Comptroller of the Treasury

Quarterly Fiscal Affairs Report

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State law directs the Comptroller to make quarterly reports to the Fiscal Review Committee concerning the state's fiscal affairs. In this report, we provide a look at the design, implementation, and effectiveness of internal controls.

Internal Controls: Managing Change and Associated Risks

Government has changed drastically over the last decade, and where there is change, there is risk. Managing change and the associated risks is one of the most significant responsibilities of government officials. The systematic management of risk, whether of fire or fraud, involves internal controls. Internal controls are methods put in place to provide reasonable assurance that the objectives of the government will be achieved in operations, reporting, and compliance. Think of internal controls as a system of checks and balances.

Managing risk must be undertaken deliberately. For example, government managers guard against the risk of a fire occurring in a government building by complying with fire codes; signage, sprinkler systems, smoke detectors, and evacuation plans are all ways to manage the risk of fire and to comply with state laws. Government managers may also purchase fire and casualty insurance as protection against losses resulting from a fire. They do this because they have performed a risk assessment and have concluded that the risk of fire, though remote, must be managed.

There are other situations that are just as important in terms of managing risks, but less obvious. For example, how do you manage the risk of preparing inaccurate financial statements? If governments are going to prepare financial statements, they want them to be accurate and in accordance with generally accepted accounting principles, which are required by Tennessee state statute. How do you manage the risk of overspending the approved budget, which would be in violation of state statutes and could possibly lead to higher taxes in next year's budget? How do you manage the risk of fraud?

Responsible government managers should be deliberate about implementing internal controls for one simple reason: the public trust. What they manage belongs to someone else. The buildings, cars, cash, gasoline, computer programs, telephones, government credit cards, water and electricity, and ink pens all belong to taxpayers. Government managers are stewards of a public trust to manage these assets with honesty and integrity. Much has been written about the lack of trust Americans have in their governments, and incidences of fraud, waste, and abuse in government further erode this trust. Internal controls are a practical, proven, commonly accepted means of managing risk and maintaining or restoring the public trust.

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The Comptroller's Office reported over 700 findings in audit reports of county governments during the 2012-2013 fiscal year. Many of these findings were related to internal control deficiencies, and many were repeat findings. Most government problems that get published as audit findings are the direct result of the absence or failure of some type of internal control. The audits also contained numerous reports of cash shortages and thefts that resulted from a lack of internal controls. Why don't all governments implement internal controls? In fact, auditors from the Comptroller's office ask government managers that question many times each year.

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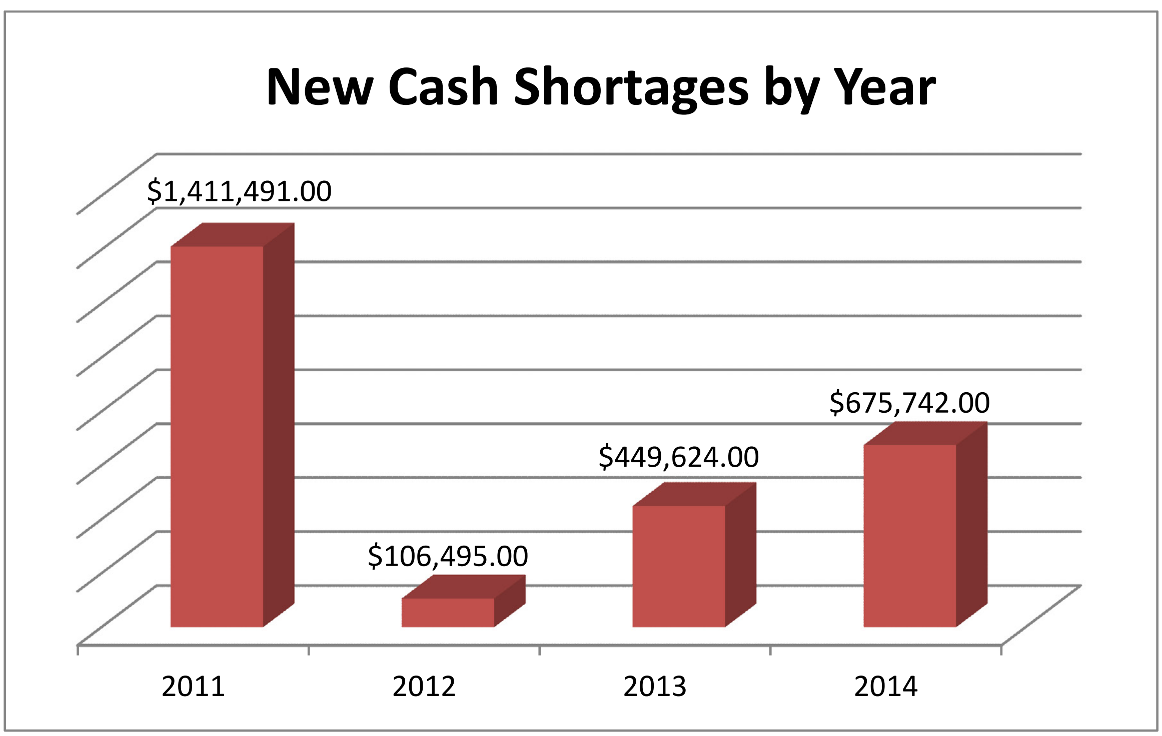

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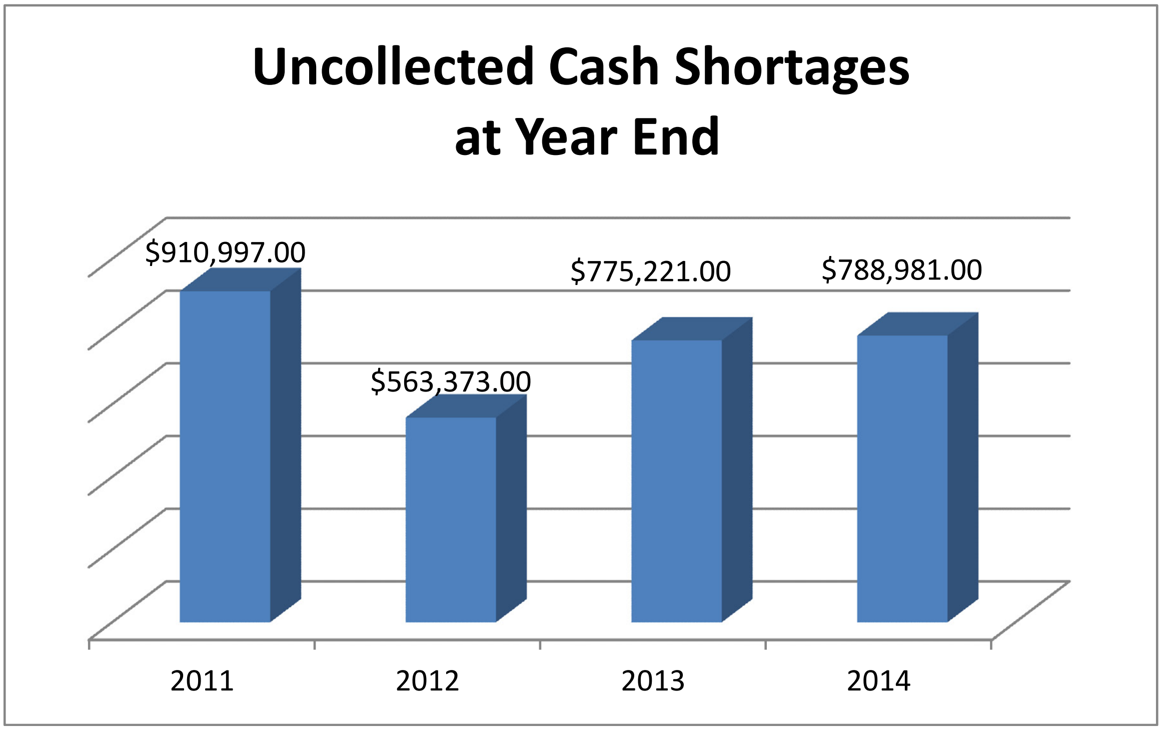

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There are five main components to internal controls:

- The Control Environment
- Risk Assessment
- Control Activities
- Information and Communication
- Monitoring

1. The **Control Environment** is the foundation for any internal control system. This is sometimes known as the "tone at the top" because government leaders set the general direction and tone and provide discipline and structure to help a government achieve its objectives. The control environment is generally seen as the most important of the five components. For example, when a governing body and managers establish a professional code of conduct for the government, this demonstrates (or sets the tone for) a commitment to integrity and ethical values. Government leaders should strive to be faultless examples of professional integrity and ethical values for the control environment to be effective.

The control environment is generally seen as the most important of the five components.

Management is primarily responsible for establishing a comprehensive framework of internal control, but the governing body remains ultimately responsible for ensuring that management meets its responsibilities in this regard. Establishment of internal controls should fall to program management while internal and external auditors serve as testers of the controls that management has put in place.

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2. **Risk Assessment** is a process used to assess an agency's level of risk and develop policies and procedures in response. For example, a manager might consider the possibility – the risk – that an employee could use a government credit card to purchase personal items.

3. **Control Activities** are the actions the governing body and management take to respond to risks identified during the risk assessment process. Control activities generally consist of written policies and procedures to ensure that risks are reduced to an acceptable level. Examples would include issuing pre-numbered receipts and checks, reconciling bank statements, controlling access to credit cards, managing gasoline inventory, and locking cash in a safe at night. Control activities are typically not complex or costly to implement. Most of the internal control findings auditors write fall under the control activity area. Most of these weaknesses are considered significant because they could lead to fraud, waste, and abuse. Some of the more common findings relate to the following weaknesses in internal controls:
    - Segregation of duties
    - Information systems control deficiencies
    - Logical access to accounting software programs
    - Lack of computer systems backup and disaster recovery procedures
    - Multiple employees operating from one cash drawer
    - Failure to perform accounting reconciliations
    - Accounting records not maintained on a current basis
    - Absence of purchasing controls
    - Inadequate time and attendance records

4. **Information and Communication** refer to the ability to produce and communicate accurate information. The decision to produce high quality financial statements – an important means of informing and communicating – in accordance with generally accepted accounting principles requires training and hiring employees who understand accounting. Yet, in Tennessee, many employees responsible for preparing financial statements do not understand accounting.

5. **Monitoring** is the activity management undertakes to assess the performance of internal controls over time. Monitoring can detect weaknesses and prompt corrective measures to prevent the occurrence of a larger problem. It is similar to looking for cracks in a dam before the dam bursts or checking the oil in a car. Examples include conducting surprise cash counts or examining some purchases to be sure that all purchasing controls have been followed. Internal controls can be properly designed, implemented, documented, and communicated, but if they are not monitored, they will eventually deteriorate and cease to be effective. Sometimes management overrides internal controls, which amounts to a bold announcement to employees that the internal controls are unimportant. If the boss doesn't do it, why should I? This is one example of how internal controls can deteriorate over time.

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Fraud Risk

Government managers try to ensure that things go right, but sometimes spend a great deal of time fixing things that have gone wrong. Internal controls are a proven method for reducing the chance that things will go wrong, such as the occurrence of fraud. Fraud is more likely to occur in contexts with weak or nonexistent internal controls. Fraud investigators often refer to three factors that are involved in the commission of fraud: (a) the incentive; (b) the opportunity; and (c) the rationalization for committing the fraud. Strong internal controls reduce the opportunity to commit fraud, which in turn diminishes the incentive to perpetrate fraud and the accompanying rationalizations. See the fraud risk triangle below.

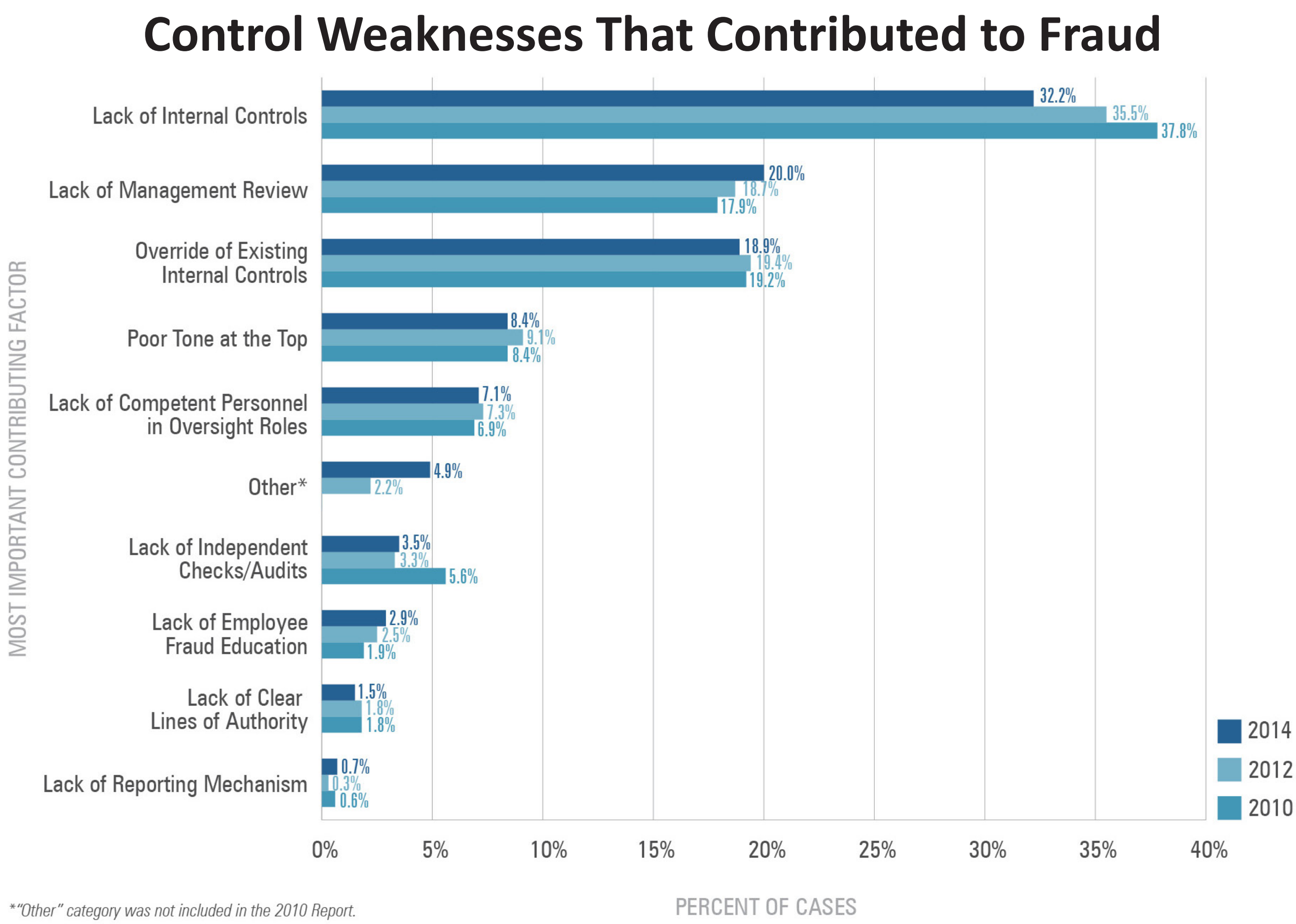
Some commonly used internal controls and related methods to reduce or prevent fraud:

- Set the ethical tone at the top (be an example of what is expected of employees)
- Institute Independent Audit Committees
- Establish a fraud/whistle blower hotline or other method of communication for employees and citizens
- Provide rewards for whistleblowers
- Establish a code of professional conduct
- Make internal control and ethics discussions a routine part of meetings
- Offer fraud training for managers and officials
- Hire and promote qualified employees
- Perform background checks for new hires
- Add an Internal Audit Department
- Implement Continuous Data Monitoring Analytics
- Conduct Formal Risk Assessments
- Perform Surprise Audits
- Institute Job Rotation/Mandatory Vacations

A parent monitoring their child's online activities is an easy and cost effective example of an internal control.

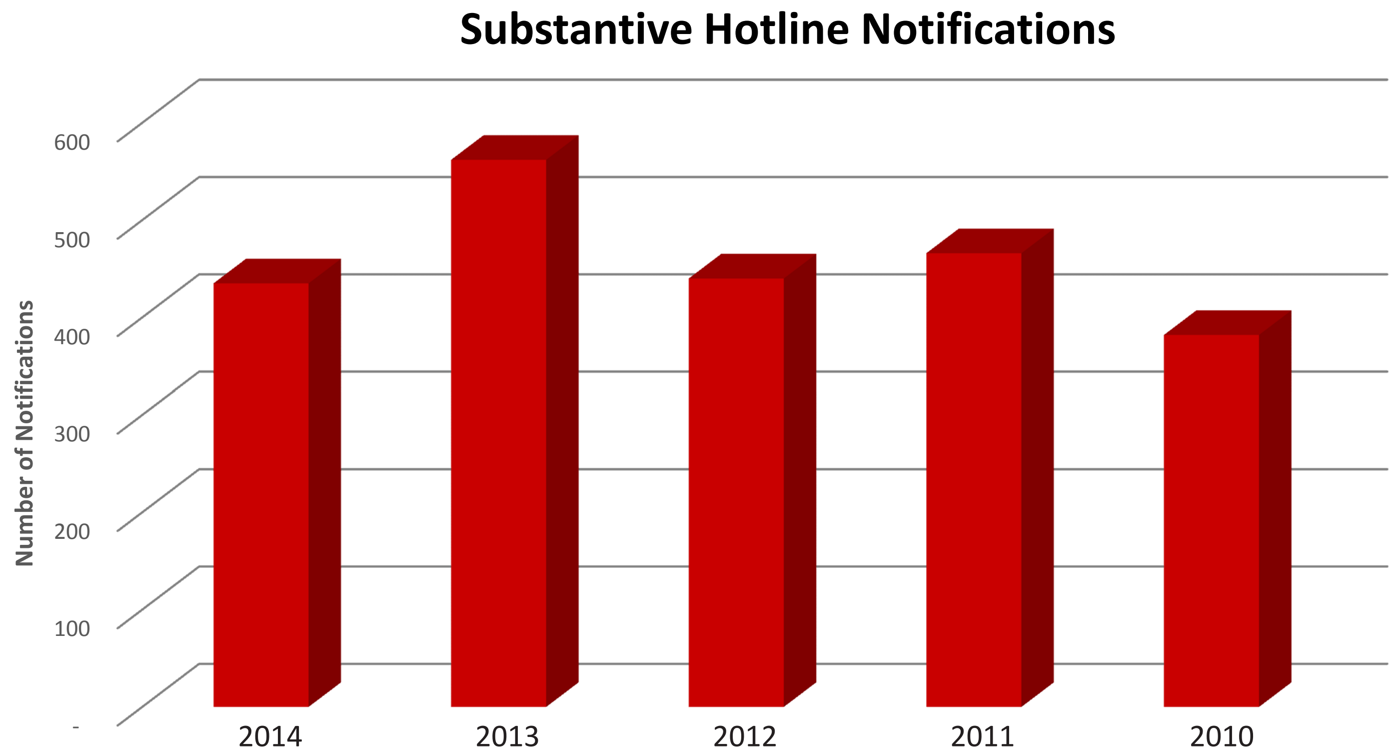
Government managers must recognize that fraud is possible in any organization and that establishing a strong system of internal controls should be a top priority. Nevertheless, it is not unusual for auditors to hear comments like the following:

- "Fraud just couldn't happen here because all our employees are honest."
- "Our government is small; we don't have any fraud risks."
- "Implementing internal controls is too costly."
- "That's why we have insurance."
- "Utilizing internal control procedures takes too much time."
- "If we get audited every year why do we need controls?"



Recent Internal Control Improvement

Thankfully, Tennessee's state legislature has decided that internal controls are important at the state and local government level. In 2008, the General Assembly amended the Financial Integrity Act, Section 9-18-101 through 104, Tennessee Code Annotated, to require internal controls in all state agencies. In 2015, the legislature passed Public Chapter 112 to require local governments to "establish and maintain internal controls." Once Public Chapter 112 is fully implemented beginning in fiscal year 2016-17, the Comptroller's Office anticipates that compliance with applicable laws will be significantly greater and expects the number of audit findings and cash shortages to decrease.



To report fraud, waste, or abuse of government funds and property, call the hotline at 1-800-232-5454 or submit a notification electronically at: http://www.comptroller.tn.gov/hotline.

Conclusion

Managing change can be made less risky with functioning and common sense internal controls. When there are more internal controls, less extensive audit procedures may be necessary. Internal controls not only promote transparency in government operations, but are an essential tool for protecting taxpayer dollars and the citizens' trust.

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