviews;
• authorizations defined, controls set to ensure authorizations are made, and authorizations periodically reviewed;
• classifications of accounts set to permit the capture and reporting of data to prepare required reports; and
• physical restrictions on access to assets and records, and training in security provided to employees.

The policy and planning control objectives and techniques provide a framework to conduct agency operations and to account for resources and results. Without that framework, administration and legislative goals may not be achieved; laws and regulations may be violated; operations may not be effective and efficient and may be misdirected; unauthorized activities may occur; inaccurate reports to management and others may occur; fraud, waste, and abuse is more likely to occur and be concealed; assets may be stolen or lost; and ultimately the agency is in danger of not achieving its mission.

Within this higher level framework for guiding and operating the agency, specific activities take place to achieve the agency’s mission and the
intended results. The procurement and management of computer equipment is an example of such a specific activity. Objectives and techniques should be established for each activity’s specific control. As examples of control objectives, vendors should be approved in accordance with laws, regulations, and management’s policy, as should the types, quantities, and approved purchase prices of computer equipment. As examples of related control techniques, criteria for approving vendors should be established and approved vendor master files should be controlled, and the purchase governed by criteria, such as obtaining competitive bids and setting specifications of the equipment to be procured. Likewise, control objectives should be set for the receiving process. For example, only equipment that meets contract or purchase order terms should be accepted, and equipment accepted should be accurately and promptly reported. Related control techniques include (1) detailed comparison of equipment received to a copy of the purchase order, (2) prenumbered controlled receiving documents that are accounted for, and (3) maintenance of receiving logs. Throughout the purchasing and receiving of equipment there needs to be appropriate separation of duties and interface with the accounting function to achieve funds control, timely payments, and inventoring and control of equipment received.

Equipment received should be safeguarded to prevent unauthorized access and use. For example, in addition to physical security, equipment should be tagged with identification numbers and placed into inventory records. Equipment placed into service should only be issued to authorized users and records of the issuances should be maintained to achieve accountability. Further, physical inventories should be taken periodically and compared with inventory records. Differences in counts and records should be resolved in a timely manner and appropriate corrective actions taken. Also, equipment retired from use should be in accordance with management’s policies, including establishing appropriate safeguards to prevent unauthorized information that may be stored in the equipment from being disclosed.

It is important to recognize that internal controls can be designed to provide reasonable, not absolute, assurance that an organization’s activities are being accomplished in accordance with its objectives. The American Institute of Certified Public Accountants—in Statement of Auditing Standards Number 55—identified internal control limitations, such as the possibility of errors arising from such causes as misunderstanding of instructions, mistakes of judgment, and personal
carelessness. Also, procedures whose effectiveness depends on segregation of duties can be circumvented by collusion. Similarly, management authorizations may be ineffective against errors or fraud perpetrated by management. In addition, 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.

Why Is Internal Control Important?

The cost of fraud, waste, and abuse cannot always be measured in dollars and cents. Such improper activities erode public confidence in the government’s ability to efficiently and effectively manage its programs. Management at a number of federal government agencies are faced with tight budgets and fewer personnel. In such an environment, related operating factors, such as executive and middle management turnover and the diversity and complexity of government operations, can provide a fertile environment for internal control weakness and the resulting undesired consequences.

It has been almost 50 years since the Congress formally recognized the importance of internal control. The Accounting and Auditing Act of 1950 required, among other things, that agency heads establish and maintain effective internal controls over all funds, property, and other assets for which an agency is responsible. However, the ensuing years up through the 1970s saw the government experience a crisis of poor controls.

To help restore confidence in government and to improve operations, the Congress passed the Federal Managers’ Financial Integrity Act of 1982. The Integrity Act required, among other items, that

- we establish internal control standards that agencies are required to adhere to,
- the Office of Management and Budget (OMB) issue guidelines for agencies to follow in annually assessing their internal controls,
- agencies annually evaluate their internal controls and prepare a statement to the President and the Congress on whether their internal controls comply with the standards issued by GAO, and
- agency reports include material internal control weaknesses identified and plans for correcting the weaknesses.

1The Integrity Act also requires each agency’s annual statement to include a separate report on whether the agency’s accounting system conforms to principles, standards, and related requirements prescribed by GAO. OMB Circular A-127, Financial Management Systems, revised July 23, 1993, prescribes policies and standards for agencies to follow in reporting on financial management systems.
OMB has issued agency guidance that sets forth the requirements for establishing, periodically assessing, correcting, and reporting on controls required by the Integrity Act. Regarding the identification and reporting of deficiencies, OMB’s guidance states that “a deficiency should be reported if it is or should be of interest to the next level of management. Agency employees and managers generally report deficiencies to the next supervisory level, which allows the chain of command structure to determine the relative importance of each deficiency.” The guidance further states that “a deficiency that the agency head determines to be significant enough to be reported outside the agency (i.e., included in the annual Integrity Act report to the President and the Congress) shall be considered a ‘material weakness.’” The guidance encourages reporting of deficiencies by recognizing that such reporting reflects positively on the agency’s commitment to recognizing and addressing management problems and, conversely, failing to report a known deficiency reflects adversely on the agency.

In 1983, we issued internal control standards as required by the Integrity Act. In developing the standards, we drew on our previously issued guidance and experts throughout the government, private sector, and academic communities. The internal control standards consist of five general standards, six specific standards, and one audit resolution standard. The five general standards require (1) a supportive attitude toward controls by managers and employees, (2) competent personnel, (3) internal controls that provide reasonable assurance that objectives are achieved, (4) the development of internal control objectives for each agency activity, and (5) control techniques that are effective and efficient in accomplishing internal control objectives. The six specific control standards identify basic techniques to help achieve control objectives. The standards address:

- documentation of control objectives and techniques and all pertinent aspects of transactions;
- required prompt and proper recording of all transactions;
- executing transactions and events according to management’s directives;


Although the standards issued in 1983 remain conceptually sound, we are revising them to recognize current terminology developed by the private sector with assistance from GAO and others and to give greater recognition to the ever increasing use of information technology. (Internal Control: Standards for Internal Control in the Federal Government - Exposure Draft (GAO/AIMD-98-21.3.1, December 1997)).
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- separation of duties between authorizing, processing, recording, and reviewing transactions;
- qualified and continuous supervision to ensure that control objectives are achieved; and
- limiting access to resources and records to authorized persons to provide accountability for the custody and use of resources.

Finally, the audit resolution standard requires managers to promptly evaluate findings, determine proper resolution, and establish corrective action or otherwise resolve audit findings. Attachment I provides a complete definition of the standards and Standards for Internal Controls in the Federal Government provides additional explanation of the standards.

The Integrity Act was beneficial in focusing management and employee attention on the importance of internal control to achieving an agency’s mission. However, agency reports required under the Integrity Act disclosed so many internal control weaknesses that additional measures were needed to provide for effective program management and accountability. Since the Integrity Act, the Congress has enacted a number of statutes to provide a framework for performance-based management and accountability. These statutes include the following:

- The Chief Financial Officers Act of 1990, as expanded by the Government Management Reform Act of 1994, laid the foundation for government to better ensure reliable financial information through audited financial statements.
- In response to the savings and loan crisis and the growing list of bank failures in the early 1990s, the Federal Deposit Insurance Corporation Improvement Act of 1991 required depository institutions whose assets exceeded certain amounts to prepare an annual statement of management’s responsibility for establishing and maintaining adequate internal controls, including an assessment of the effectiveness of the controls. Also, the institution’s independent auditors are required to attest to the fair presentation of management’s assertion on internal control effectiveness.
- The Government Performance and Results Act of 1993 requires, among other items, that agencies identify their missions, strategic goals, and approaches (strategies) for achieving the goals. The act also requires agencies to report on their performance, using performance measures, in meeting the goals.
- The Federal Financial Management Improvement Act of 1996 requires that auditors auditing financial statements pursuant to the expanded Chief
Financial Officers Act report whether each agency is maintaining financial management systems that comply substantially with federal financial management systems requirements, federal accounting standards, and the government’s standard general ledger at the transaction level.

Our report, The Statutory Framework for Performance-Based Management and Accountability (GAO/AIMD-98-52, January 28, 1998) provides more detailed information on the purpose, requirements, and implementation status of these acts. In addition, that report refers to a number of other critically important statutes that address debt collection, credit reform, prompt pay, inspectors general, and information resources management. Although these acts address specific problem areas, sound internal controls are an essential factor in the success of these statutes. For example, the Results Act focuses on results through strategic and annual planning and performance reporting. Sound internal control is critical to effectively and efficiently achieving management’s plans and for obtaining accurate data to support performance measures.

What Happens When Internal Controls Are Not Effective?

Weak internal controls pose a significant risk to government agencies. History has shown that serious neglect will result in losses to the government that can total millions, and even billions, of dollars over time. As previously mentioned, the loss of confidence in government that results can be equally serious. Although examples of poor internal controls could be drawn from many federal programs, three key areas illustrate the extent of the problems—health care, banking, and property.

Health Care

The Department of Human and Human Services Inspector General reported this past year that out of $163.6 billion in processed fee-for-service payments reported by the Health Care Financing Administration (HCFA) during fiscal year 1996—the latest year for which reliable numbers were available—an estimated $23.2 billion, or about 14.6 percent of the total payments, were improper. Consequently, the Inspector General recommended that HCFA implement internal controls designed to detect and prevent improper payments to correct four weaknesses where (1) insufficient or no documentation supporting claims existed, (2) medical necessity was not established, (3) incorrect classification (called coding) of information existed, and (4) unsubstantiated/unallowable services were paid.

Banking

During the 1980s, the savings and loan industry experienced severe financial losses. Extremely high interest rates caused institutions to pay high costs for deposits and other funds while earning low yields on their long-term portfolios. Many institutions took inappropriate or risky approaches in attempting to increase their capital. These approaches included accounting methods to artificially inflate the institutions' capital position and diversifying their investments into potentially more profitable, but riskier, activities. The profitability of many of these investments depended heavily on continued inflation in real estate values to make them economically viable. In many cases, weak internal controls at these institutions and noncompliance with laws and regulations increased the risk of these activities and contributed significantly to the ultimate failure of over 700 institutions. This crisis cost the taxpayers hundreds of billions of dollars.5

Making profitable loans is the heart of a successful savings and loan institution. Boards of directors and senior management did not actively monitor the loan award and administrative processes to ensure excessive risks in making loans were not taken. In fact, excessive risk-taking in making loans was encouraged, resulting in a lack of effective monitoring of loan performance that allowed poorly performing loans to continue to deteriorate. Also, loan documentation was a frequent problem that further evidenced weak internal supervision of loan officers and created difficulties in valuing and selling loans after the institutions failed.

Property

Poor internal controls in the area of government property has existed for decades. For example, in 1988, we reported that the Defense Logistics Agency recorded losses of about $23 million for materials because of poor internal controls.6 In 1985, we reported that for the prior 16 years, the Department of State had long-standing internal control weaknesses in managing an estimated $250 million of personal property.7 In 1987, we reported that the National Aeronautics and Space Administration had poor internal controls over $500 million of property at Goddard Space Flight Center. We noted that not all property was tagged or recorded in the accounting records and that property no longer needed by particular units

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was not made available for reuse or effectively controlled against misuse or theft.\(^8\)

More recently, we reported that breakdowns exist in the Department of Defense’s (DOD) ability to protect its assets from fraud, waste, and abuse. We disclosed that the Army did not have accurate records for its reported $30 billion in real property or the $8.5 billion reported as government furnished property in the hands of contractors.\(^9\) Further, we reported that pervasive weaknesses in DOD’s general computer controls place it at risk of improper modification; theft; inappropriate disclosure; and destruction of sensitive personnel, payroll, disbursement, or inventory information.\(^10\)

**High-Risk Areas**

Beginning in 1990, we began a special effort to review and report on the federal program areas our work had identified as high risk because of vulnerabilities to waste, fraud, abuse, and mismanagement. This effort brought a much-needed central focus on problems that were costing the government billions of dollars. Our most recent high-risk series issued focuses of six categories of high risk: (1) providing for accountability and cost-effective management of defense programs, (2) ensuring that all revenues are collected and accounted for, (3) obtaining an adequate return on multibillion dollar investments in information technology, (4) controlling fraud, waste, and abuse in benefit programs, (5) minimizing loan program losses, and (6) improving management of federal contracts at civilian agencies. See attachment II for a listing of the high-risk reports and our most recent reports and testimony on the Year 2000 computing crisis.

**Conclusion**

In conclusion, effective internal controls are essential to achieving agency missions and the results intended by the Congress and the administration and as reasonably expected by the taxpayers. The lack of consistently effective internal controls across government has plagued the government for decades. Legislation has been enacted to provide a framework for performance-based management and accountability. Effective internal controls are an essential component of the success of that legislation.

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\(^8\)Financial Integrity Act: Continuing Efforts Needed to Improve Internal Control and Accounting Systems (GAO/AFMD-88-10, December 30, 1987).


However, no system of internal control is perfect, and the controls may need to be revised as agency missions and service delivery change to meet new expectations. Management and employees should focus not necessarily on more controls, but on more effective controls.

Mr. Chairman, this concludes my statement. I would be happy to respond to any questions that you or other Members of the Subcommittee may have at this time.
Internal control standards define the minimum level of quality acceptable for internal control systems to operate 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 the development of legislation, rule making, or other discretionary policy-making 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, and 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.
Attachment II

GAO’s February 1997 High-Risk Series Reports and Recent GAO Reports and Testimony on the Year 2000 Computing Crisis

High-Risk Series Reports


High-Risk Series: Defense Inventory Management (GAO/HR-97-5, February 1997).


High-Risk Series: IRS Management (GAO/HR-97-8, February 1997).


High-Risk Series: Department of Housing and Urban Development (GAO/HR-97-12, February 1997).


High-Risk Series: Superfund Program Management (GAO/HR-97-14, February 1997).

High-Risk Program Information on Selected High-Risk Areas (GAO/HR-97-30 May 1997).
Year 2000 Computing Crisis Reports and Testimony


Year 2000 Computing Crisis: National Credit Union Administration’s Efforts to Ensure Credit Union Systems Are Year 2000 Compliant (GAO/T-AIMD-98-20, October 22, 1997).


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