

INTOSAI



*Internal Control and  
Accounting Standards:*

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INTOSAI



*Guidelines for  
Internal Control  
Standards for the  
Public Sector*

INTOSAI PROFESSIONAL STANDARDS COMMITTEE

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# *Guidelines for Internal Control Standards for the Public Sector*

## **Preface**

The 1992 INTOSAI guidelines for internal control standards were conceived as a living document reflecting the vision that standards should be promoted for the design, implementation, and evaluation of internal control. This vision involves a continuing effort to keep these guidelines up-to-date.

The 17<sup>th</sup> INCOSAI (Seoul, 2001) recognized a strong need for updating the 1992 guidelines and agreed that the Committee on Sponsoring Organisations of the Treadway Commission's (COSO) integrated framework for internal control should be relied upon. Subsequent outreach efforts resulted in additional recommendations that the guidelines address ethical values and provide more information on the general principles of control activities related to information processing. The revised guidelines take these recommendations into account and should facilitate the understanding of new concepts with respect to internal control.

These revised guidelines should also be viewed as a living document which over time will need to be further developed and refined to embrace the impact of new developments such as COSO's Enterprise Risk Management Framework<sup>1</sup>.

This update is the result of the joint effort of the members of the INTOSAI Internal Control Standards Committee. This update has been coordinated by a task force set up among the committee members with representatives of the SAIs of Bolivia, France, Hungary, Lithuania, the Netherlands, Romania, the United Kingdom, the United States of America and Belgium (chair).

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<sup>1</sup> COSO, Enterprise Risk Management - Integrated Framework, [www.coso.org](http://www.coso.org), 2004.



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An action plan for updating the guidelines was submitted to and approved by the Governing Board at its 50th meeting (Vienna, October 2002). The Governing Board was informed of the progress of the work at its 51st meeting (Budapest, October 2003). The draft was discussed at and generally accepted by a committee meeting in Brussels in February 2004. After the committee meeting it was sent to all INTOSAI members for final comment.

The comments that were received, have been analyzed and subsequent changes have been made as deemed appropriate.

I would like to thank all the members of the INTOSAI Internal Control Standards Committee for their dedication and cooperation in completing this project. Special thanks is given to the members of the task force.

The *guidelines for internal control standards for the public sector* are presented for approval by the XVIII INCOSAI in Budapest 2004.

Franki VANSTAPEL  
Senior President of the Belgian Court of Audit  
Chairman of the INTOSAI Internal Control Standards Committee



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## Introduction

In 2001, INCOSAI decided to update the 1992 INTOSAI guidelines on internal control standards to take into account all relevant and recent evolutions in internal control and to incorporate the concept of the COSO report titled Internal Control – Integrated Framework in the INTOSAI document.

By implementing the COSO model in the guidelines, the Committee not only aims at updating the concept of internal control, but also attempts to contribute to a common understanding of internal control among SAIs. It is self-evident that this document takes into account the characteristics of the public sector. This prompted the Committee to consider some additional topics and changes.

Compared to the COSO definition and the 1992 guidelines, the ethical aspect of operations has been added. Its inclusion in the internal control objectives is justified, as the importance of ethical behavior as well as prevention and detection of fraud and corruption in the public sector has become more emphasized since the nineties.<sup>2</sup> General expectations are that public servants should serve the public interest with fairness and manage public resources properly. Citizens should receive impartial treatment on the basis of legality and justice. Therefore public ethics are a prerequisite to, and underpin, public trust and are a keystone of good governance.

Since resources in the public sector generally embody public money and their use in the public interest generally requires special care, the significance of safeguarding resources in the public sector needs to be stressed. Moreover budgetary accounting on a cash basis is still a widespread practice in the public sector but it does not provide sufficient assurance related to the acquisition, use, and disposition of resources. As a result, organisations in the public sector do not always have an up-to-date record of all their assets, which makes them more vulnerable. Therefore, safeguarding resources was judged to be an important internal control objective.

Just as internal control in 1992 was not limited to the traditional view of financial and related administrative control and included the broader

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<sup>2</sup> XVI INCOSAI, Montevideo, Uruguay, 1998.



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concept of management control, this document also stresses the importance of non-financial information.

Because of the extensive use of information systems in all public organisations, information technology (IT) controls have become increasingly important, which justified a separate paragraph in these guidelines. Information technology controls relate to each of the components of an entity's internal control process including the control environment, risk assessment, control activities, information and communication, as well as monitoring. However, for presentation purposes, they are discussed under "Control Activities".

The goal of the Committee is to develop guidance for establishing and maintaining effective internal control in the public sector. Government management is therefore an important addressee of the guidelines. Government management can use these guidelines as a basis for the implementation and execution of internal control in their organisations.

Since evaluating internal control is a generally accepted field standard in government auditing<sup>3</sup>, auditors can use the guidelines as an audit tool. The guidelines for internal control standards comprising the COSO model can therefore be used both by government management<sup>4</sup> as an example of a solid internal control framework for their organisation, and by auditors as a tool to assess internal control. However, these guidelines are not intended as a substitute for INTOSAI Auditing Standards or other relevant auditing standards.

This document defines a recommended framework for internal control in the public sector and provides a basis against which internal control can be evaluated. The approach applies to all aspects of an organisation's operation. However, it is not intended to limit or interfere with duly granted authority related to developing legislation, rule-making, or other discretionary policy-making in an organisation.

Internal control in public sector organisations should be understood within the context of the specific characteristics of these organisations,

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<sup>3</sup> INTOSAI Auditing Standards

<sup>4</sup> Operative personnel are not specifically mentioned as a target group. Although they are affected by internal control and take actions that play an important role in effecting control, they, unlike management, are not ultimately responsible for all activities of an organisation, related to the internal control system. Chapter 3 of the guidelines describes individual roles and responsibilities.





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i.e. their focus on meeting social or political objectives; their use of public funds; the importance of the budget cycle; the complexity of their performance (that calls for a balance between traditional values like legality, integrity and transparency and modern, managerial values like efficiency and effectiveness); and the correspondingly broad scope of their public accountability.

In conclusion, it should be clearly stated that this document includes guidelines for standards. These guidelines do not provide detailed policies, procedures and practices for implementing internal control, but rather provide a broad framework within which entities can develop such detailed controls. The Committee is obviously not in a position to enforce standards.

### **How is this document structured?**

In the first chapter, the concept of internal control is defined and its scope is delineated. Attention is also given to the limitations of internal control. In the second chapter, the components of internal control are presented and discussed. The document ends with a third chapter on roles and responsibilities.

In every section, the main principles are first presented succinctly in a blue-shaded text box, followed by further background. Reference is also made to concrete examples, which can be found in the annexes. Also attached to the document is a glossary containing the most important technical terms.

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# 1 *Internal Control*

## 1.1 Definition

Internal control is an integral process that is effected by an entity's management and personnel and is designed to address risks and to provide reasonable assurance that in pursuit of the entity's mission, the following general objectives are being achieved:

- executing orderly, ethical, economical, efficient and effective operations;
- fulfilling accountability obligations;
- complying with applicable laws and regulations;
- safeguarding resources against loss, misuse and damage.

Internal control is a dynamic integral process that is continuously adapting to the changes an organisation is facing. Management and personnel at all levels have to be involved in this process to address risks and to provide reasonable assurance of the achievement of the entity's mission and general objectives.

### **An integral process**

Internal control is not one event or circumstance, but a series of actions that permeate an entity's activities. These actions occur throughout an entity's operations on an ongoing basis. They are pervasive and inherent in the way management runs the organisation. Internal control is therefore different from the perspective of some observers who view it as something added on to an entity's activities, or as a necessary burden. The internal control system is intertwined with an entity's activities and is most effective when it is built into the entity's infrastructure and is an integral part of the essence of the organisation.

Internal control should be built in rather than built on. By building in internal control, it becomes part of and integrated with the basic management processes of planning, executing and monitoring.



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Built in internal control also has important implications for cost containment. Adding new control procedures that are separate from existing procedures adds costs. By focusing on existing operations and their contribution to effective internal control, and by integrating controls into basic operating activities, an organisation often can avoid unnecessary procedures and costs.

### **Effected by management and other personnel**

People are what make internal control work. It is accomplished by individuals within an organisation, by what they do and say. Consequently, internal control is effected by people. People must know their roles and responsibilities, and limits of authority. Because of the importance of this concept, a separate chapter (3) is devoted to it.

An organisation's people include management and other personnel. Although management primarily provides oversight, it also sets the entity's objectives and has overall responsibility for the internal control system. As internal control provides the mechanisms needed to help understand risk in the context of the entity's objectives, the management will put internal control activities in place and monitor and evaluate them. The implementation of internal control requires significant management initiative and intensive communication by management with other personnel. Therefore internal control is a tool used by management and directly related to the entity's objectives. As such, management is an important element of internal control. However, all personnel in the organisation play important roles in making it happen.

Similarly, internal control is affected by human nature. Internal control guidelines recognize that people do not always understand, communicate or perform consistently. Each individual brings to the workplace a unique background and technical ability, and has different needs and priorities. These realities affect, and are affected by, internal control.

### **In pursuit of the entity's mission**

Any organisation is primarily concerned with the achievement of its mission. Entities exist for a purpose – the public sector is generally concerned with the delivery of a service and a beneficial outcome in the public interest.



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## **To address risks**

Whatever the mission may be, its achievement will face all kinds of risks. The task of management is to identify and respond to these risks in order to maximize the likelihood of achieving the entity's mission. Internal control can help to address these risks, however it can only provide reasonable assurance about the achievement of the mission and the general objectives.

### **Provides reasonable assurance**

No matter how well designed and operated, internal control cannot provide management absolute assurance regarding the achievement of the general objectives. Instead, the guidelines acknowledge that only a "reasonable" level of assurance is attainable.

Reasonable assurance equates to a satisfactory level of confidence under given considerations of costs, benefits, and risks. Determining how much assurance is reasonable requires judgment. In exercising that judgment, managers should identify the risks inherent in their operations and the acceptable levels of risk under varying circumstances, and assess risk both quantitatively and qualitatively.

Reasonable assurance reflects the notion that uncertainty and risk relate to the future, which no one can predict with certainty. Also factors outside the control or influence of the organisation can affect the ability to achieve its objectives. Limitations also result from the following realities: human judgment in decision making can be faulty; breakdowns can occur because of simple errors or mistakes; controls can be circumvented by collusion of two or more people; or management can override the internal control system. In addition, compromises in the internal control system reflect the fact that controls have a cost. These limitations preclude management from having absolute assurance that objectives will be achieved.

Reasonable assurance recognizes that the cost of internal control should not exceed the benefit derived. Decisions on risk responses and establishing controls need to consider the relative costs and benefits. Cost refers to the financial measure of resources consumed in accomplishing a specified purpose and to the economic measure of a lost opportunity, such as a delay in operations, a decline in service levels or productivity,



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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.

Designing internal controls that are cost beneficial while reducing risk to an acceptable level requires that managers clearly understand the overall objectives to be achieved. Otherwise, government managers may design systems with excessive controls in one area of their operations that adversely affect other operations. For example, employees may try to circumvent burdensome procedures, inefficient operations may cause delays, excessive procedures may stifle employee creativity and problem solving or impair the timeliness, cost or quality of services provided to beneficiaries. Thus, benefits derived from excessive controls in one area may be outweighed by increased costs in other activities.

However qualitative considerations should also be made.

For example, it may be important to have proper controls over high risk/low monetary unit transactions such as salaries, travel and hospitality expenses. The costs of appropriate controls might seem excessive for the amounts of money involved relative to overall government expenditures, but they may be critical to maintaining public confidence in governments and related organization.

### **Achievement of objectives**

Internal control is geared to the achievement of a separate but interrelated series of general objectives. These general objectives are implemented through numerous specific sub-objectives, functions, processes, and activities.

The general objectives are:

- *executing orderly, ethical, economical, efficient and effective operations*

The entity's operations should be orderly, ethical, economical, efficient and effective. They have to be consistent with the organisation's mission.

Orderly means in a well-organised way, methodical.



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Ethical relates to moral principles. The importance of ethical behaviour and prevention and detection of fraud and corruption in the public sector has become more emphasized since the nineties. General expectations are that public servants should serve the public interest with fairness and manage public resources properly. Citizens should receive impartial treatment on the basis of legality and justice. Therefore public ethics are a prerequisite to, and underpin public trust and are a keystone of good governance.

Economical means not wasteful or extravagant. It means getting the right amount of resources, of the right quality, delivered at the right time and place, at the lowest cost.

Efficient refers to the relationship between the resources used and the outputs produced to achieve the objectives. It means the minimum resource inputs to achieve a given quantity and quality of output, or a maximum output with a given quantity and quality of resource inputs.

Effective refers to the accomplishment of objectives or to the extent to which the outcomes of an activity match the objective or the intended effects of that activity.

- *fulfilling accountability obligations*

Accountability is the process whereby public service organisations and individuals within them are held responsible for their decisions and actions, including their stewardship of public funds, fairness, and all aspects of performance.

This will be realized by developing, maintaining and making available reliable and relevant financial and non-financial information and by means of a fair disclosure of that information in timely reports to internal as well as external stakeholders.

Non-financial information may relate to the economy, efficiency and effectiveness of policies and operations (performance information), and to internal control and its effectiveness.

- *complying with laws and regulations*

Organisations are required to follow many laws and regulations. In public organisations laws and regulations mandate the collection and spending of public money and the way of operating. Examples include the Budget Act, international treaties, laws on proper administration,



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accounting law/standards, environmental protection and civil rights law, income tax regulations and anti-fraud and corruption acts.

- *safeguarding resources against loss, misuse and damage due to waste, abuse, mismanagement, errors, fraud and irregularities*

Although the fourth general objective can be viewed as a subcategory of the first one (orderly, ethical, economical, efficient and effective operations), the significance of safeguarding resources in the public sector needs to be stressed. This is due to the fact that resources in the public sector generally embody public money and their use in the public interest generally requires special care. Moreover budgetary accounting on a cash basis, which is still widespread in the public sector, does not provide sufficient assurance related to the acquisition, use, and disposition of the resources. As a result, organisations in the public sector do not always have an up-to-date record of all their assets, which makes them more vulnerable. Therefore, controls should be embedded in each of the activities related to managing the entity's resources from acquisition to disposal.

Other resources such as information, source documents and accounting records are the key to achieving transparency and accountability of government operations, and should be preserved. However they are also in danger of being stolen, misused or destroyed.

Safeguarding certain resources and records has even become increasingly important since the arrival of computer systems. Sensitive information stored on computer media can be destroyed or copied, distributed and abused, if care is not taken to protect it.

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## 1.2 Limitations on Internal Control Effectiveness<sup>5</sup>

Internal control cannot by itself ensure the achievement of the general objectives defined earlier.

An effective internal control system, no matter how well conceived and operated, can provide only reasonable – not absolute – assurance to management about the achievement of an entity's objectives or its survival. It can give management information about the entity's progress, or lack of it, toward achievement of the objectives. But internal control cannot change an inherently poor manager into a good one. Moreover, shifts in government policy or programs, demographic or economic conditions are typically beyond management's control and may require managers to re-design controls or adjust the level of acceptable risk.

An effective system of internal control reduces the probability of not achieving the objectives. However, there will always be the risk that internal control will be poorly designed or fail to operate as intended.

Because internal control depends on *the human factor*, it is subject to flaws in design, errors of judgment or interpretation, misunderstanding, carelessness, fatigue, distraction, collusion, abuse or override.

Another limiting factor is that the design of an internal control system faces *resource constraints*. The benefits of controls must consequently be considered in relation to their costs. Maintaining an internal control system that eliminates the risk of loss is not realistic and would probably cost more than is warranted by the benefit derived. In determining whether a particular control should be established, the likelihood of the risk occurring and the potential effect on the entity are considered along with the related costs of establishing a new control.

*Organisational changes* and *management attitude* can have a profound impact on the effectiveness of internal control and the personnel operating the system. Thus, management needs to continually review and update controls, communicate changes to personnel, and set an example by adhering to those controls.

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<sup>5</sup> The limitations on internal control effectiveness need to be stressed to avoid exaggerated expectations due to a misunderstanding of its effective scope.





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## 2 *Components of Internal Control*

Internal control consists of five interrelated components:

- control environment
- risk assessment
- control activities
- information and communication
- monitoring

Internal control is designed to provide reasonable assurance that the entity's general objectives are being achieved. Therefore clear objectives are a prerequisite for an effective internal control process.

The *control environment* is the foundation for the entire internal control system. It provides the discipline and structure as well as the climate which influences the overall quality of internal control. It has overall influences on how strategy and objectives are established, and control activities are structured.

Having set clear objectives and established an effective control environment, an *assessment of the risks* facing the entity as it seeks to achieve its mission and objectives provides the basis for developing an appropriate response to risk.

The major strategy for mitigating risk is through internal *control activities*. Control activities can be preventive and/or detective. Corrective actions are a necessary complement to internal control activities in order to achieve the objectives. Control activities and corrective actions should provide value for money. Their cost should not exceed the benefit resulting from them (cost effectiveness).

Effective *information and communication* is vital for an entity to run and control its operations. Entity management needs access to relevant, complete, reliable, correct and timely communication related to internal as



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well as external events. Information is needed throughout the entity to achieve its objectives.

Finally, since internal control is a dynamic process that has to be adapted continuously to the risks and changes an organisation faces, *monitoring* of the internal control system is necessary to help ensure that internal control remains tuned to the changed objectives, environment, resources and risks.

These components define a recommended approach for internal control in government and provide a basis against which internal control can be evaluated. These components apply to all aspects of an organisation's operation.

These guidelines provide a general framework. When implementing them, management is responsible for developing the detailed policies, procedures, and practices to fit their organisation's operations and to ensure that they are built into and are an integral part of those operations.

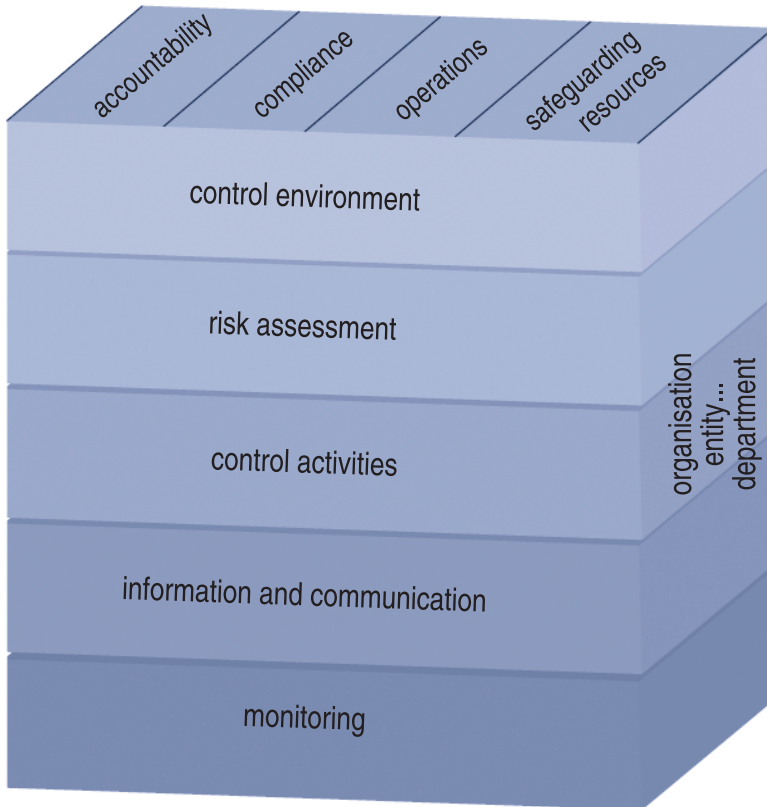
### **Relationship of objectives and components**

There is a direct relationship between the general objectives, which represent what an entity strives to achieve, and the internal control components, which represent what is needed to achieve the general objectives. The relationship is depicted in a three-dimensional matrix, in the shape of a cube.

The four general objectives – accountability (and reporting), compliance (with laws and regulations), (orderly, ethical, economical, efficient and effective) operations and safeguarding resources – are represented by the vertical columns, the five components are represented by horizontal rows, and the organisation or entity and its departments are depicted by the third dimension of the matrix.

Each component row “cuts across” and applies to all four general objectives. For example, financial and non-financial data generated from internal and external sources, which belong to the information and communication component, are needed to manage operations, report and fulfill accountability purposes, and comply with applicable laws.





Similarly, looking at the general objectives, all five components are relevant to each objective. Taking one objective, such as effectiveness and efficiency of operations, it is clear that all five components are applicable and important to its achievement.

Internal control is not only relevant to an entire organisation but also to an individual department. This relationship is depicted by the third dimension, which represents entire organisations, entities and departments. Thus, one can focus on any of the matrix's cells.

While the internal control framework is relevant and applicable to all organisations, the manner in which management applies it will vary widely with the nature of the entity and depends on a number of entity-specific factors. These factors include the organisational structure, risk profile, operating environment, size, complexity, activities and degree of

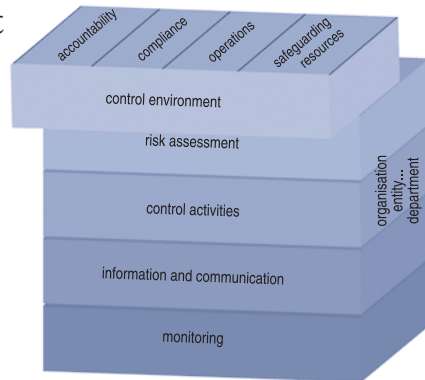
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regulation, among others. As it considers the entity's specific situation, management will make a series of choices regarding the complexity of processes and methodologies deployed to apply the internal control framework components.

In the following text, each of the abovementioned components is presented concisely with additional comments.



## 2.1 Control Environment



The control environment sets the tone of an organisation, influencing the control consciousness of its staff. It is the foundation for all other components of internal control, providing discipline and structure.

Elements of the control environment are:

- (1) the personal and professional integrity and ethical values of management and staff, including a supportive attitude toward internal control at all times throughout the organisation;
- (2) commitment to competence;
- (3) the “tone at the top” (i.e. management’s philosophy and operating style);
- (4) organisational structure;
- (5) human resource policies and practices.

### **The personal and professional integrity and ethical values of management and staff**

The personal and professional integrity and ethical values of management and staff determine their preferences and value judgments, which are translated into standards of behaviour. They should exhibit a supportive attitude toward internal control at all times throughout the organisation.

Every person involved in the organisation—among managers and employees—has to maintain and demonstrate personal and professional integrity and ethical values and has to comply with the applicable codes

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of conduct at all times. For example, this can include the disclosure of personal financial interests, outside positions and gifts (e.g. by elected officials and senior public servants), and reporting conflicts of interest.

Also, public organisations have to maintain and demonstrate integrity and ethical values, and they should make those visible to the public in their mission and core values. In addition, their operations have to be ethical, orderly, economical, efficient and effective. They have to be consistent with their mission.

### **Commitment to competence**

Commitment to competence includes the level of knowledge and skill needed to help ensure orderly, ethical, economical, efficient and effective performance, as well as a good understanding of individual responsibilities with respect to internal control.

Managers and employees are to maintain a level of competence that allows them to understand the importance of developing, implementing, and maintaining good internal control and to perform their duties in order to accomplish the general internal control objectives and the entity's mission. Everyone in an organisation is involved in internal control with his own specific responsibilities.

Managers and their staffs must therefore maintain and demonstrate a level of skill necessary to assess risk and help ensure effective and efficient performance, and an understanding of internal control sufficient to effectively discharge their responsibilities.

Providing training, for example, can raise the awareness of public servants of the internal control objectives and, in particular, the objective of ethical operations, and helps them to understand the internal control objectives and to develop skills to handle ethical dilemmas.

### **Tone at the top**

The “tone at the top” (i.e. management's philosophy and operating style) reflects:

- a supportive attitude toward internal control at all times, independence, competence and leading by example;



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- a code of conduct set out by management, and counselling and performance appraisals that support the internal control objectives and, in particular, that of ethical operations.

The attitude established by top management is reflected in all aspects of management's actions. The commitment, the involvement and support of top government officials and legislators in setting "the tone at the top" foster a positive attitude and are critical to maintaining a positive and supportive attitude towards internal control in an organisation.

If top management believes that internal control is important, others in the organisation will sense that and will respond by conscientiously observing the controls established. For example, the creation of an internal audit unit as part of the internal control system is a strong signal by management that internal control is important.

On the other hand, if the members of the organisation feel that control is not an important concern to the top management and control is given lip service rather than meaningful support, it is almost certain that the organisation's control objectives will not be effectively achieved.

Consequently, demonstration of and insistence on ethical conduct by management is of vital importance to the internal control objectives and, in particular the objective of "ethical operations". In carrying out its role, management should set a good example through its own actions and its conduct should reflect what is proper rather than what is acceptable or expedient. In particular, management's policies, procedures and practices should promote orderly, ethical, economical, efficient and effective conduct.

The integrity of managers and their staffs is, however, influenced by many elements. Therefore, personnel should periodically be reminded of their obligations under an operative code of conduct issued by the top management. Counselling and performance appraisals are also important. Overall performance appraisals should be based on an assessment of many critical factors, including the employees's role in effecting internal control.

### **Organisational structure**

The organisational structure of an entity provides:

- assignment of authority and responsibility;
- empowerment and accountability;
- appropriate lines of reporting.



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The organisational structure defines the entity's key areas of authority and responsibility. Empowerment and accountability relate to the manner in which this authority and responsibility are delegated throughout the organisation. There can be no empowerment or accountability without a form of reporting. Therefore, appropriate lines of reporting need to be defined. In exceptional circumstances, other lines of reporting have to be possible in addition to the normal ones, such as in cases where management is involved in irregularities.

The organisational structure can include an internal audit unit that should be independent from management, and reports directly to the highest level of authority within the organisation.

Organisational structure is also dealt with in chapter 3 on roles and responsibilities.

### **Human resource policies and practices**

Human resource policies and practices include hiring and staffing, orientation, training (formal and on-the-job) and education, evaluating and counselling, promoting and compensating, and remedial actions.

An important aspect of internal control is personnel. Competent, trustworthy personnel are necessary to provide effective control. Therefore, the methods by which persons are hired, trained, evaluated, compensated, and promoted, are an important part of the control environment. Hiring and staffing decisions should therefore include assurance that individuals have the integrity and the proper education and experience to carry out their jobs and that the necessary formal, on-the-job, and ethics training is provided. Managers and employees who have a good understanding of internal control and are willing to take responsibility, are vital to effective internal control.

Human resource management also has an essential role in promoting an ethical environment by developing professionalism and enforcing transparency in daily practice. This becomes visible in recruitment, performance appraisal and promotion processes, which should be based on merits. Securing the openness of selection processes by publishing both the recruitment rules and vacant positions also helps to realise ethical human resource management.



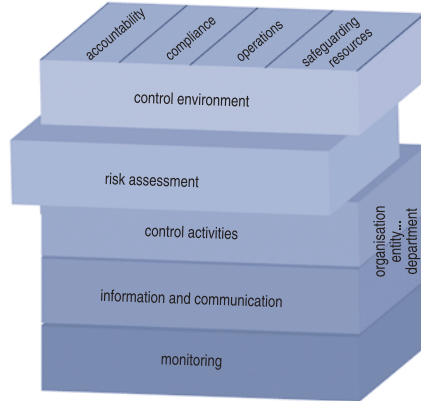


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## Examples

We refer the reader to the annexes for integrated examples on each of the objectives and the components of internal control.

## 2.2 Risk Assessment



Risk assessment is the process of identifying and analysing relevant risks to the achievement of the entity's objectives and determining the appropriate response.

It implies:

(1) risk identification:

- related to the objectives of the entity;
- comprehensive;
- includes risks due to external and internal factors, at both the entity and the activity levels;

(2) risk evaluation:

- estimating the significance of a risk;
- assessing the likelihood of the risk occurrence;

(3) assessment of the risk appetite of the organisation;

(4) development of responses:

- four types of responses to risk must be considered: transfer, tolerance, treatment or termination; of these, risk treatment is the most relevant to these guidelines because effective internal control is the major mechanism to treat risk;
- the appropriate controls involved can be either detective or preventive.

As governmental, economic, industry, regulatory and operating conditions are in constant change, risk assessment should be an ongoing iterative process. It implies identifying and analysing altered conditions and opportunities and risks (risk assessment cycle) and modifying internal control to address changing risk.



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As stressed in the definition, internal control can provide only reasonable assurance that the objectives of the organisation are being achieved. Risk assessment as a component of internal control, plays a key role in the selection of the appropriate control activities to undertake. It is the process of identifying and analysing relevant risks to the achievement of the entity's objectives and determining the appropriate response.

Consequently, setting objectives is a precondition to risk assessment. Objectives must be defined before management can identify the risks to their achievement and take the necessary actions to manage those risks. That means having in place an ongoing process for evaluating and addressing the impact of risks in a cost effective way and having staff with the appropriate skills to identify and assess the potential risks. Internal control activities are a response to risk in that they are designed to contain the uncertainty of outcome that has been identified.

Government entities have to manage the risks that are likely to have an impact on service delivery and the achievement of desired outcomes.

### **Risk identification**

A strategic approach to risk assessment depends on identifying risks against key organisational objectives. Risks relevant to those objectives are then considered and evaluated, resulting in a small number of key risks.

Identifying key risks is not only important in order to identify the most important areas to which resources in risk assessment should be allocated, but also in order to allocate responsibility for management of these risks.

An entity's performance can be at risk due to internal or external factors at both the entity and activity levels. The risk assessment should consider all risks that might occur (including the risk of fraud and corruption). It is therefore important that risk identification is comprehensive. Risk identification should be an ongoing, iterative process and is often integrated with the planning process. It is often useful to consider risk from a 'clean sheet of paper' approach, and not merely relate it to the previous review. Such an approach facilitates the identification of

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changes in the risk profile<sup>6</sup> of an organisation arising from changes in the economic and regulatory environments, internal and external operating conditions and from the introduction of new or modified objectives.

It is necessary to adopt appropriate tools for the identification of risk. Two of the most commonly used tools are commissioning a risk review and a risk self assessment.<sup>7</sup>

## **Risk evaluation**

In order to decide how to handle risk, it is essential not only to identify in principle that a certain type of risk exists, but also to evaluate its significance and assess the likelihood of the risk event occurring. The methodology for analysing risks can vary, largely because many risks are difficult to quantify (e.g. reputation risks) while others lend themselves to a numerical diagnosis (particularly financial risks). For the former, a much more subjective view is the only possibility. In this sense, risk evaluation is more of an art than a science. However, the use of systematic risk rating criteria will mitigate the subjectivity of the process by providing a framework for judgements to be made in a consistent manner.

One of the key purposes of risk evaluation is to inform management about areas of risk where action needs to be taken and their relative pri-

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<sup>6</sup> An overview or matrix of the key risks facing an entity or sub-unit that includes the level of impact (e.g. high, medium, low) along with the probability or likelihood of the event occurring.

<sup>7</sup> *Commissioning a risk review*

This is a top down procedure. A team is established to consider all the operations and activities of the organisation in relation to its objectives and to identify the associated risks. The team conducts a series of interviews with key members of staff at all levels of the organisation to build a risk profile for the whole range of activities thereby identifying the policy fields, activities and functions which may be particularly vulnerable to risk (including the risk of fraud and corruption).

### *Risk self assessment*

This is a bottom up approach. Each level and part of the organisation is invited to review its activities and feed diagnosis of the risks faced upwards. This may be done through a documentation approach (with a framework for diagnosis set out through questionnaires) or through a facilitated workshop approach.

These two approaches are not mutually exclusive and a combination of top down and bottom up inputs to the risk assessment process is desirable to facilitate the identification of both entitywide and activity level risks.



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ority. Therefore, it will usually be necessary to develop some framework for categorising all risks, for example, as high, medium, or low. Generally, it is better to minimize the categories, as over refinement may lead to spurious separation of levels which in reality cannot be separated clearly.

By means of such evaluation, risks can be ranked in order to set management priorities and present information for management decisions about the risks that need to be addressed (for example those with a major potential impact and a high likelihood of the risks occurring).

### **Assessment of the “risk appetite” of the organisation**

An important issue in considering response to risk is the identification of the “risk appetite” of the entity. Risk appetite is the amount of risk to which the entity is prepared to be exposed before it judges action to be necessary. Decisions about responses to risk have to be taken in conjunction with an identification of the amount of risk that can be tolerated.

Both inherent and residual risks need to be considered to determine the risk appetite. Inherent risk is the risk to an entity in the absence of any actions management might take to alter either the risk’s likelihood or impact. Residual risk is the risk that remains after management responds to the risk.

The risk appetite of an organisation will vary according to the perceived importance of the risks. For example, tolerable financial loss may vary in accordance with a range of features, including the size of the relevant budget, the source of the loss, or associated other risks such as adverse publicity. Identification of risk appetite is a subjective issue, but it is nevertheless an important stage in formulating the overall risk strategy.

### **Development of responses**

The result of the actions outlined above will be a risk profile for the organisation. Having developed a risk profile, the organisation can then consider an appropriate response.



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Responses to risk can be divided into four categories. In some instances, risk can be *transferred, tolerated, or terminated*.<sup>8</sup> However, in most instances the risk will have to be *treated* and the entity will need to implement and maintain an effective internal control system to keep risk at an acceptable level.

The purpose of treatment is not necessarily to obviate the risk, but more likely to contain it. The procedures that an organisation establishes to treat risk are called internal control activities. Risk assessment should play a key role in the selection of appropriate control activities to undertake. Again, it is important to repeat that it is not possible to eliminate all risk and that internal control can only provide reasonable assurance that the objectives of the organisation are being achieved. However, entities that actively identify and manage risks are more likely to be better prepared to respond quickly when things go wrong and to respond to change in general.

In designing an internal control system, it is important that the control activity established is proportionate to the risk. Apart from the most extreme undesirable outcome, it is normally sufficient to design a control that provides a reasonable assurance of confining loss within the risk appetite of the organisation. Every control has an associated cost and the control activity must offer value for its cost in relation to the risk that it is addressing.

Because governmental, economic, industry, regulatory and operating conditions continually change, the risk environment of any organisation is constantly changing, and priorities of objectives and the consequent importance of risks will shift and change. Fundamental to risk

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<sup>8</sup> For some risks the best response may be to *transfer* them. This might be done by conventional insurance, by paying a third party to take the risk in another way, or it might be done by contractual stipulations.

The ability to do anything about some risks may be limited, or the cost of taking any action may be disproportionate to the potential benefit gained. In these cases the response may be to *tolerate* the risks.

Some risks will only be treatable or containable to acceptable levels, by *terminating* the activity. In the public sector, the option to terminate activities may be severely limited when compared to the private sector. A number of activities are conducted in the government sector because the associated risks are so great that there is no other way in which the output or outcome, which is required for the public benefit, can be achieved.



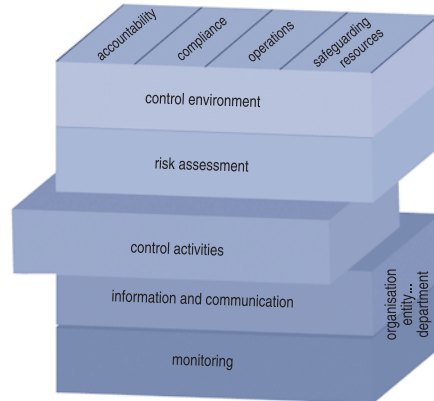
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assessment is an ongoing, iterative process to identify changed conditions (risk assessment cycle) and take actions as necessary. Risk profiles and related controls have to be regularly revisited and reconsidered in order to have assurance that the risk profile continues to be valid, that responses to risk remain appropriately targeted and proportionate, and mitigating controls remain effective as risks change over time.

### **Examples**

We refer the reader to the annexes for integrated examples on each of the objectives and the components of internal control.

## 2.3 Control Activities



Control activities are the policies and procedures established to address risks and to achieve the entity's objectives.

To be effective, control activities must be appropriate, function consistently according to plan throughout the period, and be cost effective, comprehensive, reasonable and directly relate to the control objectives.

Control activities occur throughout the organisation, at all levels and in all functions. They include a range of detective and preventive control activities as diverse, for example, as:

- (1) authorization and approval procedures;
- (2) segregation of duties (authorizing, processing, recording, reviewing);
- (3) controls over access to resources and records;
- (4) verifications;
- (5) reconciliations;
- (6) reviews of operating performance;
- (7) reviews of operations, processes and activities;
- (8) supervision (assigning, reviewing and approving, guidance and training).

Entities should reach an adequate balance between detective and preventive control activities.

Corrective actions are a necessary complement to control activities in order to achieve the objectives.





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Control activities are the policies and procedures established and executed to address risks and to achieve the entity's objectives.

To be effective, control activities need to:

- be appropriate (that is, the right control in the right place and commensurate to the risk involved);
- function consistently according to plan throughout the period (that is, be complied with carefully by all employees involved and not bypassed when key personnel are away or the workload is heavy);
- be cost effective (that is, the cost of implementing the control should not exceed the benefits derived);
- be comprehensive, reasonable and directly relate to the control objectives.

Control activities include a range of policies and procedures as diverse as:

### **1. Authorization and approval procedures**

Authorizing and executing transactions and events are only done by persons acting within the scope of their authority. Authorization is the principal means of ensuring that only valid transactions and events are initiated as intended by management. Authorization procedures, which should be documented and clearly communicated to managers and employees, should include the specific conditions and terms under which authorizations are to be made. Conforming to the terms of an authorization means that employees act in accordance with directives and within the limitations established by management or legislation.

### **2. Segregation of duties (authorizing, processing, recording, reviewing)**

To reduce the risk of error, waste, or wrongful acts and the risk of not detecting such problems, no single individual or team should control all key stages 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 and recording transactions, processing, and reviewing or auditing transactions. Collusion, however, can reduce or destroy the effectiveness of this internal control activity. A small organisation may have too few employees to fully implement this control. In such cases, management must be aware of the risks and compensate with other controls. Rotation of employees may help ensure that one person does not deal with all the key aspects of transactions or events for an undue length of time. Also,



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encouraging or requiring annual holidays may help reduce risk by bringing about a temporary rotation of duties.

### **3. Controls over access to resources and records**

Access to resources and records is limited to authorized individuals who are accountable for the custody and/or use of the resources. Accountability for custody is evidenced by the existence of receipts, inventories, or other records assigning custody and recording the transfer of custody. Restricting access to resources reduces the risk of unauthorized use or loss to the government and helps achieve management directives. The degree of restriction depends on the vulnerability of the resource and the perceived risk of loss or improper use, and should be periodically assessed. When determining an asset's vulnerability, its cost, portability and exchangeability should be considered.

### **4. Verifications**

Transactions and significant events are verified before and after processing, e.g. when goods are delivered, the number of goods supplied is verified with the number of goods ordered. Afterwards, the number of goods invoiced is verified with the number of goods received. The inventory is verified as well by performing stock-takes.

### **5. Reconciliations**

Records are reconciled with the appropriate documents on a regular basis, e.g. the accounting records relating to bank accounts are reconciled with the corresponding bank statements.

### **6. Reviews of operating performance**

Operating performance is reviewed against a set of standards on a regular basis, assessing effectiveness and efficiency. If performance reviews determine that actual accomplishments do not meet established objectives or standards, the processes and activities established to achieve the objectives should be reviewed to determine if improvements are needed.

### **7. Reviews of operations, processes and activities**

Operations, processes and activities should be periodically reviewed to ensure that they are in compliance with current regulations, policies, procedures, or other requirements. This type of review of the actual operations of an organisation should be clearly distinguished from the



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monitoring of internal control which is discussed separately in section 2.5.

### **8. supervision (assigning, reviewing and approving, guidance and training)**

Competent supervision helps to ensure that internal control objectives are achieved. Assigning, reviewing, and approving an employee's work encompasses:

- 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 it flows as intended.

A supervisor's delegation of work should not diminish the supervisor's accountability for these responsibilities and duties. Supervisors also provide their employees with the necessary guidance and training to help ensure that errors, waste, and wrongful acts are minimized and that management directives are understood and achieved.

The abovementioned list is not exhaustive but enumerates the most common preventive and detective control activities. Control activities 1 – 3 are preventive, 4 – 6 are more detective while 7 – 8 are both preventive and detective. Entities should reach an adequate balance between detective and preventive control activities, whereby often a mix of controls is used to compensate for the particular disadvantages of individual controls.

Once a control activity is implemented, it is essential that assurance about its effectiveness is obtained. Consequently corrective actions are a necessary complement to control activities. Moreover, it must be clear that control activities form only a component of internal control. They should be integrated with the other four components of internal control.

#### **Examples**

We refer the reader to the annexes for integrated examples on each of the objectives and the components of internal control.

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### 2.3.1 Information Technology Control Activities

Information systems imply specific types of control activities. Therefore information technology controls consist of two broad groupings:

(1) General Controls

General controls are the structure, policies and procedures that apply to all or a large segment of an entity's information systems and help ensure their proper operation. They create the environment in which application systems and controls operate.

The major categories of general controls are (1) entity-wide security program planning and management, (2) access controls, (3) controls on the development, maintenance and change of the application software, (4) system software controls, (5) segregation of duties, and (6) service continuity.

(2) Application Controls

Application controls are the structure, policies, and procedures that apply to separate, individual application systems, and are directly related to individual computerized applications. These controls are generally designed to prevent, detect, and correct errors and irregularities as information flows through information systems.

General and application controls are interrelated and both are needed to help ensure complete and accurate information processing. Because information technology changes rapidly, the associated controls must evolve constantly to remain effective.

As information technology has advanced, organisations have become increasingly dependent on computerized information systems to carry out their operations and to process, maintain, and report essential information. As a result, the reliability and security of computerized data and of the systems that process, maintain, and report these data are a major concern to both management and auditors of organisations. Although information systems imply specific types of control activities, information technology is not a "standalone" control issue. It is an integral part of most control activities.

The use of automated systems to process information introduces several risks that need to be considered by the organisation. These risks stem



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from, among other things, uniform processing of transactions; information systems automatically initiating transactions; increased potential for undetected errors; existence, completeness, and volume of audit trails; the nature of the hardware and software used; and recording unusual or non-routine transactions. For example, an inherent risk from the uniform processing of transactions is that any error arising from computer programming problems will occur consistently in similar transactions. Effective information technology controls can provide management with reasonable assurance that information processed by its systems meets desired control objectives, such as ensuring the completeness, timeliness, and validity of data and preserving its integrity.

Information technology controls consist of two broad groupings, general controls and application controls.

### **General controls**

General controls are the structure, policies and procedures that apply to all or a large segment of an entity's information systems - such as main-frame, minicomputer, network, and end-user environments - and help ensure their proper operation. They create the environment in which application systems and controls operate.

The major categories of general controls are:

- (1) *Entity wide security program planning and management* provide a framework and continuing cycle of activity for managing risk, developing security policies, assigning responsibilities, and monitoring the adequacy of the entity's computer-related controls.
- (2) *Access controls* limit or detect access to computer resources (data, programs, equipment, and facilities), thereby protecting these resources against unauthorized modification, loss, and disclosure. Access controls include both physical and logical controls.
- (3) *Controls on the development, maintenance and change of application software* prevent unauthorized programs or modifications to existing programs.
- (4) *System software controls* limit and monitor access to the powerful programs and sensitive files that control the computer hardware and secure applications supported by the system.
- (5) *Segregation of duties* implies that policies, procedures and an organisational structure are established to prevent one individual from controlling all key aspects of computer-related operations and



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thereby conducting unauthorized actions or gaining unauthorized access to assets or records.

- (6) *Service continuity* controls help to ensure that when unexpected events occur, critical operations continue without interruption or are promptly resumed and critical and sensitive data are protected.

### **Application controls**

Application controls are the structure, policies, and procedures that apply to separate, individual application systems - such as accounts payable, inventory, payroll, grants, or loans - and are designed to cover the processing of data within specific applications software.

These controls are generally designed to prevent, detect, and correct errors and irregularities as information flows through information systems.

Application controls and the manner in which information flows through information systems can be categorized into three phases of a processing cycle:

- input: data are authorized, converted to an automated form, and entered into the application in an accurate, complete, and timely manner;
- processing: data are properly processed by the computer and files are updated correctly; and
- output: files and reports generated by the application reflect transactions or events that actually occurred and accurately reflect the results of processing, and reports are controlled and distributed to the authorized users.

Application controls may also be categorized by the kinds of control objectives they relate to, including whether transactions and information are authorized, complete, accurate and valid. Authorization controls concern the validity of transactions and help ensure transactions represent events that actually occurred during a given period. Completeness controls relate to whether all valid transactions are recorded and properly classified. Accuracy controls address whether transactions are recorded correctly and all the data elements are accurate. Controls over the integrity of processing and data files, if deficient, could nullify each of the above-mentioned application controls and allow the occurrence of unauthorized transactions, as well as contribute to incomplete and inaccurate data.



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Application controls include programmed control activities, such as automated edits, and manual follow-up of computer-generated output, such as reviews of reports identifying rejected or unusual items.

### **General and application controls over computer systems are inter-related**

The effectiveness of general controls is a significant factor in determining the effectiveness of application controls. If general controls are weak, they severely diminish the reliability of controls associated with individual applications. Without effective general controls, application controls may be rendered ineffective by override, circumvention or modification. For example, edit checks designed to prevent users from entering unreasonable number of hours worked (e.g. more than 24 in a day) into a payroll system can be an effective application control. However, this control cannot be relied on if the general controls permit unauthorized program modifications that might allow some transactions to be exempt from the edit.

While the basic objectives of control do not change, rapid changes in information technology require that controls evolve to remain effective. Changes such as the increased reliance on networking, powerful computers that place responsibility for data processing in the hands of end users, electronic commerce, and the Internet will affect the nature and implementation of specific control activities.

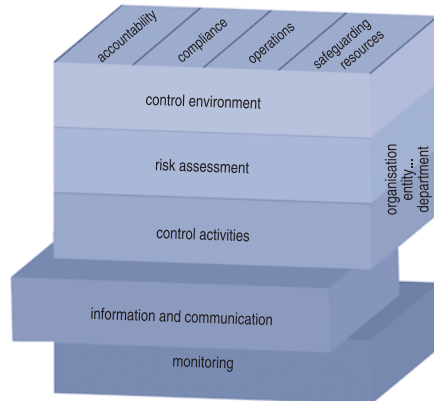
Further guidance on information technology control activities can be obtained from the Information Systems Audit and Control Association (ISACA), in particular the ISACA Control Objectives for Information and Related Technology (COBIT) reference framework, and the proceedings of the INTOSAI IT-audit committee.

### **Examples**

We refer the reader to the annexes for integrated examples on each of the objectives and the components of internal control.



## 2.4 Information and Communication



Information and communication are essential to realising all internal control objectives.

### Information

A precondition for reliable and relevant information is the prompt recording and proper classification of transactions and events. Pertinent information should be identified, captured and communicated in a form and timeframe that enables staff to carry out their internal control and other responsibilities (timely communication to the right people). Therefore, the internal control system as such and all transactions and significant events should be fully documented.

Information systems produce reports that contain operational, financial and non-financial, and compliance-related information and that make it possible to run and control the operation. They deal not only with internally generated data, but also information about external events, activities and conditions necessary to enable decision-making and reporting.

Management's ability to make appropriate decisions is affected by the quality of information which implies that the information should be appropriate, timely, current, accurate and accessible.





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Information and communication are essential to the realisation of all the internal control objectives. For example, one of the objectives of internal control is fulfilling public accountability obligations. This can be achieved by developing and maintaining reliable and relevant financial and non-financial information and communicating this information by means of a fair disclosure in timely reports. Information and communication relating to the organisation's performance will create the possibility to evaluate the orderliness, ethicality, economy, efficiency and effectiveness of operations. In many cases, certain information has to be provided or communication has to take place in order to comply with laws and regulations.

Information is needed at all levels of an organisation in order to have effective internal control and achieve the entity's objectives. Therefore an array of pertinent, reliable and relevant information should be identified, captured and communicated in a form and timeframe that enables people to carry out their internal control and other responsibilities. A precondition for reliable and relevant information is the prompt recording and proper classification of transactions and events.

Transactions and events must be recorded promptly when they occur if information is to remain relevant and valuable to management in controlling operations and making decisions. This applies to the entire process or life cycle of a transaction or event, including the initiation and authorization, all stages while in process, and its final classification in summary records. It also applies to promptly updating all documentation to keep it relevant.

Proper classification of transactions and events is also required to ensure that reliable information is available to management. This means organizing, categorizing, and formatting information from which reports, schedules, and financial statements are prepared.

Information systems produce reports that contain operational, financial and non-financial, and compliance-related information, and that make it possible to run and control the operation. The systems deal not only with quantitative and qualitative forms of internally generated data, but also with information about external events, activities and conditions necessary for informed decision-making and reporting.

Management's ability to make appropriate decisions is affected by the quality of information which implies that the information is:



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- appropriate (is the needed information there?);
  - timely (is it there when required?);
  - current (is it the latest available?);
  - accurate (is it correct?);
  - accessible (can it be obtained easily by the relevant parties?).

In order to help ensure the quality of information and reporting, carry out the internal control activities and responsibilities, and make monitoring more effective and efficient, the internal control system as such and all transactions and significant events should be fully and clearly documented (e.g. flow charts and narratives). This documentation should be readily available for examination.

Documentation of the internal control system should include identification of an organisation's structure and policies and its operating categories and related objectives and control procedures. An organisation must have written evidence of the components of the internal control process, including its objectives and control activities.

The extent of the documentation of an entity's internal control varies however with the entity's size, complexity and similar factors.

### Communication

Effective communication should flow down, across, and up the organisation, throughout all components and the entire structure.

All personnel should receive a clear message from top management that control responsibilities should be taken seriously. They should understand their own role in the internal control system, as well as how their individual activities relate to the work of others.

There also needs to be effective communication with external parties.

Information is a basis for communication, which must meet the expectations of groups and individuals, enabling them to carry out their responsibilities effectively. Effective communication should occur in all directions, flowing down, across and up the organisation, throughout all components and the entire structure.



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One of the most critical communications channels is that between management and its staff. Management must be kept up to date on performance, developments, risks and the functioning of internal control, and other relevant events and issues. By the same token, management should communicate to its staff what information it needs and provide feedback and direction. Management should also provide specific and directed communication addressing behavioural expectations. This includes a clear statement of the entity's internal control philosophy and approach, and delegation of authority.

Communication should raise awareness about the importance and relevance of effective internal control, communicate the entity's risk appetite and risk tolerances, and make personnel aware of their roles and responsibilities in effecting and supporting the components of internal control.

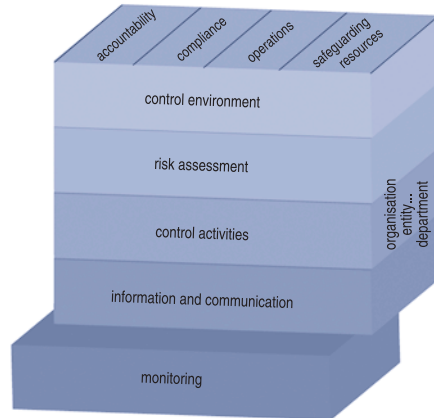
In addition to internal communications, management should ensure there are adequate means of communicating with, and obtaining information from external parties, as external communications can provide input that may have a highly significant impact on the extent to which the organisation achieves its goals.

Based on the input from internal and external communications, management has to take necessary action and perform timely follow up actions.

### **Examples**

We refer the reader to the annexes for integrated examples on each of the objectives and the components of internal control.

## 2.5 Monitoring



Internal control systems should be monitored to assess the quality of the system's performance over time. Monitoring is accomplished through routine activities, separate evaluations or a combination of both.

### (1) Ongoing monitoring

Ongoing monitoring of internal control is built into the normal, recurring operating activities of an entity. It includes regular management and supervisory activities, and other actions personnel take in performing their duties.

Ongoing monitoring activities cover each of the internal control components and involve action against irregular, unethical, uneconomical, inefficient and ineffective internal control systems.

### (2) Separate evaluations

The scope and frequency of separate evaluations will depend primarily on an assessment of risks and the effectiveness of ongoing monitoring procedures.

Specific separate evaluations cover the evaluation of the effectiveness of the internal control system and ensure that internal control achieves the desired results based on predefined methods and procedures. Internal control deficiencies should be reported to the appropriate level of management.

Monitoring should ensure that audit findings and recommendations are adequately and promptly resolved.



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Monitoring internal control is aimed at ensuring that controls are operating as intended and that they are modified appropriately for changes in conditions. Monitoring should also assess whether, in pursuit of the entity's mission, the general objectives set out in the definition of internal control are being achieved. This is accomplished through ongoing monitoring activities, separate evaluations or a combination of both, in order to help ensure that internal control continues to be applied at all levels and across the entity, and that internal control achieves the desired results. Monitoring the internal control activities themselves should be clearly distinguished from reviewing an organisation's operations which is an internal control activity as previously described in section 2.3.

Ongoing monitoring of internal control occurs in the course of normal, recurring operations of an organisation. It is performed continually and on a real-time basis, reacts dynamically to changing conditions and is ingrained in the entity's operations. As a result, it is more effective than separate evaluations and corrective actions are potentially less costly. Since separate evaluations take place after the fact, problems will often be identified more quickly by ongoing monitoring routines.

The scope and frequency of separate evaluations should depend primarily on the assessment of risks and the effectiveness of ongoing monitoring procedures. When making that determination, the organisation should consider the nature and degree of changes, from both internal and external events, and their associated risks; the competence and experience of the personnel implementing risk responses and related controls; and the results of the ongoing monitoring. Separate evaluations of control can also be useful by focusing directly on the controls' effectiveness at a specific time. Separate evaluations may take the form of self-assessments as well as a review of control design and direct testing of internal control. Separate evaluations also may be performed by the SAIs, by external or internal auditors.

Usually, some combination of ongoing monitoring and separate evaluations will help ensure that internal control maintains its effectiveness over time.

All deficiencies found during ongoing monitoring or through separate evaluations should be communicated to those positioned to take necessary action. The term "deficiency" refers to a condition that affects an entity's ability to achieve its general objectives. A deficiency, therefore, may represent a perceived, potential or real shortcoming, or an opportunity to

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strengthen internal control to increase the likelihood that the entity's general objectives will be achieved.

Providing needed information on internal control deficiencies to the right party is critical. Protocols should be established to identify what information is needed at a particular level for effective decision making. Such protocols reflect the general rule that a manager should receive information that affects actions or behaviour of personnel under his or her responsibility, as well as information needed to achieve specific objectives.

Information generated in the course of operations is usually reported through normal channels, which means to the individual responsible for the function and also to at least one level of management above that individual. However, alternative communications channels should also exist for reporting sensitive information such as illegal or improper acts.

Monitoring internal control should include policies and procedures aimed at ensuring the findings of audits and other reviews are adequately and promptly resolved. Managers are to (1) promptly evaluate findings from audits and other reviews, including those showing deficiencies and recommendations reported by auditors and others who evaluate agencies' operations, (2) determine proper actions in response to findings and recommendations from audits and reviews, and (3) complete, within established time frames, all actions that correct or otherwise resolve the matters brought to their attention.

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

### **Examples**

We refer the reader to the annexes for integrated examples on each of the objectives and the components of internal control.



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## 3 Roles and Responsibilities

Everyone in an organisation has some responsibility for internal control:

**Managers** are directly responsible for all activities of an organisation, including designing, implementing, supervising proper functioning of, maintaining and documenting the internal control system. Their responsibilities vary depending on their function in the organisation and the organisation's characteristics.

**Internal auditors** examine and contribute to the ongoing effectiveness of the internal control system through their evaluations and recommendations and therefore play a significant role in effective internal control. However they do not have management's primary responsibility for designing, implementing, maintaining and documenting internal control.

**Staff members** contribute to internal control as well. Internal control is an explicit or implicit part of everyone's duties. All staff members play a role in effecting control and should be responsible for reporting problems of operations, non-compliance with the code of conduct, or violations of policy.

External parties also play an important role in the internal control process. They may contribute to achieving the organisation's objectives, or may provide information useful to effect internal control. However, they are not responsible for the design, implementation, proper functioning, maintenance or documentation of the organisation's internal control system.



Supreme Audit Institutions (SAIs)	encourage and support the establishment of effective internal control in the government. The assessment of internal control is essential to the SAI's compliance, financial and performance audits. They communicate their findings and recommendations to interested stakeholders.
External auditors	audit certain government organisations in some countries. They and their professional bodies should provide advice and recommendations on internal control.
Legislators and regulators	establish rules and directives regarding internal control. They should contribute to a common understanding of internal control.
Other parties	interact with the organisation (beneficiaries, suppliers, etc.) and provide information regarding achievement of its objectives.

Internal control is primarily effected by an entity's internal stakeholders including management, internal auditors and other staff. However, the actions of external stakeholders also impact the internal control system.

**Managers**

All personnel in the organisation play important roles in making internal control work. However, management has the overall responsibility for the design, implementation, supervising proper functioning of, maintenance and documentation of the internal control system. The management structure may include boards and audit committees, which all have different roles and compositions and are subject to different legislation in different countries.

**Internal auditors**

Management often establishes an internal audit unit as part of the internal control system and uses it to help monitor the effectiveness of internal





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control. Internal auditors regularly provide information about the functioning of internal control, focusing considerable attention on evaluating the design and operation of internal control. They communicate information about strengths and weaknesses and recommendations for improving internal control. However their independence and objectivity should be guaranteed.

Therefore internal auditing should be an independent, objective assurance and consulting activity that adds value and improves an organisation's operations. It helps an organisation accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control and governance processes.

Although internal auditors can be a valuable educational and advisory resource on internal control, the internal auditor should not be a substitute for a strong internal control system.

For an internal audit function to be effective, it is essential that the internal audit staff be independent from management, work in an unbiased, correct and honest way and that they report directly to the highest level of authority within the organisation. This allows the internal auditors to present unbiased opinions on their assessments of internal control and objectively present proposals aimed at correcting the revealed shortcomings. For professional guidance, internal auditors should use the Professional Practices Framework (PPF) of The Institute of Internal Auditors (IIA) including the Definition, the Code of Ethics, the Standards and the Practice Advisories. Additionally, internal auditors should follow the INTOSAI Code of Ethics.

In addition to its role of monitoring an entity's internal control, an adequate internal audit staff can contribute to the efficiency of the external audit efforts by providing direct assistance to the external auditor. The nature, scope, or timing of the external auditor's procedures may be modified if the external auditor can rely upon the internal auditor's work.

### **Staff members**

Staff members and other personnel also effect internal control. It is often these frontline individuals who apply controls, review controls, correct for misapplied controls, and identify problems that may best be addressed through controls in conducting their daily assignments.



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## External parties

The second major group of internal control stakeholders are external parties such as external auditors (including SAIs), legislators and regulators, and other parties. They may contribute to achieving the organisation's objectives, or may provide information useful to effect internal control. However, they are not responsible for the design, implementation, proper functioning, maintenance or documentation of the organisation's internal control system.

### SAIs and external auditors

The tasks of external parties, in particular external auditors and SAIs, include assessing the functioning of the internal control system and informing management about its findings. However, the external party's consideration of the internal control system is determined by his/her mandate.

Auditors' assessment of internal control implies:

- determining the significance and the sensitivity of the risk for which controls are being assessed;
- assessing the susceptibility to misuse of resources, failure to attain objectives regarding ethics, economy, efficiency and effectivity, or failure to fulfil accountability obligations, and non-compliance with laws and regulations;
- identifying and understanding the relevant controls;
- determining what is already known about control effectiveness;
- assessing the adequacy of the control design;
- determining, through testing, if controls are effective;
- reporting on the internal control assessments and discussing the necessary corrective actions.

The Supreme Audit Institution also has a vested interest in ensuring that strong internal audit units exist where needed. Those audit units constitute an important element of internal control by providing a continuous means for improving an organisation's operations. In some countries, however, the internal audit units may lack independence, be weak, or be non-existent. In those cases, the SAI should, whenever possible, offer assistance and guidance to establish and develop those capacities and to ensure the independence of the internal auditor's activities. This assistance might include secondment or lending of staff, conducting lectures,



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sharing training materials, and developing methodologies and work programs? This should be done without threatening the independence of the SAI or external auditor.

The SAI also needs to develop a good working relationship with the internal audit units so that experience and knowledge can be shared and work mutually can be supplemented and complemented. Including internal audit observations and recognizing their contributions in the external audit report when appropriate can also foster this relationship. The SAI should develop procedures for assessing the internal audit unit's work to determine to what extent it can be relied upon. A strong internal audit unit could reduce the audit work of the SAI and avoid needless duplication of work. The SAI should ensure that it has access to internal audit reports, related working papers, and audit resolution information.

SAIs should also play a leadership role for the rest of the public sector by establishing their own organisation's internal control framework in a manner consistent with the principles set out in this guideline.

Not only SAIs but also external auditors play an important role in contributing to the achievement of the internal control objectives, in particular “fulfilling accountability obligations” and “safeguarding resources”. This is because external audits of financial reports and information are integral to accountability and good governance. External audits are still a primary mechanism that external stakeholders use to review performance, along with non-financial information.

### **Legislators and regulators**

Legislation can provide a common understanding of the internal control definition and objectives to be achieved. It can also prescribe the policies that internal and external stakeholders are to follow in carrying out their respective roles and responsibilities for internal control.



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# *Annex 1 Examples*



**Fulfilling accountability obligations example (1):** A department that is responsible for the management of safe transport by water and sea has been organised by different service departments responsible for piloting, buoyage, inspection of the quality of the water, promotion of the use of waterways, investments in and maintenance of infrastructure (bridges, dikes, canals and locks).

Control Environment	Risk Assessment	Control Activities	Information & Communication	Monitoring
For each of the service departments an operational manager is appointed who has to report to the general manager of the department. The operational managers have the appropriate skills and have the authority to make certain decisions. All of them also sign a code of proper conduct.	Possible risks are collisions of ships, draining off toxic waste or fuel, and bursting of dikes. If mishaps are related to negligence of the government department, it could face a huge liability.	Control activities that can be organised are the piloting of ships by competent pilots, placing buoys, beacons and markers; visual inspection by air, and taking water samples.	The information and communication related to this situation can be the reporting of collisions to warn other ships; informing ships of weather conditions, and publishing the names of polluters and the sanctions they are facing, and the remedial actions undertaken.	A follow-up of the number of collisions, environmental violations, results of the samples and a comparison with other countries and with historical data, can help to monitor the effectiveness and efficiency of the piloting of ships, the placing of the beacons and markers, the inspections, and the water samples.





**Fulfilling accountability obligations example (2):** The manager of the department of sports stipulated last year the objective that the practice of sports would increase by 15% in the coming years.

Control Environment	Risk Assessment	Control Activities	Information & Communication	Monitoring
Because of the manager's good reputation, the executive committee trusted the manager and did not carry out the usual status meetings to check on the manager's progress.  <i>(The abovementioned situation is not an example of good practice!)</i>	By not specifying the objectives, the risk arises of not achieving them. Also the danger exists that reporting will not be timely as the manager wants to wait with this report until he can say he realised the objective of 15% growth. Moreover, how to measure the 15% growth was not revealed, so he can say the number of people doing sports has increased or the number of hours people do sports, or even the number of sports centres or sports clubs has increased by 15%. This way the quality of the reported information decreases substantially.	This risk can be decreased by installing appropriate lines of reporting and a reporting model which defines the information that should be given.	This report should be delivered in time and according to the specified reporting model. It should specify the growth objectives, how they are measured and why they are measured this way. All the back up information should be available.	The verification of whether or not the report is satisfactory and what information is given and what information is still missing can be a form of monitoring.

**Compliance with applicable laws and regulations example:** The ministry of defence wants to buy new fighter planes via a public contract and publishes all stipulations and procedures for this government tender. All tenders received are left unopened until the end of the tender period. At that moment all tenders are opened in the presence of the responsible managers and some officials. Only these tenders will be investigated and compared to decide which tender is the best.

Control Environment	Risk Assessment	Control Activities	Information & Communication	Monitoring
<p>The team that will execute this transaction is composed of competent people who signed a document that they have no financial or relational bond with any of the tenderers. The responsible managers and officials also signed this document.</p>	<p>One of the risks related to government tenders and public contract is insider dealing. One of the tenderers may have prior knowledge of the bids of the other tenderers and could make a winning tender with this information resulting in what may not be the best choice of all tenders. Another risk consists of choosing the wrong tender which may result in a new public contract because the other one did not meet the expectations. Also other tenderers who feel they were unfairly treated may make claims.</p>	<p>In order to mitigate risks, procedures should be developed and applied in accordance with all relevant laws and regulations concerning public contracts.</p>	<p>The procedures relating to the publication of all stipulations for this government tender, the assessment of the received tenders and the announcement of the selected tenderer, should be documented in writing and detail all actions to be taken. When assessing the tenders, all reasons why a tender was or was not chosen should be documented.</p>	<p>Internal audit can do file-reviews and follow-up on claims.</p>







**Orderly, ethical, economical, efficient and effective operations example (1):** The department of culture wants to increase museum visits by the public. In order to accomplish this, it proposes to build new museums, give every citizen a cultural cheque and decrease ticket prices. To be economical, effective and efficient, management has to consider and evaluate whether or not the objectives as formulated can be achieved by its proposals and how much each of these proposals will cost.

Control Environment	Risk Assessment	Control Activities	Information & Communication	Monitoring
The department of culture needs to make sure that its organisation structure is suited to support overseeing design and construction of the proposed additions, as well as planning and operations of the new museums.	The fact that the number of museum visits does not increase is one of the possible risks. Also the risk that some of the proposals will backfire and exceed their budget is possible. For instance, if decreasing ticket prices does not increase museum visits, this decreases the government receipts. Further, building new museums without proper planning and consideration of requirements of lighting, temperature and security can result in expensive adjustments during or after construction.	The control activities related to the before mentioned risks can be a budgetary control that compares actual to budget, observations of the progress of the construction, and demanding justifications for overspending the budget.	The information and communication related to this example can consist of the documentation of meetings with architects, fire department (for safety regulations), artists and others. It can also contain different reports concerning following up on the budget and the progress of the construction work.	The analysis of the justifications for exceeding budget and related interest costs due to delayed work or payments are a part of monitoring.

**Orderly, ethical, economical, efficient and effective operations example (2):** The government wants to develop agriculture and increase the quality of life in the countryside. They provide funds to subsidize the construction of irrigation and the drilling of wells.

Control Environment	Risk Assessment	Control Activities	Information & Communication	Monitoring
<p>The government must ensure that it has the appropriate department in place to implement and conduct the subsidy operation, and create the appropriate tone for the timely and efficient completion of this project.</p>	<p>The risks involved are that unscrupulous associations qualify for a grant but do not use the money for what it was intended.</p>	<p>Control activities can be:</p> <ul style="list-style-type: none"> <li>- Checking the qualifications of the associations applying for a grant.</li> <li>- Checking on site the progress of and reviewing progress reports on the construction works.</li> <li>- Checking the expenditures of the associations by reviewing their invoices, and delaying payment of (or part of) the subsidy until this review is completed.</li> </ul>	<ul style="list-style-type: none"> <li>- Progress reports detailing the costs and the number of wells that were drilled and the number of acres that were irrigated.</li> <li>- (Copies of) invoices are requested as justifications for the subsidised expenses.</li> </ul>	<p>Monitoring can consist of a follow-up of the drilling of wells and the construction of irrigation, and a comparison with other similar projects.</p> <p>Also a follow-up on the proceeds of the irrigated land can be considered.</p>





**Safeguarding resources example (1):** The ministry of defence has some warehouses, military stores and fuel depots. The army command has the policy that these supplies are only for professional military use and not for personal use.

Control Environment	Risk Assessment	Control Activities	Information & Communication	Monitoring
Good human capital policies would be effective in recruiting and maintaining the appropriate personnel to staff and operate such warehouses.	The risk exists that people will want to try to steal weapons to use them inappropriately or sell them. Also other supplies like fuel can be vulnerable to theft.	Control activities that deal with these risks can be putting fences and walls around the warehouses and depots, or placing armed guards with dogs at the entrances. Regularly checking the stock records and a procedure which states that supplies can only be given with approval of a superior officer will also help to safeguard the assets.	Reports of damaged fences and differences noticed during stock takes. Supply approvals and procedures also provide information and communication related to this objective.	Monitoring can be an inspection of the fence, unannounced stock takes, follow-up of stock movements or even a secret test of security.

**Safeguarding resources example (2):** Large amounts of sensitive information are stored on computer media in an agency of the ministry of justice. However, the importance of IT controls is neglected and consequently the IT control has numerous deficiencies.

Control Environment	Risk Assessment	Control Activities	Information & Communication	Monitoring
<p>Management must dedicate its commitment to competence and proper behaviour involving IT, and provide proper training in this area. Human capital policies also play a key role in establishing a positive control environment for IT issues.</p>	<p>At the general controls level, the agency has not:</p> <ul style="list-style-type: none"> <li>- limited user access to only that needed by users to perform their duties;</li> <li>- developed adequate system software controls to protect programs and sensitive data;</li> <li>- documented software changes;</li> <li>- segregated incompatible duties;</li> <li>- addressed service continuity;</li> <li>- protected its network from unauthorized traffic.</li> </ul> <p>At the application controls level, the agency has not maintained access authorizations.</p> <p><i>(This is not an example of good practice!)</i></p>	<p>The agency can:</p> <ul style="list-style-type: none"> <li>- implement logical (e.g. passwords) and physical access controls (e.g. locks, ID badges, alarms);</li> <li>- deny the ability to log in to the operating system for application users;</li> <li>- limit access to the production environment for the application development staff;</li> <li>- use audit logs to register all access (attempts) and commands to detect security violations;</li> <li>- have a contingency and disaster recovery plan to ensure the availability of critical resources and facilitate the continuity of operations;</li> <li>- have firewalls and monitor the web server activity to secure the network traffic.</li> </ul>	<p>Procedures on IT control should be available and software changes should be documented before the software is placed in operation.</p> <p>Policies and job descriptions supporting the principles of segregation of duties should be developed.</p> <p>Audit logs on access (attempts) and (unauthorized) commands should be periodically reported and reviewed.</p>	<p>Performing an IT audit, doing a disaster simulation exercise, and monitoring the web server activity, can be part of monitoring the IT environment.</p>



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# *Annex 2 Glossary*



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This glossary is intended to provide a common understanding of the main terms used in these guidelines in respect to internal control definitions and practices. In addition to some definitions we introduced in this document, we also used existing definitions from various sources as noted.

- Code of ethics and auditing standards, INTOSAI, 2001. (INTOSAI auditing standards)
- Internal Control – Integrated Framework, COSO, 1992. (COSO 1992)
- Glossarium, Office for official publications of the European communities, P. Everard and D. Wolter, 1989. (glossarium)
- Auditing and assurance services, an integrated approach, A. A. Arens, R. J. Elder and M. S. Beasley, Prentice Hall international edition, ninth edition, 2003. (Arens, Elder & Beasley)
- the COSO exposure draft “Enterprise Risk Management Framework”, COSO, 2003. (COSO ERM)
- Handbook of international auditing, assurance, and ethics pronouncements, IFAC, 2003. (IFAC)
- Transparency International Source Book 2000, (Transparency International)
- XVI INCOSAI, Montevideo, Uruguay, 1998, Principal Paper Theme 1A (Preventing and Detecting Fraud and Corruption), February 1997, (XVI INCOSAI, Uruguay, 1998)
- Professional Practices Framework, The Institute of Internal Auditors. (IIA)

## A

### **Access control**

In information technology, controls designed to protect resources from unauthorized modification, loss, or disclosure.

### **Accountability**

- The process whereby public service bodies and the individuals within them are held responsible for their decisions and actions, including their stewardship of public funds and all aspects of performance.
- Duty imposed on an audited person or entity to show that he/it has administered or controlled the funds entrusted to him/it in accordance with the terms on which the funds were provided. (glossarium)

### **Application**

Computer program designed to help people perform a certain type of work, including specific functions, such as payroll, inventory control, accounting, and mission support. Depending on the work for which it is designed, an application can manipulate text, numbers, graphics, or a combination of these elements.



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### **Application controls**

- The structure, policies, and procedures that apply to separate, individual application systems and are designed to cover the processing of data within specific applications software.
- Programmed procedures in application software, and related manual procedures, designed to help ensure the completeness and accuracy of information processing. Examples include computerized edit checks of input data, numerical sequence checks and manual procedures to follow up on items listed in exception reports. (COSO 1992)

### **Audit**

Review of a body's activities and operations to ensure that these are being performed or are functioning in accordance with objectives, budget, rules and standards. The aim of this review is to identify, at regular intervals, deviations which might require corrective action. (glossarium)

### **Audit committee**

A committee of the Board of Directors whose role typically focuses on aspects of financial reporting and on the entity's processes to manage business and financial risk, and for compliance with significant applicable legal, ethical, and regulatory requirements. The Audit Committee typically assists the Board with the oversight of (a) the integrity of the entity's financial statements, (b) the entity's compliance with legal and regulatory requirements, (c) the independent auditors' qualifications and independence, (d) the performance of the entity's internal audit function and that of the independent auditors and (e) compensation of company executives (in absence of a remuneration committee).

### **Audit institution**

Public body which, however it is appointed, composed or organised, carries out external audit duties in accordance with the law. (glossarium)

## **B**

### **Budget**

Quantitative, financial expression of a program of measures planned for a given period. The budget is drawn up with a view to planning future operations and to making ex post facto checks on the results obtained. (glossarium)

### **Budgetary control**

Control by which an authority which has granted an entity a budget ensures that this budget has been implemented in accordance with the estimates, authorisations and regulations. (glossarium)



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## C

### **Collusion**

A cooperative effort among employees to defraud a business of cash, inventory, or other assets. (Arens, Elder & Beasley)

### **Compliance**

- Having to do with conforming with laws and regulations applicable to an entity. (COSO 1992)
- Conformity and adherence to policies, plans, procedures, laws, regulations, contracts, or other requirements. (IIA)

### **Component of internal control**

One of five elements of internal control. The internal control components are the entity's internal control environment, risk assessment, control activities, information and communication, and monitoring. (COSO 1992)

### **Computer controls**

1. Controls performed by computer, i.e., controls programmed into computer software (contrast with manual controls). 2. Controls over computer processing of information, consisting of general controls and application controls (both programmed and manual). (COSO 1992)

### **Computer information system**

A computer information system (CIS) environment exists when a computer of any type or size is involved in the processing by the entity of (financial) information of significance to the audit, whether that computer is operated by the entity or by a third party. (IFAC)

### **Control**

- 1. A noun, used as a subject, e.g. existence of a control – a policy or procedure that is part of internal control. A control can exist within any of the five components. 2. A noun, used as an object, e.g. to effect control – the result of policies and procedures designed to control; this result may or may not be effective internal control. 3. A verb, e.g. to control – to regulate; to establish or implement a policy that affects control. (COSO 1992)
- Any action taken by management, the board, and other parties to manage risk and increase the likelihood that established objectives and goals will be achieved. Management plans, organizes, and directs the performance of sufficient actions to provide reasonable assurance that objectives and goals will be achieved. (IIA)

### **Control activity**

Control activities are the policies and procedures established to address risks and to achieve the entity's objectives. The procedures that an organisation puts in place to treat risk are called internal control activities. Internal control activities





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are a response to risk in that they are designed to contain the uncertainty of outcome that has been identified.

### **Control environment**

The control environment sets the tone of an organisation, influencing the control consciousness of its staff. It is the foundation for all other components of internal control, providing discipline and structure.

### **Corruption**

- Any form of unethical use of public authority for personal or private advantage. (XVI INCOSAI, Uruguay, 1998)
- The misuse of entrusted power for private benefit. (Transparency International)

### **COSO**

Committee of Sponsoring Organisations of the Treadway Commission, a group of several accounting organisations. In 1992, it published a significant study on internal control titled Internal Control – Integrated Framework. The study is often referred to as the COSO Report.

## **D**

### **Data**

Facts and information that can be communicated and manipulated.

### **Deficiency**

A perceived, potential or real internal control shortcoming, or an opportunity to strengthen internal control to provide a greater likelihood that the entity's objectives are achieved. (COSO 1992)

### **Design**

1. Intent. As used in the definition, internal control is intended to provide reasonable assurance as to the achievement of objectives; when the intent is realized, the system can be deemed effective. 2. Plan; the way a system is supposed to work, contrasted with how it actually works. (COSO 1992)

### **Detective control**

A control designed to discover an unintended event or result (contrast with preventive control) (COSO 1992)

### **Documentation**

- Documentation of the internal control structure is the material and written evidence of the components of the internal control process, including the identification of an organisation's structure and policies and its operating categories, its related objectives and control activities. These should appear in documents such as management directives, administrative policies, procedures manuals, and accounting manuals.



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## E

### **Economical**

Not wasteful or extravagant. It means getting the right amount of resources, of the right quality, delivered at the right time and place, at the lowest cost.

### **Economy**

- Minimising the cost of resources used for an activity, having regard to the appropriate quality. (INTOSAI auditing standards)
- Acquisition at the right time and at the lowest cost of financial, human and material resources which are suitable in terms of both quality and quantity. (glossarium)

### **Edit checks**

Programmed controls built into the early stages of the input process to identify erroneous data fields. For example, alphanumeric characters entered into numerical fields can be rejected by this control. Programmed edit controls can also be applied, for example, when transactions data enter the processing cycle from another application.

### **Effective**

Refers to the accomplishment of objectives or the extent to which the outcomes of an activity match the objective or the intended effects of that activity.

### **Effectiveness**

- The extent to which objectives are achieved and the relationship between the intended impact and the actual impact of an activity. (INTOSAI auditing standards)
- Extent to which the stated objectives have been attained in a cost-effective way. (glossarium)

### **Efficient**

Refers to the relationship between the resources used and the outputs produced to achieve the objectives. It means that minimum resource inputs are used to achieve a given quantity and quality of output, or a maximum output with a given quantity and quality of resource inputs.

### **Efficiency**

- The relationship between the output, in terms of goods, services or other results, and the resources used to produce them. (INTOSAI auditing standards)
- Use of financial, human and material resources in such a way as to maximize output for a given amount of resources, or to minimize input for a given quantity or quality of output. (glossarium)



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**End user computing**

Refers to the use of non-centralized (i.e., non-IT department) data processing using automated procedures developed by end-users, generally with the aid of software packages (e.g., spreadsheet and database). End-user processes can be sophisticated and become an extremely important source of management information. Whether they are adequately tested and documented may be questionable.

**Entity**

An organization of any size established for a particular purpose. An entity, for example, may be a business enterprise, not-for-profit organization, government body or academic institution. Other terms used as synonyms include organization and department. (COSO 1992)

**Ethical**

Relates to moral principles.

**Ethical values**

Moral values that enable a decision maker to determine an appropriate course of behavior; these values should be based on what is “right,” which may go beyond what is legally required. (COSO 1992)

**External audit**

Audit carried out by a body which is external to and independent of the auditee, the purpose being to give an opinion on and report on the accounts and the financial statements, the regularity and legality of operations, and/or the financial management. (glossarium)

**F****Flowchart**

A diagrammatic representation of the client’s documents and records, and the sequence in which they are processed. (Arens, Elder & Beasley)

**Flow-charting**

Illustrates a flow of procedures, information or documents. This technique makes it possible to give a summary description of complex circuits or procedures. (glossarium)

**Fraud**

An unlawful interaction between two entities, where one party intentionally deceives the other through the means of false representation in order to gain illicit, unjust advantage. It involves acts of deceit, trickery, concealment, or breach of confidence that are used to gain some unfair or dishonest advantage. (XVI INCOSAI, Uruguay, 1998)



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## G

### **General controls**

- General controls are the structure, policies and procedures that apply to all or a large segment of an entity's information systems and help ensure their proper operation. They create the environment in which application systems and controls operate.
- Policies and procedures that help ensure the continued, proper operation of computer information systems. They include controls over information technology management, information technology infrastructure, security management, and software acquisition, development and maintenance. General controls support the functioning of programmed application controls. Other terms sometimes used to describe general controls are general computer controls and information technology controls. (COSO ERM)

## I

### **Independence**

- Freedom given to an audit body and its auditors to act in accordance with the audit powers conferred on them without any outside interference. (glossarium)
- The freedom of the SAI in auditing matters to act in accordance with its audit mandate without external direction or interference of any kind. (INTOSAI auditing standards)
- The freedom from conditions that threaten objectivity or the appearance of objectivity. Such threats to objectivity must be managed at the individual auditor, engagement, functional and organizational levels.(IIA)
- The auditor's ability to maintain an unbiased viewpoint in the performance of professional services (independence in fact) (Arens, Elder & Beasley)
- The auditor's ability to maintain an unbiased viewpoint in the eyes of others (independence in appearance). (Arens, Elder & Beasley)

### **Inherent limitations**

Those limitations of all internal control systems. The limitations relate to the limits of human judgment; resource constraints and the need to consider the cost of controls in relation to expected benefits; the reality that breakdowns can occur; and the possibility of management override and collusion. (COSO 1992)

### **Inherent risk**

The risk to an entity in the absence of any actions management might take to alter either the risk's likelihood or impact. (COSO ERM)

### **Institute of Internal Auditors (IIA)**

The IIA is an organisation that establishes ethical and practice standards, provides education, and encourages professionalism for its members.



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## **Integrity**

The quality or state of being of sound moral principle; uprightness, honesty and sincerity; the desire to do the right thing, to profess and live up to a set of values and expectations. (COSO 1992)

## **Internal audit**

- The functional means by which the managers of an entity receive an assurance from internal sources that the processes for which they are accountable are operating in a manner which will minimise the probability of the occurrence of fraud, error or inefficient and uneconomic practices. It has many of the characteristics of external audit but may properly carry out the directions of the level of management to which it reports. (INTOSAI auditing standards)
- an independent, objective assurance and consulting activity designed to add value and improve an organisation's operations. It helps an organisation accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control and governance processes (IIA)
- Internal auditing is an appraisal activity established within an entity as a service to the entity. Its functions include, amongst other things, examining, evaluating and monitoring the adequacy and effectiveness of the accounting and internal control systems. (IFAC)

## **Internal auditor(s)**

Examine and contribute to the ongoing effectiveness of the internal control system through their evaluations and recommendations, but they don't have primary responsibility for designing, implementing maintaining and documenting it.

## **Internal audit unit**

- Department (or activity) within an entity, entrusted by its management with carrying out checks and assessing the entity's systems and procedures in order to minimize the likelihood of fraud, errors and inefficient practices. Internal audit must be independent within the organization and report directly to management. (glossarium)
- A department, division, team of consultants, or other practitioner(s) that provides independent, objective assurance and consulting services designed to add value and improve an organisation's operations. The internal audit activity helps an organisation accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control and governance processes. (IIA)

## **Internal control**

Internal control is an integral process that is effected by an entity's management and personnel and is designed to address risks and provide reasonable assurance that in pursuit of the entity's mission, the following general objectives are being achieved: executing orderly, ethical, economical, efficient and effective operations,



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fulfilling accountability obligations, complying with applicable laws and regulations and safeguarding resources against loss, misuse and damage.

**Internal Control System (or Process, or Architecture)**

A synonym for Internal Control, applied in an entity. (COSO 1992)

**International Organisation of Supreme Audit Institutions (INTOSAI)**

INTOSAI is the professional organisation of supreme audit institutions (SAI) in countries that belong to the United Nations or its specialised agencies. SAIs play a major role in auditing government accounts and operations and in promoting sound financial management and accountability in their governments. INTOSAI was founded in 1953 and has grown from the original 34 countries to a membership of over 170 SAIs.

**Input**

Any data entered into a computer or the process of entering data into the computer.

**L**

**Legislature**

The law-making authority of a country, for example a Parliament. (INTOSAI auditing standards)

**Logical access**

The act of gaining access to computer data. Access may be limited to “read only”, but more extensive access rights include the ability to amend data, create new records, and delete existing records. (see also physical access)

**M**

**Mainframe**

A high-level computer designed for the most intensive computational tasks. Mainframe computers are often shared by multiple users connected to the computer by terminals.

**Management**

Comprises officers and others who also perform senior managerial functions. Management includes directors and the audit committee only in those instances when they perform such functions. (IFAC)

**Management intervention**

Management’s actions to overrule prescribed policies or procedures for legitimate purposes; management intervention is usually necessary to deal with



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non-recurring and non-standard transactions or events that otherwise might be handled inappropriately by the system (contrast this term with Management Override). (COSO 1992)

### **Management override**

Management's overruling of prescribed policies or procedures for illegitimate purposes with the intent of personal gain or an enhanced presentation of an entity's financial condition or compliance status (contrast this term with Management Intervention). (COSO 1992)

### **Management process**

The series of actions taken by management to run an entity. Internal control is a part of and integrated with the management process. (COSO 1992)

### **Manual controls**

Controls performed manually, not by computer (contrast with Computer Controls). (COSO 1992)

### **Monitoring**

Monitoring is a component of internal control and it is the process that assesses the quality of the internal control system's performance over time.

## **N**

### **Network**

In information technology, a group of computers and associated devices that are connected by communications facilities. A network can involve permanent connections, such as cables, or temporary connections made through telephone or other communications links. A network can be as small as a local area network consisting of a few computers, printers, and other devices, or it can consist of many small and large computers distributed over a vast geographic area.

## **O**

### **Objectivity**

An unbiased mental attitude that allows SAI's, internal and external auditors to perform engagements in such a manner that they have an honest belief in their work product and that no significant quality compromises are made. Objectivity requires the auditors not to subordinate their judgment on audit matters to that of others.

### **Operations**

- Used with "objectives" or "controls": having to do with the effectiveness and efficiency of an entity's activities, including performance and profitability goals, and safeguarding resources. (COSO 1992)



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- The functions, processes, and activities by which an entity's objectives are achieved.

**Orderly**

Means in a well-organised way, or methodically.

**Output**

In information technology, data/information produced by computer processing, such as graphic display on a terminal or hard copy.

**P****Physical access**

In access control, gaining access to physical areas and entities. (see logical access)

**Policy**

Management's dictate of what should be done to effect control. A policy serves as the basis for procedures for its implementation. (COSO 1992)

**Preventive control**

A control designed to avoid unintended events or results (contrast with detective control). (COSO 1992)

**Procedure**

An action that implements a policy. (COSO 1992)

**Processing**

In information technology, the execution of program instructions by the computer's central processing unit.

**Public accountability**

The obligations of persons or entities, including public enterprises and corporations, entrusted with public resources to be answerable for the fiscal, managerial and program responsibilities that have been conferred on them, and to report to those that have conferred these responsibilities on them. (INTOSAI auditing standards)

**Public sector**

The term 'public sector' refers to national governments, regional (for example, state, provincial, territorial) governments, local (for example, city, town) governments and related governmental entities (for example, agencies, boards, commissions and enterprises). (IFAC)





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## R

### **Reasonable assurance**

- Equates to a satisfactory level of confidence under given considerations of costs, benefits, and risks.
- The concept that internal control, no matter how well designed and operated, cannot guarantee that an entity's objectives will be met. This is because of inherent limitations in all internal control systems. (COSO 1992)

### **Residual risk**

The risk that remains after management responds to the risk.

### **Risk**

The possibility that an event will occur and adversely affect the achievement of objectives. (COSO ERM)

### **Risk appetite**

- The amount of risk to which the entity is prepared to be exposed before it judges action to be necessary.
- The broad-based amount of risk a company or other entity is willing to accept in pursuit of its mission or vision. (COSO ERM)

### **Risk assessment**

Risk assessment is the process of identifying and analysing relevant risks to the achievement of the entity's objectives and determining the appropriate response.

### **Risk assessment cycle**

An ongoing, iterative process to identify and analyse altered conditions, opportunities and risks and to take actions as necessary, in particular modifying internal control to address changing risk. Risk profiles and related controls have to be regularly revisited and reconsidered in order to have assurance that the risk profile continues to be valid, that responses to risk remain appropriately targeted and proportionate, and mitigating controls remain effective as risks change over time.

### **Risk evaluation**

Means estimating the significance of a risk and assessing the likelihood of the risk occurrence.

### **Risk profile**

An overview or matrix of the key risks facing an entity or sub-unit that includes the level of impact (e.g., high, medium, low) along with the probability or likelihood of the event occurring.

### **Risk tolerance**

The acceptable variation relative to the achievement of objectives. (COSO ERM)



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## S

### **Security program**

An organization-wide program for security planning and management that forms the foundation of an organization's security control structure and reflects senior management's commitment to addressing security risks. The program should establish a framework and continuing cycle of activity for assessing risk, developing and implementing effective security procedures, and monitoring the effectiveness of these procedures.

### **Segregation (or separation) of duties**

To reduce the risk of error, waste, or wrongful acts and the risk of not detecting such problems, no singular individual or team should control all key stages (authorizing, processing, recording, reviewing) of a transaction or event.

### **Service continuity control**

This type of control involves ensuring that when unexpected events occur, critical operations continue without interruption or are promptly resumed and critical and sensitive data are protected.

### **Stakeholders**

Parties that are affected by the entity, such as shareholders, the communities in which the entity operates, employees, customers and suppliers. (COSO ERM)

### **Supreme Audit Institution (SAI)**

The public body of a State which, however designated, constituted or organised, exercises by virtue of law the highest public auditing function of that State. (INTOSAI auditing standards & IFAC)

### **System software**

Software primarily concerned with coordinating and controlling hardware and communication resources, access to files and records, and the control and scheduling of applications.

### **System software controls**

Controls over the set of computer programs and related routines designed to operate and control the processing activities of computer equipment.

## U

### **Uncertainty**

Inability to know in advance the exact likelihood or impact of future events. (COSO ERM)



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## V

### **Value for money**

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*Guidance for  
Reporting on the  
Effectiveness of  
Internal Controls;  
SAI Experiences in Implementing  
and Evaluating Internal Controls*

INTOSAI PROFESSIONAL STANDARDS COMMITTEE

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# INTOSAI

## Guidance for Reporting on the Effectiveness of Internal Controls: SAI Experiences In Implementing and Evaluating Internal Controls

Issued by The Internal Control Standards Committee

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## PREFACE

In June 1992, the Internal Control Standards Committee of the International Organization of Supreme Audit Institutions (INTOSAI) issued Guidelines for Internal Control Standards. The standards set forth in the guidelines were intended for use by government management to implement an effective internal control structure and by government auditors to help evaluate those structures.

Five years later, the committee invited INTOSAI members to share their countries' experiences in developing, maintaining, and evaluating internal control structures based on the guidelines. This document provides an overview of the responses from

- Bolivia, Office of the Comptroller General;
- China, National Audit Office;
- Costa Rica, Office of the Comptroller General;
- Egypt, Central Auditing Organization;
- Iceland, National Audit Office;
- Japan, Board of Audit;
- the Netherlands, Netherlands Court of Audit
- New Zealand, Audit Office;
- South Africa, Auditor-General;
- Tonga, Audit Office;
- the United Kingdom, National Audit Office; and
- the United States, General Accounting Office.

The committee appreciates the participation of these INTOSAI members in this project. Their experiences in using INTOSAI's internal control standards can help to further guide all INTOSAI members in building or enhancing their capacity to design high-quality internal control structures and adequately assess them and thus, strengthen public sector financial management and accountability.

Arpad Kovacs, President

State Audit Office of Hungary

Chairman, Internal Control Standards Committee

Chapter I

INTRODUCTION

INTOSAI's June 1992 Guidelines for Internal Control Standards defines an internal control structure as the plans of an organization, including management's attitude, methods, procedures, and other measures that provide reasonable assurance that the following general objectives are achieved:

- promoting orderly, economical, efficient, and effective operations and quality products and services consistent with the organization's mission;
- safeguarding resources against loss due to waste, abuse, mismanagement, errors, and fraud and other irregularities;
- adhering to laws, regulations, and management directives; and
- developing and maintaining reliable financial and management data and fairly disclosing that data in timely reports.

The internal control standards prescribed by INTOSAI form a framework for an internal control structure that meets these objectives. INTOSAI's general and detailed standards are reiterated in chapters II and III, respectively. These chapters also highlight the viewpoints on implementing the standards that were provided by INTOSAI members. Their enlightening perspectives are presented in the context of both control practices that have worked well and examples of control weaknesses that have been identified.

Also, the information furnished by INTOSAI's members for this study was valuable in identifying practices that Supreme Audit Institutions have found to be most useful in creating and monitoring a strong internal control framework. These common practices include

- having a constitutional or a legislative provision that establishes in law an overall basis (or a requirement and objectives) for maintaining effective internal controls;
- prescribing internal control standards to be followed when designing an internal control structure and which can be patterned after or adopted from INTOSAI's standards;
- focusing management's attention on its responsibilities for implementing effective internal controls and continuously maintaining a positive internal control environment;
- emphasizing the prevention of internal control breakdowns - rather than detecting and correcting them - through such means as requiring managers to periodically undertake self-evaluations of internal control operations;
- stressing the role of internal auditors as a critical part of an organization's internal control structure; and
- ensuring that Supreme Audit Institutions play a key role in (1) establishing internal control standards, (2) creating a solid internal control framework, (3) working with internal auditors, and (4) evaluating internal controls as an integral part of both financial and performance audits.

These overarching elements of a sound internal control structure are further discussed in chapter IV. They reinforce guidance in these areas that the INTOSAI Internal Controls Committee promulgated in June 1992.



## Chapter II

### EFFECTIVELY IMPLEMENTING GENERAL STANDARDS

To provide the proper control environment within an organization, INTOSAI has established internal control general standards in the following areas: (1) reasonable assurance, (2) supportive attitude, (3) integrity and competence, (4) control objectives, and (5) monitoring controls.

#### REASONABLE ASSURANCE

INTOSAI's first internal control general standard states that internal control structures are to provide reasonable assurance that the general objectives will be accomplished. Reasonable assurance equates to a satisfactory level of confidence under given considerations of costs, benefits, and risks. This means that the cost of internal control should not exceed the benefit derived. INTOSAI member countries have had experience in applying this standard.

New Zealand, for example, reports that each chief executive of a government department has an obligation as a responsible manager for establishing and maintaining a system of internal control procedures that provides reasonable assurance as to the integrity and reliability of financial reporting. While this responsibility is normally delegated to the organization's chief financial officer (CFO), both the chief executive and the CFO sign a Statement of Responsibility, which is included as part of the organization's annual report along with audited financial statements and service performance measures.

In Japan, reasonable assurance that internal controls are effectively maintained is affected by public sector activities that have become increasingly complicated and diversified in the past decades and by increasing delegation of authority to lower echelons. But Japan's Constitution provides the overall foundation necessary to create an effective control environment through requirements such as for (1) the Cabinet to annually submit final accounts of State revenues and expenditures to the Diet (parliament) and (2) the Board of Audit to audit these accounts every year.

On the other hand, in the Republic of South Africa, government internal controls are reported to not yet be at a satisfactory level nor effective due to several factors, including the large size of its departments and slack controls. Compounding these problems, management does not always have the knowledge to implement the appropriate internal controls and to maintain them in a working order.

Although the Republic of South Africa's internal control environment does not currently provide reasonable assurance that adequate internal controls are in place and operating as intended, the government realizes this problem and is addressing them by means such as implementing an internal audit function in all government entities. Also, the government has appointed local and international consultants to facilitate the establishment of a professional institute for public finance and auditing.

#### SUPPORTIVE ATTITUDE

Another general control standard stipulates that managers and employees are to maintain and demonstrate a positive and supportive attitude toward internal controls at all times. INTOSAI

member countries have learned first-hand the central role this standard can play in creating an effective internal control environment.

For example, in the early 1990s, Iceland's National Audit Office conducted several audits among major governmental lending institutions that showed serious weaknesses in a range of areas related to controlling, monitoring, and reporting nonperforming loans. In many instances, government managers' lax attitude towards proper controls in lending, collections, risk management, and application of loan loss reserves contributed to the weaknesses. As a result, at the end of 1991, the Development Fund of Iceland ceased operations because its management failed to recognize heavy loan losses. Improvements have been made in some areas, such as properly accounting for loan loss reserves, which is now done on a regular basis by all major governmental funds.

In another example, in the 1980s and 1990s, the United States experienced substantial savings and loan institution and bank failures, which cost the federal government hundreds of billions of dollars. Control weaknesses were a major cause of the failures; a key factor leading to these weaknesses was a fundamental flaw in management's philosophy and operating style regarding internal controls. For instance, at some savings and loan institutions, inadequate board supervision and the presence of a dominant figure had a detrimental effect on the viability of the institution. This led to risk-oriented activities such as excessive growth-oriented practices, unwarranted loan concentrations, and an overreliance on volatile funding sources.

However, INTOSAI member countries, including Iceland and the United States, view internal control as a major and important part of their operations. For example, in response to the savings and loan institution and bank failures, the U.S. Congress enacted legislation, the Federal Deposit Insurance Corporation Improvement Act of 1990, to address the serious weaknesses that contributed to earlier bank failures and to require reporting on the effectiveness of financial reporting internal controls. In another instance, the Kingdom of Tonga's government has demonstrated a supportive attitude toward internal controls by passing legislation and establishing related regulations and policies. These include (1) laws to establish an internal control framework for disbursing public money and preparing accounts and (2) regulations setting out the internal control points for the receipt, expenditure, custody, and handing over of public funds. Further, the Audit Department emphasizes to government departments the importance of improving internal controls over financial management and programs.

## INTEGRITY AND COMPETENCE

Regarding integrity and competence, INTOSAI's general control standards call for the following. Managers and employees are to have personal and professional integrity and are to maintain a level of competence that allows them to understand the importance of developing, implementing, and maintaining good internal controls and to accomplish the general objectives of internal controls. Several INTOSAI countries have found that, when this general standard is not adhered to, the result can be weak internal control situations involving large monetary values.

In one such situation, during a governmentwide review of purchasing goods and services, which represents a significant level of New Zealand's public expenditures, the Audit Office found an array of weaknesses it attributed, in part, to the lack of integrity and competence by purchasing managers. The deficiencies ranged from not documenting the decisionmaking

processes for determining purchasing needs and not specifying delegations of authority to not providing adequate review and approval of specific purchases. The New Zealand Audit Office also reports that a recent focus on sensitive areas of discretionary expenditures, such as using credit cards, has resulted in instances of senior officials' integrity being questioned.

Another case in point is the United States government's Department of Housing and Urban Development (HUD), which is the principal government agency responsible for housing, community development, and fair housing opportunities. While HUD has since taken action to change the way the agency is managed, in 1989, major incidents of fraud, abuse, and mismanagement at HUD were found and attributed to internal control weaknesses, including an insufficient mix of properly skilled staff.

On the other hand, INTOSAI member countries also report having internal controls practices designed to help avoid situations such as those just described. For instance, the National Audit Office of the People's Republic of China reports internal controls covering personnel requirements. Applicants for a post go through strict examinations, are assessed and selected in an open and impartial way, and new members are trained. They will not be allowed to go to their new posts before they are able to procure the "Certificate for The Post." Thus, they are recognized according to their abilities. Further, the members are examined regularly and awarded or penalized according to their work performance and contribution to their organization. When necessary, they will be transferred to other posts.

## CONTROL OBJECTIVES

INTOSAI's internal control standards also suggest that specific control objectives are to be identified or developed for each ministry/department/agency activity and are to be appropriate, comprehensive, reasonable, and integrated into the overall organizational objectives. The following instances typify the experiences of INTOSAI member countries in establishing control objectives, which in some cases have not yet progressed beyond having overall organizational objectives.

The Republic of South Africa's Auditor-General reports that a primary objective for the government is to prevent errors or irregularities from occurring in management or financial information or, if any have occurred, to detect them. A range of specific overall control objectives have been identified and include (1) properly recording and accounting for business transactions and activities, (2) safeguarding assets and information from misuse and misappropriation, and (3) establishing limits to which various staff can commit an entity.

Also, the Auditor General for the Kingdom of Tonga reports taking the lead to identify and develop specific control objectives for each government ministry and department activity. The Auditor General is in the process of ensuring that the control objectives are appropriate, comprehensive, reasonable, and integrated into the overall organization structure. INTOSAI's internal control guidelines are being used as the foundation for this process.

Conversely, when internal controls and their objectives are not clearly established and understood, internal control breakdowns can result. For example, Japan's Board of Audit found that municipalities improperly included the medical costs of many retired persons in State subsidized National Health Insurance costs. Significant overpayments in subsidy costs resulted. The problem arose, in part, because municipalities did not understand the State subsidy medical cost subsidy system and requirements.

## MONITORING CONTROLS

In addition, INTOSAI's standards specify that managers are to continually monitor their operations and take prompt, responsive action on all findings of irregular, uneconomical, inefficient, and ineffective operations. The following cases show the importance of monitoring operations to ensure that controls are achieving the desired results and of building this standard into the methods and procedures used to control operations.

In one case, the Icelandic National Audit Office reports a main internal control weakness to be the lack of understanding of the importance of internal controls among individual agency managers. Along with other problems, this weakness was evident in a lack of adherence to the established internal control structure. The National Audit Office said that, although an Icelandic government agency might have well defined internal controls on paper, the reality can be quite different. The audit office has found that, without the necessary understanding and monitoring, it is more convenient for people to not follow established control practices.

Another case involves the New Zealand government, which commonly uses consultants that represents a significant expenditure. The New Zealand Audit Office reports finding irregular, uneconomical, inefficient, and ineffective operations associated with the use of consultants. Further, the Office's experience has been that the departments have not taken prompt, responsive action on these findings and thus, the standard calling for monitoring controls was not being adhered to.

On a more positive note, the United Kingdom's National Audit Office reports that, when instances of weak internal controls are identified and reported, management responds to the points raised and early corrective action will normally have been taken. The Office's aim is to monitor follow-up action, and to provide further advice to management as necessary. New areas of risk identified as a result of audit will be reflected in subsequent audit planning.

## Chapter III

### ACHIEVING CONTROL OBJECTIVES THROUGH DETAILED STANDARDS

To help achieve control objectives and an orderly and effective internal control structure, INTOSAI's internal control guidelines provide detailed standards covering (1) documentation, (2) prompt and proper recording of transactions and events, (3) authorization and execution of transactions and events, (4) separation of duties, (5) supervision, and (6) access to and accountability for resources and records.

#### DOCUMENTATION

Regarding adequate documentation, INTOSAI's detailed standards indicate the following. The internal control structure and all transactions and significant events are to be clearly documented, and the documentation is to be readily available for examination. Documentation of transactions or significant events should be complete and accurate and should enable each transaction or event (and related information) to be traced from its inception, while it is in process, to after it is completed. A cross section of INTOSAI member countries reported having learned the detrimental effects of not having adequate documentation, as illustrated by the following three situations.

First, the National Audit Office in the United Kingdom reported instances of non-existent or inadequate documentation to support financial transactions having been identified as a result of financial audits. For example, the Audit Office reported instances of

- the lack of documentation being submitted by employees to support payments made for expenses paid by government credit cards;
- the lack of adequate documentation to support legal aid applicants' claims, resulting in insufficient evidence to confirm entitlement and proper payments as authorized by Parliament; and
- the government body being unable to produce documentation to support the decision of its management board to dispense with competitive tendering for a contract.

Second, the government of Tonga's departments, ministries, and statutory bodies have also identified nonexistent and incomplete documentation and records. For instance, at one department, copies of receipts were lost but the accounting officer and the accounts section did not consider this as serious or contrary to laws and regulations.

Third, as a result of examining documentation maintained to support transactions, the Republic of South Africa's Auditor-General identified and reported to Parliament a substantial number of instances involving payments from the government's Department of Labor where beneficiaries had been paid the same amounts based on the same source documents. In other instances, the same amounts had again been paid in respect to the same source documents, although the beneficiaries' names were not exactly identical. The value of the double or multiple payments was substantial.

To help overcome deficiencies such as these, INTOSAI's internal control standards suggest that documentation of transactions or significant events should be complete and accurate. This should enable each transaction or event (and related information) to be traced from its inception, while it is in process, to after it is completed.

## PROMPT AND PROPER RECORDING OF TRANSACTIONS AND EVENTS

INTOSAI's detailed standards also provide that transactions and significant events are to be promptly recorded and properly classified. This applies to the entire process or life cycle of a transaction or event, including (1) the initiation and authorization, (2) all stages while in process, and (3) its final classification in summary records. As with documentation, INTOSAI's members reported on the challenges of meeting this standard as well.

For example, because of lapses in internal control in the system used to pay United States Army personnel, some individuals were paid that should not have been paid because they were no longer in the Army. Further, these improper payments were not detected by the payroll system. In a one-month period that the U.S. General Accounting Office reviewed, it determined that about 2,200 Army soldiers were overpaid. Many of these individuals received unauthorized payments for several months, with total overpayments reaching \$7.8 million. The improper payments occurred primarily because U.S. Department of Defense personnel did not comply with established procedures. For instance, field-level finance offices did not always enter soldiers' separations from active duty and other personnel transactions in the payroll system in a timely manner and payroll staff could not provide adequate support for some payments.

The United Kingdom's National Audit Office has also reported instances which it has classified as control weaknesses involving transactions not being promptly and properly recorded. In one instance, procedures were not in place to ensure the prompt and secure handling and recording of cash receipts. For example, the Office identified delays of over two weeks in depositing checks, which increased the risks of misappropriation. In another case, the Office reported financial control weaknesses in purchasing, including failures to record the authorization of transactions such as purchase order, inadequate proof of delivery, and inadequate checking of goods received.

Moreover, in New Zealand, a number of government entities have undergone significant system changes that were not fully tested. This has resulted in instances of untimely processing of transactions and lack of reconciliations; a common control deficiency reported by that country's National Audit Office.

To help prevent situations such as these, INTOSAI's internal control standards recognize that prompt and proper recording of information is essential. Meeting this standard is pivotal for assuring the timeliness and reliability--and thus, the value and relevance to management--of all information used by an organization to support its operations and decisionmaking.

#### AUTHORIZATION AND EXECUTION OF TRANSACTIONS AND EVENTS

INTOSAI's detailed standards set forth the expectation that transactions and significant events are to be authorized and executed only by persons acting within the scope of their authority. Conforming to the terms of an authorization means that employees execute their assigned duties

in accordance with directives and within the limitations established by management or legislation. But some INTOSAI members have reported instances where stronger controls over the authorization of transactions could have resulted in more effective controls and savings. For instance, in 1992, the Icelandic National Audit Office audited automobile expenses across many sections of the Icelandic government. The audit showed several weaknesses in the overall structure and control in this area, including many contracts that were made with individual employees in an unstructured manner regardless of transportation requirements--thus limiting managerial approval and other controls.

Yet another perspective on this issue was demonstrated by the Comptroller General of the Republic of Costa Rica through an example involving that country's use of State-owned vehicles. An audit detected that, while the use of such vehicles should be properly authorized, they were being used (1) for unauthorized purposes, (2) during non-working hours without authorization, and (3) inappropriately by an official for discretionary purposes.

Based on studies of internal control problems such as these, auditors in China have reported agreement that the concept of internal control must cover control of authorization. They advise that this control is necessary to help ensure that personnel work within the limits of their permitted authority and thus, exert control over business activities at the point at which they are started.

#### SEPARATION OF DUTIES

As with the other detailed standards, INTOSAI's member countries fully understand the risk of error, waste, or wrongful acts associated with having one person control all key stages of a

transaction or event. In this regard, INTOSAI's internal control guidelines direct that key duties and responsibilities in authorizing, processing, recording, and reviewing transactions and events should be separated among individuals. Properly implementing this standard would greatly help to avoid situations like the following episodes reported by INTOSAI members, such as Tonga, which found that separation of duties is a major weakness that is common to departments and ministries of its government.

In more specific examples, the Audit Office in New Zealand has found that risks have arisen as a result of the use of significant numbers of contracting staff in certain government entities. Although the entities may have met their aim of reducing expenditures, there has sometimes been a trade-off in creating a separation of duties risk.

To address these kinds of problems, Japan reports that its control system to prevent accounting errors and fraud incorporates separation of duties, such as those of contract officers and disbursement officers. For example, (1) the Ministry of Finance notifies the disbursement officers of approved disbursement plans, (2) the disbursement officers submit disbursement reports to the Ministry of Finance, (3) the contract officers notify the disbursement officers of contract amounts and contents, and (4) the disbursement officers approve disbursement after checking whether the contract amount is within the budgeted amounts.

However, as the United Kingdom's National Audit Office reports, it is often difficult for small organizations to maintain proper segregation of duties. The Office has found cases where (1) people were able to both authorize and check payments, (2) staff could requisition, authorize, and receive goods, and (3) there was little or no evidence that supervisory checks were done.

In cases where small organizations make adequate separation of duties difficult, INTOSAI's guidelines suggest that management must be aware of the risks and compensate with other controls. For instance, rotation of employees may help ensure that no one person deals with key aspects of transactions or events for an undue length of time.

## SUPERVISION

INTOSAI's internal control guidelines prescribe that competent supervision is to be provided to ensure that internal control objectives are achieved. The efforts of INTOSAI members to implement and audit internal controls have underscored the importance of proper supervision of assignments and employees as a fundamental internal control mechanism.

The Comptroller General of the Republic of Costa Rica has provided two excellent case studies involving noncompliance with INTOSAI's supervision standard. The first case relates to a computerized system used by banks that collect Customs revenues for the electronic transmission to Customs offices throughout Costa Rica. Auditors found that the process developed by Customs for confirming, recording, and revising this information allowed for unsupervised modification of electronically transmitted data without any documentary support or verification of its validity and reliability.

The second case relates to an evaluation of the Costa Rican government's resources used to deliver health services--particularly the external consultation service provided by one of the country's largest public hospitals. Auditors reported that medical resources were significantly underutilized because the established work schedule was not complied with, which resulted in the misuse of available equipment and facilities and the absence of timely attention to waiting

patients. The underlying cause was attributed to the absence of supervision and subsequent control of work timetables by the heads of medical specialties.

Another country, the Kingdom of Tonga, has also identified supervision, as well lack of training, as an internal control weakness common to most government agencies. The Auditor General has assisted in addressing these weaknesses by starting training programs, identifying supervisors for every level of staff, and stressing the importance of these aspects of internal control systems.

A third INTOSAI member, the National Audit Office of the United Kingdom, has found that adequate supervision is essential in operations such as those related to contracts. It found that monitoring the operation of contracts is key to ensuring that suppliers meet the terms and conditions of the contract for price, standards, and delivery and that the contract remains competitive. The Office found, for instance, that evidence of poor contract monitoring resulted in a final cost of £180,000 on a contract initially worth £25,000 without the required approval for the increase having been made. In another case, a refund was due on a contract but because of poor monitoring, the government was unaware of the potential refund and thus, did not make a claim.

To help ensure proper supervision, INTOSAI's internal control standards state that supervisors are to review and approve, as appropriate, the assigned work of their employees. They must also provide their employees with the necessary guidance and training to help ensure that errors, waste, and wrongful acts are minimized and that specific management directives are understood and achieved.

## ACCESS TO AND ACCOUNTABILITY FOR RESOURCES AND RECORDS

The last INTOSAI detailed standard instructs that access to resources and records is to be limited to authorized individuals who are accountable for their custody or use. To ensure accountability, the resources are to be periodically compared with the recorded amounts to determine whether the two agree. The asset's vulnerability should determine the frequency of the comparison. The work of INTOSAI members has demonstrated the effects of failing to effectively implement this standard to reduce the risk of unauthorized use or loss to the government and help achieve management directives.

In one circumstance involving access to records, the United States government's tax collector, the Internal Revenue Service (IRS), has been plagued by poor internal controls over its computer systems. The U.S. General Accounting Office's financial statement audits showed that IRS did not have adequate safeguards to detect or prevent unauthorized employee access to taxpayer information or to prevent employees from changing certain computer programs to make unauthorized transactions without being detected. The fundamental control problems included controls that did not adequately prevent users from unauthorized access to sensitive programs and data files. Also, numerous users had been given authorized access to powerful computer system privileges which could allow existing security controls to be circumvented.

In a situation involving the comparison of resources and records, the Auditor-General for the Republic of South Africa reported finding that the completeness and correctness of the Department of Land Affairs' bank balance could not be confirmed because the Department had not compiled a bank reconciliation for more than 1 year. The difference between the balance according to the Department's accounting records and the bank's statements was great.



INTOSAI's internal control standards point out that restricting access to resources and a periodical reconciliation of records reduces the risk of unauthorized use or loss to the government and helps achieve management directives.

## Chapter IV

### BUILDING EFFECTIVE INTERNAL CONTROL STRUCTURES

Consistent with INTOSAI's guidelines, member countries have stressed that building effective internal control structures requires the following critical elements: (1) legislative underpinnings, (2) internal control standards, (3) managers who accept primary responsibility for effective controls, (4) periodic internal control self-assessments by managers, (5) internal audits of controls, and (6) a supreme audit organization that is engaged in establishing and reviewing internal control systems.

#### LEGISLATIVE UNDERPINNINGS

As discussed in the INTOSAI internal control guidelines, in some countries, the legislators will establish the overall objectives that the internal control structures should achieve while leaving the internal control standards to be established to a responsible central organization. In others, the legislators set specific controls for certain operations in legislation.

Indeed, INTOSAI members have found it helpful to have legislation that establishes an overall requirement and objectives for maintaining effective internal controls. For example, in Bolivia and in the Netherlands a legislative foundation for public sector internal control is provided by the 1990 Governmental Management and Control law and the Government Accounts Act, respectively.

In Japan, financial and accounting check and control systems are stipulated in the Public Finance Law and the Public Account Law, as well as regulations based on this law. The financial accounting activities of all the Japanese government's ministries and agencies are governed by these statutory check and control systems.

The United States Congress has also recognized the importance of having legislative underpinning to promote effective internal controls. For instance, it has enacted legislation that requires U.S. government agencies to (1) annually evaluate and report on the status of control systems, (2) have an independent audit function, and (3) annually issue and have audited reports on their financial condition.

#### INTERNAL CONTROL STANDARDS

INTOSAI's internal control guidance also points out that, in establishing the framework for internal control structures, a specific authority should be assigned the responsibility for developing and promulgating the standards to be followed when designing an internal control structure. This responsibility could be assigned through constitutional or other legal enactment and given to a central organization with authority across various government organizations.

Several INTOSAI member countries have prescribed internal control standards that are to be followed in establishing and monitoring an internal control structure, and some have patterned their standards after, or have adopted, INTOSAI's standards. For instance, the Office of the

Comptroller General of the Republic of Bolivia used INTOSAI's guidelines to prepare and issue

internal control standards for use in that country. The Office reports that the result has contributed to and facilitated the achievement of control objectives. In the United States, under law, the Comptroller General is charged with developing internal control standards for use by agencies of the U.S. government. These were first issued in 1983 as Standards for Internal Controls in the Federal Government to provide the criteria for establishing and evaluating internal controls. These standards are currently being updated.

Another country, the Peoples Republic of China, has also found that a standard is necessary for assessing an organization's internal controls. The National Audit Office reports that the standard is defined by auditors on the basis of the regulations issued by the Chinese government and related departments. The Chinese National Audit Office advises that such a standard--which is usually referred to as an ideal control standard--embodies the control links and procedures essential for a sound internal control system, and it is used by auditors to impartially assess the target organization to determine whether its internal controls are complete and effective.

## MANAGEMENT'S RESPONSIBILITY

INTOSAI's guidelines explain at length management's internal control responsibilities, emphasizing that all managers should realize that a strong internal control structure is fundamental to their control of the organization and its purpose, operations, and resources. INTOSAI member countries that provided information for this study have experienced the need for focusing managers' attention on their responsibilities for implementing effective internal controls and continuously maintaining a positive internal control environment.

For example, the Netherlands Court of Audit reports that the framework of responsibility for internal control, which is a cornerstone of central government in the Netherlands, has been developed by means of close cooperation between Parliament, the ministry of Finance, and the Court. Also in this regard, the Government Accounts Act states that it is the minister who is responsible for pursuing sound financial management and for controlling the effectiveness and efficiency of management, organization, and policy.

Another instance involves Iceland, where the Icelandic National Audit Office reports that the management of individual governmental agencies is responsible for developing and implementing internal controls. Also, agencies within the central government--such as the Central Accounting Office, the Financial Reporting Commission and to some degree the Ministry of Finance--are directly responsible for implementation of financial controls.

Another example comes from Egypt. The Egyptian Central Auditing Organization reports that the senior management of an entity is responsible for developing and implementing internal controls such as by continuously reconsidering the organizational structure that has been created to direct and control its activities.

## SELF-ASSESSMENTS

INTOSAI member countries concentrate on preventing internal control breakdowns before they occur. To illustrate, South Africa's Supreme Auditor reports that a primary objective is to prevent errors or irregularities from occurring in management or financial information, or if

any have occurred to detect them. Also, in Egypt, auditors evaluate internal control systems to identify their efficiency in preventing or detecting major mistakes.

Several INTOSAI member countries require managers to periodically undertake self-evaluations of internal control operations. INTOSAI's guidelines recognize this practice as useful to ensure that controls for which managers are responsible continue to be appropriate and are working as planned.

For New Zealand, emphasis is given to self-review procedures in each individual government entity. These procedures include a program of self-assessment covering internal audit and financial controls, as well as management review and evaluation of output effectiveness.

In another case, agencies of the United States government are required by law to annually conduct control self-assessments. These evaluations are to be made pursuant to guidelines issued centrally by the U.S. Office of Management and Budget. The results are to be reported to the U.S. President and the U.S. Congress. These reports are to state whether systems meet the objectives of internal control and conform to standards established by the U.S. Comptroller General. Also, U.S. government agencies are required to take actions to correct control weaknesses the self-assessments identify.

In addition, the Bolivian Comptroller General's future plans call for governmental institutions to schedule self-evaluations of the design, operation, and effectiveness of their internal control structures. Bolivia's Comptroller General envisions that the highest responsible officials in each public institution would carry out a self-evaluation and at least annually report their conclusions to the Office of the Comptroller General, which would (1) evaluate the process and outcome and (2) determine the reliability of the data generated by the institution and/or proposed corrective measures.

## INTERNAL AUDITS

Management often establishes an internal audit unit as part of its internal control and self-review framework. In this tradition, most INTOSAI members find the role of internal auditors to be a critical part of an organization's internal control structure. For example, the Supreme Auditors of both Bolivia and Egypt report that internal auditors should evaluate and periodically report on the effectiveness of and deficiencies in internal control structures and the risk that such weaknesses represent for effective government operations and protecting its assets.

The Netherlands is also typical--the audit departments of the ministries audit the financial statements of their ministries and perform specific financial management systems audits. The Netherlands Court of Audit reports that, by advising the minister on internal control weaknesses found during these audits, the internal auditors play an important role in the ongoing improvement of internal (financial) controls. This is reinforced by the performance of specific internal control investigations done at the request of the ministers.

In the United Kingdom, the Accounting Officers within each central government body, who are responsible for the financial management and internal control systems, are assisted in fulfilling these responsibilities by the services of an internal audit function. Internal audit operates as a service to management by measuring, evaluating, and reporting on the effectiveness of the elements of the internal control system.

## SUPREME AUDITOR'S RESPONSIBILITY

INTOSAI members have underscored the key role Supreme Auditors play in (1) establishing internal control standards, (2) creating a solid internal control framework, (3) working with internal auditors, and (4) evaluating internal controls as an integral part of both their financial and performance audits. In sum, the Supreme Audit Institution should gear its work toward assessing the adequacy in principal and the effectiveness in practice of existing internal controls in audited organizations.

One nation's Supreme Audit Institution described its internal control responsibilities this way. Control accomplished by the Comptroller General of the Republic of Costa Rica essentially consists of the financial, accounting, economic, operational, administrative and legal examination of public resources and is basically carried out by means of investigations and audits covering financial, operational, legal, computerized and special areas.

Like the process reported in use by many INTOSAI Supreme Auditors, the Costa Rica's Comptroller General

- evaluates the internal control system in the audited institution, which is comprised of the control environment, the recording and information system, and control proceedings;
- verifies the effectiveness of the internal control system and identifies the critical areas in the activity under examination;
- prepares reports to the administration that summarize detected deficiencies and weaknesses and recommend measures to be adopted for their solution and for the prevention of more severe problems; and
- carries out pertinent follow-up studies to determine whether recommendations and measures, which have been jointly agreed upon with the administration, have been adequately enforced.

## CONCLUSIONS

In 1992, when INTOSAI's Internal Control Standards Committee issued its guidelines for internal control standards, it called for Supreme Auditors to encourage and support the establishment of internal controls. As envisioned by the Committee, this would encompass (1) educating management as to its responsibilities for implementing and monitoring the control structures and (2) auditing those structures to assure that controls are adequate to achieve the desired result.

In the intervening 5 years, INTOSAI member countries have achieved a wide range of positive results and are making progress--in some cases, substantial progress--in fulfilling this vision. The individual country papers prepared by Supreme Auditors have provided considerable new insights into the use and assessment of internal controls by various INTOSAI members.

Through these papers, the committee has identified several common elements, which this chapter outlines, that are evident in sound internal control structures in all systems of government. These elements parallel INTOSAI's 1992 guidance, which provides a foundation for supporting the prescribed general and detailed control standards.

However, this foundation is not yet fully in place and working smoothly in all of INTOSAI's member countries. Further, preserving the effectiveness of these elements and refining the adequacy of internal controls based on the standards should be a continuous process. Accordingly, each INTOSAI member can learn from the constructive examples and experiences that Supreme Auditors have shared with the committee.

Their individual country papers, which more extensively discuss the areas presented in this overview, will be available at the XVI INCOSAI in Montevideo. Also, additional information may be obtained by directly contacting the contributing Supreme Audit Institutions at the locations listed in appendix I.

## APPENDIX I

### CONTRIBUTING SUPREME AUDIT INSTITUTIONS

The following is a list of the names and telephone numbers and the mailing and INTERNET addresses for the Supreme Audit Institutions that have provided the information summarized in this overview document and presented in the related country papers.

Mr. Marcelo Zalles Barriga  
Contralor General de la Republica  
Casilla Postal 432  
La Paz, BOLIVIA  
Tel: 591 (2) 37 88 61  
Fax: 591 (2) 39 21 87

Mr. Li Jinhua  
Auditor General  
National Audit Office  
of the People's Republic of China  
1 Beiluyuan, Zhanlan Road  
Xicheng District  
Beijing 100830, CHINA  
Tel: 86 (10) 68 30 12 14  
Fax: 86 (10) 68 33 09 58  
email: cnao@public.east.cn.net

Mr. Luis Fernando Vargas Benavides  
Contralor General de la Republica  
Apartado 11-79-1000  
San Jose, COSTA RICA  
Tel: 506 220 31 20  
Fax: 506 220 43 85  
email: xcisnado@ns.casapres.go.cr

Dr. Shawky Khater  
President of the  
Central Auditing Organization  
Madinet Nassr  
P. O. Box 11789  
Cairo, ARAB REPUBLIC OF EGYPT

INTOSAI



*Providing a  
Foundation for  
Accountability in  
Government*

# INTOSAI



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# Overview

*“Internal control is a management tool used to provide reasonable assurance that management objectives are being achieved.”*

Guidelines for Internal Control Standards,  
INTOSAI

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Managers are responsible for establishing an effective control environment in their organizations. This is part of their stewardship responsibility over the use of government resources. Indeed, the tone managers set through their actions, policies, and communications can result in a culture of either positive or lax control. Planning, implementing, supervising, and monitoring are fundamental components of internal control. You may go about these activities routinely, without thinking of them as part of a broad control environment that helps to ensure accountability. But they are.

Internal control, or management control, helps to provide reasonable assurance that the organization

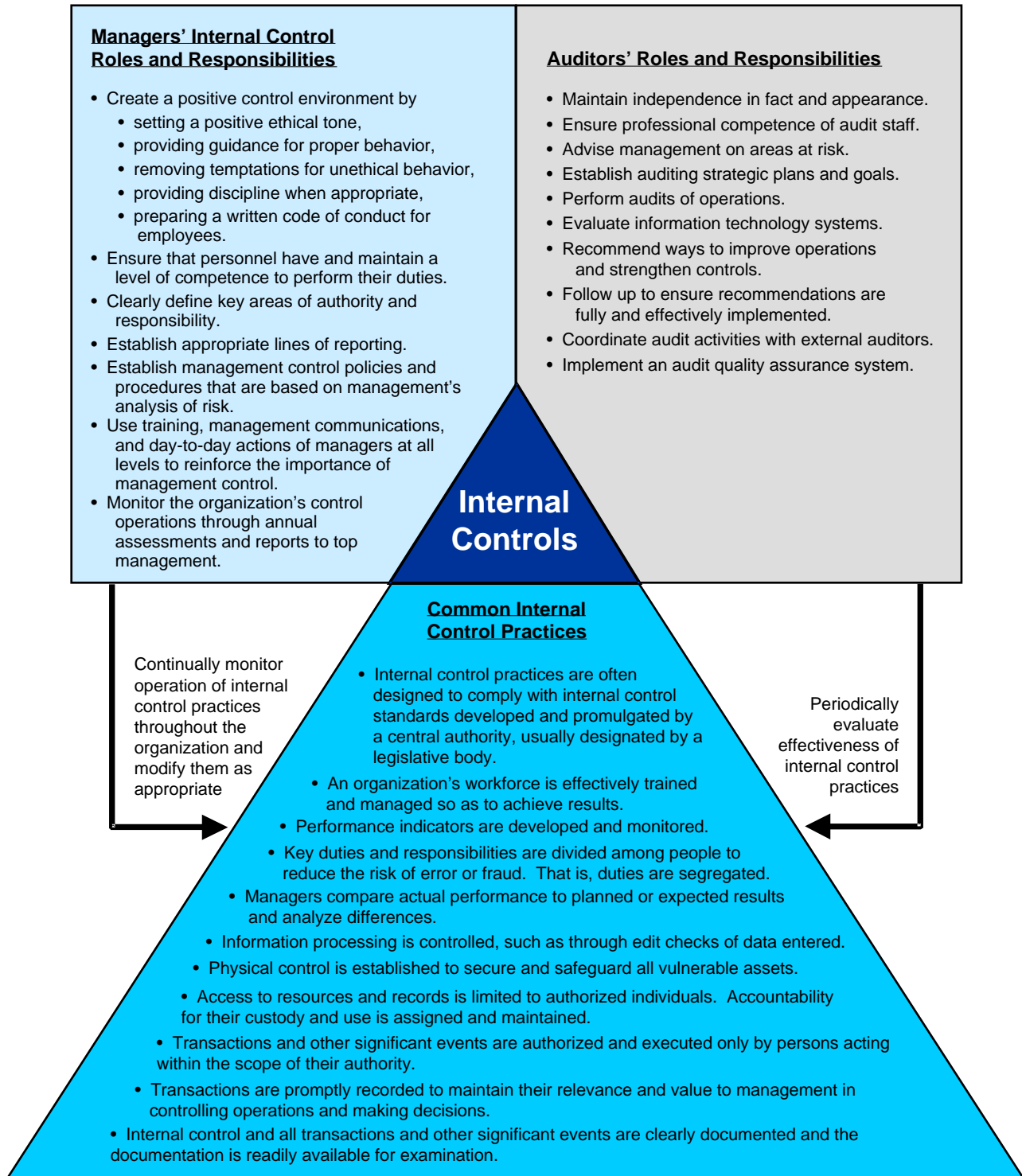
- adheres to laws, regulations, and management directives;
- promotes orderly, economical, efficient, and effective operations and achieves planned outcomes;
- safeguards resources against fraud, waste, abuse, and mismanagement;
- provides quality products and services consistent with the organization’s mission; and
- develops and maintains reliable financial and management information and fairly discloses that data through timely reporting.

Therefore, it is essential that all managers in an organization understand the importance of establishing and maintaining effective internal control. For this reason, the Internal Control Standards Committee of the International Organization of Supreme Audit Institutions (INTOSAI) has prepared this booklet to

- provide an overall framework for establishing and maintaining effective internal controls,
- describe internal control roles and responsibilities for government managers and auditors,
- describe common internal control practices,
- provide a simple checklist to help you begin thinking about whether your organization has taken appropriate steps to ensure effective internal control, and
- provide a list of references for further information.



# Framework for Establishing and Maintaining Effective Internal Control



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# Managers

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**Managers should realize that a strong internal control structure is fundamental to control of an organization and its purpose, operations, and resources.**

Responsibility for providing an adequate and effective internal control structure rests with an organization's management. The head of each governmental organization must ensure that a proper internal control structure is instituted, reviewed, and updated to keep it effective. A positive and supportive attitude on the part of all managers is critical. All managers must be individuals of personal and professional integrity. They are to maintain a level of competence that allows them to understand the importance of developing, implementing, and maintaining effective internal controls.

Management establishes an independent audit function as a key part of the internal control structure. Management should establish objectives for the audit function and place no restrictions on auditors in meeting them. To ensure independence, the head of this audit unit should report directly to the manager heading the agency. Management should also select an experienced, well-qualified person to lead the unit and provide sufficient resources and a competent staff to carry out audit operations. In this regard, managers work constructively with auditors to identify risks and design mitigating controls, and they give auditors responsibility for periodically evaluating internal control operations to identify weaknesses and recommend corrective measures.

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# Auditors

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## **Management often establishes an audit unit as part of its internal control and self-assessment framework.**

Auditors are a part of a governmental organization's internal control framework, but they are not responsible for implementing specific internal control procedures in an audited organization. That is properly management's job.

The auditors' role is to audit an organization's internal control policies, practices, and procedures to assure that controls are adequate to achieve the organization's mission. Although auditors may be part of the organization they audit, it is important and necessary that the auditors' independence be maintained.

For its part, management can demonstrate its support by emphasizing the value of independent and objective auditing. Management should also identify areas for improving performance quality and respond to information developed through audits.

## **An external audit unit may also play a role in auditing a governmental entity's internal control.**

Most governmental entities are also audited by an external audit function. This external auditor is often appointed by, and reports to, the oversight body to which an entity is responsible. This external auditor may examine and suggest improvements to a governmental entity's internal control.

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# Internal Control

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**Simply defined, internal control is the process by which an organization governs its activities to effectively and efficiently accomplish its mission.**

Internal control should not be looked upon as separate, specialized systems within a governmental organization. Rather, internal control should be recognized as an integral part of each system that management uses to guide its operations.

Establishing effective internal control involves 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 entity objectives, which are the goals or purposes to be achieved. Risk assessment is the identification and analysis of relevant risk associated with achieving the objectives. Internal control practices (such as procedures, processes, physical arrangement, organizational structure, and assignment of responsibility and authority) should then be designed and implemented to achieve the goals.

Also, information should be recorded and communicated in writing to management and others within the entity who need it and within a time frame that enables them to carry out their internal control and other responsibilities. Internal control monitoring should assess the quality of performance over time and ensure that the findings of audits and other reviews are promptly resolved.

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# Checklist for Managers

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## **In establishing your framework, have you**

- Assessed the risks the organization faces?
- Identified control objectives to manage the risks?
- Established control policies and procedures to achieve the control objectives?
- Created a positive control environment?
- Maintained and demonstrated personal and professional integrity and ethical values?
- Maintained and demonstrated a level of skill necessary to help ensure effective and efficient performance?
- Maintained and demonstrated an understanding of internal controls sufficient to effectively discharge responsibilities?

## **For implementing internal control, have you**

- Adopted effective internal control throughout the organization?
- Based the organization's internal control on sound internal control standards?
- Included in the organization's internal control structure appropriate and cost-effective control practices?
- Prescribed control practices through management directives, plans, and policies?
- Established a means of continually monitoring the operation of the organization's internal control practices?

## **Concerning the audit function, have you**

- Shown an understanding of the difference between internal control and audit?
- Recognized that an audit function is integral to your organization's internal control?
- Established an audit function?
- Ensured the audit organization's independence?
- Given the audit organization responsibility for evaluating the effectiveness of the audited organization's internal control practices?
- Established a system to monitor the organization's progress in implementing internal and external auditor recommendations?

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# References for Further Information

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**The International Organization of Supreme Audit Institutions has issued the following documents.**

- *Guidelines for Internal Control Standards*
- *Guidelines for Reporting on the Effectiveness of Internal Controls: SAI Experiences in Implementing and Evaluating Internal Controls*

These publications can be found at (<http://www.intosai.org>).

**Various professional accounting organizations can provide internal control information.**

The American Accounting Association  
(<http://www.aaa-edu.org>)

The American Institute of Certified Public Accountants  
(<http://www.aicpa.org/index.htm>)

The Canadian Institute of Chartered Accountants  
(<http://www.cica.ca>)

The Chartered Institute of Public Finance and Accountancy  
(<http://www.cipfa.org.uk>)

The Committee of Sponsoring Organizations of the Treadway Commission (COSO)  
(<http://www.coso.org>)

The Institute of Chartered Accountants in England & Wales  
(<http://www.icaew.co.uk>)

The Institute of Internal Auditors  
(<http://www.theiia.org>)

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The Internal Control Standards Committee,  
International Organization of Supreme Audit Institutions, 2001.

INTOSAI



*Guidelines for  
Internal Control  
Standards for the  
Public Sector –  
Further Information  
on Entity Risk  
Management*

INTOSAI PROFESSIONAL STANDARDS COMMITTEE

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# *Guidelines for Internal Control Standards for the Public Sector – Further Information on Entity Risk Management*

## **Preface**

The 1992 INTOSAI *Guidelines for Internal Control Standards* were conceived as a living document reflecting the vision that standards should be promoted for the design, implementation, and evaluation of internal control. This vision involves a continuing effort to keep these guidelines up-to-date.

The 17th INCOSAI (Seoul, 2001) recognized a strong need for updating the 1992 guidelines and agreed that the Committee on Sponsoring Organisations of the Treadway Commission's (COSO) integrated framework for internal control should be relied upon. Subsequent consultation resulted in a further expansion to address ethical values and provide more information on the general principles of control activities related to information processing.

The updated Internal Control Guidelines were issued in 2004 and should also be viewed as a living document

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which over time will need to be further developed and refined to embrace the impact of new developments such as COSO's Enterprise Risk Management *framework*<sup>1</sup>. Accordingly, this addition to the Guidelines has been produced to cover current thinking on risk management, as set out in COSO's *ERM framework*. As this paper is intended primarily for public sector readers the term "entity" is used in place of "Enterprise" which has a particular private sector association.

The additional information provided here is the result of the joint effort of the members of the INTOSAI Internal Control Standards Subcommittee. This update has been coordinated by a Task Force set up among the subcommittee members with representatives of the SAIs of France, Hungary, Bangladesh, Lithuania, the Netherlands, Oman, the Ukraine, Romania, the United Kingdom, the United States of America and Belgium (chair).

Franki VANSTAPEL  
Senior President of the Belgian Court of Audit  
Chairman of the INTOSAI Internal Control Standards Subcommittee

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<sup>1</sup> Enterprise Risk Management - Integrated Framework (COSO - September 2004)

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## Introduction

The underlying premise of the *COSO Entity Risk Management* framework is that every entity exists to provide value for its stakeholders. In the public sector, general expectations are that public servants should serve the public interest with fairness and manage public resources properly. Effectively the stakeholders are the public and their elected representatives.

All entities face uncertainty and the challenge for management is to determine how much uncertainty to accept as it strives to obtain best value for stakeholders. It is also important to note that uncertainty presents both risk and opportunity, with the potential to erode or enhance value or, in public sector terms to service the public interest more or less well. The aim of entity risk management is to enable management to effectively deal with uncertainty and its associated risk and opportunity, enhancing the capacity to build value, to deliver more effective services more efficiently and economically, and to target them whilst taking into account values such as equity and justice.

The INTOSAI *Guidelines for Internal Control Standards for the Public Sector* sees internal control as providing an overarching conceptual framework through which an entity can be managed to achieve its objectives. The *COSO ERM* framework and other similar models take this a stage further in that the entity can be directed on the basis of identifying future risks and opportunities to refine objectives and design internal controls to minimise risk and maximise opportunity.

As well as extending the definition of functions covered by the corporate governance regime entity risk management required a change in the way organisations think about achieving their objectives. This is because to be effective,

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entity risk management is an ongoing process applied in strategy setting, effective across and affected by all levels and every business unit of an entity and which is designed to identify all events that will affect the organisation's ability to achieve its objectives.

This document outlines a recommended framework for applying the principles of entity risk management in the public sector and provides a basis against which entity risk management can be evaluated. However, it is not intended to replace or supplant the *Guidelines for Internal Control Standards for the Public Sector* but rather is designed to provide complementary additional information to be used alongside those standards where member states consider it to be appropriate to do so. Nor, is it intended to limit or interfere with duly granted authority related to developing legislation, rule-making or other discretionary policy-making in an organisation.

In conclusion, it should be clearly stated that this document includes additional guidelines for corporate governance standards. The guidelines do not provide detailed policies, procedures and practices for implementing a best practice corporate governance regime, nor are they expected to be suitable for all organisations in all regulatory environments. However, the addendum provides an addition to the broad framework within which entities can develop regimes to best help them maximise the services provided to stakeholders.

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## **How is this document structured?**

The supplement is structured in a similar manner to the INTOSAI *Guidelines for Internal Control Standards for the Public Sector*. In the first chapter the concept of Entity risk management is defined and its scope is delineated. In the second chapter the components of Entity risk management are presented and the extensions to the internal control standards highlighted.

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# Chapter 1: *What is* *Entity Risk Management*

## **1.1 Definition**

1.1.1 COSO's *Entity Risk Management: Integrated Framework* states that Entity risk management deals with risks and opportunities affecting value creation or value preservation defined as follows:

"Entity risk management is a process effected by an entity's board of directors, management and other personnel, applied in strategy setting and across the Entity, designed to identify potential events that may affect the entity and manage risk to be within its risk appetite, to provide reasonable assurance regarding the achievement of entity objectives." (COSO ERM model 2004)

1.1.2 In the public sector the terms value creation and value preservation do not have as much direct relevance as in the private sector. However, the definition is purposefully broad to cover as many sectors and types of organisations as feasible. As such it is possible to substitute service creation and preservation for value creation and preservation for the definition to be fully applicable to public sector entities.

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## 1.2 Identifying the Mission

1.2.1 The starting point for Entity risk management is the entity's established mission or vision. Within the context of this mission, management should establish strategic objectives, select strategies to achieve these objectives and set supporting aligned objectives that are cascaded throughout the organisation.

## 1.3 Setting Objectives

1.3.1 The INTOSAI Guidelines on Internal Control Standards states that objectives can be sub-divided into four categories (although most objectives will fall into more than one category). These are:

- **Strategic** - high level goals, aligned with and supporting the entities mission
- **Operational** – executing orderly, ethical, economical, efficient and effective operations; and safeguarding resources against loss, misuse and damage
- **Reporting** - reliability of reporting including fulfilling accountability obligations
- **Compliance** - compliance with applicable laws and regulations and being able to act in accordance with Government policy

1.3.2 Objectives in the first two categories are not entirely within an entity's control so any risk management system can only provide reasonable assurance that these risks are being managed

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satisfactorily, but should enable management to be aware of the extent to which these objectives are being met in a timely fashion. However, objectives relating to reliability of reporting and compliance are within an entity's control so effective Entity risk management will usually give management assurance that these objectives are being met.

## **1.4 Identifying Events - Risks and Opportunities**

- 1.4.1 Once objectives have been set Entity risk management requires an organisation to identify events that might have an impact on the achievement of those objectives. Events can have a negative impact, a positive impact or both. Events with a negative impact represent risks, which can hinder the entity's ability to achieve its objectives. These risks can arise due to internal and external factors. Figure 1, below, sets out many of the risks which government entities face – there may well be other risks relevant to particular entities.
- 1.4.2 Events with a positive impact may offset negative impacts or represent opportunities. Opportunities are the possibility that an event will occur that will enhance the entity's ability to achieve its objectives or enable the entity to achieve objectives more efficiently. As well as seeking to mitigate risks management should formulate plans to seize opportunities.



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## **1.5 Communication and Learning**

- 1.5.1 Determining whether an entity's Entity risk management is "effective" is a fundamental part of the process. Management need to make a judgement on whether the components of Entity risk management are present and operating effectively; namely that there are no material weaknesses and that all risks have been brought within acceptable parameters given the entity's risk appetite. Where Entity risk management is effective management will understand the extent to which objectives in all four categories are aligned with the mission and are being achieved. Effective top down and bottom up communication throughout the entity is essential to facilitate this process.

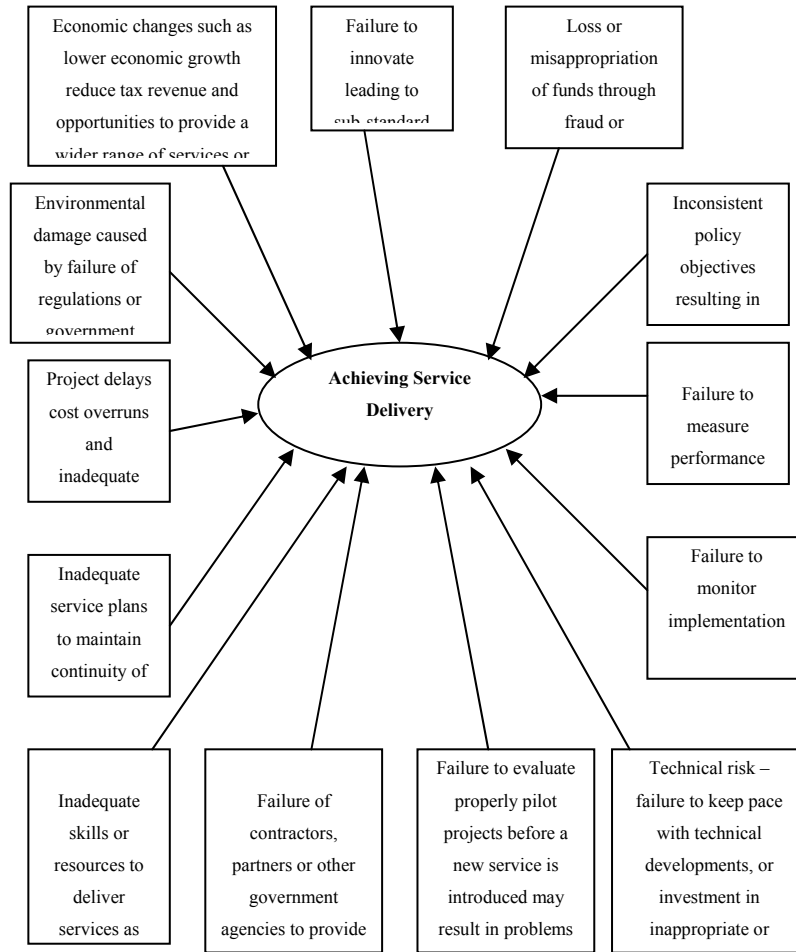
## **1.6 Limitations**

- 1.6.1 No matter how well designed and operated the system is, Entity risk management cannot provide management with absolute assurance regarding the achievement of general objectives. Instead, this supplement recognises that only a reasonable level of assurance is obtainable.
- 1.6.2 Reasonable assurance equates to a satisfactory level of confidence that objectives will be achieved or that management will be made aware in a timely fashion if objectives are unlikely to be achieved. Determining how much assurance is required to reach a satisfactory level of confidence is a matter of judgement. In exercising that judgement management will need to consider the entity's risk appetite and events that may impact on achievement of objectives.

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1.6.3 Reasonable assurance reflects the notion that uncertainty and risk relate to the future, which no-one can predict with certainty. In addition, factors outside an entity's control or its influence, such as political factors, can impact on its ability to achieve its objectives. In the public sector, factors outside an entity's control can even change core objectives at quite short notice. Limitations also result from the following realities: that human judgement in decision making can be faulty; that breakdowns can occur because of human failures such as simple errors or mistakes; that decisions on responding to risk and establishing controls need to consider the relevant costs and benefits; and that controls can be circumvented by collusion between two or more people and management can override the control system. These limitations preclude management from having absolute assurance that objectives will be achieved. Figure 1 sets out some of the risks might typically face. It is intended to be illustrative rather than exhaustive.

**Figure 1: Some Typical Risks that Government Entities Face?**



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## **1.7 Link between Internal Control and Entity Risk Management**

1.7.1 In many respects entity risk management may be regarded as a natural evolution of the internal control model. Most organisations will seek to fully apply the internal control model before implementing the concepts inherent within Entity risk management. Internal control is an integral part of entity risk management. The entity risk management framework encompasses internal control, but in addition, forms a more robust conceptualisation of how an entity's business decisions should fall out of its core mission and associated objectives and provides a tool for management to help them to determine what the correct response to a particular event should be. The ERM model goes further than the INTOSAI Internal Control Guidelines in a number of areas, in particular:

- the categories of objectives are broader, and also include more complete reporting, non-financial information, strategic objectives;
- it expands the risk assessment component and introduces different risk concepts, such as risk appetite, risk tolerance, risk response; and
- it emphasises the importance of independent directors on the board and elaborates on their roles and responsibilities.

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## *Chapter 2:*

# *Components of Entity*

## *Risk Management*

Entity risk management consists of eight interrelated components. These are derived from the way that management runs a business and are integrated with the management process. The components are:

- Internal environment
- Objective setting
- Event identification
- Assessing risks
- Risk response
- Control activities
- Information and communication
- Monitoring

In applying the components of Entity risk management, an entity should consider the entire scope of its activities at all levels of the organisation. Management should also consider new initiatives and projects using the Entity risk management framework.

INTOSAI



*Internal Audit  
Independence in the  
Public Sector*

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## 1. INTRODUCTION

1.1 This paper on internal audit independence in the public sector addresses concerns related to independence and objectivity and methods to achieve independence.

1.2 Internal auditing is performed in diverse environments and within organizations that vary in purpose, size, and structure. In addition, the laws and regulations within various countries differ from one another. Particularly, public sector auditors operate in organizational structures that are as complex and varied as the many forms of government that exist throughout the world today.

1.3 The International Standards of Supreme Audit Institutions (ISSAI) and the Institute of Internal Auditors' (the IIA's) *International Standards for the Professional Practice of Internal Auditing (Standards)*, present general terms to allow adoption in different national contexts with the understanding that implementation will be governed by the environment in which the internal audit activity carries out their responsibilities and in accordance with the applicable laws and regulations. The IIA's *Standards* are universal and are intended to apply to all members of the internal audit profession.

1.4 Internal auditing has become a factor of the new accountability and control era. The manner in which public sector entities maintain internal control and how they are held accountable has evolved to require more transparency and more accountability from these organizations that spend investor or taxpayer funds. This trend has significantly impacted how management implements, monitors, and reports on internal control.

1.5 Although internal auditors can be a valuable advisory resource on internal control, the internal auditor should not be a substitute for a strong internal control system. A system of internal control is the primary response to risks.

1.6 The role of internal auditing has evolved from an administrative procedure with a focus on compliance, to an important element of good governance. In many cases the existence of internal auditing is mandatory.

1.7 In describing public sector auditing, the Lima Declaration calls for internal audit services to be functionally and organizationally independent as far as possible within their respective constitutional frameworks (ISSAI 1/section 3, par. 2).

1.8 The IIA's *Standards* and Code of Ethics recognize the importance of internal auditors maintaining their independence and objectivity when performing their work, irrespective of whether the internal auditors are engaged in public or private sector audits. In addition, the IIA *Standards* advocate a strong system of internal control that is monitored by a well-resourced internal audit activity as a fundamental feature of good governance. In the public sector, a strong system of governance is essential in ensuring adequate service delivery to the public at large.



1.9 For both SAIs and internal auditors, the need for independence and objectivity in conducting an audit is essential. Internal auditors' independence and objectivity is an important factor to enable coordination and cooperation between SAIs and internal auditors (INTOSAI GOV 9150), including in determining whether and to what extent SAIs can use the work of internal auditors (ISSAI 1610, ISA 610/par. 9). In this regard, it is critical that public sector internal audit activities are configured and positioned appropriately within the organization.

1.10 This paper does not include tools or best practices. They will be made available on the Subcommittee for Internal Control Standards' e-platform.

## **2. THE ROLE OF INTERNAL AUDITING**

2.1 IIA defines internal auditing as an independent, objective assurance and consulting activity designed to add value and improve an organization's operations. It helps an organization accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control, and governance processes.

2.2 Internal auditing may analyze strengths and weaknesses of an organization's internal control, considering its governance, organizational culture, and related threats and opportunities for improvement which can affect whether the organization is able to achieve its goals. The analysis assesses whether risk management identifies the risks and puts controls in place to manage public funds in an effective and efficient manner.

2.3 Internal auditing works with those charged with governance,<sup>1</sup> such as board, audit committee, senior management or, where appropriate, an external oversight body, in ensuring that appropriate systems of internal control are designed and implemented. As such, internal auditing can provide assistance regarding accomplishment of goals and objectives, strengthening controls, and improving the efficiency and effectiveness of operations and compliance with authorities. It is important to clarify that while internal auditing can provide assistance on internal control, it should not perform management or operational duties.

## **3. PUBLIC SECTOR INTERNAL AUDITING**

3.1 As is true for all internal auditors, public sector internal auditors are called upon to assist organizations in improving their operations. The public sector internal audit function is an element of a strong public sector governance foundation. Most public sector internal auditors also play a role in their entity's accountability to the public as part of the check-and-balance process.

3.2 The diverse nature of the public sector places increasing importance and value on a common understanding of independence as it is key to any auditor's credibility. As

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<sup>1</sup> Those charged with governance: cf ISSAI 1260.

internal auditors are an integral part of the organization, the achievement and maintenance of independence is even more challenging.

3.3 The internal audit function can be organized and performed at various levels within an entity, or within a broader framework that covers a set of similar entities. The same principles and rules apply to these different organizational levels of internal auditing.

#### **4. MODELS FOR RESOURCING INTERNAL AUDITING**

4.1 There are various models for resourcing an internal audit activity. These include:

- In-house:  
Internal audit services are provided exclusively or predominantly by in-house employees of the organization. The internal audit activity is managed in-house by an employee of the organization.
- Co-sourced:  
Internal audit services are provided by a combination of in-house employees and service providers. The internal audit activity is managed in-house by an employee of the organization.
- Outsourced with in-house management:  
Internal audit services are provided by service providers contracted to the organization for this purpose. The internal audit activity is managed in-house by an employee of the organization, and
- Fully outsourced.  
All internal audit services are provided by service providers contracted to the organization for this purpose. The service provider also manages the internal audit activity. Project management of the service provider contract is done in-house by an employee of the organization.

#### **5. DEFINING INDEPENDENCE AND OBJECTIVITY**

5.1 Independence can be generally defined as freedom from dependence on, or influence or control by, another person, organization, or state. Internal auditors work for, and primarily report to, the audited entity. For internal auditors, independence is the freedom from conditions that threaten the ability of the internal audit activity or the chief audit executive (CAE) to carry out internal audit responsibilities in an unbiased manner. Independence permits internal auditors to render the impartial and unbiased judgments essential to the proper conduct of engagements.

5.2.1 Objectivity is defined in the IIA *Standards* as an unbiased mental attitude that allows internal auditors to perform engagements in such a manner that they have an honest belief in their work product and that the quality of their work is not compromised in any way.

5.2.2 IIA *Standards* also states that objectivity requires that internal auditors do not subordinate their judgment on audit matters to others. Threats to objectivity, such as

possible conflicts of interests, must be managed at the individual auditor, engagement, functional, and organizational levels, and disclosed as necessary.

## **6. WHY INDEPENDENCE AND OBJECTIVITY ARE VITAL**

6.1 Whatever the form of government, the need for independence and objectivity in audit is vital (ISSAI 200/2.3). Independence and objectivity are vital in ensuring that stakeholders view the audit work performed, and the results, as credible, factual, and unbiased.

6.2 The nature of internal auditing and the role of providing unbiased and accurate information on the use of public resources and services delivered require the internal audit activity to perform their duties without restrictions - free from interference or pressures from the organization being reviewed or the area under audit.

6.3 Development of sound working relationships with management and staff at all levels of the organization is fundamental to the effectiveness of the internal audit function. The internal audit activity's knowledge and understanding of the organization assist in building effective relationships and in evaluating and improving the effectiveness of risk management, internal control, and governance processes. Ideally, and where appropriate, the organization's employees should bring concerns, information, and important matters to the attention of the internal audit activity. In addition, an effective and well-run audit activity will be sought out for services, information, and guidance.

6.4 By providing unbiased, objective assessments of whether public sector operations and resources are responsibly and effectively managed to achieve intended results, the auditor can help the public sector organization achieve accountability and integrity, improve operations, and instill confidence among citizens and stakeholders.

## **7. INDEPENDENCE AND OBJECTIVITY CRITERIA**

7.1 ISSAI 1610 seeks to assess whether the environment in which internal auditing operates allows the internal auditor to be sufficiently autonomous and objective to the extent that the external auditor can use the work of the internal auditor. This is equivalent to the assessment of internal audit independence within INTOSAI GOV 9140.

7.2 In addition to the criteria in ISA 610, ISSAI 1610 provides criteria to assess the objectivity of the internal audit function in the public sector. The internal audit function:

- Is established by legislation or regulation;
- Is accountable to top management, for example the head or deputy head of the government entity, and to those charged with governance;
- Reports the audit results both to top management, for example the head or deputy head of the government entity, and those charged with governance;

- Is located organizationally outside the staff and management function of the unit under audit;
- Is sufficiently removed from political pressure to conduct audits and report findings, opinions, and conclusions objectively without fear of political reprisal;
- Does not permit internal audit staff to audit operations for which they have previously been responsible for to avoid any perceived conflict of interest; and
- Has access to those charged with governance.

7.3 Additionally, criteria to assess the independence of the internal audit function in the public sector may include:

- Clear and formally defined responsibilities and authorities of internal auditing in an audit charter;
- Functional and personal segregation of internal auditing from responsibilities for management tasks and decisions (e.g. as heads of operational working groups in administrative reform projects);
- Adequate freedom for the CAE in establishing audit plans;
- Adequate payment and grading within the salary scale according to the responsibility and significance of internal auditing; and
- Involvement and participation of the CAE in recruitment of audit staff.

7.4 Also the IIA *Standards* requires, and leading practices dictate, that the internal audit activity is independent, and that internal auditors are objective in performing their work. To achieve the degree of independence necessary to effectively carry out the responsibilities of the internal audit activity, the head of the internal audit activity has direct and unrestricted access to those charged with governance. Independence is achieved through organizational status and objectivity (IPPF 1100-1130 Independence and Objectivity).

7.5 Under IIA *Standards* the CAE must report to a level within the organization that allows the internal audit activity to fulfill its responsibilities. The CAE must confirm to those charged with governance, at least annually, the organizational independence of the internal audit activity. According to the IIA Practice Advisory 1111-1 the CAE must communicate and interact directly with the board. Direct communication occurs when the CAE regularly attends and participates in board meetings that relate to the board's oversight responsibilities for auditing, financial reporting, organizational governance, and control. Such communication and interaction also occurs when the CAE meets with the board, at least annually. The internal audit activity must be free from interference in determining the scope of internal auditing, performing work, and communicating results.

## **8. CONCERNS RELATED TO INDEPENDENCE AND OBJECTIVITY**

8.1 An internal auditor occupies a unique position within an organization. The auditor is employed by the organization but is also expected to review the conduct of operations. This has a potential to create significant tension since the internal auditor's "independence" from management is necessary for the auditor to objectively assess management's actions.

8.2 Internal auditing's in-depth knowledge and understanding of operational conditions of the audited entity can add significant value to the organization. However, it may be hindered in upholding the public trust if measures to protect its independence are not developed, implemented, and maintained. These measures include provisions to ensure that the internal audit activity is empowered to report significant issues to those charged with governance; is supported by management formally and in practice; and is provided with sufficient resources to effectively perform its duties.

8.3 The appearance or perception of a lack of independence and objectivity could be as damaging as the actual condition. If internal auditors are involved in developing the internal control systems, it may become difficult to maintain the appearance of independence when auditing these systems.

## **9. HOW TO ACHIEVE INDEPENDENCE AND OBJECTIVITY**

9.1 Clearly, independence and objectivity are key elements of an effective public sector internal audit activity. To comply with the independence and objectivity criteria mentioned above several measures may be considered. Recommended measures are:

### ***9.2 Appropriate Placement and Organizational Status***

9.2.1 The ability to achieve internal audit activity independence and objectivity is contingent on the appropriate placement and/or organizational status of the internal audit activity within the organization.

9.2.2 The organizational status of the internal audit activity should be sufficient to allow it to accomplish its activities as defined by its audit charter. The audit activity must be positioned in such a way that it may obtain cooperation from management and staff of the program or entity being audited, and have free, unrestricted access to all functions, records, property, and personnel – including those charged with governance.

9.2.3 Where practicable, those charged with governance (oversight body) should exercise discretion and at least be consulted regarding the appointment, removal, and compensation considerations of the CAE. Consideration may also be given to appointing an appropriately organized, independent body to appoint the CAE.

9.2.4 The CAE should be equal in rank to senior management of the organization. To avoid possible conflicts of interest, the CAE should report to a level in the organization that would allow the internal audit activity to effectively carry out its responsibility.

9.2.5 The CAE should have direct communication with those charged with governance. This communication reinforces the organizational status of internal auditing, enables full support and unrestricted access to functions, records, property,

and personnel, and helps ensure that there is no impairment to independence. This provides sufficient authority to ensure broad audit coverage, adequate consideration of engagement communications, and appropriate action on recommendations.

### ***9.3 Reporting Relationship***

9.3.1 Under IIA *Standards* the CAE must report to a level within the organization that allows the internal audit activity to fulfill its responsibilities.

9.3.2 The CAE should report to executive management for assistance in establishing direction, support, and administrative interface; and to those charged with governance for strategic direction, reinforcement, and accountability. Those charged with governance (e.g. the audit committee) should safeguard the independence by approving the internal audit charter and (where applicable) the mandate.

9.3.3 The IIA *Standards* requires, and other guidance strongly recommend, that to help maintain the independence of the internal audit activity, its personnel should report to the CAE, who reports administratively to the chief executive officer or equivalent and functionally to those charged with governance.

### ***9.4 Competency***

9.4.1 The IIA's Code of Ethics requires, and leading practices dictate, that internal auditors engage in those services for which they have the necessary knowledge, skills, and experience; perform duties in accordance with the *Standards*; and continually improve their proficiency and effectiveness. The *Standards* requires that internal auditors, and the internal audit activity collectively possess or develop the knowledge, skills, and other competencies needed to perform their responsibilities. Competent and professional internal audit staff, in particular those that adhere to the *Standards*, can help ensure the internal audit activity's success.

### ***9.5 Legislative Requirements***

9.5.1 Legislative requirements to establish an internal audit activity help protect the funding and independence of the internal audit activity and recognize internal audit as an important function in the public sector. Finally, adequate legal protection of internal auditor independence, in particular under civil service law, is an important element of a legislative framework.

## REFERENCES

### INTOSAI

- ISSAI 1 The Lima Declaration, Section 3. Internal audit and external audit
- ISSAI 200 General standards in Government Auditing and standards with ethical significance
- ISSAI 1260 Communication with those Charged with Governance
- ISSAI 1610 Financial Audit Guideline – Special Considerations – Using the Work of Internal Auditors
- INTOSAI GOV 9100 Guidelines for Internal Control Standards for the Public Sector
- INTOSAI GOV 9150 Coordination and Cooperation between SAIs and Internal Auditors in the Public Sector

### IFAC

- International Standard on Auditing 610
- Governance in the Public Sector: A Governing Body Perspective, 2001

### IIA

- The International Professional Practices Framework, including the Definition of Internal Auditing, the Code of Ethics, The International Standards for the Professional Practice of Internal Auditing (*Standards*), Practice Advisories, Position Papers and Practice Guides
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Best Practices and tools will be integrated in the e-platform
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INTOSAI



*Coordination and  
Cooperation between  
SAIs and Internal  
Auditors in the Public  
Sector*



INTOSAI PROFESSIONAL STANDARDS COMMITTEE

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## 1. INTRODUCTION

- 1.1 This paper provides guidance on how to achieve coordination and cooperation between Supreme Audit Institutions (SAIs) and internal auditors in the public sector—while respecting the distinctive functions and professional requirements of both.
- 1.2 In addition to SAIs and internal auditors, this guidance may also be useful to other auditors conducting internal and external audits in the public sector on their behalf..
- 1.3 This paper should be read in the context of the International Standards on Auditing for Supreme Audit Institutions (ISSAIs), International Standards of Auditing (ISAs) issued by the International Auditing and Assurance Standards Board, and the Institute of Internal Auditors International Professional Practices Framework.
- 1.4 Although SAIs and internal auditors have differing and clearly defined roles, their collective purpose is to promote good governance through contributions to transparency in and accountability for the use of public resources, as well as to promote efficient, effective, and economic public administration. Common areas of work performed by SAIs and internal auditors offer opportunities for coordination and cooperation. Through SAI and internal auditor coordination and cooperation, the efficiency and effectiveness of both party's work can be improved.
- 1.5 In developing internal auditor/SAI coordination and cooperation, cognizance should be given to the specific roles of each party.
- 1.6 Both SAIs and internal auditors can perform the full range of government audits<sup>1</sup> and can offer distinctive and important contributions.<sup>2</sup> SAIs have the additional responsibility of evaluating the effectiveness of the internal audit function.
- 1.7 If internal audit is judged to be effective, efforts shall be made, without prejudice to the right of the SAI to carry out an overall audit, to achieve the most appropriate division or assignment of tasks and cooperation between the SAI and internal audit (*ISSAI 1/3/par. 3*). This will likely benefit both parties in their ongoing drive for efficiency and effectiveness in public services.
- 1.8 All coordination and cooperation efforts between SAIs and internal auditors should take into consideration the respective constitutional and legislative frameworks or agreements. These frameworks may define collaboration and responsibilities of the different parties. Collaboration mostly occurs at the discretion of SAIs, but where

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<sup>1</sup> For the full range of government audits see chapter 3 (roles and responsibilities)

<sup>2</sup> The scope of internal auditor/SAI coordination and cooperation covers financial, compliance, and performance audits.

possible, cooperation and coordination between SAIs and internal auditors should be seen as an opportunity to improve the effectiveness of the audit.

- 1.9 Formal coordination and cooperation will only be possible where certain basic criteria regarding skills and competence are met. This paper does not preclude other forms of liaison, such as informal discussions or reviews of documents to aid in understanding of an entity's operations.
- 1.10 In the public sector, SAIs and internal auditors may cooperate in a variety of ways. Such cooperation can maximise the benefits gained from working together in areas where there is an avoidable overlap in the scope of work carried out by SAIs and internal auditors. This paper also recognises the contribution that internal auditors can make to the efficiency of external audits.
- 1.11 This paper does not include tools or best practices. They will be made available on the Subcommittee for Internal Control Standards' e-platform.

## **2. RECOGNITION OF RELEVANT EXISTING INTOSAI STANDARDS**

- 2.1 For both SAIs and internal auditors, the need for independence and objectivity in audit is essential. An internal auditor's independence and objectivity are important factors for SAIs to consider when determining whether they will be able to coordinate and cooperate with an internal auditor and to what extent they can use the work of the internal auditor (*ISSAI 1610, ISA 610/par. 9; INTOSAI GOV 9140*). Both SAIs and internal auditors have their own independence standards.<sup>3</sup>
- 2.2 Internal audit services are subordinate to the head of the entity within which they have been established. Nevertheless, they shall be functionally and organizationally independent as far as possible within their respective constitutional framework (*ISSAI 1/3/ par. 2; ISSAI 1610; INTOSAI GOV 9140*). In this paper reference is made to ISSAI 1610 and INTOSAI GOV 9140, especially with regard to the criteria used to determine the independence of the internal audit function.
- 2.3 When the SAI uses the work of an internal auditor, it performs procedures to obtain assurance that the internal auditor has exercised due care and complied with relevant auditing standards (*ISSAI 200/2.45*). The SAI may review the work of the internal auditor to satisfy itself as to the quality of that work (*ISSAI 1610*).

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<sup>3</sup> Internal auditors use the International Professional Practices Framework (IPPF) of the Institute of Internal Auditors (IIA) including the Definition of Internal Auditing, the Code of Ethics, and the International Standards for the Professional Practice of Internal Auditing (Standards) and Position Papers, Practice Advisories, and Practice Guides. SAIs use INTOSAI's ISSAI 10 - the Mexico Declaration on SAI Independence; ISSAI 11 - INTOSAI Guidelines and Good Practices Related to SAI Independence; ISSAI 30 - the INTOSAI Code of Ethics; and ISSAI - 200 INTOSAI General Standards. External auditors use the International Federation of Accountants (IFAC) Code of Ethics for Professional Accountants.

- 2.4 When an SAI has determined that an entity's internal audit function is likely to be relevant to its audit, the SAI will determine (a) whether, and to what extent, to use specific work of the internal auditors; and (b) if so, whether such work is adequate for the purposes of the audit (*ISSAI 1610, ISA 610/8-12*).
- 2.5 The SAI has sole responsibility for audit opinions it expresses, and that responsibility is not reduced by its use of the work of the internal auditors (*ISSAI 1610, ISA 610/4*).

### **3. ROLES AND RESPONSIBILITIES**

- 3.1.1 In developing coordination and cooperation between SAIs and internal auditors the specific roles of both parties are recognized.
- 3.1.2 Internal auditors work for and primarily report to the audited entity (administratively to management and functionally to those charged with governance,<sup>4</sup> such as board, audit committee, senior management or, where appropriate, an external oversight body), while SAIs function as external auditors and issue their reports to the legislature or parliament (and indirectly the public). Specific legislation may require that internal audit also report to the SAI.

#### ***3.2 Internal audit***

- 3.2.1 INTOSAI defines an internal audit function as the functional means by which the managers of an entity receive an assurance from internal sources that the processes for which they are accountable are operating in a manner which will minimize the probability of the occurrence of error, inefficient and uneconomic practices, or fraud (*INTOSAI GOV 9100*).
- 3.2.2 The Institute of Internal Auditors defines internal auditing as an independent, objective assurance and consulting activity designed to add value and improve an organisation's operations. It helps an organisation accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control, and governance processes.
- 3.2.3 Within the context of roles and responsibilities, the following general principles are applicable according to INTOSAI GOV 9100:
- Internal auditors examine and contribute to the ongoing effectiveness and efficiency of the internal control structure through their evaluations and recommendations and therefore play a significant role in effective internal control.

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<sup>4</sup> See ISSAI 1260.

- Management often establishes an internal audit function as part of its internal control framework. In this tradition, the role of internal auditors is a critical part of an organisation's internal control structure.
- However, the mandate of an internal audit function does not include implementation of specific internal control procedures in the organisation. This is the responsibility of management.
- An effective internal audit function may cover the review, appraisal, and reporting on the adequacy of controls in order to contribute to the improvement of the internal control system.
- The internal audit function should utilize a continuous, risk-based approach, which should consider the risk criteria established by the governance body and management.

3.2.4 Although internal auditors are part of the organisation they audit,<sup>5</sup> certain safeguards can be put in place to help protect the independence and objectivity of the internal audit function. The internal audit function should be functionally and organizationally independent as far as possible within its respective constitutional framework (*ISSAI 1/3/2*). An internal auditor's work and conclusions should be impartial, neutral, and free from conflicts of interest.

### 3.3 *SAIs*

3.3.1 SAIs are generally established by the Supreme Lawmaking body or by constitutional provision. In some jurisdictions, SAIs contract private auditors to perform work on their behalf, or those charged with governance (such as board, audit committee, senior management or, where appropriate, an external oversight body) appoint a non-SAI auditor as their external auditor if permitted by legislation.

3.3.2 In most countries, SAIs have a wider range of responsibilities for reporting on the activities of audited entities than do private sector auditors. The full scope of government auditing includes regularity<sup>6</sup> and performance audits (*see also ISSAI 100/39-40*), as well as special examinations and forensic audits.

3.3.3 The regularity audit embraces, amongst others, the attestation of financial accountability of accountable entities and of the government administration as a whole; the audit of financial systems and transactions; internal control and internal audit functions; and the probity and propriety of administrative decisions taken within the audited entity. It also includes the reporting of any other matters arising from or relating to the audit that the SAI believes should be disclosed (*ISSAI 100*).

3.3.4 The performance audit is concerned with the audit of economy, efficiency, and effectiveness (*ISSAI 100*).

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<sup>5</sup> However internal audit work in an organization can also be performed by a service provider. It is getting more common in both the public and the private sector to have an external audit firm providing this service (*INTOSAI GOV 9140, chapter 4, models for resourcing internal auditing*).

<sup>6</sup> Regularity will become both financial and compliance in the future (from 2013 on).

3.3.5 As external auditors, SAIs have the responsibility of evaluating the effectiveness of the internal audit function. If an internal audit function is judged to be effective, cooperation between the SAI and the internal auditor will likely benefit both parties (*ISSAI 1/3 and 16*).

#### **4. BENEFITS OF COORDINATION AND COOPERATION**

4.1 A range of benefits may be obtained from coordination and cooperation between SAIs and internal auditors, including:

- An exchange of ideas and knowledge;
- Strengthening their mutual ability to promote good governance and accountability practices, and enhancing management understanding of the importance of internal control;
- More effective audits based on:
  - Promoting a clearer understanding of respective audit roles and requirements,
  - Better informed dialogue on the risks facing the organisation leading to a more focused audit and, consequently, more useful recommendations,
  - Better understanding by both parties of the results arising from each other's work which may have an impact on their respective future work plans and programmes;
- More efficient audits based on:
  - Better coordinated internal and external audit activity resulting from coordinated planning and communication,
  - Refined audit scope for SAIs and internal auditors;
- Reducing the likelihood of unnecessary duplication of audit work (economy);
- Minimizing disruption to the audited entity;
- Improving and maximizing audit coverage based on risk assessments and identified significant risks; and
- Mutual support on audit recommendations which may enhance the effectiveness of audit services.

## **5. POTENTIAL RISKS OF COORDINATION AND COOPERATION**

5.1 Inherent in the coordination and cooperation process are certain risks which should be managed, such as:

- Any compromise of confidentiality, independence, and objectivity;
- Possible conflicts of interest;
- Dilution of responsibilities;
- Use of different professional standards relating to independence or audit;
- Misinterpretation of conclusions when using each other's work;
- Possible difference of conclusions or opinions on the subject matter;
- The possibility that potential findings of the other auditor may be prematurely communicated to an external party, before sufficient audit evidence exists to support those findings; and
- Not considering constraints or restrictions placed on the other auditor in determining the extent of coordination and cooperation.

5.2 Internal audit work in an organization can also be performed by a service provider. In some cases the same audit firm provides both external and internal audit service. The service provider should not perform internal audit work if they are also the external auditor or if they provide non-audit consulting services to that organization as it endangers independence and objectivity.

## **6. GROUNDS FOR COORDINATION AND COOPERATION:**

6.1 Coordination and cooperation are built on commitment, communication, common understanding, and confidence.

### *6.1.1 Commitment*

- Effective cooperation between internal auditors and SAIs can only be achieved if both parties are willing and committed to developing coordinated and effective audit services.
- Audit committee encouragement may improve the likelihood of successful coordination and cooperation between internal auditors and SAIs.

### *6.1.2 Communication*

- Communication is a two-way process.
- Regular and open communication between SAIs and internal auditors is essential to the success of coordination and cooperation. Auditors should establish common understanding on the timing and nature of such communications.<sup>7</sup>
- Communication may include:

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<sup>7</sup> Formal communication can include regular meetings, particularly to look at future plans to identify opportunities for cooperation; to avoid duplication of efforts; to assure that audit coverage is coordinated; and to agree on methods for the sharing of audit findings and other information.

- the exchange of audit reports and management letters;
- in some circumstances, granting access to each other's audit programs and audit documentation while providing for sufficient discretionary and confidentiality provisions.

### 6.1.3 *Common understanding*

- Auditors should understand each other's objectives, scope, techniques, methods, and terminology to facilitate reliance on each other's work.
- It may be useful for SAIs and internal auditors to use similar techniques, methods, and terminology to facilitate cooperation and effective coordination.

### 6.1.4 *Confidence*

- There should be mutual confidence based on the recognition that internal and external audits are conducted within relevant professional standards.
- There should be confidence that any information exchanged is treated professionally and with integrity and within professional ethical guidelines. This exchange of information should incorporate sufficient discretionary and confidentiality provisions.

## 7. MODES OF COOPERATION

7.1 A broad range of ways to achieve coordination and cooperation between SAIs and internal auditors are possible. The degree of coordination and cooperation may vary depending on circumstances, including considerations of independence and legislative restrictions. Modes of coordination and cooperation may include:

- Communication of audit planning / audit strategy (e.g. joint planning sessions);
- Regular meetings between SAIs and internal auditors;
- Arrangements for the sharing of information (including consultation procedures);
- Communication of audit reports to each other;
- Organizing common training programmes and courses, and sharing training material;
- Developing methodologies;
- Sharing training material, methodologies, and audit work programs;
- Granting access to audit documentation;<sup>8</sup>
- Secondment or lending of staff (e.g. training on the job);
- Use of certain aspects of each other's work to determine the nature, timing, and extent of audit procedures to be performed; and

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<sup>8</sup> The SAI must have access to the sources of information and data from the internal auditor in order to carry out its audit responsibilities. SAIs should carefully consider confidentiality issues when disclosing audit documents that may contain sensitive subjects, such as forensic investigations. In order to maintain independence of SAI's, internal auditors do not have any automatic access rights to the audit documentation of the SAI or formal influence on the SAI's work programme. Nonetheless there are some circumstances where sharing audit documentation at the SAI's discretion may aid the audit process.



- Collaborating on certain audit procedures, such as collecting audit evidence or testing data.

## **8. WAYS TO ORGANIZE THE COORDINATION AND COOPERATION**

- 8.1 Coordination and cooperation can either be organised formally or informally.
- 8.2 Formal coordination and cooperation can be organised through legislation, formal agreements, or protocols.
- 8.3 In certain low-risk engagements, SAIs and internal auditors may coordinate and cooperate in a more informal way.
- 8.4 Coordination and cooperation should be documented in compliance with applicable auditing standards.
- 8.5 Audit committees may encourage coordination and cooperation between SAIs and internal auditors.

## **9. AREAS OF COORDINATION AND COOPERATION**

- 9.1 Areas of coordination and cooperation between SAIs and internal auditors may include:
- Evaluating the audit entity's (*see also INTOSAI GOV 9100*):
    - Internal Control framework;
    - Financial statements' Compliance with Laws and Regulations;
    - Performance indicators and performance studies;
    - Public Governance; and
    - Risk management (*INTOSAI GOV 9130*).
  - Documenting the audit entity's systems and operational processes;
  - Developing audit procedures;
  - Performing audit procedures, (e.g. audit of multi-located entities); and
  - Investigating fraud and corruption allegations.

## **10. PHASES & CONTENT OF COORDINATION AND COOPERATION**

- 10.1.1 Coordination and cooperation can happen during the entire audit process:
- Preliminary to the engagement;
  - At the planning stage;
  - Performing further audit procedures;
  - Concluding, finalisation, and reporting stage; and

- Follow up of audit findings and recommendations

10.1.2 The continuous nature of the assessment and communication between SAIs and internal auditors should be documented in their respective audit documents.

10.1.3 SAIs coordinate and cooperate during the audit process as follows:

## **10.2 Preliminary to the engagement**

- Obtain an understanding of the audited entity and of each other's function;
- Consider the scope of the work performed by each party; and
- Evaluate the use of the internal auditor's work before determining its impact on the nature, timing, and extent of audit procedures to be conducted. This involves ensuring that the internal auditor that carried out the work was independent of the audited entity or activity and was objective in carrying out that work

## **10.3 Planning stage**

10.3.1 In preparing the audit plan and determining the audit strategy, the SAI may evaluate the effect, if any, that the internal auditor's work may have on the external audit procedures. In this stage the auditor should perform a risk assessment to identify areas of significant risk.

10.3.2 When the SAI intends to use the work of the internal auditor, the SAI should evaluate:

- The independence of the internal audit activity;
- The objectivity and professional and technical<sup>9</sup> competence of the internal auditor;
- Whether the work of the internal auditor is carried out with due professional care (conclusions are based upon audit objectives, audit scope, acceptable audit methodology, and sufficient audit evidence); and
- The effect of any constraints or restrictions placed on the internal audit function by any party or individual.

## **10.4 Performing further audit procedures**

10.4.1 The work of internal auditors may be used to obtain part of the audit evidence that is necessary to achieve the objectives of SAI audit procedures.

10.4.2 The SAI should evaluate the internal auditor's work for the following:

- Whether the work was performed by persons having appropriate skills and expertise;

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<sup>9</sup> The work has to be performed by persons having appropriate skills and expertise.

- Whether the work was properly supervised, reviewed, and documented;
- The suitability of the working methods employed by the internal auditor;
- Whether sufficient, appropriate, and relevant evidence was obtained to draw reasonable conclusions;
- Whether the conclusions reached are appropriate in the circumstances and any reports prepared are consistent with the results of the work performed; and
- Whether any findings reported on by the internal auditor have been properly addressed by the audited organisation.

10.4.3 Where necessary, the SAI performs additional audit work to obtain this assurance.

10.4.4 Documenting the assessment of the decision to use the work of internal auditors will provide evidence to support the SAI's procedures, findings, and conclusions.

### **10.5 Concluding, finalisation, and reporting stage**

10.5.1 When the work of internal auditors corroborates the findings obtained or conclusions reached by the external auditors, then the SAI may use the work performed by the internal auditor. This does not exempt the SAI from obtaining sufficient, appropriate audit evidence to reach a conclusion based on audit objectives, but it may reduce the extent of the auditor's work.

10.5.2 When there is a discrepancy between the findings or conclusions arising from an audit and those presented in the report of the internal auditor, the SAI and internal auditor:

- investigate the cause of the discrepancy, and
- reconsider and determine whether the analysis and interpretation of the audit evidence obtained was adequate and reasonable.

10.5.3 The SAI may discuss any discrepancies with the internal auditor and consider reporting on it to the relevant and appropriate parties.

### **10.6 Follow up of audit findings and recommendations**

10.6.1 As part of the SAI's audit process, a follow up of the implementation and fulfillment of the SAI's audit recommendations should be undertaken. In cooperation and understanding with the SAI, the internal auditor may follow up the implementation and fulfillment of the SAI's audit recommendations, as a means of cooperating with the SAI's audit processes.

## REFERENCES

### INTOSAI

- ISSAI 1 The Lima Declaration, Section 3. Internal audit and external audit
- ISSAI 100 I Auditing Standards - Basic Principles
- ISSAI 300 I Auditing Standards - Field Standards
- ISSAI 1260 Communication with those Charged with Governance
- ISSAI 1610 I Financial Audit Guideline – Special Considerations – Using the Work of Internal Auditors
- INTOSAI GOV 9100 Guidelines for Internal Control Standards for the Public Sector
- INTOSAI GOV 9110 Guidance for Reporting on the Effectiveness of Internal Controls: SAI Experiences in Implementing and Evaluating Internal Controls
- INTOSAI GOV 9120 Internal Control: Providing a Foundation for Accountability in Government
- INTOSAI GOV 9130 Further information on Entity Risk Management
- INTOSAI GOV 9140 Guidance for Good Governance, Internal Audit Independence in the Public Sector

European implementing guidelines for the INTOSAI auditing standards

### IFAC

- International Standard on Auditing 610
- Governance in the Public Sector: A Governing Body Perspective

### IIA

- The International Professional Practices Framework, including the Definition of Internal Auditing, the Code of Ethics, The International Standards for the Professional Practice of Internal Auditing (Standards), Practice Advisories, Position Papers and Practice Guides

### NAO & HM Treasury

- Cooperation between internal and external auditors, a good practice guide

### GAO

- Financial Audit Manual, FAM 650 Using the work of others

Best Practices and tools will be integrated in the e-platform
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INTOSAI



*Management  
Discussion and  
Analysis of Financial,  
Performance and  
Other Information*

INTOSAI PROFESSIONAL STANDARDS COMMITTEE

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PSC-SECRETARIAT

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**Accounting Standards Framework  
Implementation Guide for SAIs:  
Management Discussion and Analysis Of  
Financial, Performance and Other Information**

**INTOSAI**

Issued by the Committee on Accounting Standards  
October 2001

## PREFACE

1. As a result of recommendations made at the Sixteenth International Congress of Supreme Audit Institutions (INCOSAI XVI) in 1998, the International Organization of Supreme Audit Institutions (INTOSAI) Committee on Accounting Standards (CAS) undertook to expand the *Accounting Standards Framework Implementation Guide for SAIs: Departmental and Government-wide Financial Reporting* (November 1998) to include a new Management Discussion and Analysis (MD&A) section. This publication, *Accounting Standards Framework Implementation Guide for SAIs: Management Discussion and Analysis of Financial, Performance, and Other Information* (MD&A Implementation Guide), constitutes that section. It further develops reporting concepts included in prior CAS publications.
2. The purpose of the MD&A is to provide a means for government management officials to discuss what the financial statement numbers mean (financial information), what was accomplished during the reporting periods (performance information) and the organization's systems, controls and legal compliance (governance information). With the addition of the MD&A section, the Guide will contain the basic components of an Accountability Report.
3. An Accountability Report presents financial, performance, and governance information about a government entity and charts the entity's progress in meeting its goals. The report provides useful information about the government entity's accountability for and management of resources entrusted to it, - that is, the results of government activities, the costs and benefits of those activities, and how those activities help achieve government goals. It links all the information together in a clear and concise report to help users make informed judgments about the reporting entity.
4. Similar to prior CAS publications, this Guide was prepared by CAS according to approved INTOSAI committee procedures for developing and publishing products. A subcommittee of CAS prepared an initial draft of this product that was reviewed by the full committee, which provided valuable comments. An exposure draft was then provided for review and comment to all SAIs, the INTOSAI Governing Board, and the CAS associates network. The associates network was formed in 1993, and is composed of preparers of government accountability reports and representatives of public sector standard-setting bodies from the countries represented on the CAS and the Public Sector Committee (PSC) of the International Federation of Accountants (IFAC). The final step in this process was the publication of the Guide for distribution at INCOSAI XVII in Seoul Korea. In keeping with INTOSAI practice, the Guide is considered a living document that will be modified and enhanced over time as circumstances and SAIs needs change. The Chair of the Committee on Accounting Standards would be pleased to receive comments on or suggestions for changes to this Guide at any time.



5. In addition to guidance provided in this Guide, SAIs may also wish to refer to Appendix I, which lists a number of sources for additional information and examples of governmental reports including MD&As.
  
6. The CAS is chaired by the SAI of the United States of America and also includes SAIs' from the following member countries: Austria, Canada, Cuba, Ghana, Italy, Kenya, Libya, Malaysia, Malta, Morocco, New Zealand, Peru, Sweden, and Trinidad and Tobago. The CAS wishes to express its appreciation to INTOSAI members who have supported its work and made these products possible. Particular appreciation is expressed to the SAI of Canada who provided consultation during this product's development, and to the SAI's of Italy, New Zealand, and Peru who reviewed early drafts of this product and provided valuable input.

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## INTRODUCTION

7. In 1995, INTOSAI published its “Accounting Standards Framework” (Framework). The Framework includes sections on the users, objectives, and qualitative characteristics of government financial reports. Financial reporting as described in the Framework includes government-wide and departmental reports as well as compliance and performance reports.
8. In 1998, INTOSAI published its “Accounting Standards Framework Implementation Guide for SAIs: Departmental and Government-wide Financial Reporting”, (Framework Implementation Guide). The Framework Implementation Guide provides practical guidance to SAIs on how to implement the Accounting Standards Framework. The Guide shows how to implement the five reporting objectives included in the Framework. Using the Framework concepts, the Framework Implementation Guide contains sections that discuss and provide illustrative examples of department and government-wide reporting. These examples include Overview, Highlights, Financial Statements, and Compliance and Performance sections.
9. This MD&A Implementation Guide builds on and complements these previously issued CAS publications and replaces the information contained in the Highlights and Overview sections referred to in the Framework Implementation Guide with the information in this Guide.
10. This MD&A Implementation Guide contains two sections:
  - (1) Purpose of MD&A – Generally discusses the basic objectives of the MD&A and how it relates to financial statements, performance reports, and reports on governance.
  - (2) Objectives of MD&A – Provides a detailed discussion of the objectives of the MD&A and suggests the type of information that would meet those objectives, including examples.
11. This guide also includes an appendix listing sources of additional information and examples of governmental reports including MD&As.
12. This Guide has been designed as an audit tool to help SAIs review and comment on the MD&A prepared by government officials. Where MD&As are not prepared and published, SAIs are encouraged to help their governments do so. In infrequent cases, if an MD&A is not prepared by government officials, a financial and/or performance analysis may be prepared by the SAI. However, it should be clear that it was not prepared by management and should not include “management” in the title. This guide provides a basis for discussions about the development of such a document.

13. The preparation of an MD&A, and its possible inclusion in a broader Accountability Report, requires consideration by SAIs and the government about the audit roles appropriate for these components. At a minimum, the auditor should read the entire MD&A to determine if the information presented is consistent with audited information included in the Accountability Report. Appendix II to this Guide provides an illustrative table of contents of an Accountability Report.
  
14. CAS acknowledges that the nature and extent of accountability reporting varies across the INTOSAI community. Therefore, the illustrative MD&A information presented in this Guide should be viewed only as examples, rather than as a standard. Preparers have flexibility to structure their MD&A in the manner most appropriate to reflect the administrative practices in their countries and to meet their needs. Regardless of the precise reporting format selected, the Committee strongly believes that citizens and legislators of all countries will increasingly expect their governments to demonstrate open and transparent accountability. A quality MD&A is a key component of this accountability reporting.

## **SECTION 1**

### **PURPOSE OF THE MANAGEMENT DISCUSSION AND ANALYSIS**

## PURPOSE OF THE MANAGEMENT DISCUSSION AND ANALYSIS

15. Reporting objectives identify the goals and purposes of accountability reports and the nature of the information that the reports should convey. The basic objectives of financial and performance reporting are described in the Accounting Standards Framework. These same objectives are applicable to the MD&A, and are included in the discussion in the next section of this Guide. The overall reporting objective is, to the extent practicable, to provide users with the information they need. Increasingly, these users include national and international funding and rating organizations that require a high standard of accountability reporting. The MD&A helps meet that expectation.
16. The Framework discusses the types of information, such as financial statements and performance information that may be appropriate to help satisfy these user needs.
17. Financial statements should provide information about the reporting entity's (departmental or government-wide) financial position, operating results, and cash flows. Overall financial position describes what a government owns (its assets) and what a government owes (its liabilities) at a point in time. Operating results reports the extent to which a government's financial position has improved or deteriorated from one period to the next, and includes information about revenues (or receipts) and expenses/expenditures (or disbursements). Generally, financial statements also include information about future commitments and obligations.
18. Performance reports provide information about the extent to which programs and activities are achieving their desired objectives (effectiveness), and the related cost (economy and efficiency) of achieving those goals.
19. In many cases, both financial and performance reports may explain what has happened, but not necessarily why it happened or whether or not it is desirable. In such circumstances, financial and performance reports may require the insight of management to help users understand the answers to these important questions. A fully developed MD&A should provide that insight.
20. In addition to financial and performance results, two other types of information are useful to be included in the MD&A – governance information and forward-looking information.
21. Governance information refers to information about an entity's management and information systems, internal controls, and compliance with laws and regulations. Compliance information, which includes budgetary compliance, is often reported on an exception basis. This type of information is useful to help discern any issues or concerns with the day-to-day operations of the entity, and could include a discussion of management's plans or efforts that are underway to remedy identified problems.

22. Forward-looking information to be presented may include discussion of the possible future effects of currently identified risks, uncertainties, trends, or other significant events or conditions that could have a major impact on the entity. This could include, for example information about future commitments, including social insurance obligations, as necessary to help the reader assess the future financial environment. This type of information is especially important during times of significant demographic, economic or policy changes.
23. In summary, the MD&A supplements traditional financial and performance reports. It is an important medium for government managers to communicate at a high-level, their insights about the mission and goals of the government entity, its major initiatives, and results achieved during the year. It gives the reader an opportunity to look at the organization through the eyes of management by providing an analysis of the business of the organization. It is a way of communicating financial, performance, and governance information about the government entity and its activities to people who need it. In short, it provides a description of the organization, what it does, how well it met the goals it set, and the cost of its activities.
24. Therefore, an effective MD&A generally should contain sections that include information about the organization's:
- Mission and organization structure
  - Financial results
  - Performance results
  - Governance
  - Forward looking information
25. Section 2, which follows, includes explanations and examples relating to these five components. However, additional and/or different information components may be appropriate to include in the MD&A, depending on the circumstances. Ultimately, each government entity should include information and organize its MD&A in a manner that is most useful to help achieve its reporting objectives.

## **SECTION 2**

### **OBJECTIVES OF THE MANAGEMENT DISCUSSION AND ANALYSIS (WITH EXAMPLES)**



## OBJECTIVES OF THE MANAGEMENT DISCUSSION AND ANALYSIS

### Introduction

26. This part of the Implementation Guide describes and illustrates each of the five types of MD&A information referred to previously. The purpose of this information is to satisfy the Objectives of Government Financial Reports that are part of the Committee’s Accounting Standards Framework. The first of these objectives, which is overarching, is “to provide users with the information they need”. There are four other specific objectives that further expand on the first objective. The interrelationships between the five types of MD&A information and the objectives in the Accounting Standards’ Framework, is shown in the matrix below:

Objective 1 <b>Provide users with the information they need to:</b>	<b>Mission &amp; Organization Structure Information</b>	<b>Financial Information</b>	<b>Performance Information</b>	<b>Governance Information</b>	<b>Forward Looking Information</b>
Objective 2 Help understand the size of the government entity, the nature and scope of its activities, and its financial position.	<b>X</b>	<b>X</b>	<b>X</b>	<b>X</b>	<b>X</b>
Objective 3 Help understand and forecast how the government entity finances its activities.		<b>X</b>			<b>X</b>
Objective 4 Help understand and forecast the effects of the government entity’s activities.		<b>X</b>	<b>X</b>		<b>X</b>
Objective 5 Help determine whether the government entity did what it said it would do and the costs of its activities.	<b>X</b>	<b>X</b>	<b>X</b>	<b>X</b>	

## Mission and Organization Structure Information

27. To provide users with overview information about the government entity, the MD&A could contain a brief description of the entity's:
- mission
  - major programs, functions, and activities
  - organization structure
  - operating environment

### Mission Statement

28. At the national government level, the government mission statement may represent a statement about jurisdictional responsibilities of the government or what it hopes to achieve. By their nature, national government mission statements may be very broad. For example, some national governments are given defined powers by their constitutions, while all other powers remain with component government units such as provinces or states. Other national governments have all governmental powers and other governmental units receive their powers from the national government. The MD&A could discuss these differences.
29. At levels of government below the national level, and for component units of the national government, the mission statement may be more specific since such government units are often organized and set up for a specific purpose or with specific goals and objectives. For example, the mission statement of the United States Small Business Administration (SBA) reads as follows:

U.S. Small Business Administration  
Mission

The SBA helps maintain and strengthen the Nation's economy by counseling, assisting, and protecting the interests of small businesses and by helping businesses and families recover from disasters.

The SBA helps create opportunities for small business success through its credit and business assistance programs. The critical success factor for SBA is a more vibrant and healthy small business sector. The responsibility for achieving this outcome is not only the SBA's, but is shared by many programs, often by several levels of government, and by the Agency's small business customers themselves. SBA's measures of success are directly related to those small businesses that are started, expanded, and maintained using the Agency's products and services.

### Major Programs, Functions, and Activities

30. A high-level summary of the government's programs, functions, and activities provides the reader with information about what the government unit does. In some cases the government entity's policies, strategies, or priorities may significantly affect its programs. Where this is so it may be appropriate to explain which programs are affected and in what way. For example, facing increasing social insurance costs, a national priority may be to reduce program benefits instead of raising taxes or social insurance contributions, or some combination of the two strategies.

31. The U.S. Social Security Administration’s MD&A describes the social security programs as follows:

Social Security Administration (U.S.)  
Social Security Programs

The Social Security Act of 1934 established a program to help protect aged Americans against the loss of income due to retirement. Protection for survivors of deceased retirees was added by the 1939 amendments, thus creating the Old Age and Survivors Insurance Program. Social security was expanded again in 1956 to include the Disability Insurance (DI) Program, and in 1972 to include the Supplementary Security Income Program (SSI). SSA’s responsibilities in 1998 focused on administration of these three entitlement programs that deliver cash benefits to about 50 million beneficiaries every month.

The OASI and DI programs, commonly referred to as Social Security, provide a comprehensive package of protection against loss of earnings due to retirement, disability, and death. Monthly cash benefits are financed through payroll taxes paid by workers and their employers and by self-employed people.

32. This description shows the types of services that SSA provides and describes how these services have increased over time.

33. The U.S. Department of Veteran’s Affairs (VA) MD&A summarizes its major programs as follows:

Department of Veterans Affairs (U.S.) Programs

- Medical Care—provides primary care, specialized care, and related medical and social support services throughout its 172 hospitals, 131 nursing homes, 439 clinics and other support services.
- Medical Education—helps to ensure an adequate supply of clinical care providers for veterans.
- Medical Research—contributes to the nation’s knowledge about disease and disability.
- Education—provides educational assistance to men and women of the armed forces to adjust to civilian life after separation from the services.
- Insurance—provides life insurance benefits and services to veterans and beneficiaries.
- Burial—ensures that the military service of veterans is honored by providing dignified burials and memorials.

34. To help understand the relative size of programs, the VA MD&A also presented information comparing the number of veterans and dependents it served:

Department of Veterans Affairs (U.S.)  
 Medical Programs, Benefits and Administration Expenses for fiscal years 1997 and 1998

Benefits or Services	Veterans and Dependents Served	
	FY 1997	FY 1998
Medical Care	3,431,400	3,142,000
Medical Education and Research	2,269,700	2,256,700
Education	299,400	294,800
Insurance	2,408,700	2,300,100
Burial Service	76,700	73,000

Organizational Structure

35. In many cases, it is useful to describe the organizational structure of the entity. This will provide the user with the context of the other information presented, including how it is organized to carry out its mission through programs, functions, and activities. The organizational structure may be described in a chart, narrative, or other means.

36. The Social Security Administration (SSA) describes its organizational structure in terms of how it meets its needs to provide services to the public as follows:

Social Security Administration (U.S.)  
 Organizational Structure  
 SSA's organizational structure is designed to provide responsive and accurate world-class service to the public. SSA's organization features centralized management of the national Social Security programs and a decentralized nationwide network of 10 Regional Offices overseeing 6 Program Service Centers, 1,348 Field offices, 1 Data Operations Center, 36 Teleservice Centers and 132 Hearings offices.  
 Field offices are located in cities and rural communities across the nation and are the Agency's main physical point of contact with beneficiaries and the public.

## Operating Environment

37. A description of the government entity's operating environment provides important information that will help the reader better understand its financial and performance results. The operating environment includes major factors or conditions affecting the entity. Some countries have significant vulnerability to external variables including world economic conditions or the price of specific commodities. In such cases it would be appropriate to highlight such variables.
38. The following example, which was modified for presentation in this guide, is from the 1998 – 1999 Annual Report MD&A of the Canadian Farm Credit Corporation (FCC), a governmental entity which provides loans to the agriculture sector of the economy, and describes its operating environment as follows:

Farm Credit Corporation (Canada)  
Global Marketplace Affects Canadian Agriculture

Canada's agricultural industry is rapidly transforming to compete effectively in an increasingly global marketplace. This transformation affects the entire spectrum of agriculture – from inputs and primary production to value added and the consumer. Farmers, input suppliers, equipment dealers, processors and manufacturers are working together to create new markets and expand existing ones.

Tremendous growth in the agriculture and agri-food industry is expected in the next several years. The industry has set the target of increasing agri-food exports to four per cent of the world's total trade by the year 2005, effectively doubling our current exports from \$22 billion to approximately \$40 billion per year.

Canadian producers and agribusinesses are the driving force in meeting these goals. Their ability to anticipate needs, produce high quality products and adopt leading-edge technologies and processes will determine Canada's share of the global agriculture and agri-food market in the next millenium. The push to be competitive requires capital. Producers are making the necessary capital investments to increase their productivity and profits. As Canada's largest agricultural term lender, FCC is working with producers and agribusiness operators to help them make the necessary investments to succeed with financing tailored to the unique needs of the industry.

39. The FCC MD&A then discusses its operating environment in terms of:
- the effects of changing demographics on markets and farm ownership
  - pressures to diversify products
  - the industry shift to value added products
  - changes in producer financing options
  - the advantages of producer partnerships and alliances.

## **Financial Information**

40. The MD&A of a government entity should summarize the most important financial information for that entity. This would involve incorporating a summary of more extensive information contained in the entity's financial statements, as well as financial information about the entity contained in other separate reports to the extent appropriate. The following four types of information may be useful in helping users of the MD&A understand the key financial aspects of the entity:

- financial highlights
- financial condition
- sources of financing – taxes and other receipts
- financing provided by debt and debt management.

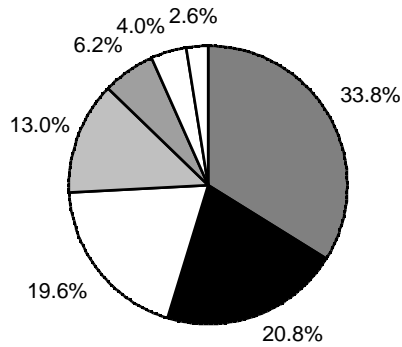
## Financial Highlights

41. Financial highlights information summarizes the government's financial position and operating results. Financial position includes what the entity owns (its assets) and what it owes (its liabilities) at a point in time. Operating results reflect the extent to which the entity's financial position has improved or deteriorated from one period to the next, and includes an entity's information about revenues (or receipts) and expenses/expenditures (or disbursements).

42. The following graphs from the 1999 United States Financial Report clearly show the relative significance of major categories of assets, liabilities, revenues and net cost<sup>1</sup>:

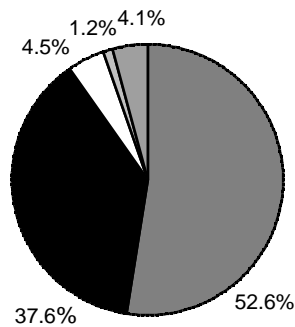
### Major Categories of Assets

- Property, plant and equipment - 33.8%
- Loans receivable - 20.8%
- Inventories & related property - 19.6%
- Cash & other monetary assets - 13.0%
- Other - 6.2%
- Accounts receivable - 4.0%
- Taxes receivable - 2.6%



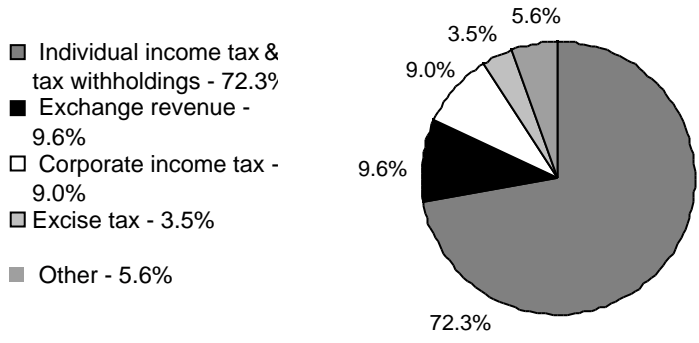
### Major Categories of Liabilities

- Federal debt held by public - 52.6%
- Federal employee and veterans benefits - 37.6%
- Environmental & disposal liabilities - 4.5%
- Accounts payable - 1.2%
- Other - 4.1%

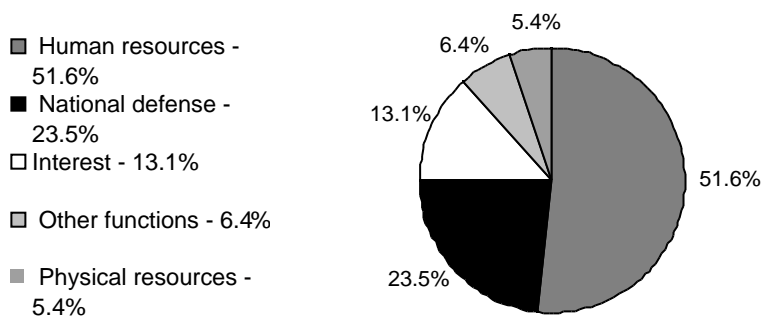


<sup>1</sup> It should be noted that the amounts in this presentation are significantly affected by U.S. accounting principles that do not place a value on certain national defense and stewardship assets, which are significant.

### Components of Revenue by Major Source



### Net Cost by Major Function



43. The financial highlights section of the MD&A can help the reader understand the entity's financial results and financial position by providing (1) general information such as the total budget of the entity and (2) more specific information such as a summary of assets, liabilities, revenues, and expenses, and (3) various financial ratios such as revenues or cost as a percent of gross domestic product (GDP). The information is often provided in table or graph format and is most useful if accompanied by a discussion of year-to-year changes and/or comparisons to budgeted amounts.



44. The financial report of the New Zealand Government includes discussion and analysis sections of Financial Performance, Financial Position, Prior Year Comparisons, and a five-year table of historical information. For example, the Financial Performance section, which was modified for presentation in this guide, is as follows:

1999 Financial Report of the New Zealand Government

Financial Performance

This section compares the actual 1998/99 financial performance against the 1999 budget forecast.

The operating balance for the year ended 30 June 1999 was made up as follows:

Operating Balance	Actual \$m	Forecast \$m	Variance \$m
Revenues	36,357	36,462	(105)
Expenses	35,825	35,256	(569)
SOEs and Crown entities surplus	1,245	958	287
Operating Balance	1,777	2,164	(387)

The operating surplus was \$387 million lower than the 1998/99 estimated actual forecast. The main variances were:

- A significant increase in the valuation of GSF unfunded pension liability (\$646 million) partly arising from a change in discount rate methodology, and
- A shortfall in taxation revenue of \$200 million compared to forecast, largely due to:
  - Lower than forecast new companies taxation (\$194 million), mainly due to higher than expected overpayment of company tax in the earlier part of 1998/99 leading to a downward correction in the June quarter, and
  - A shortfall in stamp duty (\$134 million), partly due to higher than expected refunds from the abolition of conveyance and lease duties.

These factors were partly offset by:

- Gains on sale of TVNZ's shares in Clear Communications and Sky Network TV (\$140 million) and the sale of the Cobb Hydro station (\$80 million) by Meridan Energy Limited, contributing to the higher net surpluses from SOEs and Crown entities (\$287 million); and
- The recognition of Public Trust reserves (\$86 million) by the Crown for the first time.

These items were not forecast as a matter of policy.

45. Additional financial highlights and narrative discussion included in the 1999 Financial Report of the New Zealand Government, also modified for this presentation, follow:

1999 Financial Report of the New Zealand Government

Overview

The Crown financial statements show:

- A \$1.8 billion surplus, despite a period of slower economic growth, due to a number of positive one time items;
- A significant decrease in net worth, reflecting the recognition of a \$3.1 billion claims liability for future actuarial pension costs;
- A fall in net debt, due to sale proceeds from Contract Energy Limited, and other assets.

	30 June 1999 Actual		30 June 1999 Forecast		30 June 1998 Actual	
Financial Summary	Actual \$m	Ratio to GDP %	Forecast \$m	Ratio to GDP %	Actual \$m	Ratio to GDP %
Operating Balance Surplus	1,777	1.8%	2,164	2.2%	2,534	2.6%
Net Worth	6,022	6.1%	5,456	5.5%	9,921	10.1%
Net Crown Debt	21,701	22.0%	22,369	22.5%	24,069	24.6%

The 1998/99 operating balance surplus contained a number of one-time items, both positive and negative. Adjusted for these one-time items, the operating surplus would be around \$150 million.

The positive items that boosted the surplus were largely gains on sales of assets – Contact Energy Limited, Auckland and Wellington Airport companies, and smaller hydro power stations.

These gains were moderated somewhat by tax cuts from 1 July 1998 and slower economic growth resulting in lower tax revenue. Expenses grew by 4.7% with increases in health (9.5%) and education spending (3.2%), partly offset by a reduction in finance costs. An increase in the valuation of Government Superannuation Fund (GSF) pension liability also contributed to higher expenses.

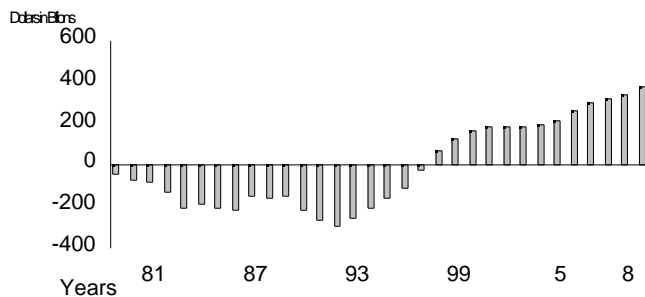
46. Financial highlights may also include a focus on the budget deficit or surplus amounts for the year. The following discussion and analysis, as modified for this presentation, was included in the 1999 United States Financial Report<sup>2</sup> and has such a focus:

U.S. 1999 Financial Report  
Continued Improvement in Fiscal Performance

Seven years ago, the federal budget deficit had exploded. It dominated the Government's ability to make policy and imposed an insidious burden on our economy. In 1992, the \$290 billion deficit was the largest in American history and was projected to continue spiraling upward without restraint. The economy suffered, interest rates were high and job creation stalled. Capital that should have been used for productive investments to create new jobs was used to finance the Government's massive deficit-driven borrowing.

In 1993, the Omnibus Budget Reconciliation Act was signed. Its deficit reduction was to cut the deficit in half as a percentage of the economy in 5 years. That goal was met in only three years. The 1997 Balanced Budget Act proposed to eliminate the federal deficit by fiscal 2002. In fact, it reached its goal 4 years ahead of schedule, producing the first budget surplus (\$69 billion) in 1998.

**Unified Federal Budget Surpluses and Deficits**

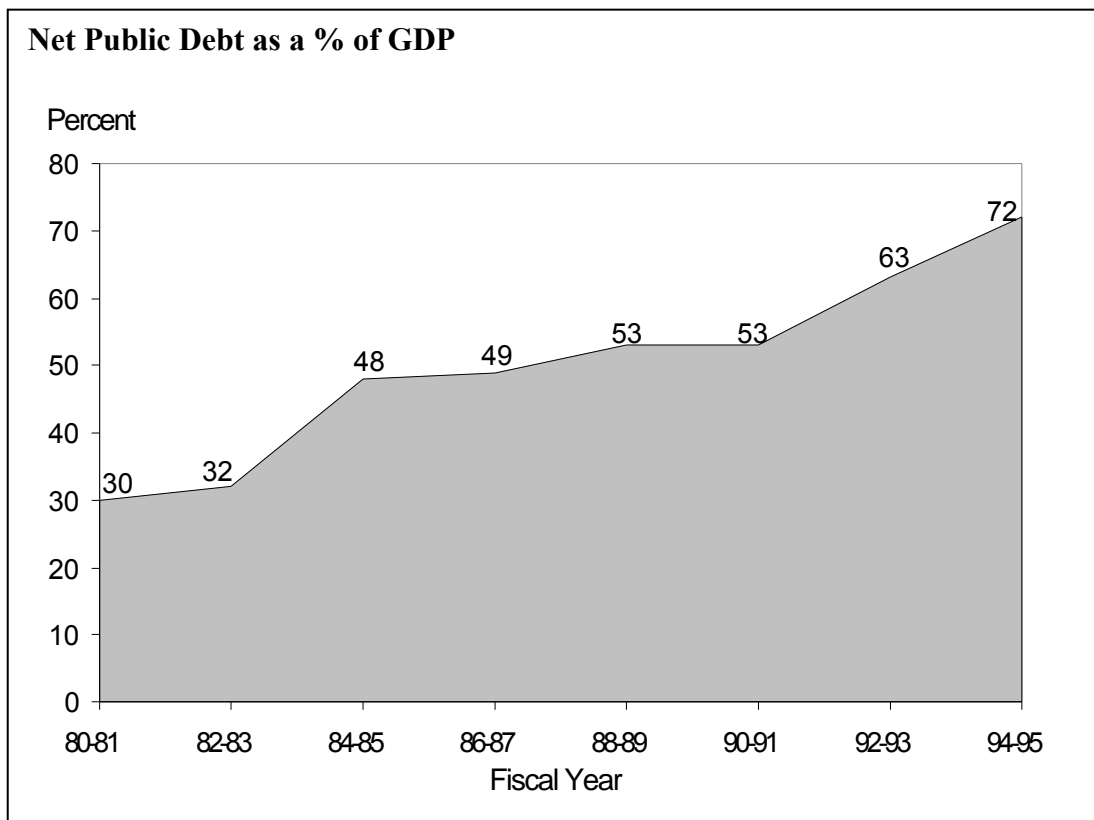


We can now look back with pride at our progress and ahead with confidence as we consider the success of our fiscal discipline and the opportunity to build upon it. Today we have lower interest rates, a higher level of investment, and unprecedented prosperity. Our economy has added more than 20 million new jobs. The unemployment rate is the lowest in 30 years; the welfare rolls are down by more than 50% since 1993; the core inflation is the lowest in 35 years; and more Americans own their homes than at any time in our history. Strong economic growth and passage of deficit reduction programs placed the budget on its path toward surplus.

<sup>2</sup> It should be noted that the calculations of the U.S. unified budget surplus includes social insurance and similar revenues

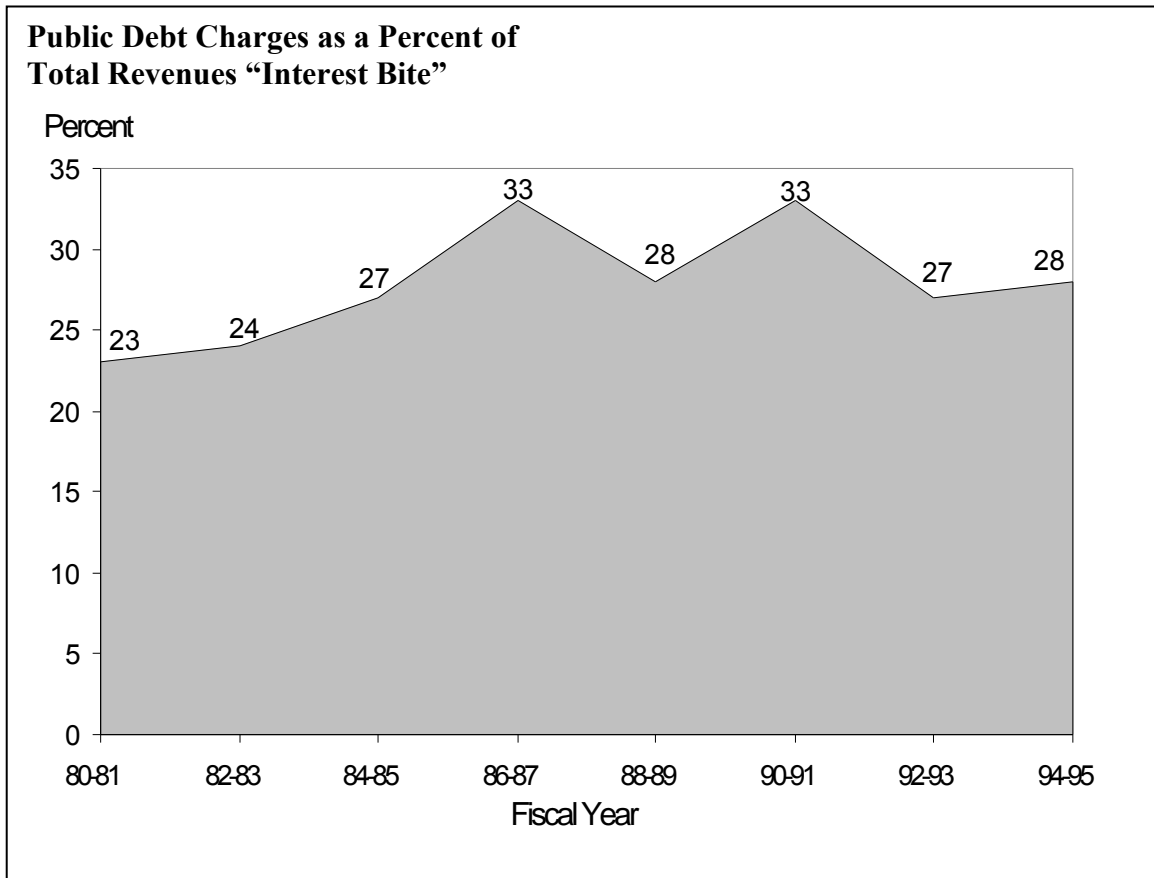
## Financial Condition

47. In describing the government entity's financial condition in the MD&A, it may be useful to discuss how it is influenced by conditions and institutions both inside and outside of the control of the government entity. In some cases, it may be appropriate to adjust financial data for the impact of inflation to provide meaningful information and comparisons.
48. For government-wide reporting, the MD&A could discuss the government's financial condition in terms of various indicators such as sustainability, flexibility, and vulnerability. These indicators are discussed and defined in a research report prepared by the Canadian Institute of Chartered Accountants titled *Indicators of Government Financial Condition*<sup>3</sup>. Due to their nature, these types of indicators may apply more to national governments than to their subdivisions. However, where appropriate, government departments may find these concepts appropriate for discussion, especially, for example where dedicated revenues or debt exist.
49. *Sustainability* is defined by the report as the degree to which a government can maintain existing programs and meet existing creditor requirements without increasing the burden on the economy. The primary indicator of a government's sustainability is the ratio of its net debt (liabilities minus financial assets) to its gross domestic product (GDP). The following example modified from the Canadian research report illustrates the movement of the Debt-to-GDP ratio for the Canadian government:



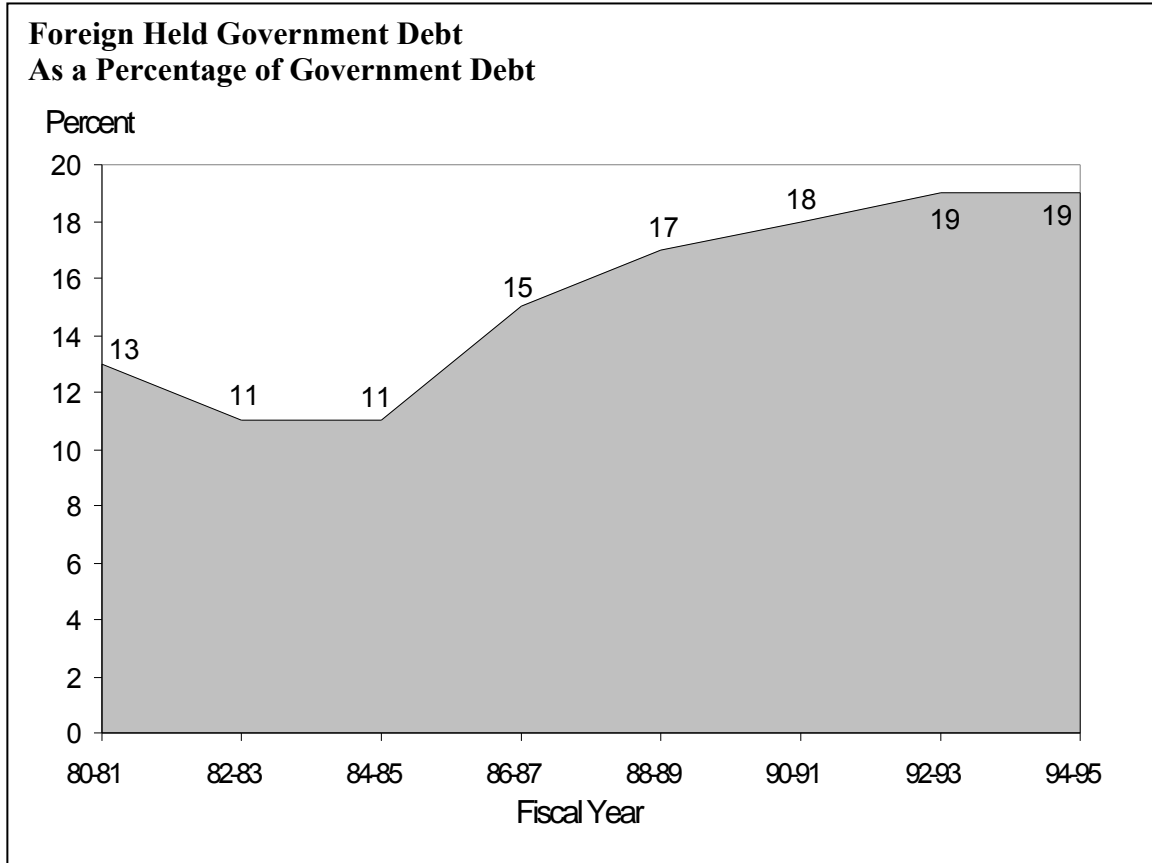
<sup>3</sup> *Research Report of the Canadian Institute of Chartered Accountants, Canada, 1997.*

50. *Flexibility* is defined by the Canadian research report as the degree to which a government can increase its financial resources to respond to rising commitments by either expanding its revenues or increasing its debt burden. One way to look at a government's flexibility is to show debt charges as a percent of total revenue over a period of years. The following example, derived from the Canadian research report, shows public debt charges as a percent of total revenues over a period of time for the Canadian government.



51. *Vulnerability* is defined in the Canadian research report as the degree to which a government becomes dependent, and therefore vulnerable, to sources of funding outside of its control or influence, both domestically and internationally. One way of portraying this type of vulnerability is to compare foreign government debt as a percent of total government debt over a period of years.

52. The following example of foreign debt as a percent of the total government debt is derived from the Canadian research report. The chart shows that foreign holdings of Canadian government debt increased significantly. This increases vulnerability to outside economic pressures.



53. In addition, the composition of debt (short, medium, or long term) as well as the ability to modify its terms affects the vulnerability of the government entity to outside factors such as changes in domestic or international interest rates.

54. Other indicators of financial condition could include current assets compared to current liabilities (a liquidity indicator) and net revenue compared to debt service requirements.

Sources Of Financing – Taxes and Other Receipts

55. The MD&A may also include information about how the government entity has financed and expects to finance its activities. Government financing includes the external sources of the entity’s funding such as taxes and other receipts, debt financing, and the sale of government assets, which may be used to finance deficits. Financing data in the MD&A should not merely duplicate data in the financial statements, but rather should also include an analysis and discussion of the changes in financing sources from year-to-year and other information that would provide insight on financing activities. The U.S. Department of the Interior’s 1998 Financial Report describes its financing as follows:

U.S. Department of the Interior  
1998 Financial Report  
Revenues

In general, Interior’s missions are intended to be funded by general government funds derived from tax receipts and other sources. However, an increasing number of Departmental activities are being supported by other fees and collections.

Federal government revenue is either classified as Exchange Revenue or Non-exchange Revenue. Exchange Revenue occurs when both parties to the transaction receive value (e.g., the government sells maps to the public for a price).

Interior’s revenues from the public derive from sales of hydroelectric power, entrance fees at parks and wildlife refuges, sales of maps, and other products and services directly related to the operating responsibilities of the Department. (See figure below) Approximately \$853 million of revenues were collected from the public and were either retained in the Department after congressional appropriation to further Interior’s mission, or were returned to the General Fund of the Treasury. This represents a 25% decrease over the prior year. These revenues offset the taxpayer investments in the Department. In addition, Interior earned \$721 million from other Federal agencies, mostly resulting from cross-servicing agreements or reimbursable services to other agencies. These efforts help reduce the total cost of government operations by sharing expertise among agencies.

Exchange Revenue

Dollars in billions	1998	1997	% Change
Revenue from Sale of Goods and Services to the Public	\$ .85	\$ 1.13	-24.8
Revenue From Sale of goods and Services to Federal Agencies	\$ .72	\$ .67	7.5%
Other Revenue	\$ .32	\$ .55	-41.8%

In addition, during 1998, the Department collected over \$5.9 billion in revenue from outer Continental Shelf and onshore oil, gas, and mineral lease sales and royalties, making Interior one of the largest collectors of revenue in the Federal government. This was a decrease of \$335 million from the prior year. These receipts are presented on the Department’s Statement of Custodial Activity since these collections are revenue of the government as a whole rather than of the Department. These revenues are distributed primarily to Federal and State treasuries, Indian Tribes and allottees, the Land and Water Conservation Fund, and the Historic Preservation Fund.

56. A presentation of historical and forecast data by financing source over several years provides significantly more information than that included in the financial statements themselves. The inclusion of forecast data along with a discussion of the economic outlook assumptions that affect government entity financing provides financial statement users a perspective about future financing sources and the basis for the forecasted amounts.
57. The following example of reported and forecasted financing sources, along with a related discussion and analysis, was prepared at the government-wide level from summarized information published in the 1999 U.S. Financial Report and the 2000 President's Budgets.

U.S. 1998 Financial Report

(\$ in billions)

Governmental Receipts are Growing

Governmental receipts in 1998 increased significantly from 1997 and, based on current assumptions, are expected to continue to increase in the future as shown in the following table:

Source of receipts	1997 Actual	1998 Actual	1999	2000	2001	2002	2003	2004
Individual income taxes	737.5	828.6	868.9	899.7	912.5	942.8	970.7	1017.7
Corporation income taxes	182.3	188.7	182.2	189.4	196.6	203.4	212.3	221.5
Social insurance/retirement	539.4	571.8	608.8	636.5	660.3	686.3	712.0	739.2
Excise taxes	56.9	57.7	68.1	69.9	70.8	72.3	73.8	75.4
Estate and gift taxes	19.8	24.1	25.9	27.0	28.4	30.5	31.6	33.9
Customs duties	17.9	18.3	17.7	18.4	20.0	21.4	23.0	24.9
Other receipts	25.5	32.7	34.7	42.1	44.9	50.3	51.7	53.0
Total receipts	1579.3	1721.8	1806.3	1883.0	1933.3	2007.1	2075.0	2165.5

1997 versus 1998 - The expanding economy during 1998 brought a surge in tax revenue. Receipts increased from 1997 by 9.0% to \$1,722 billion, faster than gains over the previous several years. Growth was led by a more than 12% increase in individual income tax payments, reflecting rapid job and income growth as well as high levels of capital gains from the rising stock market. That increase was more than enough to offset a slowdown in corporate income tax receipts, which grew by 3% in 1998 compared with a 6% increase in 1997. Corporate profits weakened in 1998 primarily due to the impact of the global situation on earnings, particularly on manufacturing firms.

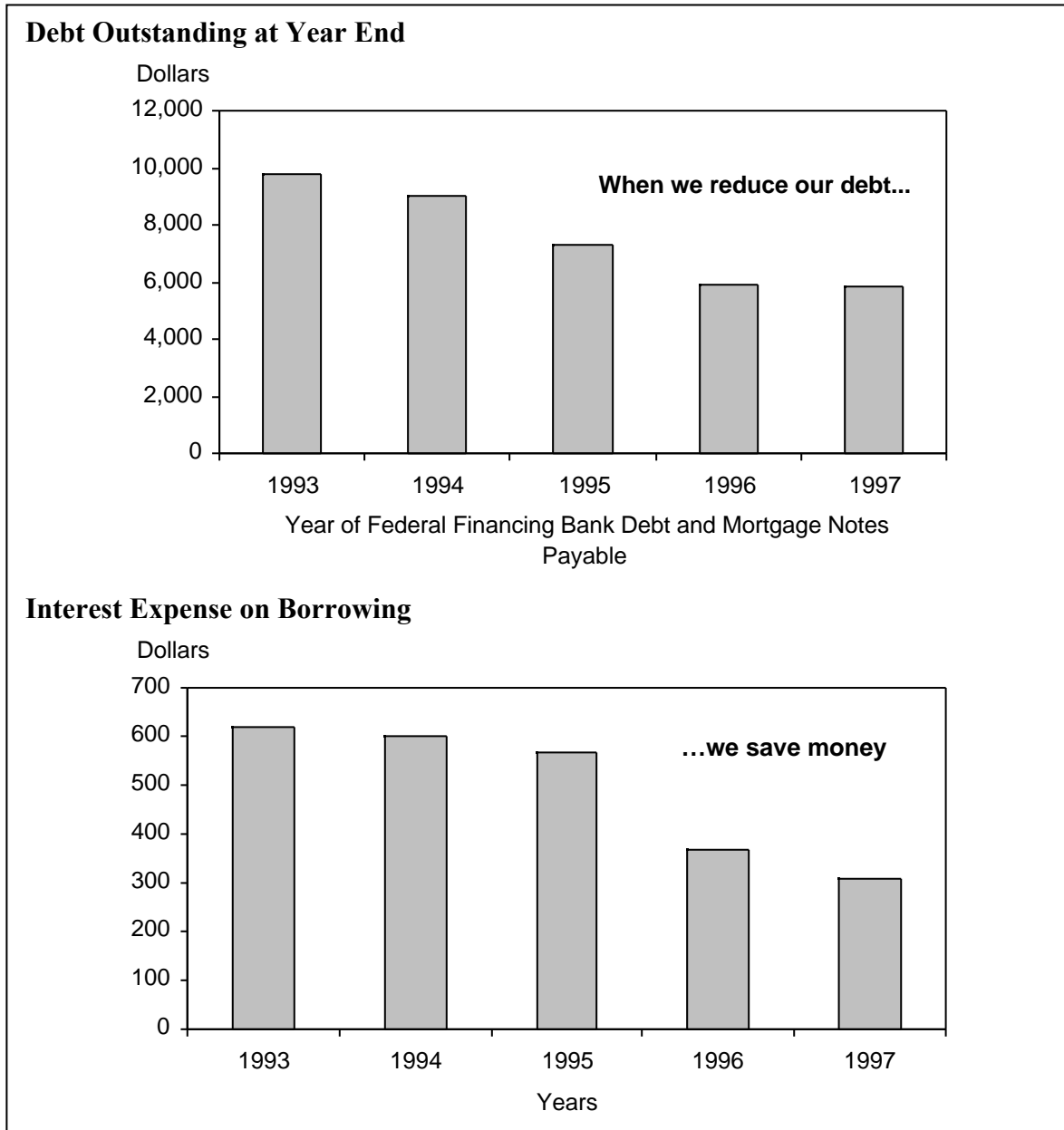
Estimated receipts - Total receipts in 2000 are estimated to be \$1.883 billion, an increase of \$76.7 billion or 4.2% above 1999. This increase is largely due to assumed increases in incomes resulting from both real economic growth and inflation. Receipts are projected to grow at an average annual rate of 3.6% between 2000 and 2004. As a share of gross domestic product, receipts are projected to decline from 20.6% in 1999 to 20.0 percent in 2004. In addition, several new laws were enacted in 1999 that will have a future effect on governmental receipts.

58. The MD&A may also provide information about the major economic assumptions used to prepare revenue (and expense) forecasts. For example, the United States year 2000 President's Budget provides detailed tables as well as discussions and analyses about future assumptions for gross domestic product, corporate profits, wages and salaries, the consumer price index, and unemployment and interest rates, among others. At a summary level, such information may be appropriate to include in the MD&A. This provides forward-looking information to the user as discussed later in Section 2, paragraphs 91 – 95.



## Financing Provided By Debt and Related Debt Management Activities

59. A discussion of an organization's debt and debt management can be presented in various ways in the MD&A. One way is to show what the debt is comprised of and the effect changing the amount of debt has or would have on the organization. The following graphs from the 1997 annual report of the United States Postal Service show the relationship of outstanding debt to interest.



60. Another way to describe an organization's debt and debt management is a discussion of debt activity during the year including information on borrowings made and debt retired during the year. The State of Texas fiscal year 1998 annual report discussed its debt activity as follows:

State of Texas

Fiscal Year 1998 Annual Report

During fiscal year 1998, Texas' state agencies and universities issued \$2.5 billion in state bonds to finance new construction, housing, water conservation and treatment, and other projects. General obligation debt accounted for \$1.2 billion of the state bonds. The remaining \$1.3 is due to new issuances of revenue bonds. Bonds retired were composed of \$224.5 million in general obligation bonds and \$1.1 billion in revenue bonds during the year. There were also \$887.5 million in general obligation bonds and \$410.5 million in revenue bonds that were refunded.

61. Debt may also be described in the context of its purpose. For example, borrowings made to finance current expenditures may require a discussion about whether or not the condition is due to temporary economic conditions, or longer-term structural financing factors. The latter situation, in particular, may have significant implications about the ability of the government to maintain its programs or continue as a going concern.

## **Performance Information**

62. Performance information helps the users of government accountability reports understand the effects or outcomes of the entity's activities. Performance information also helps readers determine related outputs and costs, and whether expected or targeted results were achieved.

63. The MD&A for a government entity should summarize the most important indicators of performance for that entity. This might involve incorporating a summary of more extensive information provided in separate, more detailed performance reports.

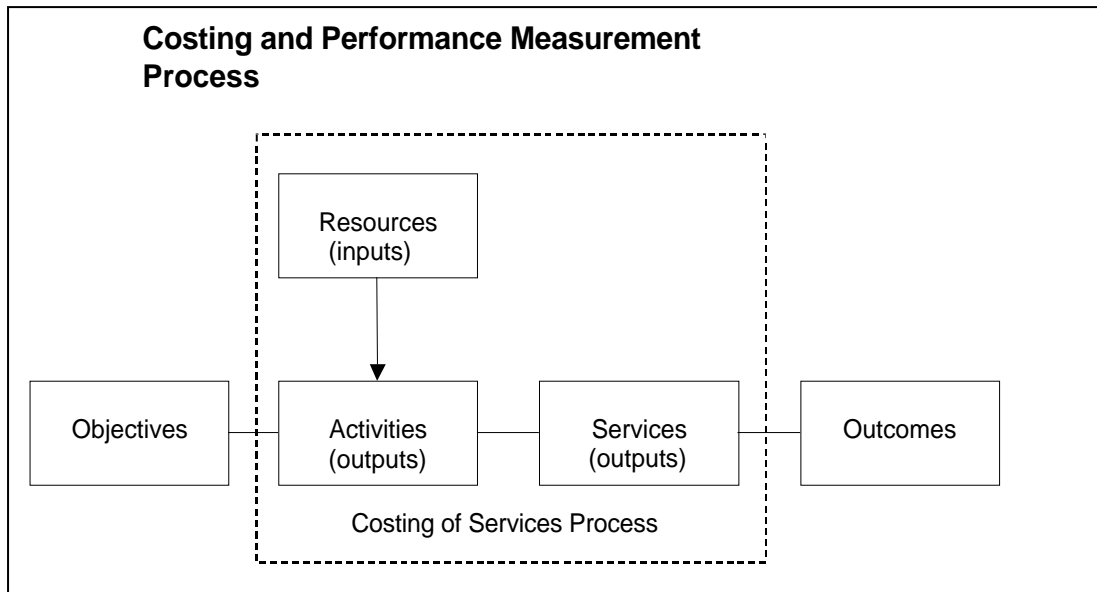
64. Government performance reports, and the information summarized in MD&As, are most useful if they, at a minimum, contain information that:<sup>4</sup>

- focuses on results and achievements
  - is presented in the context of expectations
- relates costs to results.

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<sup>4</sup> In discussing the measurement and reporting of government performance, it should be noted that, while concepts and techniques are relatively well advanced at the departmental level, this is not yet the case at the government-wide level. There are relatively few examples of government-wide performance information, although some governments are experimenting with various approaches. Part of the conceptual difficulty is that, unlike financial information, performance information at detailed levels generally does not roll-up easily to more summary levels.

65. A graphic representation of the performance measurement process that was taken from the Canadian Research Study, might look as follows:



66. Most governments should be able to provide basic performance information in published accountability reports, and to refine and broaden that information over time. Initially information about inputs and activities might be provided; related outputs, costs, and eventually outcomes and/or reasons why outcomes did not achieve the objectives could be added later.

#### Focus on Results and Achievements

67. Historically, performance information for government entities has concentrated on resource inputs, activities and processes rather than on actual results or achievements. Recently, the focus has broadened to also incorporate results and achievements, expressed in terms of outputs and occasionally outcomes.

68. Outputs are the goods and services delivered to achieve desired outcomes, and are often more readily identifiable and measurable than outcomes. However, by themselves, outputs are not a wholly satisfactory measure of the achievement of objectives. Aspects related to outputs that may be measured and reported include cost, efficiency, quality, and client satisfaction.

69. The New Zealand Department of Corrections' Annual Report contains a number of output performance standards that are measured. The following illustration, extracted from that report, measures various performance standards for clinical treatment services:

New Zealand Department of Corrections			
Annual Report 1997/1998			
Output – Clinical Treatment Services – Public Prisons			
Performance Standard	Budget	Actual	Variance
The projected number of psychological consultation hours	19,000	18,619	-381 (-2%)
The projected number of psychological reports	1,700	1,481	-219 (-12.9%)
Psychological treatment arising from consultations provided to the standards stated in the Psychological Services Manual	95%	96.9%	1.9%
Psychological reports provided to the standards stated in the Psychological Services Manual	95%	92.5%	-2.5%
<p>Comment: Performance measures for Clinical Treatment Services were introduced for the first time in the 1997/1998 financial year. The provision of these services is demand driven, and the initial forecasts did not match the level of demand. As a result, the forecasts have been revised for the 1998/1999 financial year.</p>			

70. Outcomes are the measurable consequences of a government policy, program or initiative. While at times outcomes can be easy or inexpensive to measure, at other times they can be difficult or costly to measure. As outcomes may result from multiple factors, in order for a specific outcome to be a valid measure of performance, causal relationships should be demonstrated, when possible. In some circumstances, it may be appropriate to measure outputs against output objectives in the short run when outcomes cannot be directly measured. Also, as outcomes are often delayed or long-term, they likely need to be reported over a longer period than outputs.

71. The following example, summarized from the Swedish Rescue Services Agency 1997 Annual Report, describes the objective of a program and a graph of accomplishments to date in terms of outputs. The accomplishments discussion detail was omitted for the purposes of this example.

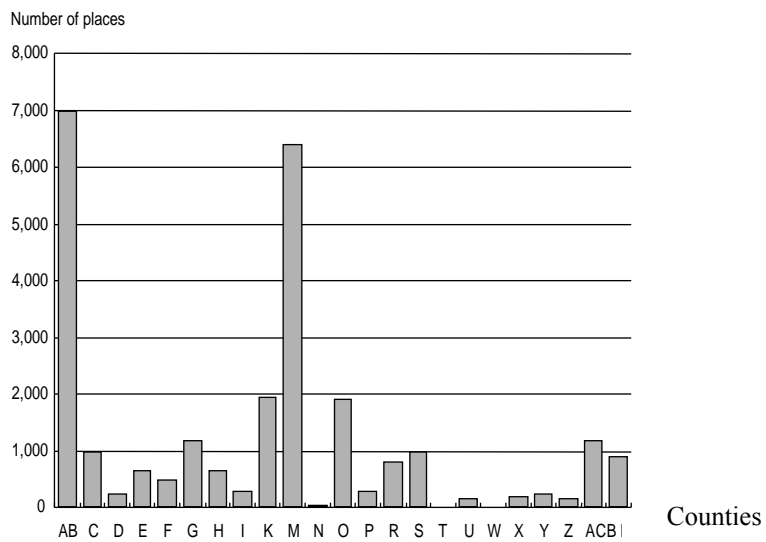
The Swedish Rescue Services Agency  
1997 Annual Report

Objective

The Swedish Rescue Services Agency shall ensure that shelters are built for residents and people involved in essential civil total defence activities within areas that are particularly exposed to risk so that the intentions in the 1996 total defence resolution can be realised.

Accomplishments to Date

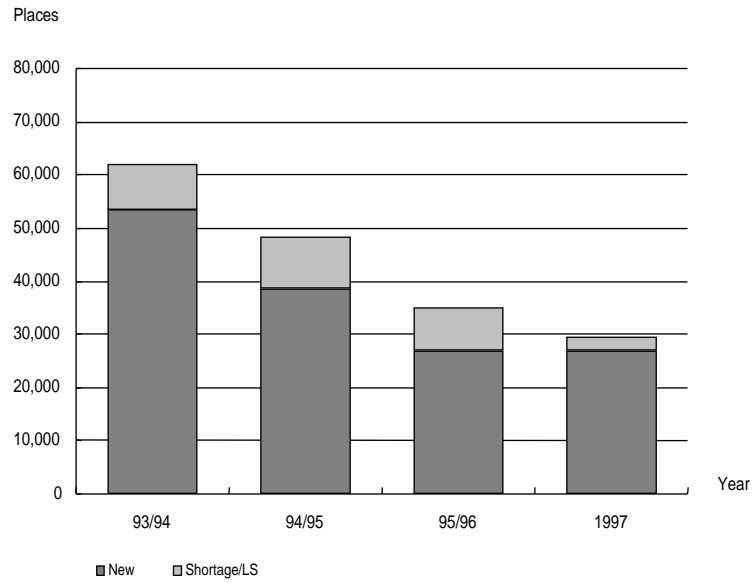
Number of shelter places prepared in conjunction with new, extended and reconstructed facilities, by county.



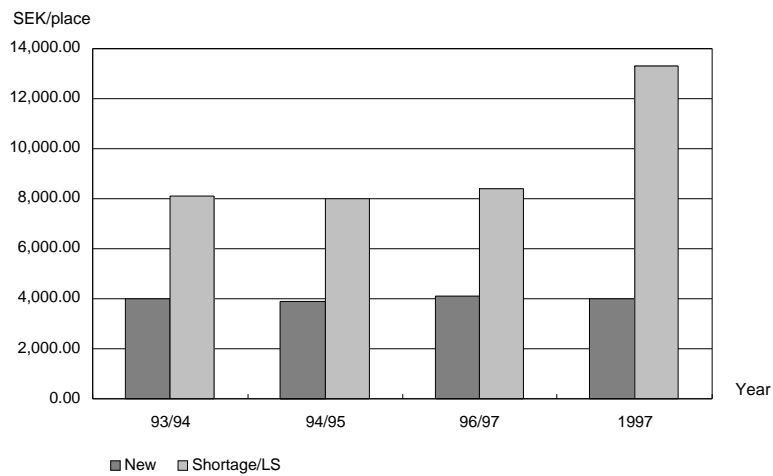
72. The Swedish Rescue Services Agency example also graphically compares numbers of new shelter places and unmet shortages for four years, as well as the cost per shelter space.

The Swedish Rescue Services Agency  
1997 Annual Report

Total number of shelter places prepared in conjunction with new extended and reconstructed facilities and shelters concerning the shortage of places and large shelters.



Costs (Swedish Kroner) per shelter place in conjunction with new, extended and reconstructed facilities including shelters concerning the shortage of places and large shelters.



73. In another example, the Corporation of Social Security of the Kingdom of Jordan shows its progress towards one of its mission statement objectives, “establishing a saving mechanism to contribute to the financing of the investment projects in Jordan, and achieving higher growth rates that improve the standards of living at all levels of the society.” The following table shows the investment in projects by the corporation as a percent of GDP.

The Corporation of Social Security of the Kingdom of Jordan The Contributions In Jordan’s Economy For Years 1995 Through 1999.					
Year	1995	1996	1997	1998	1999
Investment rate to (GDP)	16.3%	18.29%	19.98%	20.89%	24%

Present in the Context of Expectations

74. An important aspect of assessing performance is being able to compare achievements to expectations. Knowing the intentions, or plans, of government entities is a critical part of the accountability cycle. It provides users of accountability reports with a basis for assessing the results subsequently achieved. Readers of the report should be informed, therefore, about both planned and actual performance. Expectations however may not necessarily be set by the government entity itself. They may be set by, or at least in conjunction with, the legislative process that provides the entity with the resources it needs to operate.
75. In addition to reporting actual performance results, government entities should provide explanations for significant performance variances, as well as information on what action is being taken when performance has not met expectations.

76. An example of reporting performance targets and results in narrative and table form was summarized from the MD&A of the Canadian 1998 Export Development Corporation (EDC) annual report.

Export Development Corporation (EDC) (Canada)

1998 Financial Report

EDC's corporate objectives of doing more business with more customers and taking on more risk on behalf of those customers, in a financially sound manner, are tracked by way of a number of performance measures.

Customers Served – The number of companies benefiting directly or indirectly from EDC services increased by 13%, short of the Corporation's target of 16.5%. EDC did not meet the target in part because a new telemarketing campaign, introduced in 1998, did not generate the expected number of new customers. Of the customers served, 88% were small – and medium-sized enterprises, a priority customer segment for EDC. In 1999, EDC's strategic focus will be to increase the awareness of the Corporation's services among Canadian companies, which should serve to increase EDC's customer base.

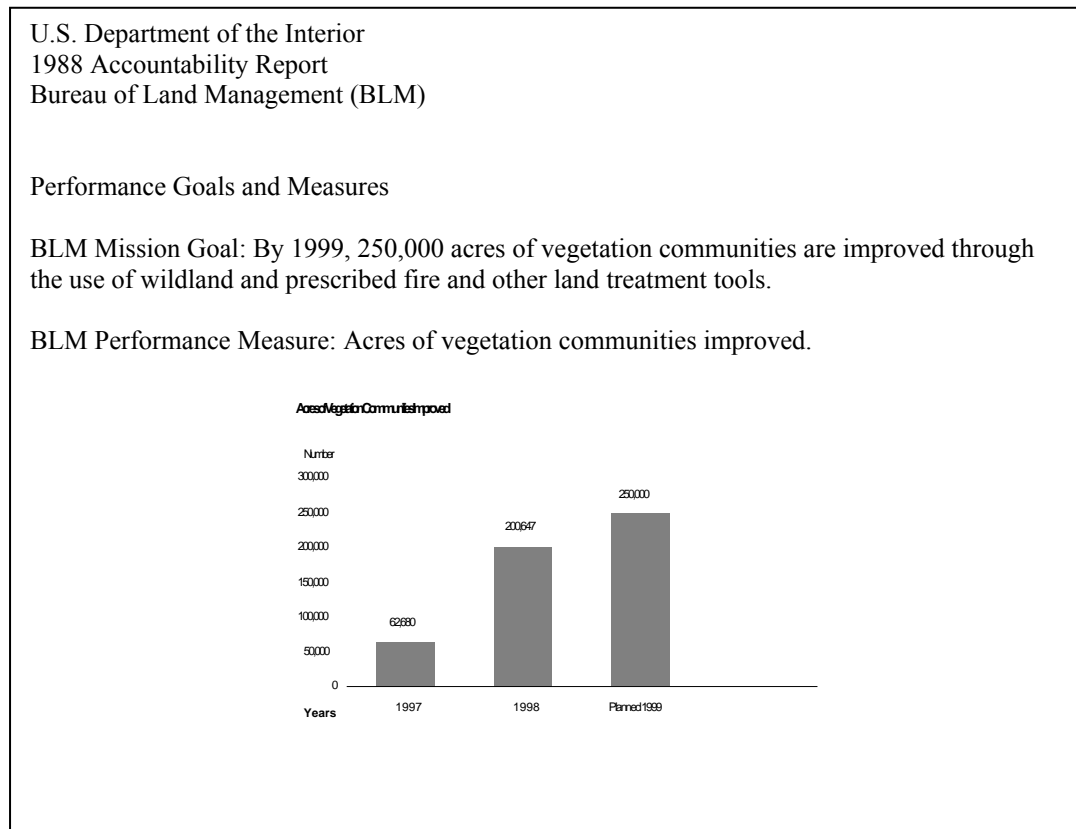
	1999 Target	1998 Actual	1998 Target	1997 Actual
Customers served	5,100	4,183	4,325	3,711

Business Volume – A measure of the Corporation's success in meeting the financial needs of its customers is the volume of business concluded during the year. The volume supported under each of the Corporation's programs increased in 1998, for a total increase of 21% over 1997 and 6% over the 1998 target. Included in the volume for 1998 was \$8.9 billion in higher risk markets. This met the 1998 target and was a 14% increase over the 1997 higher risk market volume. As a result of the current economic turmoil and uncertainty in the markets, EDC is projecting a more modest overall increase of 6% in business volume for 1999, of which \$8.5 billion is expected to be in the higher risk markets.

<i>(\$ in billion)</i>	1999 Target	1998 Actual	1998 Target	1997 Actual
Short-term	26.0	24.0	23.3	20.3
Medium- and long-term	11.0	10.8	9.4	8.3
Total	\$37.0	\$34.8	\$32.7	\$28.6



77. In addition, the following example from the 1998 U.S. Department of Interior Accountability Report shows how it links mission goals, performance goals, and performance measures:



### Relate Costs to Results

78. Efficiency and effectiveness are important elements of performance measurement, and measuring cost is an integral part of assessing the efficiency of programs.

79. Cost information is important in order to help accountability report users understand whether entities are achieving results at reasonable cost. Many government entities, while they report performance information on a regular basis, do not yet have the capability to link performance to the related cost information. As better cost accounting capabilities are developed, this linkage will become easier to achieve.

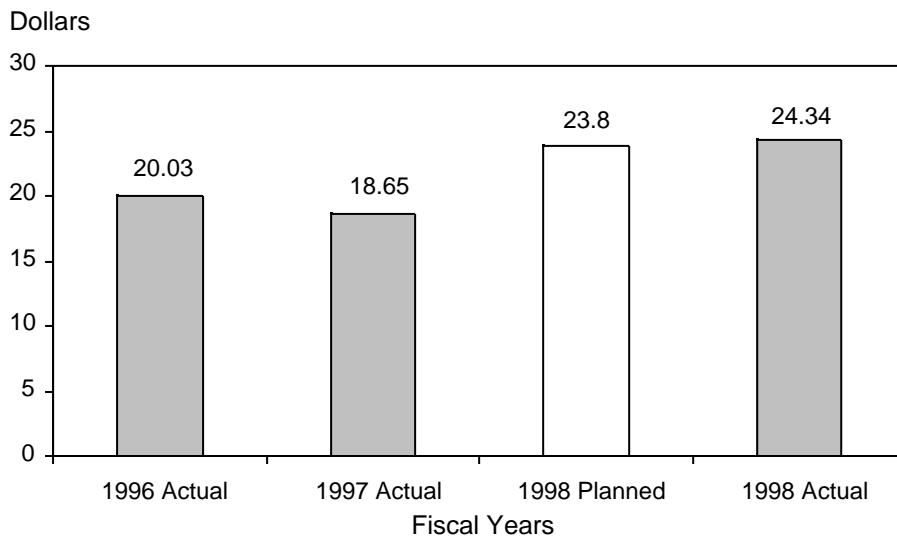
80. As shown in the following example, the use of planned versus actual cost information helps show how efficiently an organization is meeting its program goals and managing its resources:

Department of the Treasury (U.S.)  
Bureau of Engraving and Printing  
FY 1998 Accountability Report

Goal: Improve the efficiency of production operations

The following program performance measure, which reflects the efficiency of organizational performance, is used to monitor progress towards established goals:

**Manufacturing Cost for Currency (per 1,000 notes)**



Currency spoilage was higher than planned in 1998 as a result of higher than anticipated rejection rates during the transition to new electronic inspection equipment. This higher spoilage as well as unanticipated wage increases resulting from the resolution of wage negotiations contributed to manufacturing costs being higher than planned.

## **Governance Information**

81. The MD&A may also include governance information to help provide a context for the financial and performance information included in other sections of the MD&A<sup>55</sup>. Examples of the types of governance information that could be included are:
- a high-level discussion of the entity's systems and controls
  - a reporting of and discussion about compliance with laws and regulations (often presented on an exception basis)
  - a comparison and discussion of budgeted to actual amounts.
82. The MD&A should be clear about the sources of the information presented. For example, governance information may include findings from an audit report as well as actions undertaken by management to correct deficiencies. However, the presentation should clearly distinguish the audit finding from the related management discussion.

## Systems and Controls

83. An MD&A section on systems and controls could discuss internal accounting and administrative controls, sometimes referred to as management controls, and whether they are adequate to ensure that:
- assets are properly acquired and safeguarded to deter theft, accidental loss or unauthorized disposition and fraud,
  - transactions are executed in accordance with budgetary and financial laws and other requirements, consistent with authorized purposes, and recorded in accordance with recognized accounting standards, and
  - performance information is based on reliable data.
84. A Government entity's ability to prepare auditable financial statements and other reliable management reports from the entity's books and records is a positive signal about the finance related systems and controls of that entity. To convey this message, the MD&A could include information such as a summary of audit reports on controls (and reported weaknesses) and compliance, and the corrective actions taken or planned pursuant to legal requirements.

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<sup>55</sup> Although the inclusion of governance information in the MD&A is not a universal practice, it does help provide accountability report users additional insight about the context of the discussion of the financial and performance information presented.

85. The following systems and controls discussion from the Fiscal Year 1999 SSA Accountability Report includes a control certification by the SSA Commissioner as well as comments about a control audit finding.

Social Security Administration (U.S.)  
Systems and Controls  
FMFIA Assurance Statement Fiscal Year 1999

On the basis of SSA's comprehensive management control program, I am pleased to certify, with reasonable assurance, that SSA's systems of accounting and internal control are in compliance with the internal control objectives in OMB's Bulletin Number 98-08, as amended. I also believe these same systems of accounting and internal controls provide reasonable assurance that the Agency is in compliance with the provisions of the Federal Managers' Financial Integrity Act.

Kenneth S. Apfel, Commissioner of Social Security

Finding 1, SSA Needs to Further Strengthen Controls to Protect Its Information

In the audit report for FY 1998, the contractor noted that SSA made significant progress in strengthening controls to protect its information in the automated mainframe environment and recommended additional attention to the distributive environment. SSA completely or partially addressed 15 of the 26 recommendations in this finding and continues work on the remainder.

In the audit report for FY 1999, the auditor stated that SSA continued to make "notable" progress in addressing the information protection issues raised in prior years, but the information control structure needs improvement. Since many of the recommendations in the FY 1999 report are variations of recommendations in the auditor's previous audit reports, SSA has been addressing those issues on an ongoing basis and will continue to work on them until completed.

## Compliance with Legal Requirements

86. Compliance reporting provides management an opportunity to comment on the government entity's compliance with (1) its legal authority to spend, borrow, and raise revenues, and (2) related laws and regulations. For example, in many countries legislatures may have decided that certain taxes paid by citizens are to be used only for specified purposes. A failure to comply with such a restriction may require an explanation by the government's management.
87. Compliance reporting in the MD&A is often only reported on an exception basis. This means that authority, such as specific uses of appropriations, that has been used according to legal requirements need not be mentioned specifically. However, exceptions to compliance with legal requirements should be reported in the MD&A when specified limits have been exceeded, or where a material violation of rules has occurred. Exception descriptions could include narrative explanations of the individual authorities granted and reasons for significant differences with the authorities.
88. In addition, compliance reporting in the MD&A may be restricted to those laws and regulations that are applicable to financial matters. In some governments, the reporting of legal compliance with budget restriction laws as well as other regulations and conditions may be required by law, which may result in extensive legal compliance reporting.

## Budget to Actual Comparisons

89. The MD&A may include a comparative analysis of the reporting entity's actual results with related budget projections. Such analyses may be presented in terms of revenue in total and by source, expenditures in total and by program or function, and the overall surplus or deficit. A narrative could be used to explain any significant differences between budget and actual amounts. However, if budget comparisons are presented in the financial information part of the MD&A, they typically would not be repeated again.
90. The following example of a comparison of budget and actual revenue and cost is summarized and taken from the New Zealand Department of Corrections' Annual Report for 1997/1998. This is one of eight cost classes for which such comparisons were made.

New Zealand Department of Corrections

Annual Report 1997/1998

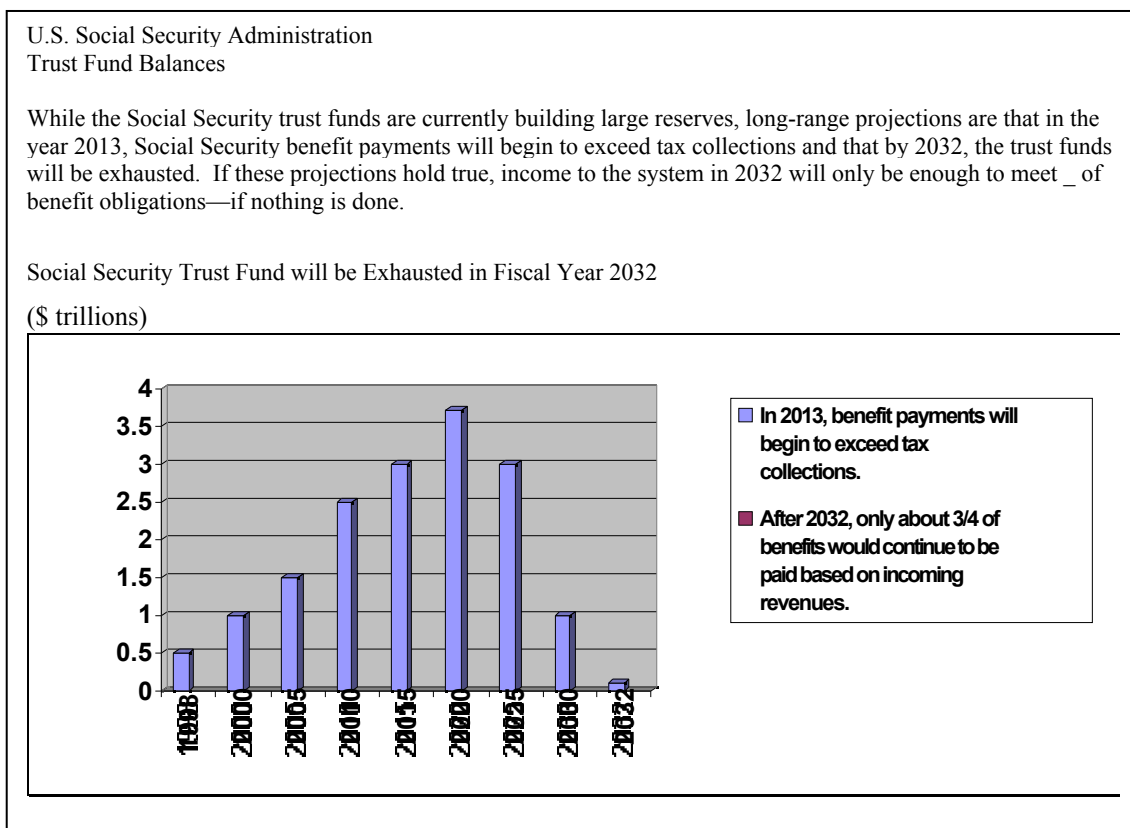
This class of outputs contributes to the Government's objectives in the area of safe communities through the provision of rehabilitative programmes including the provision of clinical treatment services to Public Prisons.

Output Statement: Rehabilitative Programmes for the year ended 30 June 1998

	Actual \$000	Budget \$000	Variance \$000
Revenue:			
Crown	35,570	35,570	0
Other	14,404	13,018	1,386
Total revenue	49,974	48,588	1,386
Total expenses	48,411	48,588	177
Net Surplus/(deficit)	1,563	0	1,563

## Forward-Looking Information

91. To help users forecast the effects of the government’s activities, the MD&A should also include forward-looking information on the current status of, and possible future effects of, currently-known demands, risks, events, conditions, and trends. For example, discussions about the future effects of programs such as social insurance and government loan guarantees – including such factors as trends, risks, and assumptions, would provide users with a basis for understanding significant uncertainties related to these programs in the future. Information related to these factors may include both descriptions of the existing conditions, such as demographic characteristics, as well as expected future conditions.
92. In many cases, forward-looking information may be integrated with other MD&A information. For example, a discussion about historical costs in the financial highlights section of the MD&A could also include forecasted future costs. Such information would typically not be repeated in this section.
93. Forward looking information may also include information about, and the sources of major economic and other assumptions used to prepare any forecasts presented.
94. The following example from the 1998 U.S. Social Security Trust Fund’s Accountability Report depicts in both narrative and graphic terms a future condition that may be encountered:



95. Generally, if there is a reasonable prospect of a major effect on the reporting entity from any anticipated future condition, this information may be appropriate to discuss in the MD&A.



**Sources for Additional Information and Examples of Governmental Reports Including  
MD&As**

**Australia**

1. The Commonwealth Government Entry Point  
[www.fed.gov.au](http://www.fed.gov.au)
2. Australian Department of Finance & Administration Publications  
[www.dofa.gov.au/scripts/pubs.asp](http://www.dofa.gov.au/scripts/pubs.asp)
3. Australian Department of Finance & Administration Annual Report 1998-99  
[www.dofa.gov.au/scripts/annual\\_report98-99.asp](http://www.dofa.gov.au/scripts/annual_report98-99.asp)

**Canada**

1. Departmental Performance Reports for the period ending March 31, 1999  
[www.tbs-sct.gc.ca/rma/dpr/98-9899dpre.html](http://www.tbs-sct.gc.ca/rma/dpr/98-9899dpre.html)
2. 1997-1998 Part III – Departmental Performance Reports  
[www.tbs-sct.gc.ca/tb/estimate/p3b9798e.html](http://www.tbs-sct.gc.ca/tb/estimate/p3b9798e.html)
3. Public Accounts of Canada for 1999  
[www.pwgsc.gc.ca/text/pubacc-e.html](http://www.pwgsc.gc.ca/text/pubacc-e.html)
4. Treasury Board of Canada Secretariat – Reports and Estimates  
[www.tbs-sct.gc.ca/repsproj\\_e.html](http://www.tbs-sct.gc.ca/repsproj_e.html)

## **Japan**

1. The Organization Of Japanese Central Government (links to Japanese government offices)  
<http://www.kantei.go.jp/foreign/server-e.html>
2. Audit Report (Board of Audit : the Supreme Audit Institute of Japan)  
<http://www.jbaudit.go.jp/engl/engl1/index.htm>  
(<http://www.jbaudit.go.jp/engl/index.htm>)
3. The Japanese Budget In Brief 2000 (Ministry of Finance)  
<http://www.mof.go.jp/english/budget/brief/2000/brief01.htm>  
(<http://www.mof.go.jp/english/index.htm>)
4. Central Government Reform of Japan in 2001  
[http://www.kantei.go.jp/foreign/central\\_government/index.html](http://www.kantei.go.jp/foreign/central_government/index.html)
5. Annual Review 2000 of Bank of Japan (Central Bank)  
[http://www.boj.or.jp/en/seisaku/01/seisak\\_f.htm](http://www.boj.or.jp/en/seisaku/01/seisak_f.htm)  
(<http://www.boj.jp/en/index.htm>)
6. Administrative Evaluation and Inspection  
<http://www.sumu.go.jp/kansatu/index.htm> (Japanese only)

## **United States of America**

1. Federal Accounting Standards Advisory Board – Statement of Federal Accounting Concepts (SFFAC) and Standards (SFFAS)  
SFFAC 3 – Management’s Discussion and Analysis – concepts  
SFFAS 15 – Management’s Discussion and Analysis – standard  
[www.financenet.gov/financenet/fed/fasab/concepts.htm](http://www.financenet.gov/financenet/fed/fasab/concepts.htm)
2. U.S. General Accounting Office  
<http://www.gao.gov/acreport.pdf>

3. Government-wide Financial Report  
<http://www.fms.treas.gov/cfs>
4. Department of Agriculture Financial Statements  
<http://www.usda.gov/oig/auditrpt/50401-30-FM.pdf>
5. Department of Commerce Financial Statements  
<http://www.oig.doc.gov/reports/1999-3/1999-3-10899-01.pdf>
6. Department of Energy Accountability Report index  
<http://www.cfo.doe.gov/ficor/index.htm>
7. Health and Human Services Accountability Report index  
<http://www.hhs.gov/of/reports/account>
8. Housing and Urban Development Accountability Report  
<http://www.hud.gov/cfo/cfoacct.html>
9. Department of Interior Accountability Report index  
<http://www.doi.gov/pfm/deptrept.html>
10. Department of Labor Accountability Report index  
<http://www.dol.gov/dol/ocfo/public/publications/main.htm>
11. National Aeronautics and Space Administration Accountability Report  
<http://ifmp.nasa.gov/codeb/about/excellence.htm>
12. Nuclear Regulatory Commission Accountability Report  
<http://www.nrc.gov/NRC/planning.html>
13. Social Security Administration Accountability Report *index*  
[http://www.ssa.gov/finance/finance\\_intro.html](http://www.ssa.gov/finance/finance_intro.html)

14. Department of Treasury Accountability Report

<http://www.ustreas.gov/tcfoc/finrep.htm>

15. Tennessee Valley Authority Annual Report

[http://www.tva.gov/finance/reports/annualreport\\_99/index.htm](http://www.tva.gov/finance/reports/annualreport_99/index.htm)

16. Veterans Administration Accountability Report index

<http://www.va.gov/cfo/pubs.htm>

## Illustrative Accountability Report

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<sup>6</sup> A separate Forward Looking Information section may not be necessary. Instead, such information may be more meaningful if it is incorporated with other appropriate sections.

<sup>7</sup> The Independent Auditor's Report may include separate sections for different types of reporting. For example, in addition to financial reporting, other sections may report on compliance and controls.

<sup>8</sup> As illustrated in the Accounting Standards Framework Implementation Guide for SAIs, management may prepare a separate report on Compliance Information. Management's compliance information typically might include budget to actual comparisons to demonstrate whether or not compliance with authorized amounts was achieved.

INTOSAI



*Guidance on  
Definition and  
Disclosure  
of Public Debt*

INTOSAI PROFESSIONAL STANDARDS COMMITTEE

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**PUBLIC DEBT COMMITTEE**



## **FOREWORD**

Public debt has always been a useful source of funds for financing the economic and social development of nations. Governments have often resorted to borrowing to finance budget deficits and large infrastructure projects. It has also been used to balance external accounts and as an instrument for monetary policy. Increasingly however, public debt has been seen as a real threat to the economic stability of a growing number of countries.

This threat has been recognised by SAIs but for most of us the audit of public debt is still a new area of interest and there is a perceived need for guidance and the development of methodology and techniques. In response, the Governing Board of INTOSAI established in 1991 a Public Debt Committee to develop guidelines which could be used by SAIs to encourage the proper reporting and sound management of public debt. The Committee comprises representatives from the SAIs of Argentina, Canada, Portugal, the United Kingdom and the United States and is chaired by Mexico. The Committee also counts on the support of the SAIs of Chile, Finland, Gabon, Jordan, Korea, and Sweden.

This current Guidance on Definition and Disclosure of Public Debt was approved by the General Assembly of INTOSAI at its Congress in Cairo in 1995. The Public Debt Committee hopes that these first results of its work will contribute towards a better understanding of this complex aspect of public finance. Because of the diversity of the political and administrative structures in which the SAIs of INTOSAI operate, the guidance has been drawn up in general terms which nevertheless the Committee hopes SAIs will find informative and update. The Committee will continue to revise and update the guidance from time to time to take account of new ideas and experiences.

Finally I should like to thank my colleagues on the Committee for their enthusiasm and dedication which made possible this first contribution to the work of our Organization.

JAVIER CASTILLO AYALA  
Contador Mayor de Hacienda  
de Mexico and Chairman of the Public Debt Committee.

## **PART I: INTRODUCTION**

### **1. Background**

The Governing Board of INTOSAI established the Public Debt Committee with the following general objectives:

"To publish guidelines and other informational materials for use by Supreme Audit Institutions to encourage the proper reporting and sound management of public debt."

The Committee's first task was to produce and issue to all Supreme Audit Institutions (SAIs) a questionnaire designed to obtain information about the following public debt issues:

Definition

Planning

Management and Control

Measurement

Disclosure

The Committee analyzed responses to the questionnaire and prepared an Interim Report which summarized the questionnaire findings and offered preliminary conclusions. The report was distributed to all SAIs in April 1994.

The Committee believes that adoption of an appropriate definition is a pre-requisite for the study of any aspect of public debt. The choice of definition depends, at least to some extent, on the context within which it is used. Accordingly, this document considers together the related matters of definition and disclosure of public debt.

The current document provides more detailed guidance to SAIs on two of the issues included in the questionnaire and related Interim Report, namely definition of public debt and disclosure of public debt.

Additional guidance to SAIs on other aspects of public debt will be developed and issued separately in future years.

### **2. Other Studies Consulted**

In considering these two matters, the Committee has taken into account work already done by the INTOSAI committees on internal controls, accounting standards, and auditing standards. The Committee has also consulted a number of international organizations with an interest in public debt matters, including the World Bank, the Inter-American Development Bank, the Organization for Economic Cooperation and Development (OECD), the United Nations, and the European Union.

The Committee has also examined the definition of public debt developed and used by the International Monetary Fund (IMF). This is reproduced in Annex 2 of the Committee's April 1994 Interim Report.

And finally, the Committee has taken into account studies published by the Public Sector Committee of the International Federation of Accountants. These studies also examine the definition of public debt, including different ways of recording it which arise from the adoption of various bases of accounting ranging from modified cash to modified accrual and full accrual.

The conclusions on definition and disclosure of public debt drawn by the Committee from considering these various sources are presented in the remainder of this document.

Additional guidance to SAIs on other aspects of public debt will be developed and issued separately in future years.

## **PART II: THE ROLE OF THE SAI AND RELATED CONTEXT**

In an overall sense, the Committee believes that proper reporting and sound management of public debt are matters of great importance in virtually all countries represented in INTOSAI. In this respect, the Committee believes that SAIs should do whatever they can, within the limits of their powers and responsibilities, to encourage the governments they audit to adopt sound and appropriate definition and disclosure practices for public debt.

The Committee recognizes that the amount of public debt that may be incurred and the purposes for which related proceeds may be used are generally matters of policy determined through normal constitutional or policymaking processes within of the country concerned.

In addition, some of the decision taken by governments in raising and managing public debt may well be based on policy judgments which are not readily distinguishable from purely financial considerations. In most countries, there is some limitation on the right of the SAI to examine or question policy judgments, although the nature and extent of the SAI's powers and responsibilities in this regard will depend on the political and constitutional circumstances in the country concerned. SAIs will therefore need to exercise their own judgment when considering the nature and extent of the examinations that they can undertake and the reports that they can prepare on public debt matters within their countries.

While the SAI may have no direct part to play in deciding the level of the purpose of public debt, the SAI may nevertheless have a role in helping to ensure that decisions with respect to public debt are based on the disclosure to all affected parties of complete and reliable information on the likely effects of the proposed borrowing.

After funds have been borrowed, the SAI is also likely to have some responsibility for helping to ensure the publication of complete and reliable information on the government's performance in raising and subsequent management of public debt.

The examination of matters related to public debt may present SAIs with unique problems due to the technical complexity of the subject. This may require, for example, the engagement of individuals with specialized know-ledge or expertise not available presently within all SAIs. Although outputs of this Committee should assist SAIs, they may nevertheless be required to provide specialized training to existing staff or perhaps hire additional staff with the necessary new skills.

In summary, there are a number of possible roles for SAIs with respect to the definition and disclosure of public debt.

**Auditing disclosed debt information:** As reported in the April 1994 Interim Report on the survey, most SAIs fulfill this primary role.

**Encouraging improvements in disclosure:** Where debt disclosure is incomplete, the SAI may wish to identify additional elements of debt that should be disclosed and actively encourage the government to make such disclosure.

**Commenting on the fiscal and economic implications:** In addition, the SAI may undertake independent analyses of the data disclosed to foster improved management of the debt and improved understanding of the current and future implications of public commitments.

Additional information with respect to the role of SAIs in examining and reporting on the definition and disclosure of public debt is set out in Part V of this document that deals with the medium for disclosure.

The remainder of this document identifies a number of factors that SAIs should consider in making judgment as to the nature and extent of their examinations and reports on the definitions and disclosure of public debt. This guidance is in the form of broad principles. These principles do not prescribe or identify definitions of public debt. Rather, they identify various elements which may constitute liabilities of public bodies and the circumstances in which it would be appropriate to disclose them as part of public debt.

Similarly, the guidance provided in this document does not prescribe one basis of accounting or one type of report to be used for disclosing information about public debt. The Committee recognizes that information about public debt may be provided through general purpose financial statements, but also through reports on compliance, performance and individual government departments and agencies.

The guidance in this document will be update and expanded from time to time as additional works is carried out by the Public Debt Committee and by other standing committees of INTOSAI.

### **PART III: GENERAL GUIDANCE ON DEFINITION**

As a pure semantic exercise, the definition of public debt may be of little consequence. However, the use of an appropriate definition in the compilation of the various types of government financial reports referred to above is of considerable practical importance. The reliability of these reports depends to a large extent on the soundness of the definitions used in preparing them. The main requirements for a sound definition include

- \* precision to avoid doubt or dispute about the inclusion or exclusion of particular elements;
- \* clarity to make the reports readily understandable by users;
- \* consistency from year to year, with other financial statistics or accounting records within a particular country and, where relevant, between countries;

- \* appropriateness for the purpose the criteria for inclusion of particular elements should be based on their relevance to the objectives that the reports are designed to satisfy;
- \* comprehensiveness to ensure that all particular elements of debt are brought within the scope of appropriate approval, planning, management and control procedures.

The primary consideration is that the content of government financial reports be appropriate to the purpose for which are prepared. Such reports may be prepared and used for a wide variety of purposes, including those summarized below.

A. Certain reports may assist in the formulation and monitoring of:

- \* general economic policy, because of the effect of public borrowing on the use of resources;
- \* monetary policy, because of the effect of public borrowing on the money supply;
- \* fiscal policy, because of the need to balance the sharing of financial burdens between existing and future taxpayers, and to ensure that the future cost of servicing and repaying outstanding debt will be sustainable; and
- \* exchange rates and balance of payments policies if external public debt is a significant part of a country's total external debt, the division of total public debt between domestic and foreign currencies between internal and external creditors may influence exchange rate and balance of payments policies.

B. Other reports may be used for a variety of international purposes. Some may fulfill obligations of membership in bodies such as the IMF, the World Bank, the OECD, and the European Union, and should be compiled in accordance with the rules of the bodies concerned, including definitions of public debt. Some may demonstrate a country's credit-worthiness.

C. Of particular importance is the use of government financial reports in the rendering of accountability such as that of the executive to the legislature for the exercise of borrowing powers and the use of related proceeds.

D. And various financial reports may be used in the planning and control of a public body's borrowing programs.

In summary, the scope of financial reports on public debt and the nature or type of liabilities shown will vary based on the differing purposes for which the reports are prepared. Different definitions of public debt will be used for different purposes, and there are many instances of variations in scope between the resulting types of reports. For example, reports produced for macroeconomic analysis could well cover the whole of the public sector, whereas the scope of reports used to demonstrate accountability of particular bodies of public administration might be much narrower. In addition, the scope of reports might be quite different as between unitary and federal states. All reports should disclose clearly their intended scope.

The Committee has not attempted to develop one or more model definitions of public debt. Rather, the Committee has identified and defined various elements of public debt which could be considered for inclusion in various types of reports.

Depending on the purpose for which a financial report is prepared, an appropriate definition of public debt might include the following:

\* Liabilities or other commitments incurred directly by public bodies such as

- (a) a central government, or a federal government, depending on the manner of political organization in the country;
- (b) state, provincial, municipal, regional and other local governments or authorities;
- (c) owned and controlled public corporations and enterprises; and
- (d) other entities that are considered to be of a public or quasipublic nature.

\* Liabilities or other commitments incurred by public bodies on behalf of private corporations or other entities.

The appropriate treatment of borrowings by those central banks that are not considered public bodies will depend on the precise status of the banks and their relationship with the public sector.

#### *Elements of Debt to Consider*

As summarized below, the various elements of liabilities and other commitments incurred by public bodies or by corporations sponsored by such bodies may be thought of as lying on a spectrum that extends from direct borrowing through a range of other financial obligations from trade accounts payable to various contingencies and commitments. These commitments may or may not be recorded as liabilities in financial statements. However, they may have a significant effect on future borrowing needs and, therefore, future demands on the country's economic resources. These commitments might include the following:

1. Securities. These include traditional borrowings from creditors, including those within government, under formal agreements which normally specify the amount borrowed, the interest rate charged or discount required, the security to be given ( if any), and the period over which repayment is to be made. For purposes of this document, securities include those executed for the short, medium and long term.
2. Bank loans
3. Loans from foreign governments or international bodies.
4. Proceeds of public savings schemes. These include amounts on deposit in savings banks operated by a government and other similar programs.
5. Issues of national currency, notes, and coins. These include banknotes and coins issued by or for a governments and in circulation.

6. Accounts payable for goods and services.
7. Taxation repayable.
8. Liabilities under long-term leases. Leases that extend beyond one year and that may be for either capital or operating purposes
9. Pension liabilities and health care benefits for public employees.
10. Other benefits provided by public sector entities. These include social commitments that involve explicit or implicit obligations by a government to pay future claims under a variety of programs. While they may be difficult to quantify, they are almost always significant and should therefore be considered, perhaps on a best estimates basis, in any assessment of public sector debt.
11. Guarantees to third parties. These would include, where appropriate, guarantees of borrowing, both by other public sector bodies and by private or quasipublic bodies, together with guarantees for a variety of other purposes such as financing for exports and exchange rates.
12. Indemnities.
13. Comfort letters or other forms of legally non-binding assurances.
14. Insurance and reinsurance programs.
15. Other Commitments. These are other obligations arising from existing contracts, agreements or legislative enactments or regulations that could become actual liabilities upon fulfillment of specified conditions.

Additional information with respect to the various elements of debt that may be shown under different bases of accounting is provided in Statement 4 of INTOSAI 's Committee on Accounting Standards.

While each SAI will need to exercise its own judgement on the appropriate content of reports on public debt produced for particular purposes, those used to assist in the formulation and monitoring of general economic and fiscal policies should normally cover all relevant items identified above. In particular, SAIs should be aware that the existence of various contingencies and commitments such as those described in items 9 through 14 above may well affect the ability of public sector entities to meet future cash requirements. Such liabilities could derive from moral or social obligations in addition to those of a strictly legal nature. The appropriate treatment of these liabilities will depend on their materiality. Additional guidance on contingencies and commitments will be provided by this Committee in future years.

The valuation of liabilities or other commitments included in any definition of public debt may be applied to the total debt outstanding or to the net increase or decrease in debt during some period of time. General guidance on disclosure of public debt is provided in Part IV of this document which follows.

## PART IV: GENERAL GUIDANCE ON DISCLOSURE

In an overall sense, regular disclosure of a country's public debt can reveal whether debt levels have been kept within the country's ability to support them and can help ensure that potential problems are visible. Moreover, such disclosure may provide the impetus to address potential problems before they become crises.

One of the most troublesome issues in public debt disclosure is how to make it understandable, and thus relevant to the reasonably informed and interested, but nonexpert, reader. In considering the adequacy of disclosure, SAIs should look for and encourage the use of generally accepted ways of bringing these huge numbers to life for affected taxpayers. There are a number of what might be called "simple indicators" of a government's overall financial condition that could be considered in this regard. For such indicators are summarized below.

**The interest bite.** This is the percentage of interest costs on borrowed funds to government revenues. It is somewhat analogous to a percentage frequently used by mortgage lenders in determining whether or not an individual can afford to carry increased debt.

**The expenditure ratio.** This is the percentage of total government spending to total government revenue. If this percentage is consistently greater than 100, the revenue shortfall is likely made up by additional borrowings which, over time, could lead to financial instability unless corrective action is taken.

**The tax bite.** This is the percentage of tax revenues to gross domestic product (GDP). Gross domestic product is the value of goods and services produced within a country in a year. If the tax bite increases year after year, it means that more and more of a country's production is being diverted to government and away from reinvestment in the private sector.

**Debt to GDP.** This is the percentage of a government's debt to the country's GDP. If this percentage increases year after year, it means that debt is growing faster than the economy, which could lead to burdensome and perhaps unaffordable debt loads. Both the level of the government's gross indebtedness and that amount net of borrowing between public entities can be useful indicators.

Indicators such as those outlined above should help interested individuals understand more clearly the significance of their government's debts and how their government compares with other levels of government within the country and with governments in other countries.

Another useful report to help people understand debt levels and what caused them is a budget-to-actual scorecard, comparing forecast deficit and debt levels with results achieved.

It would also be useful if the total indebtedness could be analyzed to distinguish between debt incurred to finance revenue producing capital assets and that incurred to finance current account deficits; and if the latter could be further analyzed to distinguish between cyclical deficits, attributable to the national economy operating below normal capacity, and structural deficits, reflecting a continuing imbalance between expenditure and revenue.

It is appropriate to note that indicators need to be exactly defined when used and their informative value and limitations explained. And it should be stressed that in any international comparison,



indicators may be rooted in different basic concepts which may stand in the way of straightforward comparison.

### *Information to Disclosure*

In addition to these general considerations, there are also a number of more specific types of information that SAIs should take into account when reviewing and commenting on the adequacy of disclosure of public debt. These types of information are summarized below under the categories of reporting elements used in Part III of this document.

This information should be presented separately for each public body and in aggregated and consolidated form depending on the purpose of the report within which it is shown. In all cases, consideration might be given to disclosing both total cumulative public debt as of the end of the reporting period and new debt incurred during the period. Public debt should not normally be reduced by related assets such as gold and foreign currency holdings or sinking funds.

In some cases it may be appropriate for these to be taken into account if they are freely available for the redemption of debt, but not if they are retained for other purposes.

#### **A. Securities, bank loans, from foreign governments or international bodies, and, proceeds of public saving schemes.**

1. The total amount due, showing separately the gross amount borrowed and the portion thereof represented by borrowing of agencies included in the entity.
2. Amounts held by foreigners, where possible. This disclosure is important because the outflow of interest and principal to other countries may limit the growth of the debtor's economy. The Committee recognizes that where public debt is issued through marketable notes, the nationality of holders may not be known.
3. Amounts denominated in foreign currencies and the exchange rates used in its valuation. Debt denominated in foreign currencies may be more volatile than debt denominated in the country's own currency because of the effects of changes in exchange rates.
4. New liabilities. For liabilities incurred during the period, disclosure would include the types of lenders, the terms of the issues and loan agreements, and perhaps future disbursements.
5. Types and terms of instruments. For types of instruments, issued debt would be broken down between various major classifications such as bills, notes and bonds. For terms of instruments, the disclosure would set out information respecting maturities, callable features and the like. Other useful information on maturities could be the consolidated amounts due in the short, medium, and long term, and the long-term or average maturity of amounts outstanding.
6. Measurement bases. Both the bases of measurement and any changes since the prior report would be disclosed. The use of different measurement bases can produce significantly different results. For example, depending on the type of bond issue, the market value of bonds can fluctuate widely with changes in interest rates. Different methods of amortizing premiums and discounts can affect significantly the amount of disclosed debt service costs, and debt values may be restated if being retired prior to maturity.

7. Principal repayments. Disclosure would include the amounts of principal repayments during the reporting period, the means used to finance these repayments, and the effects on related sinking fund balances.
8. Debt service costs. This disclosure would include interest payments and other administrative and commission costs paid during the reporting period. In addition, the “interest bite” and the budget-to-actual scorecard referred to in the preceding paragraph would be useful.
9. Restructured debt. Disclosure would include the results of any public debt renegotiations that occurred during the period, together with the terms and conditions of the renegotiated debt.
10. The use of funds. When funds are borrowed for specific projects, details would be shown with respect to the purpose and expected benefits of the projects. Where possible, information would also be provided on expected revenue sources and cash flows to finance the debt and the expected life of the project.
11. Actual levels versus estimates. Disclosure should include an appropriate comparison between the forecasts and the actual levels of total debt, principal repayments, service costs, and interest rates. Explanation for any significant deviation, where possible, should also be given.
12. Risk assessment. Information would be provided to describe potential vulnerabilities to fluctuations in interest rates, currency values, or other factors that affect repayment costs. Debt pegged to floating interest rates would be disclosed, for example. Information would also be provided with respect to actions taken in derivatives markets, such as interest rate and currency swap agreements, in order to limit such vulnerabilities. Because activities in derivatives markets may be highly complex and technical in nature, care should be taken to ensure that the information provided can be easily read and understood by individuals who may not have specialized and technical knowledge of derivatives products.
13. Legal requirements and restrictions. All significant legal requirements and restrictions would be appropriately disclosed. The information provided should be sufficient to demonstrate that all such requirements have been satisfied. In considering what to disclose, a number of sources could be reviewed appropriate, including constitutional and other legal limits on the amount of public debt or debt service costs; limits on the uses of proceeds of borrowed funds; regulations specifying who may borrow on behalf of a public body; laws outlining the public bodies which are responsible for public debt incurred by others; and requirements regarding the currency in which public debt may be held or the lenders who are to be used.

If liabilities were incurred by one public body on behalf of another, disclosure would be limited to the amount of debt, the types of instruments and the use of the proceeds. All other information would be provided by the entity that received the borrowed funds.

#### **B. National currency notes and coins.**

Information would include banknotes and coins issued by the public body and in circulation as of the reporting date, and whether they are backed by retention of separately earmarked holdings of monetary assets. Generally speaking, currency is issued by a country’s central bank and the relationship between a central bank and its government may vary from one country to another. Full details regarding this relationship should be obtained and analyzed in order to determine whether it

would be appropriate to consolidate a central bank with its government for financial reporting purposes.

**C. Accounts payable for goods and services; liabilities under long-term leases; and pension liabilities and health care benefits in respect of public employees.**

These types of liabilities are often recorded in the accounts and reported on the financial position statement or balance sheet of the public body to which they relate. For long-term leases and pension and health care benefits, additional information can be provided in footnotes to the statement.

For leases, this information would include the operating and capital components of the liability and minimum annual payments for each of the next five years. The liabilities for pension and health care benefits are determined by actuaries. Details with respect to the actuarial approach followed and significant assumptions used would be summarized and reported in the footnotes. Sensitivity analyses, setting out the extent to which the recorded liabilities would vary if actuarial assumptions were to change, would also be desirable.

**D. Other benefits provided by public sector entities.**

Disclosure would include the long-term fiscal effects of public pension programs as currently defined and other similar long range commitments of public resources. A brief description of the programs and their sources of financing would be provided as well as actuarial and economic assumptions used, as appropriate, in determining best estimates of costs and benefits. In future years, the Committee will study such disclosure further and provide additional guidance to SAIs to the extent possible.

**E. Guarantees, comfort letters, and other legally non-binding forms of assurances.**

Disclosure with respect to guarantees can include a description of the policies and/or the programs that underlie the guarantees; the maximum exposure to the public body that issued the guarantee, including responsibilities for principal repayment and interest costs, commissions, and exchange rate risks, if applicable (subdivided into domestic and foreign currency denominated responsibilities); amounts paid during the period to honor guarantees; default experience in prior periods; and, where possible, forecasts of amounts that are likely to default in future periods. With respect to comfort letters and other similar instruments, disclosure can include a description of the nature and extent of the assurances; the policies and/or programs that underlie them; amounts paid under them during the reporting period; and, if possible to forecast, amounts that are likely to be paid in subsequent periods. The exchange rates used in the valuation of these liabilities would also be disclosed.

**F. Indemnities.**

Disclosure would include a description of the terms and conditions of indemnity agreements in force; the conditions under which amounts are payable; the amounts paid under the agreements during the reporting and prior periods; and, if possible to forecast, amounts that will likely be payable in future periods.

**G. Insurance and reinsurance programs.**

Disclosure would include a description of the major features of each significant program, its funding, trend information on claims paid and premiums received, and estimates of future losses.

If a fund is maintained, details respecting the value of the fund and its adequacy to cover losses would also be provided.

#### **H. Other commitments.**

The nature and amount of each significant commitment or type of commitment would be summarized and provided. These might include costs expected to be incurred to repair environmental damage.

### **PART V: THE MEDIUM FOR DISCLOSURE**

As explained throughout this document, financial information about public debt may be reported in a wide variety of documents. General purpose financial statements and related notes could disclose many of the items discussed above. In addition, information could be disclosed in financial reports on compliance, performance and individual government departments, and agencies. Other public documents could also be used, including budgets, central bank bulletins, and a variety of other reports to legislatures.

It would be helpful to disclose planned and actual public debt periodically as part of the ongoing budget decisionmaking and accountability process.

Opportunities may also exist in the government's normal fiscal policymaking and reporting cycle for reporting the elements of planned and actual debt.

For example, planned levels of debt could be disclosed in the budget, with the actual levels realized periodically reported during the year as appropriate. In addition, a year-end accounting of debt could be provided, possibly through audited general purpose financial statements and possibly through other types of centrally provided reports. Attachment A to this document provides a simplified illustration of what an overall reporting framework for public debt might look like.

As explained in Part II of this document, SAIs have many opportunities to examine and report on issues related to the definition and disclosure of public debt. The extent of SAIs' concern with the form and content of reports on public debt will vary according to the purposes for which the reports are produced and used. This variation is examined in items A through E that are set out below and with which this document concludes.

*A. Reports produced by governments to assist in the formulation and execution of their economic, monetary and fiscal policies.* These reports may not be subject to formal verification by SAIs.

However, if they are submitted to the legislature to support budget proposals, the SAI might wish to review the reports to determine whether they are compiled on an appropriate basis and whether information is presented in an understandable and consistent manner.

*B. Forecasts of annual changes that are expected to result from budget proposals.* These reports may not be subject to direct verification either, but the audit of subsequent results might provide the SAI with an opportunity to comment on the bases used to prepare the reports.

*C. Forecasts of the long-term impact on public finances of the future costs of servicing and repaying outstanding debt.* Although not subject to direct verification, SAIs might consider and comment on the apparent relevance and understandability of the reports if they are submitted to the legislature.

*D. Reports on results, both with respect to changes in debt and with respect to debt outstanding, to help ensure appropriate accountability of public bodies with borrowing powers.* These “after-the-fact” reports are likely to be subject to formal audit by SAIs, which provides an opportunity to examine and comment on both the reasonableness of the bases on which the reports have been compiled and their general understandability and relevance.

*E. Returns to international bodies.* These returns are to be compiled in accordance with rules prescribed by the bodies, which may also govern the possible involvement of SAIs.

## **APPENDIX A**

### **Illustrative Model of Disclosure**

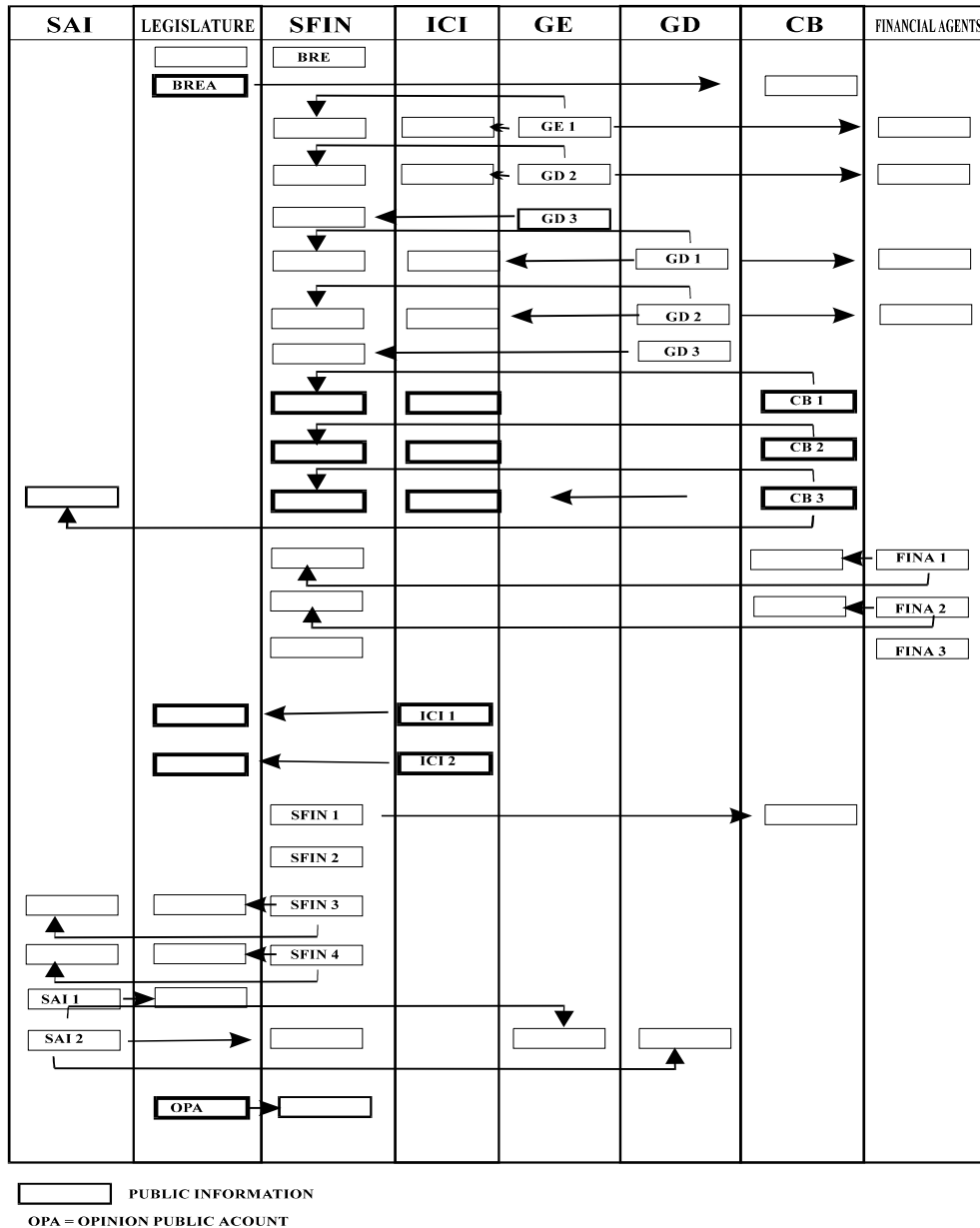
An adequate flow of information is a crucial aspect of any effective control scheme for the management of public debt. Disclosure could therefore, consider two factors: (1) the path of information, e.g., who should inform whom within the government and who should inform the public; and (2) what information could be included in each report and with what periodicity it could be prepared.

A flow diagram is attached describing a possible scheme of debt disclosure, indicating typically where each report originates and where they are utilized. Each report is labeled according to the institution that prepares it, and its contents are described below under each label.

**BRE [Budget of Revenues and Expenditures] (Annual).** The government (Executive), through the Secretary of Finance (Treasury), normally presents before each fiscal year a budget of expected revenues and expenditures to the Legislature, which includes a proposal for fund allocations, as well as where revenues will originate, and what debt is to be issued. Specific debt ceilings will be set by the Legislature.

**BREA [BRE Authorization] (Annual).** The legislative body authorizes and publicly discloses the maximum level of new net debt to be issued, as well as the approved application for such funds, where applicable, as part of the general authorization of revenue and expenditure.

**FLOW DIAGRAM OF REPORTS ON PUBLIC DEBT**



GD1 [Government Departments report 1] & GE1 [Government Entities report 1] (Monthly). This report prepared by each government department or government entity holding public debt includes the terms and amounts of the new debt contracted, as well as payments on loans existing, and details on maturity dates, currency, amortization, and interest payment schedules.

GD2 [Government Departments report 2] & GE2 [Government Entities report 2] (Quarterly). This report prepared by each government department or government entity summarizes accumulated individual balances and payments made during the quarter on capital and interest, expressed in the currency of origin as well as in local currency. A complete schedule of payments on capital and interest should also be kept to the maturity of each instrument. A comparison between programmed and actual amounts is presented here as well as an explanation of the variances with respect to the previous quarter.

GD3 & GE3. (Annual). Each department & entity could prepare for the Secretary of Finance (Treasury) a comprehensive closing report on its performance and finances for the year, which is integrated by the Financial Authority into what is normally named The Public Account. This report includes consolidated information on the state of each entity's debt holdings, describing the new debt issues for the year, actual payments made on capital and interest, and their comparison with estimates and the preceding year. A detailed explanation of any restructuring, assumptions, transferences, adjustments and conciliations at closing, as well as an analysis of financial factors affecting the cost of debt (e.g. domestic and foreign rates, exchange losses, etc.), as compared with the expected outcome should also be included.

CB1. [Central Bank report 1] (Monthly) and CB2 [Central Bank report 2] (Quarterly). The Central Bank could publicly disclose within its monthly and quarterly reports on economic, monetary, financial and commercial performance, the Public Sector debt, as well as its impact on monetary aggregates, reserves, and the capital balance. It also include an analysis of relative and nominal deviations that have occurred during the previous three years.

CB3 (Annual). This report is prepared normally by Central Banks and disclosed to the general public, and is a global account of the various economic aspects, including a description of the public debt balance and its impact on the performance of various economic indicators (Public Deficit, Balance of Payments, Economic Sectors Activity, interest rates, monetary aggregates and other aspects indicative of the behaviour of the financial system). This report is usually used as a general base for planning and analysis by financial authorities, the government in general, as well as by economic consultants and business in general.

Specifically, regarding public debt, this report could analyze the behavior of the total average balance, gross and net, foreign and domestic, for the year, with comparisons with respect to historic trends in real terms, in absolute and relative to GDP levels, explaining for each type of debt the main causes of the movements observed in the balance at closing.

Fin A. [Financial Agents] (Monthly, Quarterly and Annual). Through these reports, financial agents inform the Secretary of Finance and the Central Bank, with varying degrees of detail, on the change observed in market conditions that affect debt service.

Financial agents report on how outstanding debt notes are distributed among residents and non-residents, and on loans contracted to fund the programs of the Development Banks, explaining differences vs estimated figures.

ICI1. [Internal Control Institution report 1] and ICI 2 [Internal Control Institution report 2] (Quarterly and Annual). The Internal Control Institution of the Executive validates in these reports the information on public debt presented in the reports prepared by the Secretary of Finance for the Legislature on a quarterly and annual basis.

S Fin 1 [Secretary of Finance report 1] (Monthly). In this report the Secretary of Finance should inform the Central Bank on new debt issued in a foreign currency, the capital flow for each currency should be calculated separately to allow the Central Bank to take into account this component of the capital flow for monetary and exchange policy considerations and other strategic aspects related to the management of reserves.

This report should also include estimates as to the holdings of government securities by residents and non-residents, which the Central Bank would take into account for exchange risk measurement and reserve management.

S Fin 2. (Monthly). This fundamental report is prepared by the Secretary of Finance for internal use, and should constitute the cornerstone of the overall debt disclosure scheme. It is the first and most detailed concentration of all of the relevant information related to public debt, and based on this report, the rest of the reports prepared by the Secretary of Finance are assembled. Some of the concepts included are the specific terms and conditions of each debt issue (outstanding balance, interest rate, payments made on capital and interest, currency, exchange losses, etc.) and their actual situation, as well as a comparative analysis with respect to estimates and previous years.

S Fin 3. (Quarterly). This report should be presented to the Legislative body, to the Internal Control Office of the Executive and to the SAI. This report should summarize and aggregate information on Public Debt with the necessary degree of detail to allow the members of the Legislature to appreciate the state of the debt, its effect on the situation of the economy and on government management. It should include a comparative analysis against the preceding quarter and 12 month period, as well as actuals versus budget estimates. It could also include an explicative analysis of the evolution of the financial markets during the quarter and how this affected budget estimates. For the case of debt denominated in foreign currency, the variances observed for each individual instrument should be explained, including exchange losses registered per item and currency and country of residence of holder.

For the case of debt in local currency, its net balance, individual placements, the evolution of the mix of instruments, and maturities and repayment profiles should be indicated, as well as the approximate holdings by residents and non-residents.

Guarantees granted by the National Government in relation to debt contracted by State and Local Governments might not be included if its repayment and service is adequately assured by the Federal resources assigned to State and Local Governments (direct deductions are possible). When this possibility does not exist, the guarantees should be included.

S Fin 4 (Annual). This public debt report is part of the overall Annual Public Account usually presented by a Government to the Legislative Body, which is assembled by the Secretary of Finance or the equivalent Financial Authority within the Government. This report should include a consolidated description of the evolution of the balance of the debt and its service for the complete year, in sufficient detail. It should also include an analysis of the variances observed with respect to budget estimates and the preceding years, along with adequate explanations of the effects of public debt on financial market performance.

SAI 1. (Annual). This report should be a part of the integrated report that the SAI presents to the Legislature or the public on the general analysis and audit of the Annual Public Account prepared by the government for the Legislature. This report should include an evaluation of general public debt management performance, as well as its impact on public finance and the performance of the economy for the year. The report could also include an analysis of new debt as a share of total revenues, the terms of its issue in view of prevailing financial market conditions, and if the debt was allocated as authorized in the budget.

On the other hand the SAI should pay special attention to public debt aspects of the financial audits of entities holding debt, as well as that debt which is pegged to specific goals within government



programs. This information as contained in SAI reports to the Legislative body, should allow the legislators to consider the public debt aspects when analyzing the next project to be presented for budget approval.

The SAI would inform on irregularities and deficiencies detected in the managing of debt in the process of its systems (internal controls) and financial audits, and on the efficiency, efficacy and economy with which debt financed investments have behaved. Specific public works audits could also provide additional support in this last case. The SAI should pay special notice to this appraisal of the explanations on variances of actual vs budget presented in the Public Account.

SAI 2. (Annual). This is not a report in the strict sense of the term, but a document the SAI presents to audited bodies in which it informs of irregularities and deficiencies found (when their nature allows), as well as recommendations to correct them.

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