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Guide for
Incorporating Internal
Control Evaluations
Into GAO Work

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PREFACE

This guide is to help implement GAO's current policy (contained in Policy Bulletin No. 2, pp. 3-15 to 3-20 of the General Policy Manual) for evaluating and reporting on agency internal control systems. It recognizes that, although Associate Directors now decide how individual assignments will address internal controls, other individuals and groups throughout GAO have important responsibilities that influence how well those assignments are carried out.

The guide emphasizes that internal controls are integral to all agency operations and highlights evaluation steps that should be followed in the planning/scoping phases of most GAO assignments. It provides guidance on when an assignment should include a comprehensive evaluation of internal controls or when a more limited evaluation, referred to in the guide as a "targeted approach," is appropriate. It also discusses the basic steps for carrying out and reporting on results of both types of evaluations as well as the responsibilities of key GAO players in the internal control area.

The guide should be filed behind Policy Bulletin No. 2 in the General Policy Manual.



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**GUIDE FOR INCORPORATING INTERNAL CONTROL
EVALUATIONS INTO GAO WORK**

INTRODUCTION

Policy Bulletin No. 2, issued in February 1986, reaffirms GAO's commitment to previously issued internal control standards and assigns to Associate Directors the primary responsibility for assuring that our work adequately considers internal controls.

In 1972, GAO issued (and in 1981 revised) Standards for Audit of Government Organizations, Programs, Activities, and Functions--commonly referred to as the Yellow Book. The Yellow Book provides that, during a government audit, an evaluation shall be made of the internal control system applicable to the organization, program, activity, or function under audit. This evaluation should assess whether the internal controls can be relied on to ensure compliance with applicable laws and regulations and whether the entity is managing or using its resources effectively and efficiently. **It is common practice in some audits, and consistent with Yellow Book standards, to identify problem areas first and then review management controls that relate to the area in which the problem exists.**

GAO issued Standards for Internal Controls in the Federal Government in 1983, as required by the Federal Managers' Financial Integrity Act of 1982 (FIA). These broad standards, commonly referred to as the Green Book, are to be used by agency managers in establishing effective internal control systems and in reporting on the overall status of their systems.

This guide helps implement Policy Bulletin No. 2 by outlining practical steps GAO staff can take to evaluate internal controls using the concepts set forth in the three policy documents noted above.

**EVALUATING
INTERNAL
CONTROLS**

This section provides general guidance on how to evaluate internal controls. It begins by discussing what internal controls are and emphasizing that they are integral to all agency operations, not just the financial or administrative areas. Next, it highlights several important review steps that should be followed in the planning/

scoping phases of an assignment. It concludes with a detailed discussion of two approaches for conducting internal control evaluations during assignment implementation--a "comprehensive" approach and a "targeted" approach. Consistent with Policy Bulletin No. 2, the nature, scope, objectives, and timing of GAO evaluations should be used to determine which of these approaches is more appropriate for a specific assignment. However, because much of GAO's work is directed to identifying problem areas, it is anticipated that the targeted approach (which restricts internal control evaluation to specific findings or problem areas) would be used most of the time.

What Are
Internal
Controls?

Internal controls are the combination of management objectives (policies) and techniques (procedures) used by managers to help assure that their agencies, programs, or functions are effectively and efficiently managed in conformity with applicable laws and regulations. Obtaining an understanding of an agency's internal control systems relating to a program or activity under review should be a key concern during most GAO assignments.

Essentially, control objectives are the positive things agency managers want to happen or negative things they want to prevent from happening. Control objectives address the risks inherent in the work being done. Control techniques are the procedures managers use to provide reasonable assurance that their control objectives are achieved--that is, to accomplish the positive things and prevent the negative things from happening.

Effective internal controls help ensure that (1) funds are used, and activities are conducted, consistent with laws, regulations, and policies; (2) resources are safeguarded against waste, loss, and misuse; (3) programs and activities are efficiently and effectively carried out; and (4) reliable data are obtained, maintained, and fairly disclosed in reports. Administrative, management, and accounting controls are all part of an agency's internal control system. Internal controls often include such common sense actions as

--verifying earnings of families on a test basis to assure only eligible families receive food stamps;

--assuring proper security is maintained over seized property; and

--making sure that physical inventories are not conducted by the same persons who are responsible for maintaining inventory records.

The Green Book should be a helpful reference in all GAO audits (except for those limited-scope assignments described in Policy Bulletin No. 2, where our objectives clearly do not focus on internal management responsibilities). The Green Book contains 12 standards--5 general, 6 specific, and an audit resolution standard. The Green Book standards are very broad, and professional judgment must be used in determining whether they have been adequately met in specific situations. The five general standards provide that:

--Internal control systems are to provide reasonable assurance that management's objectives will be accomplished.

--Managers and employees maintain and demonstrate positive and supportive attitudes toward internal controls at all times.

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

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

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

A number of specific internal control techniques can be used to provide assurance that the general internal control standards are achieved. GAO's six specific internal control standards classify the wide variety of different techniques that may be used to achieve control objectives. In abbreviated form, the six standards require that:

1. Transactions and other significant events must be documented.

2. Transactions and other significant events must be recorded promptly.
3. Transactions and other significant events must be authorized and executed by persons acting within their authority.
4. Key duties be separated among individuals.
5. Qualified and continuous supervision be provided to ensure that internal control objectives are achieved.
6. Access to resources and records be limited and accountability for custody be assigned with periodic comparisons of the resources with the recorded accountability.

The audit resolution standard requires that managers promptly evaluate and take action on findings and recommendations reported by auditors.

Consideration
of Internal
Controls in
Planning/
Scoping

During the planning/scoping phase of all GAO audits, evaluators should use agencies' internal control evaluations and annual FIA reports to the President and the Congress. Agencies' reports and supporting documentation can help develop an understanding of acknowledged weaknesses (and progress in correcting weaknesses) in the area being reviewed. Therefore, all audits--financial, economy and efficiency, and program results--should, at a minimum, include the following steps:

1. Review agency's latest FIA report to determine whether issues were reported that could affect the scope or objectives of the audit.
2. Discuss with division's FIA team whether they have any knowledge of agency internal control weaknesses not disclosed in the agency's FIA report that might affect the audit.
3. Determine from agency officials and obtain any reports related to:
 - Whether the activity, program, operation, or function under review was evaluated under FIA and what the results were.
 - Whether control objectives and techniques are established for the area under review and whether the control techniques were tested to ensure they work as intended.

--Their perceptions on the adequacy of the control environment (objectives and techniques) for the area under audit.

The results of the above steps should be considered in determining whether the comprehensive or targeted approach to evaluating internal controls should be used during the implementation phase. While many GAO assignments are not specifically directed at the issue of internal controls, weak or nonexistent controls should be explicitly considered because they can be one of the underlying causes of problems GAO finds. The targeted approach is tailored to these situations.

Comprehensive
Approach to
Evaluating
Internal
Controls

The "comprehensive approach" calls for the evaluator to determine the relative risks associated with the entire internal control system of the agency, program, or function being reviewed. Using this approach, the evaluator determines whether adequate control measures exist and are working. This comprehensive approach should be used if the primary objective of the work is to evaluate the internal controls of a particular area. There is no presumption that the evaluator is already aware of a problem or finding in the area.

Consistent with GAO's Green Book, there are generally six steps involved in evaluating internal controls using this comprehensive approach:

1. Identifying groups of related activities within the agency, program, or function being reviewed.
2. Gaining an understanding of how these groups of related activities operate and interrelate.
3. Evaluating internal controls for the groups of related activities. (Identifying key risk determining control objectives and seeing if management has implemented techniques to achieve those objectives.)
4. Testing the existence and adequacy of controls for the groupings of related activities and whether they are being followed.
5. Determining appropriate corrective actions to fix weak controls.
6. Assess risks associated with the general control environment (considering such factors as the

size of budget, organizational structure, and prior evaluations).

It is important to note that under the comprehensive approach, the internal control weaknesses represent the cause of a problem or adverse effect yet to be found. If agency management is convinced of the need to implement corrective actions based on identification of control weaknesses, it may be appropriate to terminate review work and finalize a report. However, significant internal control deficiencies in an area where management does not agree that corrective action is needed may warrant more extensive testing to determine dollars lost or fraud, waste, or abuse that has occurred as a result of the weakness (i.e., the problem or adverse effect). For example, the legislation authorizing a federal loan or grant program may contain eligibility requirements governing program participation. If the evaluator concludes that the agency has serious deficiencies in controls over determining and monitoring eligibility and the agency does not concur, the evaluator may need to do more work to determine the extent to which ineligible participants are in the program--in other words, establish the bad effect.

Targeted
Approach to
Evaluating
Internal
Controls

The "targeted approach" essentially calls for evaluators to better integrate internal control evaluations into the criteria, condition, cause, and effect development of individual findings and recommendations. This approach would be used once a problem has been identified. The agency's control objectives and Comptroller General standards represent criteria that GAO staff should use to link identified problems (condition/effect) to their cause. Often, control techniques are a principal cause of the problems because they are inadequate or not complied with.

The criteria, condition, cause, and effect elements of a finding are the building blocks of sound recommendations and effective GAO reports. Determining how the relevant control techniques operated relative to the identified problem (condition/effect) should help identify underlying causes of the problem and more effectively facilitate agency corrective action. The underlying cause of a problem is often the failure to follow internal control techniques that have been established to achieve a desired result. In other situations, the cause may be poor internal control techniques or the lack of techniques.

Four basic steps are involved in evaluating internal controls using the targeted approach:

1. Identifying internal control objectives (policies) management has designed to assure that an observed adverse condition/negative effect does not occur.
2. Identifying key internal control techniques (procedures) management has established to achieve the above objectives.
3. Testing operating procedures to determine their effectiveness in preventing the observed adverse condition/negative effect from occurring.
4. Identifying any needed adjustments to management's existing objectives or techniques.

For illustrative purposes, the following narrative briefly describes how these four steps might be applied in the context of a GAO audit of the Drug Enforcement Administration's (DEA) seized property program (Drug Enforcement Administration's Use of Forfeited Personal Property, GAO/ GGD-87-20, Dec. 10, 1986). In this case, GAO identified an adverse condition that government agents were inappropriately using seized property. The work already done demonstrated that the use of the property was not consistent with agency policy (control objectives.)

The four-step targeted approach might then be applied as follows:

1. The internal control objective relative to this adverse condition was that seized property should be converted to official government use only when appropriate.
2. GAO identified the following internal control techniques (procedures) that were established for seized property:
 - All seized property must be accounted for when received and entered into the inventory records on a timely basis.
 - All seized property must be periodically inventoried and these inventories reconciled with official inventory records.

3. By examining the forms used to authorize the use of seized property for official government use, GAO determined that the conversions were not properly justified or reviewed by someone independent of the special agent. (This is not consistent with GAO's fourth specific internal control standard calling for separation of key duties.)

4. DEA implemented GAO's suggestions for strengthening internal controls by issuing instructions for converting forfeited property to government use. The instructions require field managers to provide written justification for the need and use of forfeited property that they desire to convert to government use and to obtain headquarters approval before the property is placed into service. Periodic rejustifications could also help assure there is a continuing need for particularly valuable property.

This targeted approach should help assure that adverse conditions/negative effects identified during GAO's work are better linked to internal control weaknesses, if they are determined to be the cause, and help facilitate agency acceptance of GAO recommendations.

REPORTING ON INTERNAL CONTROLS

While Policy Bulletin No. 2 provides guidance, it also allows a considerable amount of flexibility in reporting on the results of GAO's internal control evaluations. The Bulletin prescribes that GAO reports should include a statement on the extent to which internal controls were examined during the review and the extent to which reliance was placed on agency internal controls. It also requires that if material internal control weaknesses are identified, GAO should disclose whether these weaknesses were included in the agency's year-end report under FIA and, if not, why not.

While the Green Book presents standards or principles to be used by managers in setting up internal control procedures, they are general and do not, by themselves, provide sufficiently detailed criteria for determining whether internal controls are effective. Therefore, in reporting on the results of GAO's internal control work, evaluators should comment on the adequacy or inadequacy of specific control techniques (such as separation of duties) used by an agency to accomplish a particular control objective (such as protection of property from

theft). However, whether it is appropriate to cite inconsistencies with specific Green Book standards should be determined on a case-by-case basis, taking into consideration the objectives and scope of the review as well as the extent of available evidence.

GAO's report on DEA's seized property program, discussed previously, included the following:

--The objectives, scope, and methodology section stated that:

"Our objective was to evaluate the adequacy of controls governing DEA's conversion of forfeited personal property to official government use. Specifically, we determined whether the Dallas field division office had adhered to DEA policies and procedures in converting forfeited personal property to government use. We did not review all property that had been converted because DEA headquarters officials believed that the Dallas situation illustrated the need for clarification and/or changes of DEA's policy and procedures."

--As part of the discussion of the finding, GAO reported that the seized property conversion decisions were not reviewed by someone independent of the special agent. In this case, the lack of independent review was a cause of the problem and was developed along those lines. The report also stated that the agency's controls were deficient relative to internal control standards established by the Green Book. This disclosure was in harmony with the review objectives, and sufficient evidence was available to draw such a broad conclusion.

ROLES AND RESPONSIBILITIES

Policy Bulletin No. 2 clearly recognizes the central role played by cognizant Associate Directors in deciding whether and how individual GAO assignments will address internal controls. However, many other individuals and groups also have important roles and responsibilities. GAO staff involved in program issue areas, as well as FIA staff, need to be involved if the objective of Policy Bulletin No. 2--Evaluating and Improving Internal Controls--is to be more effectively integrated into our work.

Associate
Directors,
Group
Directors,
and
Evaluators-
in-Charge

Associate Directors, supported by Group Directors and Evaluators-in-Charge, should decide whether, consistent with Policy Bulletin No. 2, an evaluation of internal controls applies to a specific assignment. They should also decide on the most appropriate methodology for evaluating and the most appropriate approach for reporting on internal controls. Also, decisions on the scope of internal control evaluations and on the reporting of internal control issues, should be appropriately documented for future reference.

The primary responsibility for assuring that available FIA-related information is adequately considered in the planning/scoping phase of each assignment rests with GAO's Associate Directors. As a minimum, for each assignment, they should ensure that:

1. The agency's latest FIA report is reviewed to determine whether it discloses any pertinent material weaknesses.
2. The objectives and scope of the assignment are discussed with the cognizant FIA team to determine whether there are any weaknesses, not disclosed in the agency's FIA report, that should be considered.
3. The results of any FIA evaluations within the areas covered by the assignment are identified. This can be done through discussions with agency officials or the review of FIA reports or other documentation. Specifically, the Associate Director or his staff should (1) determine whether control objectives and techniques have been established and tested for the activity or program being evaluated and (2) if established, assess the overall adequacy of these objectives and techniques.
4. The work needed to determine whether an observed problem was caused by an underlying internal control weakness is conducted.
5. An appropriate reporting approach is followed with respect to internal control weaknesses for both the objectives, scope, and methodology section and the findings section of GAO reports.

Headquarters
and Field
Office
Heads

The need for reviewing and reporting on internal controls should be integrated in GAO's planning and individual assignment management process. As part of the review of job decision packages and

FIA Steering
Committee

review guidelines (FALS, Forms 100, etc.), division and regional management should assure that adequate consideration is given to the question of whether and how internal controls should be evaluated. Also, they should assure that staff receive appropriate training and supervision for evaluating and reporting on internal controls.

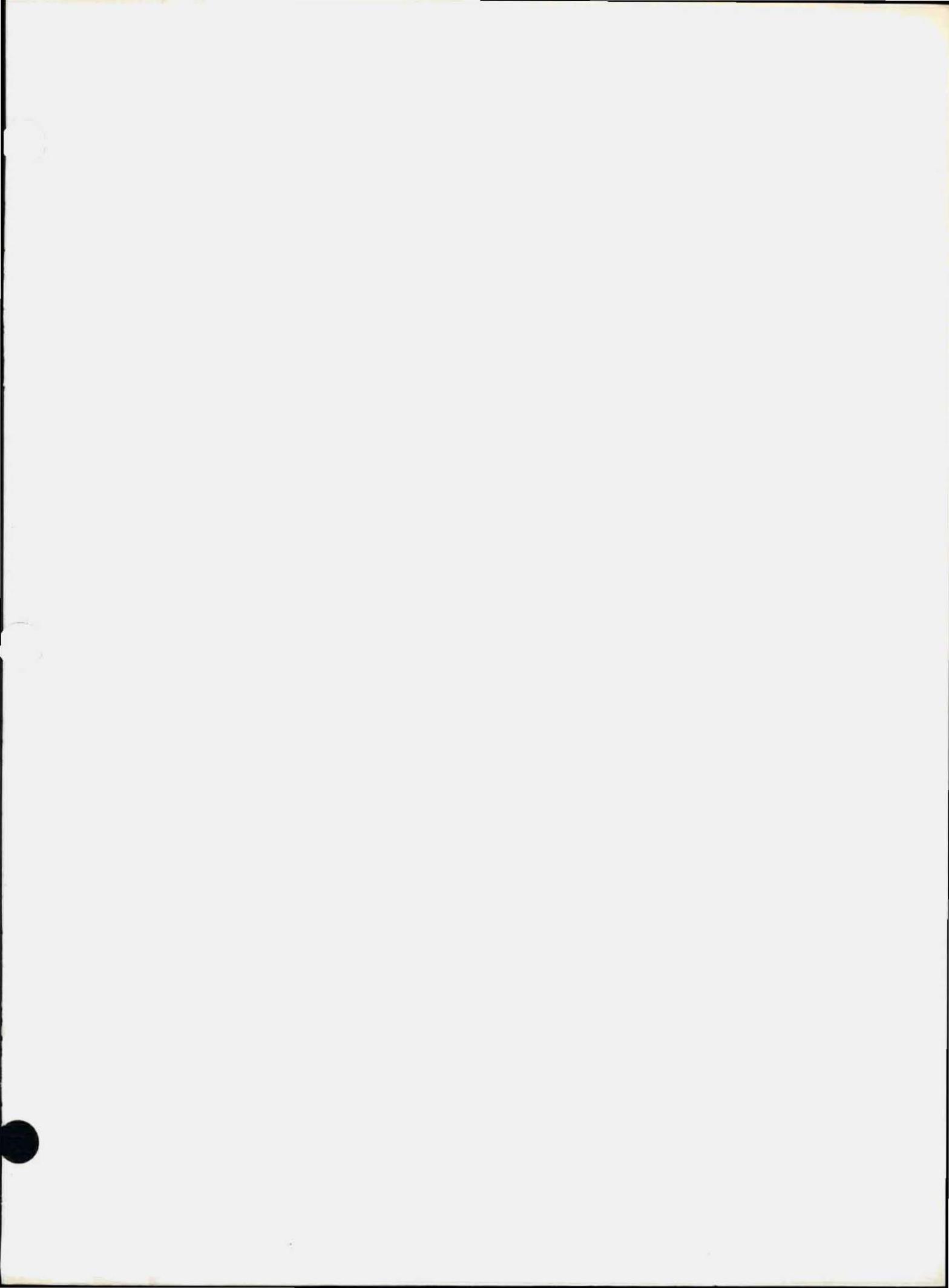
Members of the FIA Steering Committee, and their staffs, are available to work with program audit groups to help decide how best to incorporate internal control evaluations in their assignments. This should be of particular help to the program audit groups for those evaluations where the principal focus of the work is not internal controls but where weak internal controls may be the cause of a problem GAO has identified. Specifically, the FIA teams are available to assist in:

- Obtaining information on (1) internal control weaknesses identified by the agencies in their FIA and other agency efforts and (2) the status and adequacy of related corrective actions.
- Planning the scope of internal control evaluation work that should be included in specific assignments.
- Determining the amount and type of testing needed to determine if an observed problem was caused by an underlying internal control weakness. When internal control weaknesses are identified, the FIA teams can help determine if additional development of the internal control weakness is warranted.
- Developing report language for the scope of internal control work and the results of internal control evaluations.

Through these specific actions, the FIA teams can help the Associate Directors provide the focus on internal controls that will be needed to meet the Comptroller General's expressed goal of providing the Office with a basis for keeping the Congress informed on the progress being made in improving the government's internal control systems and encouraging agency managers to strengthen those systems.



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